UHY LLP Certified Public Accountants

NOT-FOR-PROFIT INSIDER

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THE CHALLENGE OF INTERNAL CONTROLS IN SMALLER NOT-FOR-PROFITS

When it comes to maintaining a proper accounting environment and having effective internal controls, not-for-profits (NFP) have essentially the same requirement as commercial organizations do. Having both are critical to capturing accounting data to provide for proper financial reporting, decision making, third party requirements, etc. However, in the increasingly competitive landscape of charitable organizations, smaller NFPs face some unique constraints that can significantly impact the internal control environment.

These can include:

- Less access to individuals with the education and expertise needed for NFP accounting and reporting.
- High turnover of key accounting personnel.
- Accounting and control environments that are poorly designed or implemented.
- Board or management that lacks the expertise to fully understand the financial statements and related accounting.
- Increased pressure to raise funds amidst changes to the Federal tax laws and increased competition among NFPs.
- An increased risk of fraud because of the risks associated with the aforementioned challenges.

While larger NFPs may have an increased level of sophistication that reduces these constraints, smaller NFPs tend to encounter significant internal control problems which create additional risks for their accounting and financial reporting. This article focuses on those smaller NFP organizations.

The need for proper accounting and financial reporting

A significant reason that NFPs are unique is that their financial statements and Form 990s are often reviewed by third parties such as funding sources, potential donors, and Federal/State Agencies. It is common for NFPs seeking grants to submit audited financial statements to funding sources. These funding sources want to have a level of confidence that their grants are going to be properly used and administered, so it is crucial to have effective accounting systems and internal controls in place to allow for a successful audit.

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Similarly, many potential donors review the Form 990 as part of their decision making process. The Form 990 tells the story of the NFP in both quantitative and qualitative terms. These donors look at key metrics and amounts such as total revenues, functional expenses, officer/director salaries, etc. As with an audit, having the proper systems and controls in place helps ensure that the NFP is reporting the Form 990 correctly.

NFPs may also receive Federal/State awards that are subject to additional compliance requirements and potentially a Single Audit in accordance with Uniform Guidance rules. It is also not uncommon for the Federal/State agencies to perform regular reviews of the NFP's administration of the awards. If the NFP is unable to administer the award requirements properly, they risk consequences such as lost funding or having to repay past award proceeds.

Entity level and activity level controls

Internal controls are generally grouped into two categories – entity level and activity level.

Entity level controls can be thought of as higher level and include board or management involvement. Examples include:

- Reviewing financial statements and budget to actual reports on a regular basis.
- Reviewing cash disbursements and vendor lists.
- Approval thresholds for transactions over certain dollar amounts.
- Having a board member receive the bank statements directly from the bank.
- Regular meetings with the accounting/finance team to discuss operating results, accounting problems, unexpected issues, etc.

Activity level controls are more specific in nature and are usually found at the detail level and involve individuals directly responsible for various types of transactions. Examples include:

- Preparing bank reconciliations on a monthly basis.
- Reconciling balance sheet accounts on a monthly or periodic basis.
- Approval of vendor invoices prior to payment.
- Separating the functions of opening cash receipts and posting them to the accounting records.
- Approval of payroll records prior to processing.
- Review of contributions and agreements for donor restrictions.

The constant challenge that smaller NFPs face is how to design and implement internal controls with the limited staffing and budget constraints that are often present. One of the key elements of any internal control environment is segregation of duties. Any time you can have more than one person involved in processing transactions, the risk of errors or fraud is reduced. However, it isn't uncommon for smaller NFPs to have only 1 or 2 people involved in all of the accounting functions.

In light of the constraints mentioned above, smaller NFPs often make sacrifices to the internal control environment that can have a negative impact on the accounting and financial reporting. These choices may be unavoidable – if the accounting functions are performed by only one person, how can there be a segregation of duties over cash receipts and disbursements? Likewise, if the board doesn't have any members that have experience in NFP accounting and reporting, how can there be an effective review of monthly financial statements?

Finding the right internal control balance

The most effective internal control environments include both entity and activity level controls. To determine the best balance and type of internal controls to implement, NFPs need to assess several factors such as:

- The ability to segregate duties among accounting staff and management.
- The knowledge and expertise of board members and management.
- Areas that carry a higher risk of error or fraud such as cash or vendor payments.
- The extent that the accounting system is based on manual processes vs. IT based.

Larger NFPs often have the ability to implement more activity level controls because of larger accounting staffs, greater expertise, etc. However, smaller NFPs are often faced with limited resources and/or a lack of expertise, so they need to rely on greater entity level controls to mitigate risks.

In practice there is no single best solution to finding the right balance of internal controls to implement, so performing this assessment will help ensure that the NFP has the best available information to design and implement the most efficient and cost effective internal controls.

Examples of common control deficiencies in smaller NFPs

Through our experience with NFPs of varying sizes and types we have identified some areas where internal control deficiencies are common and made recommendations on how to strengthen the internal controls. For example, if you are limited with segregation of duties for the following areas, adding entity level controls will help mitigate risks.

- Bank reconciliations – Have a qualified board member or management review the bank reconciliations, check registers, and/or receive and review the bank statements direct from the bank.
- Cash disbursements – Establish dollar thresholds which would require board approval prior to authorizing the purchase or making the payment.
- Cash receipts – Have someone independent of the accounting function summarize cash receipts prior to posting to the accounting records. A qualified board member or management can then review and compare the cash receipts against other source documents such as receivable ledgers, donor agreements, etc.
- Vendor activity – Limit the access to add vendors and require board approval for any changes.
- Payroll activity – Have a qualified board member review the payroll reports on a periodic basis. Limit the access to add employees or make rate changes, and require board approval for any changes.
- Account reconciliations and close processes – Require the use of a monthly checklist to manage the close process and preparation of account reconciliations. A qualified board member can then review the checklist monthly and account reconciliations as needed.
- Financial statements and budget reports – Mandate that financial statements be prepared on a periodic basis and have a qualified board member review and scrutinize them. If the NFP utilizes budgets, compare the budget to actual information on a regular basis.

While these issues may be common to smaller NFPs, this is not a comprehensive list. Each NFP should assess their risks and options for activity level and entity level controls. Establishing and maintaining effective internal controls will always be a challenge for smaller NFPs and require constant monitoring to ensure they are operating effectively. UHY's team of NFP professionals has the experience to work with you and help you assess your internal controls and identify areas for improvement.

“Each NFP should assess their risks and options for activity level and entity level controls.”

Michael Federlein
Senior Manager
(Farmington Hills, MI)

IMPACT OF LEASE STANDARDS ON NOT-FOR-PROFITS: RECORDING DONATED AND BELOW-MARKET RENT

The new lease accounting standard, ASU 2016-02 (Topic 842), is set to take effect for not-for-profit organizations that have issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, with fiscal years beginning after Dec. 15, 2018 and for all other not-for-profits for fiscal years beginning after Dec. 15, 2019. Issued by the FASB in February 2016, the new standard significantly affects the way leases are recorded on the balance sheet. While there has been considerable emphasis placed on understanding what will change under this new standard, it is just as important to understand what will remain the same.

A client recently approached us and presented an interesting question. His not-for-profit organization utilizes office space that is contributed, or donated, to the organization on an annual basis. The organization pays no rent to the donor and there is no formal agreement in place governing the use of this space, meaning there is no defined period of use or set value of rent. Naturally, the client wanted to know how the new standard would affect the organization's accounting.

Our client was surprised to learn that the new standard would have no impact on their accounting as this scenario was not within the standard's scope.

The new ASU defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property and equipment for a period of time in exchange for consideration. The above scenario is for an unspecified amount of time without the exchange of cash or other consideration. As such, there is no contract formed and this standard is not applicable.

Under the scenario described above, the client would simply record contribution revenue in the period in which the contribution is received and rent expense in the period in which the facilities are used at fair value. There is no balance sheet impact. Assuming fair value of rent for the office space used is $50,000 per year, the client would record contribution revenue and rent expense for this amount on a periodic basis.

Modifying the facts above slightly, let's assume the client enters an agreement with an unconditional promise from the donor to utilize the office space for three years. The client will continue to pay no rent or other consideration. As such, there is no exchange for consideration and the standard continues to be not applicable. However, the accounting for the transaction changes due to the multi-year agreement. The client would contribute revenue and the corresponding contribution receivable at the present value of the total known future donated rent's fair value in the period contributed. The client would then recognize rent expense in the period of use and amortize the receivable over the specified three-year period.

In this new scenario, let's assume the fair value of the rent will increase five percent each year, starting at $50,000 in year one and increasing to $52,500 in year two and $55,125 in year three for a total contribution of $157,625. The present value of the rent (assumed discount rate of five percent) totals $142,857. The payments would be amortized as follows:

	Year 1	Year 2	Year 3
Contribution receivable, beginning	$157,625	$100,000	$52,500
Beginning discount	(14,768)	—	—
Amortization of discount	7,143	5,000	2,625
Fair value of rent for donated space	(50,000)	(52,500)	(55,125)
Contribution receivable, ending	$100,000	$52,500	$ —

In year one, the client will record a contribution receivable and contribution revenue in the amount of the present value of the future rent of $142,857. The client would then record rent expense and a reduction of the receivable in the amount of $50,000. They would also recognize the amortization of the time value discount of $7,143. Years two and three would be handled similarly, adjusting the amounts for the increase in the fair value of rent.

While the new standard doesn't apply in the two scenarios noted above, there are situations in which a not-for-profit organization may receive contributed rent which would be affected by the new standard. One common case that would bring the new standard into scope is below-market rent.

For instance, modifying the facts of our preceding example, instead of the client receiving free rent, it instead pays $10,000 in rent each year, significantly below market rate. There is no transfer of ownership of the office at the end of the lease, nor is there an option to purchase the office at the lease's conclusion, and no other criteria which would cause the lease to be considered a finance lease are present.

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Per the details of our scenario above, an operating lease is present. A total of $30,000 consideration is given over three years, $10,000 in each year. The present value of the consideration (assumed discount rate of 5%) totals $27,232.

	Year 1	Year 2	Year 3
Lease liability, beginning	$27,232	$18,594	$9,524
Amortization (treated as lease expense)	1,362	930	476
Lease payment	(10,000)	(10,000)	(10,000)
Net lease liability, ending	$18,594	$9,524	$ —

	Year 1	Year 2	Year 3
Right of use asset, beginning	$27,232	$18,594	$9,524
Amortization (treated as lease expense)	(8,638)	(9,070)	(9,524)
Right of use asset, ending	$18,594	$9,524	$ —

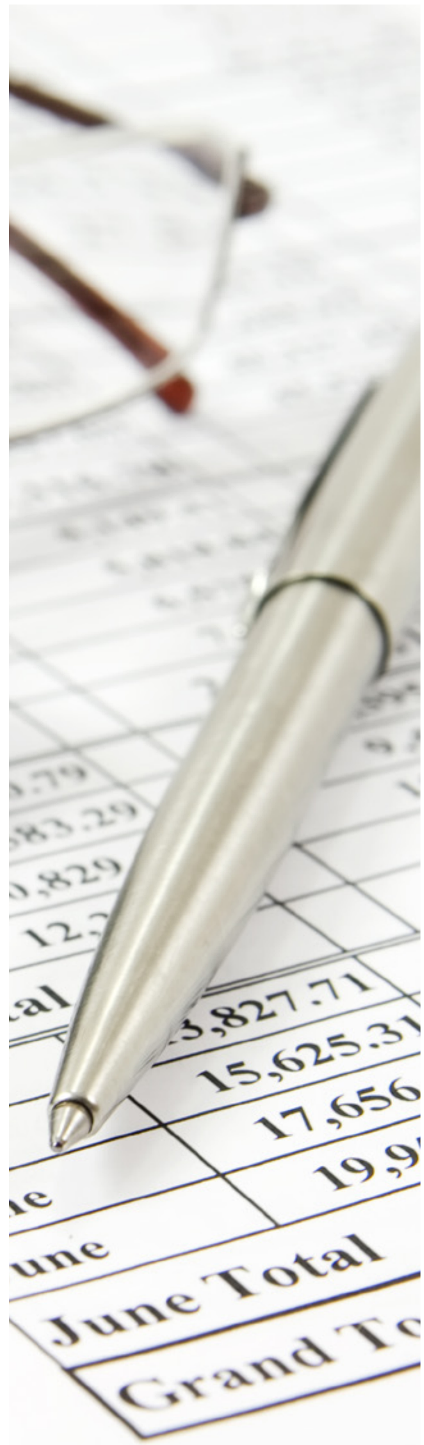
As shown above, the client would record a right of use asset and a lease liability on the balance sheet. In addition, the client would record the cash payment of the lease by reducing the lease liability and also amortize the right of use asset over the course of the lease.

The contributed portion of the rent (the excess of the fair market rent over the rent paid) is treated like the donated rent in the previous example, with contribution revenue and the corresponding contribution receivable recorded at the present value of the total known future donated rent in the period contributed. The client will then recognize rent expense in the period of use and will amortize the receivable over the term of the lease.

As noted above, this scenario was for an operating lease. If the lease is a financing lease, the amortization of the lease liability would be treated as interest expense. In addition, the amortization of the right of use asset would be treated as amortization expense on a straight line basis.

The new lease standard could significantly impact the balance sheets of not-for-profit organizations. However, the first step in approaching the new standard is to determine whether your organization is dealing with a lease at all. With the standard's effective date looming, it is critical that not-for-profit organizations understand and evaluate how it will affect them and how to implement any changes that may be required.

As always, UHY is here to help! Please do not hesitate to contact us with any questions.



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NOT-FOR-PROFIT INDUSTRY INSIGHT

With the increasing complexity of laws and regulations, it's important for associations, foundations, charities, hospitals, schools and other tax-exempt entities to seek out professionals with extensive experience in nonprofit compliance issues. We understand there are many challenges affecting the industry and provide the attention needed to help clients stay focused on their job at hand.

UHY LLP's National Not-For-Profit Practice offers comprehensive audit and assurance, tax planning and compliance and business advisory services to meet the unique, complex needs of nonprofit organizations.

These types of specialized services, which cut across the traditional service lines, demonstrate our philosophy of skilled professionals integrating industry expertise with technical services.

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