# Avoiding Nonprofit Audits


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Published on www.lorman.com - October 2017

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Nonprofit audits are a nightmare. When the IRS finds something suspicious, officers and employees of nonprofit organizations are held accountable and can be fined for their actions or inactions. In extreme cases, the IRS may revoke an organization's tax-exempt status. Groups that operate under section 501(c)(3) of the Internal Revenue Code must abide by stringent reporting requirements in exchange for tax-exempt benefits. Proper internal governance controls, internal and external audits and timely filings are compulsory. While it's impossible to predict which organizations the IRS will audit, there are many ways nonprofit organizations can reduce their chances of being audited and adopt proactive procedures to ensure all financial statements, disclosures and documents are in order if an audit occurs.

**Who is at Risk for Nonprofit Audits?**

The not-for-profit sector is highly complex, and its tax requirements are equally intricate. To ensure compliance, the IRS has stepped up their auditing processes, and more nonprofit organizations are being reviewed each year. According to government statistics, more than 500,000 nonprofit organizations complete and submit forms 990 and 990-EZ each year. These organizations include multi-million dollar groups and small startup offices that collect less than $25,000 in donations each year. Regardless of an organization's size, there are several red flags that make audits more likely.

**Avoiding Nonprofit Warning Signs**

IRS officials are trained to identify red flags. Some of these warning signs are obvious while others are more subtle. The first and most obvious signal would be failing to file appropriate tax returns. State officials and federal tax officers both see a clear link between tax problems and fraud, wastage and lack of internal governance, so these are things agents and IRS computer programs are trained to look for when reviewing tax returns. The Government Accountability Office has developed a list of Government Auditing Standards (GAS) that instructs auditors to report instances of non-compliance. Key issues that lead to non-compliance audits include the following items.

• Financial statements that don't use Generally Accepted Accounting Principles (GAAP)

• Material adjustments applied to cash flow records during audits

• Failure to include prior period adjustments

• Instances of internal fraud

The Office of Management and Budget also identified key areas of concern. These issues include the following record keeping insufficiencies and instances of monetary wastage.

• Failure to document a Schedule of Expenditures of Federal Awards (SEFA)

• Failure to complete SEFA and cash management records

• Failure to monitor grant sub-recipients

• Failure to submit grant progress reports in a timely manner

• Failure to engage in competitive bidding

• Distributing grant funds to ineligible parties

• Excessive administrative costs

Colleges, universities, community groups and hospitals have traditionally had the highest audit risk, but more and more small organizations are being reviewed today.

The IRS takes a dim view of certain activities that nonprofits partake in, and participation in these often leads to audits, especially when organizations engage in two or more of these dubious practices. With nonprofit audits on the rise, some organizations are more likely to be audited than others. Here are several nonprofit areas that have a high risk for audits.

• Nonprofits that sponsor gambling events

• Nonprofits that sponsor travel tours

• Nonprofits that work with for-profit businesses

• Nonprofits that participate in political lobbying

• Nonprofits that accept donor-advised gifts

• Nonprofit credit counseling agencies and student loan groups

When completing audits, the IRS examines all financial statements, business records and tax forms to make sure nonprofit organizations are following appropriate guidelines. These IRS oversight guidelines are designed to ensure transparency and accuracy, including the following points.

• To ensure nonprofits are operated for public interests

• To ensure assets are used exclusively for tax-exempt efforts

- To determine whether organizations engage in taxable, nonexempt activity

- To assess accounting standards for interactions with non-charitable groups

- To discover whether nonprofits administer excessive compensation or benefits

- To determine if nonprofit groups engage in lobbying or political campaigns

- To determine if nonprofits should be reclassified as charities or foundations

**Avoiding Nonprofit Audits**

Prevention and proper record keeping are the best strategies for avoiding official audits and handling a nonprofit audit if one occurs. The first step is fulfilling IRS reporting obligations and maintaining fastidious financial records. If records aren't compiled until after an audit begins, officials will be less understanding and more suspicious. Proper training, clear delineations of accounting duties and proper internal and external oversight are critical in the not-for-profit industry. With such tight accountability standards, there is no room for error. All executives, employees and volunteers must know the rules and follow them. Effective financial reporting strategies begin with strong internal controls.

Here are several of the most important accounting issues.

- Disclosure rules for cash and non-cash donations

- Managing unrelated taxable income

- Proper bookkeeping basics

- Completing Form 990

- Preparing IRS filings and disclosures accurately

- Completing a Form 1023 conflict of interest policy

- Working with contractors and volunteers

- Handling property donations

**How the IRS Selects Accounts for Audit**

The IRS can be an organization's worst enemy or a strong ally. If proper protocols are followed, a nonprofit has nothing to hide. This starts by understanding how the IRS flags accounts for audits. Some of this is done by convoluted, highly classified computer algorithms. Other referral reports are provided by news agencies, consumer watchdog groups and disgruntled donors.

The IRS has a sophisticated computer program known as RICS that reviews returns line by line to detect suspicious red-flag entries. These are often associated with taxable income, executive wages and failing to file Form 990-T or the Employment Tax Return Form 941. Referrals are also received from other branches of the IRS, Congress, government agencies and consumer watchdog groups. The public also has the ability to report inappropriate nonprofit activities using Form 13909. Playing by the rules and filling out all required forms with assistance from a nonprofit specialist can help prevent audits.

**IRS Nonprofit Audits**

Nonprofit audits are generally related to information or a lack of information on Form 990 and other related IRS documents. This important nonprofit form was updated in 2008 for the first time in 30 years. Current 990 forms are more comprehensive and promote greater levels of transparency and compliance. There are four types of this reporting form. The first type is 990-PF, which is used for private foundations; postcard Form 990-N is used for nonprofits with minimal earnings. Form 990-EZ is used for organizations that meet a certain threshold, and Form 990 is used by large organizations that receive many donations and have large asset holdings. These forms must be filled out in their entirety to create a complete financial picture.

To maintain compliance, Form 8283 must be used to record donations, and the value and nature of all contributions must be included on Schedule B of Form 990. To avoid issues with donors, complete disclosure letters must be created and sent before January 31 of the filing year. These letters must state the value of the donation as well as any quid pro quo issues that could cause the donor to claim more than the gift was worth.

Beginning in 2010, Tax Sheltered 403(b) Annuity Plans are subject to much tighter restrictions and compliance requirements. To avoid IRS audits and issues, nonprofit employers must have a written plan document in place, and they must properly document all withdrawals, transfers and contributions. In the past, employers relied on documents from plan providers, but these materials are no longer sufficient. Employers who use these plans must consult a qualified legal or financial advisory service that can draft appropriate plan documentation.

### Training Programs and Industry Partners

Lack of knowledge is the most common error that leads to the downfall of non-profit groups following IRS audits. Failing to prepare is the worst thing a non-profit organization can do. Organizations that are committed to their missions tend to focus less on the financial side of things. Ultimately, this could lead to an organization's undoing, but there is some good news. Many, many law firms, business consultants and accountants specialize in working with nonprofit groups. These agencies conduct periodic external audits that prepare organizations in case the real thing happens. They also provide sound financial, legal and tax advice above what regular bookkeepers and CPAs know. The IRS also provides a variety of free interactive training courses that are designed specifically for employees of nonprofit groups. These training materials cover Form 990, disclosure rules, employee payment strategies and a variety of related topics.

Nonprofit groups are complex and highly evolved, and tax laws are continually changing to keep up with this financially challenging industry. Complying with stringent government guidelines demands a strong combination of specialized knowledge and experience with nonprofit financial issues. Remaining compliant requires diligence in all business aspects, including disclosures, reporting and monitoring. When done right, financial statements and publicly available Form 990 documents can increase transparency, improve donor opinions and lead to more contributions. Maintaining proper reporting documents and preparing for an audit is the best way to prevent the IRS from selecting your nonprofit organization for review.