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## **Businesses Using Automatic Clearinghouse (“ACH”) Transactions for Collections and Payments Could be Subject to Annual Audit Requirements**

### ***Reclassification by Your Bank as a Third-Party Sender Could Result in Annual ACH Audit Requirement***

***By John Robichaud, CPA, CITP, CIA, CISA***

As more businesses demand access to the nation’s automated clearinghouse network (ACH), a common electronic banking service used to easily transfer funds for collection and payment, the need for greater oversight and regulation has grown. To this end, in March 2011 the National Automated Clearing House Association (NACHA), which oversees ACH, implemented new rules regarding the roles and responsibilities of third-party senders.

Third-party senders are organizations that perform any functions of an originating depository financial institution (“ODFI”) or bank in ACH transactions. An ODFI acts as the interface between the Federal Reserve or ACH network and the originator of the transaction. For example, if you pay your mortgage electronically to your bank, your bank then submits your payment through the ACH – and therefore is the ODFI.

Banks that participate in the ACH network are required to have in place systems and controls to mitigate the risks associated with their ACH activities and comply with NACHA rules and regulations. For several years now banks have been required to perform annual ACH-related audits to verify their compliance with the NACHA rules and regulations, and identify and correct any shortcomings in their processes. With the new rules implemented by NACHA, third-party senders must also now perform such annual ACH audits, which must comply with provisions stated in Appendix Eight of *NACHA Operating Rules & Guidelines (2012 edition)*. By making this rules change, NACHA aims to better protect the banks and related financial institutions, as well as the NACHA network, from violations, errors and control shortcomings by third-party senders.

### **A Little Background**

With the increased popularity of electronic banking, participation and use of the ACH network has grown. There has been a significant increase in use by bank customers functioning as third-party senders. According to the U.S. Department of the Treasury, a bank is typically the client of a traditional ACH vendor. A merchant is the customer of a third-party sender (often called an originator aggregator or merchant processor). The third-party sender is a customer of the bank. “When a third-party sender is interposed between the bank and the originator, there is no contractual agreement between the bank



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and originator. A bank should be aware of the distinct risks arising from relationships with third-party senders. Although third-party senders are bank customers, they require oversight by bank management.” And third-party senders that fail to conduct the newly required ACH audits could have their ACH privileges with the bank terminated.

## Push for Compliance

While the NACHA rules were changed in 2011, banks have been slow and inconsistent in adopting them. As of late, regulators and NACHA have been pushing financial institutions to reclassify customers as third-party senders and enforce the annual audit requirement. The move toward reclassification is gaining steam because financial institutions face increased exposure to risk when their customers process ACH transactions through their ACH network access – transactions that involve other institutions and customers who are not their own and, as such have not directly provided authorization to them. From a practical perspective, this means that if your business uses ACH for collections and payments with your customers and vendors -- organizations that are not also customers of your bank-- your bank is likely to reclassify you as a third-party sender subject to this annual ACH audit requirement.

Many organizations are potentially affected by these rules because the types of ACH transactions in question – from credit transfers, such as direct deposit payroll and vendor payments, and direct debit transfers, such as consumer payments on insurance premiums, mortgage loans and other bills, to a point-of-purchase check conversion pilot program (sponsored by NACHA) – are vast and common to most businesses. Financial institutions are actively reclassifying many of their ACH customers as third-party senders, making these businesses subject to the new rules. What types of business may be affected? Payroll processors, online check cashing services, collection and payment services, even law firms that oversee clients’ escrow and trust accounts are just a few of those that potentially could be reclassified by their bank and in turn face this new yearly audit requirement.

And not-for-profits may not be immune from reclassification because many may use ACH transfer to pay their vendors and collect from donors during fundraising campaigns.

Businesses and organizations that get reclassified as third-party senders but do not comply with the annual ACH audit requirement face the potential loss of their ACH processing privileges.

Banks that offer business and not-for-profit customers access to Internet banking applications to facilitate the direct origination of payments, such as credit or debit payments or wire transfers, expose themselves to increased risk for these online activities. While offering these applications makes business sense – web-based banking applications provide an efficient way to conduct treasury management activities such as invoice payments and funds transfers – they also increase the likelihood for errors and fraud. For example, according to NACHA fraud could arise from malicious software designed to “circumvent online authentication methods to obtain credentials that can be used to initiate fraudulent payments.”

So why target third-party senders? Third-party senders are involved in critical aspects of ACH processing and are responsible for key origination functions and controls but in the past have not been required to adhere to the same requirements – specifically that of an annual rules compliance audit – as all other players in the ACH network. With these 2011 rules, each participating depository financial institution (DFI) – a bank that accepts deposits from its customers and also can accept credits from a Federal Reserve Bank – must conduct an ACH annual audit. The same goes for third-party senders, which perform these responsibilities on behalf of their bank. Examples of third-party senders include data processing service bureaus, correspondent banks or financial institutions acting on behalf of other financial institutions.

The new rules make the ACH audit requirement more consistent so *every* organization involved in the ACH processing chain – including third-party senders – faces compliance scrutiny and has the opportunity to identify and correct errors. The goal is to help financial institutions minimize the risks associated with ACH processing, and strengthen their ACH program.

### About ACH Audits

The ACH audit requirement for third-party senders is designed not only to verify compliance with NACHA rules and regulations but also to identify errors and potential fraud exposures. It also aims to educate corporate and not-for-profit customers, particularly small businesses and community-based entities such as churches and schools, that may have limited awareness of payment-fraud techniques. An ACH audit can point out specific weaknesses in payment systems; help customers better understand their compliance responsibilities and the importance of good business practices, for example daily account reconciliation; and map out measures to better protect the integrity of their computer systems, such as beefing up virus protection or installing stronger encryption measures to mitigate payment risk.

This NACHA-mandated third-party sender ACH audit must be performed under the direction of an organization's audit committee, internal audit manager, senior-level officer or independent (external) auditor no later than December 31 of each year, and records must be maintained for six years.

Even though federal regulators do not enforce the NACHA rules, working with an external auditor to conduct the annual ACH audit may be helpful because of the complex and time consuming nature of the examination requirements. For example, an organization subject to a NACHA-mandated ACH audit must have appropriate risk-management and control processes in place to ensure compliance with NACHA rules and applicable laws and regulations.

There are many other requirements as well, such as a mandate that banks have an official agreement with any third-party sender that has direct access to an ACH operator, contributing to the complexity of such audits. That's why when executing your annual ACH audit your auditor should inspect your ACH operations, from receiving and originating to risk exposure and customer service risk. Other areas for inspection include operating procedures and internal controls, in particular those related to ACH exception handling. Based on the findings, your auditor should then recommend needed improvements and suggest specific areas on which to focus any employee training programs designed to enhance your ACH-related processes, as well as attest on your compliance with the NACHA rules and regulations.

Look for an external auditor to assist with the annual ACH audit requirements if you lack the in-house resources or skill sets necessary to conduct the audit on your own while maintaining focus on your organization's core goals and operations.

For more information, contact John Robichaud, a Shareholder in our Accounting & Auditing Group and Leader of the Internal Audit, Internal Controls and Service Organization Controls (formerly SAS 70) Practice, at 617-761-0546 or [jrobichaud@cbiztofias.com](mailto:jrobichaud@cbiztofias.com).

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