Fall 2023

Profitable Solutions for Nonprofits

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Understanding internal controls

Why nonprofits need both preventative and detective policies

The median loss for nonprofits that fell victim to fraud was $60,000, according to the Association of Certified Fraud Examiners' (ACFE) *Occupational Fraud 2022: A Report to the Nations.* The *average* loss for nonprofits was $851,000. Such losses could prove devastating for many organizations. But with strong internal controls to prevent and detect fraudulent activity, organizations can reduce this risk.

The ACFE report found that almost 30% of the victim organizations lacked adequate internal controls to prevent fraud from occurring. In addition to minimizing fraud, comprehensive internal controls also help ensure accurate accounting records and financial statements. And strong internal controls are essential for compliance with relevant laws, regulations and grant requirements.

4 critical measures

Your organization should have a mix of preventative and detective controls. The most effective internal controls include:

1. Segregation of duties. No individual should have control over more than one phase of a financial transaction or function. That means individuals with access to assets shouldn't be responsible for accounting for those assets. Nor should an individual have the ability to both initiate and approve a transaction, such as paying a vendor invoice. Don't let staff members who receive checks also deposit them. Finally, don't allow employees who write checks then also be responsible for reconciling monthly bank statements.

Segregation of duties is among the most vital of internal controls. But it can be challenging to segregate duties for nonprofits with few staff or that have shifted to remote work arrangements. Consider assigning some duties to board members and trusted volunteers and/or consider outsourcing functions such as payroll and accounts payable. Also consider using cloud solutions to overcome hurdles related to employees working remotely.

Beyond internal controls

Internal controls are largely about reducing the opportunity for would-be fraudsters. But opportunity is only one side of the "fraud triangle" that extensive research has shown generally must exist for fraud to occur. The other two sides of the triangle are:

Motive. This sometimes is referred to as "pressure." The pressure could be professional — for example, a perpetrator might fudge some numbers due to pressure from management or the board to meet certain growth targets. It also may be personal, such as the need to maintain a high standard of living or pay off debt from credit cards, medical bills, gambling or some other addiction.

Rationalization. Fraud perpetrators must be able to rationalize or justify their misconduct to themselves. Most people who commit occupational fraud are first-time offenders who don't consider themselves criminals, just people caught up in circumstances they can't control. They might make unauthorized credit card charges thinking, "I'll pay it back later," or record overtime hours they didn't actually work, reasoning "Everyone else does it, why shouldn't I?"

2. Controls over credit cards. Credit cards have become increasingly common in nonprofits, but they come with the risk of unauthorized usage. If you find it necessary to give credit cards to employees, board members or volunteers, take steps to reduce related risks. Start by limiting the number of cards in use.

Require a receipt for each purchase, along with documentation of the business purpose. Require someone who isn't an authorized card user to scrutinize card statements and supporting documentation every month for unusual or questionable activity. Depending on the issuer, you may be able to set limits on the types or amounts of purchases. It's also advisable to enforce real consequences for unauthorized usage, such as revoking card privileges or termination.

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3. Regular financial statement reviews. It's customary for nonprofit boards or audit committees to review financial statements annually or semi-annually. But the ACFE study confirms that the longer fraud goes undetected, the greater the financial loss for the victim organization.

Your organization's leaders should review financial statements at least quarterly, if not monthly. They should also receive regular budget reports, showing variances between budget and actual figures, as significant variations can indicate potential fraud.

4. Job rotation/mandatory vacation. According to the ACFE study, job rotation/mandatory vacation is associated with at least a 50% reduction in the median loss and median duration of fraud schemes. Not surprisingly, unwillingness to share duties and refusal to take vacation are some of the red flags for fraud schemes.

For example, scams involving receivables often require perpetrators to be in the office to cover their tracks. So rotating job duties and requiring employees to take regular vacations can act as both a preventative and a detective control.

Level of internal controls may vary

Controls such as segregation of duties are advisable for every organization, but additional policies may be more or less appropriate depending on your nonprofit's particular risks and circumstances. We can help you determine and establish the right internal controls to reduce fraud risk. ■

Are your operating reserves enough?

Operating reserves — generally, assets without donor restrictions that you can tap into easily — frequently are referred to as "rainy day funds." But stable reserves are critical for far more pressing reasons than the metaphorical rainy day.

Funding reserves

Solid operating reserves demonstrate responsible financial stewardship to your stakeholders. Reserves also increase the odds that your organization can achieve self-sufficiency, making your organization less vulnerable to unpredictable or cyclical revenue streams and government funding cutbacks.

Adequate reserves put your organization in a better position to handle market-based swings in investment income and enable it to cover unbudgeted expenses (for example, a roof replacement not covered by insurance). Reserves can protect against staff or program cost reductions that would prevent you from meeting your mission. And reserves can empower your organization to take advantage of opportunities (such as the availability of new facilities).

On the other hand, you generally shouldn't rely on reserves to make up for income shortfalls — unless you have a realistic plan to quickly replenish the reserves fund. Reserves are better applied to income-timing problems than they are to deficit issues.

Finding the right amount

Every nonprofit's circumstances are different, so you shouldn't base your reserves level on a rule of thumb, such as three to six months of operating expenses. Six months of expenses may be too much for one organization but not enough for another. At a minimum, though, your organization should at least have enough reserves set aside to cover one payroll cycle.

Also look at organization-specific factors. If you're heavily dependent on government grants, public donations or fundraising events — each can experience dramatic shifts due to political or economic winds — your organization should have robust reserves. But, if you have multiple, diverse revenue streams, you probably can get away with less reserves.

To determine the right amount of reserves for your organization, prepare a long-term financial forecast. Review your latest budget and how your strategic plans will affect the budget going forward. It's essential to develop a realistic financial forecast for all aspects of your organization, including every revenue stream and expense. Is any revenue stream in jeopardy or uncertain? Is a new program launch expected to hike certain expenses? For how long? Make sure you don't limit the financial forecast to a single year. Taking a longer view — say, five years — will help you recognize trends and key influences that might not stand out in a one-year snapshot.

Other tips

Among other best practices, quantify your risks. Setting your operating reserves is one good reason to undergo a comprehensive risk assessment. This should include risks related to your mission, sector and geographic location; the economy; and pending or potential litigation.

Also assess the likelihood and potential downside financial impact of each risk. These estimations of risk exposure can help you determine appropriate reserve amounts. Once the target level has been determined, develop a plan to fund your operating reserves.

Bear in mind that, while it might seem counterintuitive, your operating reserves can become *too* large. Most stakeholders want to see an organization using funds to achieve its mission, rather than accumulating stockpiles of money. Charity watchdogs often monitor nonprofits' reserves so potential donors can check on financial stability. If your reserves are too high, donors may conclude that you don't truly need their money.

Financial safety net

With tax laws affecting the level of donations for many nonprofits and uncertainties about government funding, operating reserves may be more important than ever for long-term sustainability. Failure to maintain adequate reserves could potentially lead to financial disaster. As with most financial policies, your operating reserves policy should be regularly revisited to ensure it remains current and relevant to your organization's situation. Now is the time to address operating reserves. ■

What nonprofits need to know about alternative investments

With today's economic uncertainty, businesses, including nonprofit organizations, are increasingly considering the use of alternative investments. But these investments can have unexpected tax implications for nonprofits. Here's what you need to know before your organization moves ahead.

The basics

The term "alternative investment" stands in contrast to more traditional investment vehicles for nonprofits, such as stocks, bonds and mutual funds. Alternative investments generally don't have an easily ascertained fair market value. Examples include hedge funds, private equity, real estate, venture capital and cryptocurrency investments.

Alternative investments are appealing largely because their long-term performance can be greater than those of traditional securities. They may provide investors with access to high-growth companies in cutting-edge industries and often are less vulnerable to financial market swings. However, because alternative investments may be illiquid, investors typically can't easily cash out or shift their allocations. This can be a substantial risk to a nonprofit without other sources of available operating capital. The complex nature of such assets also increases risk to the investor, which is why returns may be higher. For instance, cash paid into a venture capital fund could be lost if that new business investment isn't successful.

Form and management

Alternative investment funds generally are formed as partnerships or limited liability companies (LLCs). Both are types of pass-through entities, meaning the income and the tax liability pass through to the investors, who are considered partners or members.

Manager selection is crucial — you want someone with a proven track record and access to the best investments. Nonprofits must pay attention to management fees. In addition to a base management fee (generally about 1.5% to 2% of the fund's capital or net asset value), managers generally charge performance-based fees known as carried interest. These fees can reach as high as 20% or more of an alternative investment's profits.

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Tax matters

Although investment income (for example, dividends, gains and interest) typically is excluded from taxable unrelated business income (UBI), investors in partnerships or LLCs are treated as if they're conducting that entity's business. As a result, their distributions of income may be treated as taxable UBI.

In addition, UBI includes unrelated debt-financed income from investment property in proportion to the debt acquired to purchase it. The IRS defines debt-financed property as any property held to produce income (including gain from its disposition) for which there's an acquisition indebtedness. In other words, if you used financing to invest in a fund — or, if the fund financed the purchase of an income-producing asset — some of the associated income may be taxable.

Pass-through entities report each partner's or member's share of income, dividends, losses, deductions and credits on IRS Schedule K-1. Nonprofits can use the schedule to determine if they've received UBI income that must be reported on their Form 990-T. State taxes may also apply.

UBI could be included on the form in the boxes for ordinary income, net rental real estate income or other income, as well as in the footnotes. But it may not appear anywhere on the form or footnotes, especially if the income is derived from debt-financed property.

Tread carefully

Your organization must consider its objectives, short- and long-term needs, and the trade-offs (including loss of your original investment) the organization is willing to accept before venturing into alternative investments. We can help you evaluate whether alternative investments may be right for you. ■

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Watchdog launches campaign to measure equitable funding

Candid, the nonprofit evaluation organization that resulted when GuideStar and Foundation Center merged, has announced a new data-driven campaign to encourage equitable funding practices. "Demographics via Candid" is designed to provide a standardized benchmark measurement, reduce inefficiencies and cut down on duplicate information requests from funders.

Funders increasingly seek nonprofits' demographic information and nonprofits may receive multiple requests with different questions and formats. Through "Demographics via Candid," nonprofits are encouraged to enter their demographic information once in their Candid profile. From there, organizations that have earned a Candid Seal of Transparency will receive a unique link that they can use to share their profile with supporters.

Candid's partners commit to retrieving and using the demographic data from those profiles rather than requesting it separately. The goal is to empower nonprofits to spend more time on their missions and less on responding to requests. ■

Helping donors make informed decisions with misconduct alerts

Charity Navigator is now offering a feature that provides donors with information detailing alleged and confirmed charity misconduct. Alerts appear on the website's search results and organizations' profile pages and are designed to help the more than 11 million donors who visit the site annually to make more informed philanthropic decisions. Charity Navigator says the feature also can help trustworthy charities improve and maintain confidence and credibility with supporters.

The organization has issued reports of alleged and confirmed charity misconduct through its advisory system for 12 years. The new alerts build on and replace advisories, providing donors additional information and direction through four levels of concern: Review Before Proceeding, Proceed With Caution, Proceed With Increased Caution and Giving Not Recommended. When the resource first became available in March 2023, it already had more than 400 alerts. ■

McKinsey offers free assessment tool for organizational health

The international consulting behemoth McKinsey is giving nonprofits free access to its Organizational Health Index (OHI), a digital survey tool that quantitatively diagnoses an organization's ability to align around and achieve strategic goals. With the information it provides, nonprofits can create targeted action plans to improve their overall organizational health and success. The firm says the tool has delivered "major returns" for its for-profit clients over the past 20 years.

The OHI assesses factors including a nonprofit's direction, leadership, employee motivation and capabilities, work environment, and accountability measures. Participating nonprofits receive access to an organization-wide survey that evaluates their current ways of working as well as identifying strengths and weaknesses in how their teams work together to advance their mission. That's followed by a custom organizational health report, with a comparison to McKinsey's nonprofit benchmarks, and best practice resources to improve organizational health, such as webinars. ■

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