

# Guarding Your Assets: Everything you Need to Know about Finance

Presented by:  
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January 7, 2012

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# Learning Objectives

This seminar will address the essential ingredients to successful fiduciary governance:

- **What information should you be requesting from your Board?**
- **How to understand the information you are given.**
- **Which financial policies should be in place?**
- **Is your organization compliant with the most recent legal requirements?**

# Defining the Purpose, Responsibilities and Expectation of the Board of Directors and its Members



“The problems we have today, cannot be solved by thinking the way we thought when we created them.” - Albert Einstein





# Role of the Board of Directors

The Board of Directors' oversight role is important for every board member to understand. The key responsibilities of the Board of Directors in fulfilling its crucial functions are as follows:

- **Setting policy** - policies help boards and staff leaders advance their organizations, make better collective decisions, and guide individual actions and behaviors.
- **Fiduciary oversight** - responsible for the finances of the organization.
- **Establishing the strategic direction for the organization** - gives the board and senior management an understanding of where the organization is trying to go.
- **Providing connections to resources and information** - in today's world knowledge sharing is everything. Being able to connect people and resources to advance the purpose and mission of the organization is the key to success.

Today we will focus on the top two functions.



# Questions for the Board of Directors

It is very important for the Board of Directors to have a **clear understanding of their mission, purpose and strategy**. These items should be well defined in order for one to be effective and send a unified message to all stakeholders. Some thought provoking questions that a Board of Directors may want to ask itself are:

- Who are we as an organization, and where are we going?
- Whom do we serve, with what programs and services?
- What impact are we having on our constituents?
- What are the issues and challenges that the organization is facing?
- Given where we are going, who else do we need on the board, and why?
- Why would a potential board member want to be on our board?

# Ten Basic Responsibilities of a Nonprofit Board

- **Determine mission and purpose** - It is the board's responsibility to create and review a statement of mission and purpose that articulates the organization's goals, means, and primary constituents served.
- **Select the Executive Director** - It is important that the Board reach consensus on the Executive Director's responsibilities and undertake a careful search to find the most qualified individual for the position.
- **Support and evaluate the Executive Director** - The board should ensure that the Executive Director has the moral and professional support he or she needs to further the purpose, mission and goals of the organization.
- **Ensure effective planning** - Boards must actively participate in an overall planning process and assist in implementing and monitoring the plan's goals.
- **Monitor the organization's programs and services** - Ensure that they are consistent with the organization's mission and that they are effective.

# Ten Basic Responsibilities of a Nonprofit Board

(cont'd)

- Ensure adequate financial resources - Help secure adequate resources for the organization to fulfill its mission.
- Protect assets and provide proper financial oversight - The board must assist in reviewing the annual budget and ensuring that proper financial controls are in place.
- Build a competent board - All boards have a responsibility to articulate qualifications for candidates, orient new members, and periodically evaluate their own effectiveness.
- Ensure the legal and ethical integrity of the organization - The board is ultimately responsible for adherence to legal standards and ethical norms of society and ensuring policies and procedures are in place to provide monitoring and oversight.
- Be the voice of the organization to the community and other stakeholders - The board should clearly articulate the organization's mission, accomplishments, and goals to the public and garner support from the community.

Note: See Appendix A for Nonprofit Organization - Financial Checkup



# Expectations of a Board Member

What are the expectations of the board members and the committee members of the board of directors?

This should include all important expectations such as:

- Supporting the mission of the organization
- Attending regular meetings
- Attending special events
- **Coming prepared to board meetings**
- **Serving on board committees**
- Contributing annually with either a financial or resource commitment
- **Understanding governance/oversight/fiduciary responsibilities**
- Attending board retreats
- Responding timely to other organizational requests
- Speaking knowledgeably and as one voice for the organization



# Characteristics of an Effective Board of Directors

- Adequate financial expertise on board.
- Active audit committee (2 - 3 meetings per year; more if needed).
  - At least one financial expert and a strong chair.
- No compensated personnel (including close family of same, or outside contractors) on Board or committees.
- Audit Committee Members must outnumber Finance Committee members if any sit on the Audit Committee. Finance Committee Chair and Board President cannot be voting members of the Audit Committee (See **Appendix B: CA Nonprofit Integrity Act**).
- All Committees have clear charters, approved by full board and reviewed regularly.
- Process for educating its members about their responsibilities.
- Formal meeting agendas.
- Committees regularly report to full board.
  - Each Committee understands its responsibility and authority .



# Characteristics of an Effective Board of Directors

- The Board of Directors regularly reviews quality of financial reports and internal controls with assistance of Finance or Audit Committee.
- The Board is always alert to any indication of problems.
- The Board does not allow itself to be controlled by management.
- The Board does not micro-manage the operations of the organization.
- Board is fully aware of its overall fiduciary responsibility for the financial health of the organization.
  - Board insists on a strong internal control environment.
  - Board has a policy on the desirable level of operating reserves, and works to achieve that level.
  - Timely and understandable financial information is reviewed by the board.
  - Board does not hesitate to insist on obtaining the information it needs, in a format it can understand, on a timely basis but board does not micro-manage.



# Best Practices for an Effective Board of Directors

- Create the Right Tone at the Top
- Be Independent
- Reflect a Balance of Skills
- Make a Time Commitment
- Establish Board Committees (especially an audit committee)
- Develop a Clear Charter
- Develop Specific Board and Committee Duties
- Plan the Year's Agenda
- Document the Board and Committees' Work



# ACCOUNTABILITY

The Board is ultimately responsible for ensuring the accuracy and completeness of the Organization's communications related to fund-raising and other financial activity with the general public.


In satisfaction of this responsibility the Board should ensure that:

- a) the annual report of the Organization is available upon request to the public;
- b) the Organization's website provides electronic access to solicitation material and to the Organization's three most recently filed IRS Form 990's and audited financial statements (in CA, a charity must also post their audited financial statements on the web if they post their Form 990's)
- c) the reasonable privacy concerns of donors are addressed.

Note:

Management, or its legal counsel, should establish policies and procedures to monitor the Organization's compliance with all state charitable solicitation laws where the Organization solicits charitable contributions and monitors all web-based solicitations for compliance with applicable state and federal laws.

# ETHICS and COMPLIANCE



“Fraud and deceit abound in these days  
more than in former times!” - Sir Edward Cole (1602)



# ETHICS AND COMPLIANCE

The Board is ultimately responsible for promoting an organizational culture that encourages a commitment to compliance with laws and regulations.

The Board should establish a Conflict of Interest Policy for both Board and Committee Members and Employees.

The Board should take all necessary steps to instill a “culture of compliance” within the Organization:

- a) Ensure an organizational information and reporting system is designed to prevent and detect violations of existing law;
- b) Be knowledgeable about the content and operation of such system;
- c) Exercise reasonable oversight with respect to the implementation and effectiveness of such system;
- d) Ensure that legally appropriate document retention policies and procedures are in place; and
- e) Ensure that “non-retaliation” protections (whistle blower protection) are in place for employees who disclose potential concerns, issues and legal violations under the reporting system.



# ETHICS AND COMPLIANCE (Cont'd)

Larger and International nonprofit organizations, particularly those that operate in a highly regulated environment, should establish a standing Compliance Committee, comprised of independent directors, that are given the direct responsibility to oversee corporate ethics and compliance activity of the organization.

A member of senior management of the organization should be assigned direct, overall responsibility for the compliance system, be given adequate resources and authority to carry out such responsibility, and report to the Board (directly or through a Corporate Compliance Committee).

# Committees of the Board of Directors



# THE AUDIT COMMITTEE

A standing Audit Committee must be appointed for California charities that have to comply with the Nonprofit Integrity Act. One best practice is to comprise the committee entirely of independent directors of the Board of Directors. At a minimum, the Chair should be a board member so that they can report directly to the Board on the results of their meetings.

The Audit Committee should adopt a written charter and should meet periodically in executive session with the audit firm (that is, outside the presence of any members of senior management).

The Board resolution establishing the Audit Committee should specify whether some or all committee decisions are to be made exclusively by the Committee, or by the Board of Directors upon recommendation of the Committee.

The Audit Committee, under the Board's supervision, is responsible for making recommendations to the Board to engage independent CPA's as their audit firm.



# THE AUDIT COMMITTEE (cont'd)

The Audit Committee should be:

- a) Authorized to hire and terminate the Organization's outside auditors (or, at a minimum, to recommend such hiring or termination to the Board), and to establish the terms of the outside auditor's engagement;
- b) Responsible for establishing, proposing or carrying out policies related to non-audit services provided by the outside auditor to the Organization and other aspects of the organization-auditor relationship that potentially could affect the auditor's independence;
- c) Responsible for reviewing and commenting on the adequacy of the Organization's financial disclosure and internal controls; and
- d) Responsible for any other activities that are set forth in the Committee charter.



# The Executive Compensation Committee

A standing Executive Compensation Committee should be appointed, to be comprised entirely of independent directors of the Board of Directors. (See [Appendix C](#) for Sample Compensation charter)

The Executive Compensation Committee should meet periodically in executive session (that is, outside the presence of any members of senior management).

The Executive Compensation Committee should be responsible for establishing (or making a recommendation with respect to) the compensation and benefit arrangements (including qualified and non-qualified benefit plans) provided to the senior management of the Organization; and such other activities as shall be set forth in the Committee's charter.

In the decision-making process, the Executive Compensation Committee should establish and adhere to a compensation philosophy which reflects the charitable, tax-exempt mission of the Organization. Any incentive compensation arrangements should be supported specifically with a description as to how the incentive arrangement furthers the tax exempt mission and charitable purposes of the Organization.

# The Executive Compensation Committee

(cont'd)

The Board bylaw or resolution establishing the Executive Compensation Committee should specify whether some or all Committee decisions are to be made exclusively by it, or by the Board of Directors upon recommendation of the Committee.

The Executive Compensation Committee should be authorized (and provided with sufficient funding) to engage outside independent compensation and legal advisors, when deemed necessary and advisable by the Committee.

The CEO should not be present for, or participate in, Committee deliberations concerning CEO executive compensation (other than to answer questions) but may, with the approval of the Committee, participate in the deliberations concerning the compensation of other members of senior executive management.

The Executive Compensation Committee should ensure compliance with the “Rebuttable Presumption of Reasonableness” under Section 4958 of the Internal Revenue Code.



# The Executive Compensation Committee

(cont'd)

- Charities that must comply with the CA Nonprofit Integrity Act must have their Board or authorized compensation committee review and approve the compensation of:
  - CEO or Executive Director
  - CFO or the highest accountant on staff

The review should ensure that the compensation is just and reasonable. Compensation includes all compensation, including certain car allowances and pension contributions.



## TRANSACTIONS WITH DISQUALIFIED PERSONS

The Board should review and understand the Internal Revenue Code provisions dealing with “excess benefit transactions.” As part of its review, the Board should seek to identify (through periodic disclosure statements and other means) those categories of individuals and entities (e.g., corporations and partnerships who may be considered “disqualified persons”) under these provisions and, accordingly, potentially subject to excess benefit transaction excise taxes (“Disqualified Persons”).

The Board should adopt policies and procedures for reviewing and approving all transactions between the Organization and a Disqualified Person to ensure ongoing compliance with state and federal law.

The Board should consider the appropriateness of adopting a policy providing that it will comply with the “Rebuttable Presumption of Reasonableness” in all but the most exceptional of circumstances.



## TRANSACTIONS WITH DISQUALIFIED PERSONS (cont'd)

At a minimum, such procedures should include the following:

- a) The Board, or a committee created by the Board, should review the compensation arrangement or terms of the transaction with the Disqualified Person. The Board or committee conducting the review should be comprised entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction being reviewed.
  
- b) In making its determination of reasonableness, the Board or committee should obtain and rely upon appropriate data as to comparability from internal or external sources prior to making its determination. [See recent survey by Charity Navigator at Appendix D.](#)

## TRANSACTIONS WITH DISQUALIFIED PERSONS (cont'd)

At a minimum, such procedures should include the following:

c) The Board or Executive Compensation Committee should document the basis for its determination of reasonableness concurrently with making that determination. For a decision to be documented adequately, the written or electronic records of the Board or committee should note:

1. The terms of the transaction that was approved and the date it was approved;
2. The members of the Board or committee who were present during the discussion of the transaction or arrangement that was approved and results of the vote;
3. The comparability data obtained and relied upon by the Board or committee and how the data was obtained; and
4. The Board should ensure that member involved in the conflict of interest be removed from all discussions and abstain from any votes related to the issue.
5. The actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the Board or committee but who had a conflict of interest with respect to the transaction or arrangement.

# Governance and the IRS



“You do not have to do anything improper to have a conflict of interest; it is strictly situational.” - Paul J. Friedman



# Transparency, Governance, and Accountability

These three “buzz” words are the subject of many conversations these days among members of the nonprofit community and are a consistent theme on Capitol Hill and at the IRS.

- Nonprofit organizations should promote *transparency* within their organization since they are spending public or stakeholders’ funds - either through donations, dues, fees, or taxpayer money passed through to them from government entities.
- Nonprofits should practice effective board *governance* in order to provide proper oversight and monitoring over those funds received from the public and the activities of the organization.
- Nonprofits should be *accountable* in the stewardship the public has placed upon them and make sure that the funds raised as a nonprofit organization are used for the activities that aligned with its mission and purpose and most importantly are not used to provide benefits to private parties.

In the Form 990, one of the biggest changes is the section that has been added on board governance, which is directly related to and based on these core principles. (see [Appendix E](#))



## IRS Activity

Steve Miller, Commissioner of Tax Exempt and Government Entities at the IRS, stated that the “Service is going to be involved with governance.” The IRS encourages an active and engaged board and believes that it is “important to the success of a charity and to its compliance with applicable tax law requirements.”

The IRS has now gone as far as to implement a checklist on governance for its Revenue Agents to complete on any nonprofit audit, which is available on their website at [http://www.irs.gov/pub/irs-tege/governance\\_check\\_sheet.pdf](http://www.irs.gov/pub/irs-tege/governance_check_sheet.pdf). (See [Appendix F](#))



## IRS Form 990

Part VI of the Form 990, Section A, question 10 asks, “Was a copy of the Form 990 provided to the organization’s governing body before it was filed? All organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990.” There is no existing legal requirement to provide board members with the 990.

This new section on board governance asks specific questions ([See Appendix E](#)) relating to board policies and procedures. Question 10 really relates to how an organization’s governing body reviews the 990. The IRS not only wants to know if the nonprofit organization has these policies and procedures in place, but they also want to know exactly what the processes are and how the organization provides monitoring and oversight.



## IRS Form 990 - NPO Practices

Practices among nonprofit organizations vary regarding the internal review process of the Form 990 by their board and management. The IRS Form 990 Instructions indicate that an organization should describe on Schedule O the process by which the nonprofit organization reviews their form 990. Some the items that would be described on Schedule O are as follows:

- How do officers, directors, trustees, board committees members or management review the prepared Form 990?
- Indicate whether the review occurred before or after the Form 990 was filed with the IRS.
- Include specific procedures that were used in the review, when the review was conducted, by whom the review was conducted and the extent of such review.

In light of these items, boards might want to consider adopting a Form 990 review policy that provides adequate time for meaningful review by at least a subcommittee of the board and a method for allowing for feedback and revisions based on board input.



## Best Practices:

- A copy of the 990 (hard copy or electronic) should be provided to the Board prior to filing.
- The actual review and discussion should be held by the committee/full board, facilitated perhaps by the Finance Director, Audit Committee Chair, Treasurer or 990 Preparer.
- Documentation of this review should be included in meeting minutes.



# Questions ???

# BDO Resources

# BDO USA's Institute for Nonprofit Excellence - Resources

*For almost 100 years, BDO USA, LLP has provided assurance, tax, financial advisory and consulting services to a wide range of publicly traded, privately held companies and nonprofits. We offer a sophisticated array of services and access to global capabilities combined with local presence and the personal attention of experienced professionals.*

*Below is a summary of just some of the many resources BDO makes available at no additional charge to our clients.*

## **Client Advisories**

Our Client Advisories are concise documents that provide timely commentary, analysis and insights on events and trends of interest to managers and directors. To subscribe to future client advisories, please use our RSS (Really Simple Syndication) Feeds or send an e-mail to BDO USA, LLP's National Assurance practice at [assurance@bdo.com](mailto:assurance@bdo.com).

## **Nonprofit Financial Reporting and Tax Webinars**

BDO USA, LLP conducts regular webinars for our clients and friends on current nonprofit issues involving timely and relevant nonprofit accounting, auditing and tax updates and issues. See Appendix E for a schedule of our upcoming webinars. We make the archives of our calls available to our clients and contacts. To receive invitations to future conference calls, please send an e-mail to [TDecker@bdo.com](mailto:TDecker@bdo.com).



# BDO USA's Institute for Nonprofit Excellence Resources (cont'd)

## Newsletters

BDO's Institute for Nonprofit Excellence issues a quarterly newsletter (see Appendix D for the most recent editions) discussing current issues involving nonprofit accounting, auditing and tax updates, which include new accounting and auditing standards, executive compensation and benefit issues, areas of concentration of the Internal Revenue Service, industry best practices and information for those that are required to have an OMB Circular A-133 audit (Single Audit) to name a few.

## Industry Publications

BDO's industry publications are numerous and include the nonprofit, technology, retail and consumer products, and real estate sectors to name a few.

For a complete listing of services, publications, archives of various webinars and events, and other information regarding BDO USA, LLP, please contact Cindy Bertrand at [cbertrand@bdo.com](mailto:cbertrand@bdo.com) or 858.431.3461.

**Nonprofit Organization - Financial 'Checkup'**

(This is a generic document and should be tailored to your particular organization)  
Should be completed at least annually; more often if concerns arise

	YES	NO
<b>I. Related parties and other sensitive areas</b>		
Do we have a formal conflict of interest policy?		
Describe (or attach a copy):		
What transactions have we had with related parties <sup>1</sup> (other than the executive director's compensation)?		
Were they approved by the board - with full knowledge of the relationship, and without input from the related party?		
Do we have a formal conflict of interest policy?		
Has the executive director's total compensation been approved by the board?		
Who approves board members' and the executive director's travel and entertainment expenses (please list and briefly describe the process)?		
List (or attach a copy):		
<b>II. Internal Controls and Risks</b>		
Is there a healthy attitude about internal controls, originating at the very top of the organization?		
Do we have adequate written procedures manuals for important financial and operational areas?		
What procedures do we have in place to assure that:		
What procedures do we have in place to assure that all cash receipts are recorded and deposited, especially, contributions (please briefly describe)?		

<sup>1</sup> "Related parties" include organization officers, directors, trustees, and management in decision-making positions, major donors, and members of the immediate families of any of the preceding; controlled and affiliated organizations and trusts, and businesses in which any of the preceding are in significant positions of authority (owner or manager).

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	YES	NO
What procedures do we have in place to assure that only properly supported and approved cash disbursements are made (please briefly describe)?		
What procedures do we have in place to assure that Restricted resources are used only in accordance with applicable restrictions (please briefly describe)?		
What procedures do we have in place to assure that assets are protected from theft (please briefly describe)?		
Who reconciles our bank statements, and how quickly?		
Is this person independent of other cash and bookkeeping functions?		
Has our auditor made recommendations for improvements in controls?		
If so, have they been implemented?		
How soon after the end of an accounting period is a budget-to-actual comparison made and significant variances (or lack thereof, where expected) investigated (please briefly describe)?		
Has someone knowledgeable about computers reviewed our computer security (please briefly describe)?		
Has someone knowledgeable about nonprofit taxes reviewed our activities for possible exposure (please briefly describe)?		
Consider the following: <ul style="list-style-type: none"> <li>• Private inurement or benefit, especially compensation</li> <li>• Possible unrelated business income</li> <li>• Possible excess lobbying/political activity ((c)(3)'s are not permitted to engage in <i>any</i> political activity)</li> <li>• Employee vs. independent contractor status</li> </ul>		

<ul style="list-style-type: none"> <li>Possible failure to comply with rules related to receipt of gifts (acknowledgement, quid-pro-quo, etc.)</li> <li>Public disclosure of Form 990 on request</li> </ul>		
	<b>YES</b>	<b>NO</b>
Has a knowledgeable attorney reviewed our activities for possible legal risks?		
Is there anything about our organization or its operations that we would be embarrassed to read about in the local newspaper or discussed on the evening news (Describe what those items might be)?		
<b>III. Government Grants, etc. (as relevant)</b>		
Are we following all required sections of OMB Circulars A-110 and A-122 (A-21 for colleges)?		
Do we have adequate time records to support charges to grants?		
Are we following acceptable procurement procedures?		
Are we adequately monitoring subrecipients?		
Have we filed all required reports on a timely basis?		
Have we had all required audits under Circular A-133?		
Were there any findings?		
If so, have they been appropriately followed up?		
Has any government agency challenged any of our procedures or charges to grants?		
If so has the matter been satisfactorily resolved?		
<b>IV. Financial Reporting and Audits</b>		
Have we received clean (unqualified) reports from our auditor?		
Have we received clean (unqualified) reports from our auditor?		
Are we satisfied that our auditor is independent?		
How much in non-audit fees have we paid our audit firm? \$_____		
Does our auditor understand that (s)he has unrestricted access to the board/audit committee?		
Has our auditor received a clean peer review report?		
Have we filed all required government reports (Form 990, state forms, etc.) on a timely basis?		
<b>V. Other</b>		
Have we made all payroll tax deposits fully and on a timely basis? (If this is not done, officers and board members can be held personally liable.)		
Do we carry adequate property and liability insurance?		
Has our board adopted a formal policy on desired levels of operating reserves, and are we comfortable that our reserves are adequate?		



# Governance Check Sheet

This check sheet is to be used by EO Revenue Agents in the examination of I.R.C. 501(c)(3) public charities. Please complete all parts of this check sheet.

## Part 1 - Revenue Agent and Exempt Organization Information

1. Agent Name	<input type="text"/>	Group Number	<input type="text"/>
2. Organization Name	<input type="text"/>		
3. EIN	<input type="text"/>		
4. Tax Period(s) Examined	<input type="text"/>	<input type="text"/>	<input type="text"/>
5. Form Being Examined	<input type="text"/>		
6. Foundation Code	<input type="text"/>		

## Part 2 - Governing Body and Management

7. Does the organization have a written mission statement that articulates its current I.R.C. § 501(c)(3) purpose(s)? Select one of the options.

8. Do the organization's bylaws set forth the following information for the members of the governing body and the organization's officers? Select one of the options from each of the drop down boxes.  
Composition  Duties  Qualifications  Voting Rights

9. Have copies of the most recent versions of the organization's articles and bylaws been provided to the following? Select all that apply.  
 All Board Members  Only Voting Board Members  General Public (by request)  General Public (online)  Not Provided

10. At the beginning of the primary year under examination, what was the number of board members with voting rights? Enter a whole number.

11a. How often did a quorum of voting board members meet during the primary year under examination? Enter a whole number.

11b. How often did the full board meet during the primary year under examination? Select one of the options.

12. Did the number of meetings referred in 11a and 11b meet or exceed the meeting requirements set forth in the organization's bylaws? Select one of the options.

## Part 3 - Compensation

13. Are compensation arrangements for all officers, directors, trustees, and key employees approved in advance by an authorized body of the organization composed of individuals with no conflict of interest with respect to the compensation arrangement? Select one of the options.

14a. Does the authorized body rely upon comparability data in making compensation determinations? Select one of the options.

14b. If "Always" or "Sometimes" for 14a, select the comparability data considered by the organization? Select all that apply.  
 Exempt Organizations  Non-Profit Entities Not Exempt From Tax  Governmental Entities  For-Profit Entities  Other

14c. If the "Other" box is checked for 14b, provide a brief explanation of the other source.

15. Is the basis for all compensation determinations contemporaneously documented. Select one of the options.

## Part 4 - Organizational Control

16a. Did any of the organization's voting board members have a family relationship and/or outside business relationship with any other voting or non-voting board member, officer, director, trustee, or key employee? Select one of the options.

16b. If YES to 16a, list the number of relationships between the officers, directors, trustees, or key employees.

16c. Number with Family Relationships  Number with Business Relationships  Number with Both Relationships   
Total Number of Relationships (should equal the amount listed in 16b)

17. Does effective control of the organization rest with a single or select few individuals? Select one of the options.

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**Part 5 - Conflict of Interest**

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18a. Does the organization have a written conflict of interest policy? Select one of the options.

18b. If **YES** to 18a, does the policy address recusals? Select one of the options.

18c. If **YES** to 18a, does the policy require annual written disclosures of conflicts of interest? Select one of the options.

18d. If **YES** to 18a, during the primary year under examination, if any actual or potential conflicts of interest were disclosed, was the organization's conflict of interest policy adhered to? Select one of the options.

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**Part 6 - Financial Oversight**

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19. Are there systems or procedures in place intended to make sure assets are properly used, consistent with the organization's mission? Select one of the options.

20a. How often did the organization provide board members with written reports of the organization's financial activities? Select one of the options.

20b. How often did the board discuss/consider reports of the organization's financial activities? Select one of the options.

21. Prior to filing, was the Form 990 reviewed by the full board and/or a designated committee? Select one of the options.

22a. During the primary year under examination, was an independent accountant's report prepared? Select one of the options.

22b. If **YES** to 22a, was the accountant's report discussed/considered by the full board and/or a designated committee? Select one of the options.

23a. Was a management letter prepared by the independent accountant? Select one of the options.

23b. If **YES** to 23a, was the management letter reviewed by the full board and/or a designated committee? Select one of the options.

23c. If **YES** to 23a, did the organization adopt any of the recommendations contained in the management letter? Select one of the options.

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**Part 7 - Document Retention**

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24a. Does the organization have a written policy for document retention and destruction? Select one of the options.

24b. If **YES** to 24a, does the organization adhere to its written policy for document retention and destruction? Select one of the options.

25. Does the board contemporaneously document its meetings and retain this documentation? Select one of the options.

26. Was your examination hindered by a lack of necessary documentation? Select one of the options.

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**Part 8 - Disposition**

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27. Examination Disposal Code for Primary Return

28. Principal Issue Codes for Primary Return

First Issue

Second Issue

Third Issue

Fourth Issue

# NONPROFIT INTEGRITY ACT OF 2004

## SUMMARY OF KEY PROVISIONS

Effective January 1, 2005

Applies To

### ■ Charities

### ■ Commercial Fundraisers

### ■ Fundraising Counsels

### ■ Unincorporated Associations

### ■ Trusts

Attorney General  
Bill Lockyer

October 2004

## 1. Charitable Organizations Have 30 Days, Instead Of Six Months, To Register And File Articles Of Incorporation With The Attorney General's Registry Of Charitable Trusts [Government Code section 12585]

▶ Charitable corporations, unincorporated associations and trusts must file with the Attorney General articles of incorporation, or other documents governing the organization's operations, (e.g., articles of association or trust instrument) within 30 days after initial receipt of property.

## 2. Independent Audit Of Annual Financial Statements Now Required For Charities With Gross Revenues Of \$2 Million Or More [Government Code section 12586(e)(1)]

▶ Charitable corporations with gross revenues of \$2 million or more must prepare annual financial statements audited by an independent certified public accountant (CPA). The statements must use generally accepted accounting principles. The independent CPA must follow generally accepted auditing standards.

▶ If the accounting firm and CPA performing the audit also provides non-audit services to the nonprofit, the accounting firm and CPA must follow the independence standards in the Yellow Book issued by the U.S. Comptroller General.

▶ The audited financial statements must be made available for inspection by the Attorney General and the public no later than nine months after the close of the fiscal year covered by the financial statement.

▶ The audit requirement applies to charitable corporations, unincorporated associations and trustees required to register and file reports with the Attorney General, whenever such organizations accrue \$2 million or more in gross revenue in any fiscal year.

▶ The \$2 million-threshold excludes grants received from governmental entities, if the nonprofit must provide an accounting of how it used the grant funds.



### **3. Charities With Gross Revenues Of \$2 Million Or More Must Establish And Maintain An Audit Committee** [*Government Code section 12586(e)(2)*]

- ▶ Requirements for an audit committee apply only to charitable corporations that must register and file reports with the Attorney General, whenever such organizations accrue \$2 million or more in gross revenue in any fiscal year.
- ▶ \$2 million-threshold excludes grants received from governmental entities, if the nonprofit must provide an accounting of how it uses the grant funds.
- ▶ Governing boards must appoint an audit committee. The audit committee may include persons who are not members of the governing board.
- ▶ The audit committee cannot include staff members, the president or chief executive officer, the treasurer or chief financial officer of the organization. If an organization has a finance committee, members of that committee may serve on the audit committee, but cannot comprise 50 percent or more of the audit committee. The chairperson of the audit committee may not be a member of the finance committee.
- ▶ The audit committee, under the governing board's supervision, is responsible for making recommendations to the board on the hiring and firing of independent certified public accountants (CPAs). The audit committee can negotiate the independent CPA's compensation, on behalf of the governing board.
- ▶ The audit committee must:
  - Confer with the auditor to satisfy committee members that the financial affairs of the nonprofit organization are in order;
  - Review the audit and decide whether to accept it; and
  - Approve non-audit services by the independent CPAs accounting firm, and ensure such services conform to standards in the Yellow Book issued by the U.S. Comptroller General.

### **4. Executive Compensation By Charitable Corporations, Unincorporated Associations And Charitable Trusts Must Be Review And Approved** [*Government Code section 12586(g)*]

- ▶ Charitable corporations and unincorporated associations must have their governing board or authorized board committee review and approve the compensation of the Chief Executive Officer or President, and the compensation of the Chief Financial Officer or treasurer, to ensure that the payment is "just and reasonable."

▶ All trustees of a charitable trust must review and approve any executive compensation to ensure it is “just and reasonable.”

▶ The review and approval must occur at the time of initial hiring, when the term is renewed or extended, and when the compensation is modified.

▶ Compensation includes benefits.

## 5. Commercial Fundraisers Must Notify Attorney General Before Starting A Solicitation Campaign *[Government Code section 12599(h)]*

▶ Commercial fundraisers for charitable purposes must report to the Attorney General’s Registry of Charitable Trusts the start of a solicitation campaign or event. This notice must be filed not less than 10 working days prior to the start of a solicitation campaign or event.

▶ If proceeds are intended for victims of disasters or emergencies, the commercial fundraiser must file the required disclosure report no later than the date on which the campaign begins. The report must include:

- The Identity of the commercial fundraiser;
- The name of the organization for whom donations are being solicited;
- The name of the person directing and supervising the fundraiser’s work within the commercial fundraising company; and
- Projected start and end dates for the commercial fundraiser’s work.

## 6. Commercial Fundraisers Must Have Written Contracts With The Charitable Organizations For Whom They Are Working *[Government Code section 12599(i)]*

▶ For every solicitation campaign or event produced by a commercial fundraiser for a charitable organization, there must be a written contract between the fundraiser and the charitable organization.

▶ The written contract must contain or state:

- The charitable purpose for which the solicitation campaign or event is being conducted.
- The respective obligations of the commercial fundraiser and charitable organization.

California Registry  
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- If the commercial fundraiser will be paid a fixed fee, the amount of the fee and a good faith estimate of what percentage of the total contributions the fee will comprise. The contract must clearly set forth the assumptions on which the good faith estimate is based.
  - If the commercial fundraiser will be paid a percentage fee, the percentage of total contributions the charitable organization will retain. If the solicitation involves the sale of goods or services, or sale of admission to an event, the contract must state the percentage of the purchase price the charitable organization will retain. The percentage must be calculated by subtracting from total contributions and sales receipts not only the commercial fundraiser's fee, but also any additional fundraising costs the charitable organization must pay.
  - The effective date and terminate date of the contract, and the date the solicitation will start in the state.
  - A provision setting forth the requirement that all contributions received by the commercial fundraiser must, within five working days of receipt, either be deposited in a bank account controlled by the charitable organization or delivered in person to the charitable organization.
  - The charitable organization controls and approves the content and frequency of any solicitation.
  - The maximum amount the commercial fundraiser plans to pay individuals or entities to secure any person's attendance at, or approval, sponsorship or endorsement of, a fundraising event.
  - Provisions specifying that the charitable organization has a right to cancel the contract without liability for 10 days following the date the contract is executed. The organization may cancel the contract with 30-days notice and payment for services provided by the commercial fundraiser for up to 30 days after the notice is served.
  - Provisions specifying that after the initial 10-day period, the charitable organization has a right to cancel the contract for any reason without liability if the commercial fundraiser or its agents make material misrepresentations, harm the charitable organization's reputation or are found to have been convicted of a crime arising from charitable solicitations.
  - Any other information required by regulations adopted by the Attorney General.
- ▶ The contract must be signed by the commercial fundraiser's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.

## **7. Charitable Organizations Can Void Contracts With Unregistered Commercial Fundraisers** *[Government Code section 12599.3(a)]*

- ▶ Contracts between commercial fundraisers for charitable purposes and charitable organizations are voidable unless the commercial fundraiser is registered with the Attorney General's Registry of Charitable Trusts prior to the start of the solicitation campaign or event.

## **8. FUNDRAISING COUNSEL MUST NOTIFY ATTORNEY GENERAL BEFORE STARTING SOLICITATION CAMPAIGN**

*[Government Code section 12599.1(e)]*

- ▶ Fundraising counsel must file a notice with the Attorney General's Registry of Charitable Trusts not less than 10 working days prior to the start of a solicitation campaign or event; or if the purpose is to raise funds for victims of disasters or emergencies, no later than the date on which the campaign begins.
- ▶ The form of notice will be specified by the Attorney General's Registry of Charitable Trusts.
- ▶ The information that must be reported includes: the commercial fundraiser's name, address and telephone number; the name, address and telephone number of the organization with whom the fundraising counsel has contracted; the name, address and telephone number of the person who will direct and supervise the work of the fundraising counsel; and the projected dates when the contract will begin and end.

## **9. Fundraising Counsel Must Have Written Contracts With Charitable Organizations** *[Government Code section 12599]*

- ▶ For every solicitation campaign or event, there must be a written contract between the fundraising counsel and the charitable organization. The contract must be signed by the fundraising counsel's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.
- ▶ The written contract must contain or state:
  - The charitable purpose for which the solicitation campaign or event is being conducted.
  - The respective obligations of the fundraising counsel and charitable organization.

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- A statement that the fundraising counsel will neither solicit, receive nor control donated funds, assets and property, or employ any other person to do so.
- A statement that the charitable organization exercises control and approval over the content and frequency of solicitation.
- A clear statement of the fees and any other forms of compensation that will be paid to the fundraising counsel.
- The effective date and terminate date of the contract, and the date the solicitation will start in the state.
- Provisions specifying the charitable organization's right to cancel the contract without liability for 10 days following the date the contract is executed; and right to cancel the contract after the initial period by giving 30-days notice and payment for services provided by the fundraising counsel up to the effective date of the notice.
- Any other information required by regulations adopted by the Attorney General.

## 10. Charitable Organizations Can Cancel Contracts With Commercial Fundraisers *[Government Code sections 12599.3(b)(f)(g)]*

- ▶ Charitable organizations have the right to cancel a contract with a commercial fundraiser without liability for 10 days following the date the contract is executed.
- ▶ Following the initial 10-day period, charitable organizations have the right to cancel a contract with a commercial fundraiser by providing 30-day notice. The charitable organization is liable for services provided by the commercial fundraiser up to 30 days after the notice is served.
- ▶ Following the initial 10-day period, a charitable organization has the right to cancel a contract with a commercial fundraiser without liability if the commercial fundraiser or its agents make material misrepresentations during a solicitation, harm the charitable organization's reputation during a solicitation, or are found to have been convicted of a crime arising from fundraising activities.

## 11. Charitable Organizations And Commercial Fundraisers For Charitable Purposes Have Specific Obligations When Fundraising *[Government Code sections 12599.6(a)(b)(c)(d)(e)]*

- ▶ Charitable organizations and commercial fundraisers cannot misrepresent the purpose of a charitable organization, or the nature or purpose of the beneficiary of a solicitation.

▶ Charitable organizations must establish and exercise control over fundraising activities conducted for their benefit. This obligation includes approving all written contracts and agreements, and assuring fundraising activities are conducted without coercion.

▶ Charitable organizations cannot enter into any contract or agreement with a commercial fundraiser that is not registered with the Attorney Generals Registry of Charitable Trusts.

▶ Charitable organizations cannot raise funds for any charitable organization required to be registered with the Attorney Generals Registry of Charitable Trusts unless the charitable organization is so registered or, if not, agrees to register prior to the start of a solicitation.

▶ Commercial fundraisers must, within five working days, either deposit in a bank account controlled by the charitable organization or deliver personally to the charitable organization all contributions received on behalf of the charitable organization.

## 12. Charitable Organizations And Commercial Fundraisers For Charitable Purposes Are Prohibited From Engaging In Misrepresentation And Certain Other Acts When Soliciting Donations

*[Government Code section 12599.6(f)]*

▶ The following acts are prohibited in the planning, conduct or execution of solicitation campaigns:

- Operating in violation of the Supervision of Trustees and Fundraisers for Charitable Purposes Act [Govt. Code sec. 12580 et seq.], regulations and orders issued by the Attorney General.
- Committing unfair or deceptive acts, or engaging in fraudulent conduct.
- Using any name, symbol, emblem or other information that falsely suggests or implies a contribution is for a particular charitable organization.
- Falsely telling donors that a contribution is for a charitable organization or will be used for a charitable purpose.
- Telling donors that a person sponsors, endorses or approves a charitable solicitation when that person has not agreed in writing to have their name used for such a purpose.
- Misrepresenting that goods or services have endorsements, sponsorships, approvals, characteristics or qualities they do not have.
- Misrepresenting that a person has endorsements, approvals, sponsorships, status or affiliations they do not have.

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- Misrepresenting that registration with the Attorney General's Registry of Charitable Trusts constitutes an endorsement or approval by the Attorney General.
- Representing that a charitable organization will receive an amount greater than the reasonably estimated net proceeds from a solicitation campaign or event.
- Issuing cards, stickers, emblems, plates or other items that can be used for display on a motor vehicle, and which suggest an affiliation with, or endorsement by, public safety personnel or a group of public safety personnel.
- Representing that any portion of contributions solicited by a charitable organization will be given to another charitable organization unless the second charitable organization provides prior written consent for such use of its name.
- Representing that tickets to events will be donated for use by another person or entity unless: the charitable organization or commercial fundraiser has obtained written commitments from charitable organizations that they will accept a specific number of donated tickets; and the donated tickets, when combined with other ticket donations, do exceed either the ticket donations received from charitable organizations or the total capacity of the event site.

### **13. Commercial Fundraisers Must Keep Records Of Solicitation Campaigns For At Least 10 Years** [Government Code section 12599.7(a)]

- ▶ Commercial fundraisers must maintain for at least 10 years following each solicitation campaign records that contain:
  - The date and amount of each cash contribution.
  - The date, amount, name and address of each non-cash contributor.
  - The name and address of each employee or agent involved.
  - Documentation of all revenue received and expenses incurred.
  - For each account into which the fundraiser deposited revenue, the account number and name and location of the bank or other financial institution in which the account was maintained.

Charities, Commercial Fundraisers, Fundraising Counsels, Unincorporated Associations and Trusts with Questions About the New Law Can Contact  
The Attorney General's Charitable Trust Staff by e-mail:

[belinda.johns@doj.ca.gov](mailto:belinda.johns@doj.ca.gov) - Deputy Attorney General Belinda Johns

[james.cordi@doj.ca.gov](mailto:james.cordi@doj.ca.gov) - Deputy Attorney General James Cordi

**SAMPLE**  
**Compensation Committee Charter**

**Compensation Committee Purpose:**

The Compensation Committee is charged with the responsibility to recommend to the full board on an annual basis the appropriate compensation for the Executive Director/CEO and the total compensation strategy for [Name of Organization.]. The Compensation Committee is created by a board resolution and its composition is reviewed annually and approved by the full board.

**Membership:**

The Committee shall be composed of at least two (2) members who are independent of and not compensated by [Name of Organization.]. If the Chair of the board is not a member, the Chair may attend meetings of the Committee and vote on Committee actions.

**Authority and Responsibility:** The board grants the Committee authority and responsibility to:

1. [Approve][Recommend to the full board] the compensation strategy of [Name of Organization.], consistent with the organization's mission and values.
2. Review management proposals regarding [Name of Organization.]'s compensation and benefits programs to ensure such programs support the established strategy.
3. Review comparable compensation and benefits data of similar organizations and make recommendations to the full board based on that review.
4. With input from the [Board][Executive Committee][Personnel Committee of the Board] regarding the performance of the Executive Director/CEO, recommend the Executive Director's/CEO's compensation package for approval by the full board.
5. [Approve][Recommend to the full board] the compensation of other senior staff and consultants who report directly to the Executive Director/CEO [who are considered highly compensated and whose compensation is reported on the organization's annual Form 990 to the IRS as "key employees.]
6. [Approve][Recommend to the full board] strategies and plans for merit pay/incentives/severance pay and other unusual compensation arrangements that may arise.
7. Regularly report to the full board on its activities.
8. Annually review the Compensation Committee charter and recommend any changes to the full board.

Report is available at the following  
address:

[http://www.charitynavigator.org/\\_\\_asset\\_\\_/studies/2010\\_CEO\\_Compensation\\_Study\\_Revised\\_Final.pdf](http://www.charitynavigator.org/__asset__/studies/2010_CEO_Compensation_Study_Revised_Final.pdf)

# CHARITY NAVIGATOR

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## 2010 CEO Compensation Study

August 2010



## Introduction

Charity Navigator has completed its sixth annual CEO Compensation Study. This year's study examined the compensation practices at 3,005<sup>1</sup> mid to large sized U.S. based charities that depend on support from the public. Our analysis revealed that the top leaders of these charities earned a median salary of \$147,273<sup>2</sup> in 2008 representing a pay raise of 4.7% over the previous year.

We know from the conversations taking place in the comment section of our charity ratings pages that many donors continued to be concerned by what they believe to be excessive charity CEO pay. Many donors assume that charity leaders work for free or minimal pay and are shocked to see that they earn six figure salaries. But these well-meaning donors fail to consider that these CEOs are running multi-million dollar operations that endeavor to change the world. Leading one of these charities requires an individual that possesses an understanding of the issues that are unique to the charity's mission as well as a high level of fundraising and management expertise. Attracting and retaining that type of talent requires a competitive level of compensation as dictated by the marketplace. While there are nonprofit salaries that we would all agree are out-of-line, it is important for donors to understand that since the average charity CEO earns roughly \$150,000, a six-figure salary is not necessarily a sign of excessive pay for a mid to large sized charity.

This report offers insight into how a charity's mission, size, and location impact its CEO's salary. It also highlights some questionable salaries, such as those that approach and exceed a million dollars, and suspect compensation policies, such as charities that have multiple highly-paid family members on staff. We round out the report by offering advice for judging the appropriateness of a nonprofit executive's pay.

### Footnotes

<sup>1</sup>Data from the 2010 study is based on the financial data provide on their FYE 2008 Forms 990 by 3,005 charities in Charity Navigator's database of 5,500 charities. For more information on what types of organizations Charity Navigator evaluates, please click [here](#). Also, read the appendix to learn which charities were excluded from the study.

<sup>2</sup>Based on the data found in each charity's most recently filed Form 990, we include salary, cash bonuses, and expense accounts when we measure a CEO's compensation. We do not include contributions to benefit plans or deferred compensation that is allocated to be paid in later years. Deferred compensation is often accrued over many years and then is paid as a lump sum in one year. As such, we do include deferred compensation as part of the compensation figure in the year in which it is actually paid out to the employee.

## Methodology

This year we refined our methodology to improve the quality of information that we provide to donors, regulators and to the nonprofit community. We want to thank our pro bono advisor, [Pete Smith](#), for his assistance in making this our most precise report to date.

## Median versus Mean

In the past, this study focused on the mean value of CEO pay. This year, we decided to look at the median. In contrast to the mean, which is a simple average, the median is the middle value of a set of numbers such that in this report half of the salaries are higher and half are lower than the median figure. The median is less sensitive to extreme salaries than the mean and is a more representative figure of the center of a series of salaries.

## Exclusions

To paint a more accurate picture of the compensation landscape among mid to large public charities, we eliminated a number of charities from our sample (see the Appendix for more information on exclusions). Instead of looking at all 5,500 charities in our database, we've restricted our analysis to 3,005 charities which is still the largest sample of its kind and ample data to draw some significant conclusions.

## Comparisons to Prior Studies


Changes made to the 2010 study make it impossible to draw comparisons to prior iterations of this report. However, in this report, we are able to offer valid and insightful comparisons between 2008 and 2007 compensation levels.<sup>3</sup>


### Footnotes

<sup>3</sup>We re-evaluated our 2007 data, using the same methodology as this year, to make some meaningful comparisons.

## Geography

Just like the for-profit sector, salaries at nonprofits differ based on the part of the country in which the entity is located. Here's how the median pay for the various regions compare to the overall median pay (\$147,273):

 **Higher CEO Pay:** Northeast (\$185,000) and Mid-Atlantic (\$164,575)

 **Lower CEO Pay:** Mountain West (\$108,000), South (\$128,678), Southwest (\$130,505), Midwest (\$139,012) and Pacific West (\$139,066).



In comparison to last year's data, each region experienced an increase in median pay. Median pay increased the most in the Mid-Atlantic (5.5%) and the least in the Mountain West (3.7%).

Region	2008 Median Salary	# of Charities	Median Raise	Median Total Expenses
Mid-Atlantic	\$164,575	443	5.5%	\$5,247,075
Midwest	\$139,012	490	4.2%	\$5,990,281
Mountain West	\$108,000	107	3.7%	\$3,752,524
Northeast	\$185,000	645	5.1%	\$6,807,934
Pacific West	\$139,066	543	4.1%	\$4,934,564
South	\$128,678	525	4.4%	\$4,954,985
Southwest	\$130,505	252	4.9%	\$4,822,989
<i>Grand Total</i>	<i>\$147,273</i>	<i>3,005</i>	<i>4.7%</i>	<i>\$5,321,963</i>

## Geography (cont.)

### Location and Size

This year, in response to requests from Board compensation committees and others who use this study as part of their benchmarking analysis, we drilled down further to examine the variation that occurs not just by location, but also by size.<sup>4</sup> We determined that regardless of size, charities in the Northeast have the highest median pay and charities in the Mountain West have the lowest.

-  **Highest CEO Pay is in the Northeast** for small (\$120,000), medium (\$178,620) and large (\$351,539) charities
-  **Lowest CEO Pay is in the Mountain West** for small (\$80,790), medium (\$120,000) and large (\$194,374) charities


Region	Size					
	Large		Medium		Small	
	Median Salary	# of Charities	Median Salary	# of Charities	Median Salary	# of Charities
Mid-Atlantic	\$300,000	121	\$172,500	165	\$105,530	157
Midwest	\$255,861	144	\$152,737	173	\$84,215	173
Mountain West	\$194,374	20	\$120,000	37	\$80,790	50
Northeast	\$351,539	210	\$178,620	246	\$120,000	189
Pacific West	\$267,048	121	\$155,442	207	\$95,939	215
South	\$269,057	129	\$145,701	184	\$91,750	212
Southwest	\$229,009	54	\$139,925	100	\$90,555	98


#### Footnote

<sup>4</sup>Size is defined by total expenses such that small are charities with total expenses <\$3.5 million, medium charities are those with total expenses between \$3.5 and \$13.5 million and large charities have total expenses >\$13.5 million.

## Charitable Mission

The compensation a CEO receives depends, in part, on the types of programs and services offered by the charity. And the difference in pay across categories can be significant. For example, the median CEO pay at an educational institution is \$182,645 more than that paid to the typical religious leader. Here's how the median pay for the various categories compare to the overall median pay (\$147,273):

 **Higher CEO Pay:** Education (\$272,645), Arts, Culture and Humanities (\$190,550), Public Benefit (\$168,490)


 **Lower CEO Pay:** Religion (\$90,000), Animals (\$106,030), Environment (\$120,000), Human Services (\$122,082), International (\$136,771) and Health (\$144,080)


In comparison to last year's data, each region experienced an increase in median pay. Median pay increased the most among Education (5.9%) charities and the least among Religious (1.0%) charities.

Category	2008 Median Salary	# of Charities	Median Raise
Animals	\$106,030	210	5.0%
Arts, Culture, Humanities	\$190,550	415	4.8%
Education	\$272,645	300	5.9%
Environment	\$120,000	187	4.1%
Health	\$144,080	331	5.3%
Human Services	\$122,082	614	4.5%
International	\$136,771	274	5.3%
Public Benefit	\$168,490	485	4.5%
Religion	\$90,000	189	1.0%

## Size

Not surprisingly, there is a predictable relationship between the size of a charity and the CEO's salary - the larger the charity the higher the median pay. Here's how the median pay for the various sizes of charities compare to the overall median pay (\$147,273):

 **Higher CEO Pay:** Large organizations with total expenses greater than \$13.5 million (\$280,000) and medium sized charities with total expenses between \$3.5 and \$13.5 million (\$157,056)

 **Lower CEO Pay:** Small charities with total expenses under \$3.5 million (\$95,481)

Size	2008 Median Salary	# of Charities	Median Raise
Large	\$280,000	799	6.0%
Medium	\$157,056	1,112	4.4%
Small	\$95,481	1,094	3.9%

These figures demonstrate that as the size, and thus the complexities of running a non-profit increases, so does the salary of the institution's top executive. So much so that if we probe deeper into the top tier of charities (by size), we see even larger salaries. Charities with total expenses of \$13.5 million and greater pay their CEOs in the range of a quarter million dollars to almost three quarters of a million dollars. In illuminating this information, it is not our intention to give donors, who often bemoan this level of pay, a reason to not support a great charity. Rather, we want donors to understand and appreciate that the top nonprofit leaders, those who are sought after for their ability to manage multi-million dollar institutions and who are tasked with the mammoth goal of making the world a better place, command significant salaries. On the other hand, it is evident that seven-figure salaries do not seem warranted, even in the largest sized charities.

Size	2008 Median Salary	# of Charities
\$13.5 - \$25 Million	\$211,899	266
\$25 - \$50 Million	\$265,005	229
\$50 - \$100 Million	\$336,104	139
\$100 - \$200 Million	\$378,942	81
\$200 - \$500 Million	\$429,754	46
Over \$500 Million	\$695,379	38

## Biggest Paychecks

Some CEO salaries raise more eyebrows than others. The following list reveals which charity within each category pays its CEO the most. For context and comparison purposes, the table includes the median pay for each category as well as the total expenses for the charity with the highest salary in each category.

Category	Median Pay/ Category	Highest Compensa- tion	Charity Name	Total Expenses	Supplemental Information Provided By Charity on Form 990
Animals	\$106,030	\$725,485	Wildlife Conservation Society	\$197,389,730	Base compensation: \$503,927; Expense account and other allowances: \$221,558 which includes estimated value of housing provided as condition of employment
Arts, Culture, Humanities	\$190,550	\$2,649,540	New York Philharmonic	\$65,067,908	Base compensation: \$850,000 plus distribution of deferred compensation (includes contri- butions and earnings on such amounts)
Education	\$272,645	\$2,049,976	Evans Scholars Foundation	\$15,216,197	Base compensation: \$195,000; Bonus & incentive compensation: \$160,000; Other compensation: \$1,694,976 which consists of one time distribution of deferred compensation.
Environment	\$120,000	\$454,125	Conservation International	\$135,290,726	
Health	\$144,080	\$1,024,776	The Scripps Research Institute	\$364,666,641	

(chart continues on next page ⇨)

## Biggest Paychecks (cont.)

Category	Median Pay/ Category	Highest Compensa- tion	Charity Name	Total Expenses	Supplemental Information Provided By Charity on Form 990
Human Services	\$122,082	\$661,634	YMCA of Greater Houston	\$109,098,649	
International	\$136,771	\$683,014	Foreign Policy Association	\$4,604,348	
Public Benefit	\$168,490	\$947,999	The Heritage Foundation	\$64,645,625	Base compensation: \$413,856; Bonus & incentive compensation: \$521,300; Other compensation: \$12,843
Religion	\$90,000	\$648,537	Educational Media Foundation	\$68,990,148	Base compensation: \$320,414; Bonus & incentive compensation: \$85,231; Other compensation: \$242,892; Additional Note: CEO received non-fixed bonus as part of compensation.

While this list is sure to astound many donors, salaries really should be judged in the context of the charity's overall performance.

## Biggest Paychecks (cont.)

### Seven Figure Salaries

Of the 3,005 charities included in the study, 14 paid their top executive more than \$1 million. Those charities range in total expenses from \$13.5 million to \$3.5 billion. This list is comprised of 8 Education charities, 5 Arts, Culture, Humanities charities and 1 Health charity.

### Half A Million In Pay

The study also revealed that 106 charities paid their CEOs between \$500,000 and \$1 million. Total expenses among these organizations ranges from \$3.8 million to \$3.6 billion. This group consists of 47 Education charities, 24 Arts, Culture, Humanities charities, 13 Public Benefit charities, 8 Health charities, 7 Human Services charities, 3 International charities, 3 Animal charities and 1 Religion charity.

## Other Salaries of Note

### Organizations that Compensate Relatives over \$100,000

When relevant, our charity reports also include information on salaries paid to top executives and Board Directors, not just the CEO. For example, there are a number of charities that have members of the same family on the payroll. Here are some of the organizations that compensate at least two of the CEOs relatives, with at least one relative earning over \$100,000.

Charity	Person	Title	Relationship	Salary
American Endowment Foundation	Philip T. Tobin	President, Chairman, Co-Founder	CEO	\$134,620
	Thomas Tobin	Executive Vice President, COO, Co-Founder	Relative of the CEO	\$111,300
	John Tobin	Executive Vice President	Relative of the CEO	\$111,300
	Gail Tobin	Treasurer	Relative of the CEO	\$84,800
Christian Relief Services Charities	Paul Krizek	Executive Director/ General Counsel	CEO	\$151,800
	Eugene Krizek	President, Founder	Relative of the CEO	\$152,100
	Bryan Krizek	Vice President of Housing	Relative of the CEO	\$166,600
Feed The Children <sup>5</sup>	Larry Jones	President	CEO	\$258,562
	Frances Jones	Executive Vice President	Relative of the CEO	\$205,347
	Larri Sue Jones	Vice President	Relative of the CEO	\$167,520

(chart continues on next page ⇨)

#### Footnote

<sup>5</sup>Larry Jones was terminated from Feed The Children in November of 2009. His daughter, Larri Sue Jones, was fired in August of 2010. At the time of this report's publication, Frances Jones, Larry Jones' wife, was still employed by the charity.

## Other Salaries of Note

### Organizations that Compensate Relatives over \$100,000 (cont.)

Charity	Person	Title	Relationship	Salary
Hosanna/Faith Comes By Hearing	Gerald Jackson	President	CEO	\$76,837
	Morgan Jackson	International Director	Relative of the CEO	\$116,147
	Clay Jackson	Secretary, Treasurer	Relative of the CEO	\$110,934
Messenger International	John P. Bevere Jr.	President, CEO	CEO	\$299,407
	Lisa Bevere	Vice President	Relative of the CEO	\$128,695
	Addison Bevere	Manager	Relative of the CEO	\$75,978
Pediatric Brain Tumor Foundation	Mike E. Traynor	President	CEO	\$138,544
	Dianne Traynor	Secretary, CFO	Relative of the CEO	\$103,254
	Brian Traynor	Executive Director	Relative of the CEO	\$109,167
Trinity Broadcasting Network	Paul F. Crouch Sr.	President, Director	CEO	\$419,500
	Janice Crouch	Vice President, Director	Relative of the CEO	\$361,000
	Paul Crouch	Vice President, Director	Relative of the CEO	\$214,137
	Ruth Brown	Secretary, Treasurer	Relative of the CEO	\$98,780
Turning Point	David P. Jeremiah	President, CEO	CEO	\$107,038
	David Jeremiah	Vice President, Director	Relative of the CEO	\$185,867
	Donna Jeremiah	Secretary, Director	Relative of the CEO	\$63,965

## Conclusions

While it is true that the paychecks of some nonprofit executives are outrageously high, this study confirms that those receiving excessive pay are in the minority. The data also shows that top pay at charities can vary greatly by location - with CEOs in the Northeast typically earning \$77,000 more than their peers in the Mountain West - by mission - with the heads of Education charities earning \$182,645 more than those running Religion charities - and by size - with CEOs managing large charities earning \$184,510 more than those at small charities. Finally, the study shows that with a 4.7% median increase in pay from 2007 to 2008, the beginning of the recession appears to be having a minor effect on raises.

We recognize that many donors will be hesitant to agree that the CEO of their favorite charity deserves a six figure salary. To the skeptics, we ask that you keep in mind that most of the charities included in this study are multi-million dollar operations. Leading one of them requires an individual that possesses both an understanding of the issues that are unique to the charity's mission as well as extensive management and fundraising expertise. Even so, charities tend to pay less than private sector firms for similar competencies. For example, the charities in our study pay a median total compensation of roughly \$150,000, compared to median salaries at S&P 500 companies of \$1 million, excluding bonus packages and stock options that drive the median compensation up to \$6.6 million.<sup>6</sup>

### Footnote

<sup>6</sup>To view USA Today and the Associated Press complete study, please click [here](#).

## Appendix

### Advice for Donors

We offer the following tips to help you critique the compensation of a charity's top leader.

1. ***Obtain comparison data.***

Use the information provided in this study to compare a CEO's salary to other similarly sized charities, as well as those in the same category and region. Our 2010 [Metro Market Study](#) provides median CEO salaries for 30 large cities. [Charity Navigator registered users](#) can compare the CEO salaries of specific charities on their "My Charities" page and on each charity's rating page by clicking on the "Compare These Charities" link. Registered users can also access Charity Navigator's [Sector Analysis Tool](#) to calculate the *average* CEO pay by cause and state.

2. ***Find out if the charity has a Compensation Committee.***

Drawing on its experience in investigating charities, the IRS recently redesigned the Form 990 (the informational tax return that charities must file annually and the document that Charity Navigator utilizes to obtain the necessary data to rate each charity) to provide more transparency regarding executive compensation practices. At Charity Navigator we agree with the IRS that it is important for each charity to conduct an independent review of its CEO's pay using comparative data. As such, we have included this as part of our newly launched [Accountability & Transparency Methodology](#). Within the year, we will publish this information for each of the 5,500 charities in our database. If the charity you are considering has not yet been reviewed for Accountability & Transparency, then we encourage you to contact the charity to inquire if it has a compensation committee in place and how it makes salary decisions.

3. ***Be cautious if the charity has given the CEO a loan.***

If a charity's top leader received a loan, then you may want to think twice about supporting that charity. We maintain that a charity isn't in business to provide low or no-interest loans so its CEO can move into an exclusive neighborhood or purchase a new, luxury car. If the CEO's compensation is reasonable, then why does he/she require a discount loan to work for that charity? Therefore, this information will be included among the new Accountability & Transparency information that we will track for all 5,500 charities in our database.

4. ***Consider the performance of the charity in relation to the CEO's pay.***

If you come across a charity whose CEO pay is higher than other similar charities, don't immediately dismiss that charity's request for funding. You're better off supporting a charity that is fiscally efficient, accountable and transparent, achieving its programmatic goals and paying its CEO well, than a charity that has substandard fiscal health, fails to live up to its mission, but under-pays its CEO. Charity Navigator's financial ratings and new Accountability & Transparency data can be of help in your research.

## Appendix (cont.)

### Advice for Donors

5. ***Be skeptical of charities that report zero CEO compensation.***

There are very few individuals that can afford to work full-time managing complex, multi-million dollar organizations without receiving any compensation. If a charity you are considering reports no salary for its CEO, then we recommend you contact it directly- using the information we provide- to learn how it has been able to attract and retain a competent leader without paying that individual. It might have a legitimate answer. However, it may be that the charity failed to appropriately report the CEO's salary to the IRS or respond to our analysts' requests for that data.

### Advice for Charities

We are not alone in recommending that charity Boards include an independent compensation committee which is responsible for reviewing the CEO's performance and ensuring that the CEO's pay is appropriate. We offer this report and the other tools available on our free website as a starting point in that committee's endeavors to set a reasonable level of pay. But this study should not be a substitution for hiring an outside expert to conduct a compensation study.

## Appendix (cont.)

### Exclusions

Charity records that were excluded from this study include:

- **Fiscal Year Ends**—This study examines CEO compensation for charities in Charity Navigator’s database that have Forms 990 for the fiscal year ending 2008 .
- **No CEO Reported**– The organization either did not report any leadership information on its most recently filed Form 990 or it only reported the board of directors (no compensated staff).
- **No Compensation Reported** – Although there are a few actual volunteer CEOs that receive no pay, the current process by which we collect data precludes us from identifying which charities have nonpaid CEOs versus those that simply failed to report compensation on their Form 990. In the future, we may be able to isolate each group and offer some analysis on volunteer CEOs.
- **Affiliate Pay** – Some charities pay their leaders through multiple affiliated organizations. In these cases, we do publish the affiliate pay on the charity’s ratings page. However, we’ve excluded those records from this study, since we currently can not confirm how much of the affiliate pay is compensation for the CEO position as opposed to a separate job.
- **Older Data** – This study excludes the few charities in our database whose most recent financial data is from their fiscal year ending 2007 or earlier.
- **Prior or Interim CEO** – If the organization reported a prior or an interim CEO on the current Form 990, then there is a good chance that the current CEO served a partial term with partial pay. Including such records would skew the data towards lower pay and would be less accurate. So we have excluded these records.
- **New CEO with Lower Salary** – Similarly, if the current CEO is different than the prior CEO and has a salary at least 20% lower, we assume that there’s a good chance that the current CEO served a partial term and thus didn’t receive a full year’s pay. Again, we exclude these records so as not to skew the data to lower pay.

**Part VI Governance, Management, and Disclosure** For each "Yes" response to lines 2 through 7b below, and for a "No" response to line 8a, 8b, or 10b below, describe the circumstances, processes, or changes in Schedule O. See instructions.

**Section A. Governing Body and Management**

		Yes	No
<b>1a</b>	Enter the number of voting members of the governing body . . . . .		
<b>1b</b>	Enter the number of voting members that are independent . . . . .		
<b>2</b>	Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee? . . . . .		
<b>3</b>	Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors or trustees, or key employees to a management company or other person? . . . . .		
<b>4</b>	Did the organization make any significant changes to its organizational documents since the prior Form 990 was filed? . . . . .		
<b>5</b>	Did the organization become aware during the year of a material diversion of the organization's assets? . . . . .		
<b>6</b>	Does the organization have members or stockholders? . . . . .		
<b>7a</b>	Does the organization have members, stockholders, or other persons who may elect one or more members of the governing body? . . . . .		
<b>7b</b>	Are any decisions of the governing body subject to approval by members, stockholders, or other persons? . . . . .		
<b>8</b>	Did the organization contemporaneously document the meetings held or written actions undertaken during the year by the following:		
<b>8a</b>	a The governing body? . . . . .		
<b>8b</b>	b Each committee with authority to act on behalf of the governing body? . . . . .		
<b>9</b>	Is there any officer, director, trustee, or key employee listed in Part VII, Section A, who cannot be reached at the organization's mailing address? If "Yes," provide the names and addresses in Schedule O . . . . .		
<b>9a</b>			

**Section B. Policies** (This Section B requests information about policies not required by the Internal Revenue Code.)

		Yes	No
<b>10a</b>	Does the organization have local chapters, branches, or affiliates? . . . . .		
<b>10b</b>	b If "Yes," does the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with those of the organization? . . . . .		
<b>11</b>	Has the organization provided a copy of this Form 990 to all members of its governing body before filing the form? . . . . .		
<b>11A</b>	Describe in Schedule O the process, if any, used by the organization to review this Form 990.		
<b>12a</b>	Does the organization have a written conflict of interest policy? If "No," go to line 13 . . . . .		
<b>12b</b>	b Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts? . . . . .		
<b>12c</b>	c Does the organization regularly and consistently monitor and enforce compliance with the policy? If "Yes," describe in Schedule O how this is done . . . . .		
<b>13</b>	Does the organization have a written whistleblower policy? . . . . .		
<b>14</b>	Does the organization have a written document retention and destruction policy? . . . . .		
<b>15</b>	Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?		
<b>15a</b>	a The organization's CEO, Executive Director, or top management official . . . . .		
<b>15b</b>	b Other officers or key employees of the organization . . . . .		
	If "Yes" to line 15a or 15b, describe the process in Schedule O. (See instructions.) . . . . .		
<b>16a</b>	Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year? . . . . .		
<b>16b</b>	b If "Yes," has the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements? . . . . .		

**Section C. Disclosure**

- 17** List the states with which a copy of this Form 990 is required to be filed ► .....
- 18** Section 6104 requires an organization to make its Forms 1023 (or 1024 if applicable), 990, and 990-T (501(c)(3)s only) available for public inspection. Indicate how you make these available. Check all that apply.  
 Own website     Another's website     Upon request
- 19** Describe in Schedule O whether (and if so, how), the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.
- 20** State the name, physical address, and telephone number of the person who possesses the books and records of the organization: ► .....

THE NEWSLETTER OF THE BDO NONPROFIT & EDUCATION PRACTICE

# NONPROFIT STANDARD

## BUYER BEWARE: ALTERNATIVE INVESTMENT COMPLIANCE AND TAX ISSUES

By R. Michael Sorrells, CPA



**W**ith the promise of greater investment yields, many nonprofit organizations are jumping on the bandwagon and investing in an array of alternative investments, many of which derive income from offshore sources. Such investments include partnerships, limited liability companies (LLCs), hedge funds, funds-of-funds and other similar entities.

Alternative investments can lead to both unrelated business income tax (UBIT) and significant additional filing requirements even when there is no tax liability. These additional filing requirements have to be taken very seriously as there are significant penalties for not filing.

### ► TAXATION

Any investment (not related to the organization's exempt purpose) that is purchased with borrowed funds may be subject to the debt-financed income rules. Under these rules, passive income that is normally excluded from UBIT (such as interest, dividends, royalties and rent) becomes at least partially taxable if there is acquisition debt on the part of the nonprofit organization. Acquisition debt can occur if the organization borrows to make the investment or, in the case of a pass-through entity, if the "fund" has borrowed to purchase an income-producing asset (most commonly real property). This is true regardless of whether the income is foreign or domestic.

► Read more on next page

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▶CONTINUED FROM PAGE 1

## BUYER BEWARE

Many alternative investment funds are organized as U.S. partnerships or LLCs. Thus, the partnership or LLC pass-through income is taxed at the organization level (on its distributive share as reported on Form K-1) and not at the partnership or LLC level. If the partnership has borrowed funds to finance its operations, it will likely generate debt-financed UBIT as discussed above. Any K-1s from U.S. partnerships or LLCs should be carefully analyzed to ascertain if UBIT is being passed through to the partner or member. UBIT is required to be reported to nonprofit partners or members, but sometimes the partnership return preparer is not aware of the UBIT rules or does not even realize that the partner or member is a tax-exempt organization (there is a box on the K-1 which should identify what kind of organization the partner or member is; if it says anything other than tax-exempt organization, careful scrutiny is required to determine if there is UBIT). Partnerships and LLCs may also have UBIT sourced from states other than the nonprofit's state of domicile, which may require filing income tax returns and payment of tax to multiple jurisdictions (*see the article entitled "State Tax Liability for Alternative Investments" on page 3*).

Some funds are structured as corporations which then invest in domestic or foreign partnerships. Corporations pay dividends to investors and do not pass through items of income with various characteristics as partnerships and LLCs do. Dividend income is not generally taxable to nonprofit organizations and the debt-finance income rules do not come into play unless the nonprofit has borrowed to make the investment. Typically, many funds invest in foreign partnerships but through the intermediary of a foreign corporation which effectively blocks the UBI from passing directly through to the nonprofit investor (all income is nontaxable dividends).

Some foreign corporations are classified under U.S. law as passive foreign investment companies (PFICs). This is generally the case when 75% or more of the gross income is passive or, if the average percentage of assets held by the corporation which produces passive income is 50% or more. PFICs may generate taxable income to for-profit investors but generally not to nonprofits unless the

income is unrelated business income (which it generally is not, since it is usually dividends or capital gains) or if the organization borrowed funds for the investment.

If foreign partnerships are invested in directly, the income is recognized in the year the partnership earns it. The fact that a nonprofit invested in a foreign partnership does not receive a K-1 does not excuse the organization from reporting any income whether or not it is distributed. Such income may or may not be UBIT, depending upon its characteristics.

### ▶POSSIBLE REQUIRED FORMS

Whether or not tax is generated by the alternative investment, there may be an onerous burden for the organization in terms of additional forms that generally are required to be attached to Form 990 or 990-T. There are very significant penalties for not filing these forms (**\$10,000 to \$100,000 per form**). Not filing most of these forms leaves the statute of limitations open for any year the form was not filed, so a non-compliant organization may be subject to these penalties (with interest added) if the IRS discovers the omission. The IRS is currently stepping up enforcement of these filing rules which in prior years were not such a high priority. Additionally, for 2010, the Form 990 Schedule F has been modified to ask specifically if the organization is liable for filing these forms. K-1 footnotes will usually contain significant information about many of these filings related to pass-through investments.

For organizations who are remiss in filing these forms, there is an **Offshore Voluntary Disclosure Initiative** available until August 31, 2011 for filing prior-year forms that were omitted. For most tax-exempt entities, there should be no penalties involved with filings under this program (although the work involved in gathering the information and preparing the filings may be extensive).

### Some of the Forms That May Be Required:

- **Form 926:** generally required for investments of \$100,000 or more in a foreign corporation, even if done through a partnership or LLC.

- **Form 8865:** generally required for purchase or sale of investments in foreign partnerships of \$100,000 or more.

- **Form 5471:** may be required if the organization owns 10% or more of a foreign corporation (directly or indirectly).

- **Form 8621:** may be required for investments in PFICs.

- **Form TD F90-22.1 Report of Foreign Bank Accounts (FBAR):** required for organizations and their officials with signatory authority. Even if the organization does not directly have a foreign account, it may be required if it controls an entity which has such an account. Unlike the above forms, the FBAR is not filed as an attachment to the 990 or 990-T. It is a separate filing due annually on June 30th.

### ▶CONCLUSIONS

The tax and reporting rules related to alternative investments are extremely complex. Organizations that are contemplating alternative investments should consider the tax consequences and reporting burdens of the specific investment carefully before making the investments. Organizations already invested in alternatives should take a careful look at their investments to determine if they have an unreported tax liability and to determine if all required filings were properly prepared and filed. This will generally require the assistance of tax professionals with expertise in international tax issues. If the required forms have not been filed, nonprofits should consider filing under the Offshore Voluntary Disclosure Initiative before it is too late.

For more information, contact Michael Sorrells, national director, Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).

# STATE TAX LIABILITY FOR ALTERNATIVE INVESTMENTS

## What you can do if you did not pay state taxes

By Laura Kalick, JD, LLM in Tax

**N**onprofit organizations that have adopted Accounting Standards Codification (ASC) 740-10 (FIN 48) have gone through the exercise of determining whether there are any material uncertain tax positions. This analysis should have been performed for all income tax positions at the federal, international, and state and local levels. The identification of tax positions should have taken into account all the open tax years, i.e., those years that would be subject to assessment by the taxing authorities. In general, for federal income tax purposes, the government has three years from the date a tax return is filed to go back to assess taxes. Otherwise, there is a statute of limitations on going back further unless there is a material understatement of tax liability, i.e., greater than a 25% understatement.

Most organizations have filed Forms 990 and 990-T and information and tax returns in their state of domicile. Also, most organizations are in compliance with state filings in states where they have a physical location and employees and it is clear that there is nexus in the state, i.e., that there are enough points of contact with the state that the state can claim jurisdiction over taxing the entity. On the other hand, organizations may not have been aware of state filing requirements that have arisen because of an ownership interest in a partnership or alternative investment that has activities and property in another state. *If an organization never filed a state tax return where one was required there is no statute of limitations on how many years the state can go back to assess taxes.* Also, if the state were to pursue the organization, in addition to the back taxes, there could also be significant interest and penalties.

Whether or not there is nexus through a partnership interest is not always clear cut and different states have different rules. If an alternative investment reports on a K-1 that there is unrelated trade or business income or loss in a particular state, an exempt organization should look into its reporting

responsibilities. This is true both when there is net income and if there is a net loss. If an organization never files a tax return, then a loss in one year cannot be used to offset income in another year.

An organization that has not filed a tax return that it should have filed may have to establish a reserve to take into account the liability. The reserve should take into account all the income earned when the organization held the investment and the interest and penalties associated with that liability. If the organization continues to not file returns, the reserve will keep growing. If the organization decides to rectify the situation by just filing returns in the future or even files returns for the last three years, this may be a serious "red flag" because now the state knows of the organization's existence and may pursue previous years and the related interest and penalties.

If there is potential liability in just one state, an organization could consider contacting that state in order to determine what the state will find acceptable. Their representative could even contact the state on a no-name basis. However, the potential problem is that unless the state has a written procedure indicating how many years' returns will be required, the amount of interest and whether penalties will be imposed, the organization is at the mercy of the state. Also, if there are multiple states where there is potential liability, contacting the states and getting an agreement can be a full-time job.

Fortunately, there is an alternative to continually carrying a reserve or revealing yourself to the taxing authorities and begging for mercy.

### ►MULTISTATE VOLUNTARY DISCLOSURE PROGRAM

The Multistate Tax Commission (MTC), an intergovernmental state tax agency working on behalf of states and taxpayers to administer the tax laws equitably and efficiently, has established a Multistate

Voluntary Disclosure (MVD) Program that allows a tax non-filer with potential liability in multiple states (including DC) to negotiate a settlement agreement regarding back liability on favorable terms through a single point of contact and a single, uniform procedure. The procedure does not determine whether nexus exists with respect to an organization, but the parties set that issue aside and come to an agreement for past non-filing and agree that filing will occur in the future.

The MTC does not charge for their services. An organization or its representative can have the MTC approach all the participating states on a no-name basis to reach an agreement. The agreement usually includes that the organization files and pays back tax and interest with respect to the prior periods or "lookback period;" the state(s) waives all penalty and tax prior to the lookback period and the organization will continue to file with the state(s) unless its nexus status changes. The identity of the organization is only revealed to the state(s) after a legally binding voluntary disclosure contract has come into force. The program is not available if the organization has already made "contact" with a state. "Contact" includes filing a return, paying a tax, and receiving an inquiry from the state regarding the type of tax at issue. So this means that an organization must come forward before it is too late.

All but six states participate in the MVD Program. For a full list of the states, see <http://www.mtc.gov/Default.aspx>.

BDO has assisted organizations in navigating through the MVD Program. Please contact Laura Kalick if you need further information or assistance.

For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at [lkalick@bdo.com](mailto:lkalick@bdo.com).

# NONPROFIT BOARD MEMBERS: PAID OR VOLUNTEER?



By Mike Conover

The propriety of pay for board members serving tax-exempt organizations is in the news again. While not a new topic (it has been raised at any number of points in past years), the sentiments of some opposed to the practice has intensified. Undoubtedly, the financial turmoil of recent years, the gloomy economy and the predictable appearance of excesses in executive pay, in for-profits and nonprofits alike, have all contributed to this opposition. The outcry from the public has, in at least one recent instance in Massachusetts, prompted pending legislation to prohibit the practice of compensating board members altogether.

This article explores the topic of compensation for board members of nonprofit organizations from a few different perspectives. The intent is to discuss some of the background factors associated with the topic and acquaint readers with some criteria that may be useful for a thoughtful, rather than a reflexive, decision about volunteer versus paid board members.

The general public's frequent and interchangeable use of the "nonprofit" designation with the "tax-exempt" designation gets things started on the wrong foot. All types of exempt organizations are then thought of as "charitable" and operating under an assumed "vow of poverty" versus being only a description of their tax status. It leads to suspicions about pay for any full-time staff member that makes more than \$\_\_\_\_ (note: the reader is free to insert the number of their choice here). Still worse, it can produce

outrage over board members getting anything more than a nice lunch and reimbursement of parking fees for their service.

Increased disclosure requirements for nonprofit organizations and continued media publicity of compensation levels have also played a part in the current situation. They have contributed to greater public awareness of pay levels, but not necessarily any understanding of the subject. To further complicate matters, media coverage often comes about in adverse circumstances. An organization's disappointing performance, discovery of a significant irregularity, departure of an executive or some combination of these events often gets the organization's board members (and their compensation) in the spotlight.

Public outrage predictably prompts a reflexive reaction from legislators and regulators. Eager to get out in front of the issue with constituents, these individuals quickly demonstrate determination to "do something" about the problem by proposing new laws and regulations that will "fix" it. Like the many constraints imposed on pay in the for-profit sector following the recent financial crisis, the nonprofit sector has experienced similar instances of increased disclosure requirements and regulation (i.e. Intermediate Sanctions, new Form 990, etc.). Massachusetts is now proposing legislation that would prohibit pay for board members in any exempt organization unless the state's Attorney General can be convinced with "sound justification" of the need for it.

In light of current circumstances, what should a nonprofit organization that pays its board members (or wants to) do? Opponents of the practice point out that a board member should serve out of a sense of community service or the mission of the organization in question. They cite statistics that show only a small percentage of exempt organizations offer board members pay. Some go on to explain that volunteer status ensures the board member's independence and ability to govern objectively because no pay is at stake. The case for, or against, board member pay in an exempt organization rests squarely on the strength of the business need for it. The fact that a particular organization always has paid board members or never has really falls short of the requirement for deciding the question one way or another. The explanation that "everyone else does it/doesn't do it" may be slightly more persuasive, but still falls short of a satisfactory answer.

Information from surveys or public filings about the prevalence of pay for nonprofit organization board members shows that only a small percentage of ALL nonprofit organizations do so. However, looking more closely at certain types and sizes of nonprofit organizations reveals the practice is far more prevalent and a growing one. As an example, more than 50% of large independent foundations (and many smaller ones) are offering pay to some or all of their board members. Other types of exempt organizations (i.e., some associations/trade groups, specialized service organizations, etc.) also have some instances of pay for board members.

The organizations offering pay for board members frequently cite several factors as the basis for doing so. At the top of the list in most cases is the need to attract, engage and retain outside expertise that is essential to fulfilling the mission of the organization. The expectations and the exposure for individuals serving on boards have increased significantly in recent years. Organizations committed to complex mission issues, stewarding

▶CONTINUED FROM PAGE 4

## NONPROFIT BOARDS

substantial financial resources and/or having complex structures cannot necessarily expect to obtain the outside expertise they require for board members from volunteers.

For example, a large private foundation may determine it is in the best interest of perpetuating its donor's bequest to secure significant involvement from a particular type of individual to serve as a board member. An individual with the required experience/expertise may be supportive of the organization's mission but unable to devote what is required on a strictly volunteer basis.

In other instances, nonprofit organizations may have an ample supply of qualified individuals willing to serve on a volunteer basis. It is interesting to note that these volunteer situations sometimes present their own set of challenges. There are, of course, those individuals who work tirelessly as volunteer board members and others who simply join the board for little more than "yearbook credit." Sometimes, no-show volunteers seriously impede an organization's ability to secure the outside expertise and independent advice it requires.

The answer to the question "Board pay or not?" seems, therefore, to lie in each exempt organization's commitment to a process that will define or affirm its own basis for the answer to this question. I would suggest the following steps as a way to arrive at the answer:

1. Develop a clear understanding of the specific role of a board member in the organization. This should be as specific as possible in terms of the experience and expertise sought, time commitment required, responsibilities/accountabilities, etc.
2. Evaluate the impact that compensation can/should play in retaining and engaging qualified individuals to fill the specified role.
  - a. Outside advisors/consultants can provide helpful information on competitive practices – prevalence and levels of pay for board members in similar situations
  - b. Input from significant stakeholders committed to the organization's mission

### INSTITUTE PROFESSIONAL PROFILE

## MEET MIKE CONOVER

Mike Conover is a senior director in BDO's Compensation and Benefits Practice. Based in our Boston office, he has more than 25 years of consulting experience, a significant portion of it devoted to work with a wide variety of nonprofit organizations. Mike's client experience includes service to hospitals, health plans, foundations, professional & trade associations, higher education institutions, private secondary schools and a variety of highly specialized organizations in the nonprofit sector.



The focus of Mike's consulting work is compensation and related human resource issues. Much of his work with nonprofit organizations is related to work with the boards of organizations on matters such as executive compensation, pay program governance & administration and IRS Intermediate Sanctions. His experience encompasses all aspects of compensation including competitive assessments, plan audits, plan design, board compensation, executive employment and severance arrangements, succession plans and performance management programs.

Mike is a frequent speaker and author on compensation. He is a former member of the board of directors of a successful internet company and was an elected town official for more than 10 years.

Mike has a B.A. degree in Psychology from Drew University in Madison, New Jersey.

3. Based on steps #1 & #2, develop a formal policy stating the organization's policy for a paid or volunteer board and, if board pay is adopted, a detailed description of the process that will be used to govern and administer board pay.
4. Keep the documentation associated with all the preceding steps and contemporaneous minutes of all meetings held to discuss and decide the organization's position on pay for board members.
5. On a regular basis, every two or three years, review the board pay policy and practices adopted to ensure they continue to be fully supportive of the organization's needs.

The process outlined above follows the guidelines offered in the IRS Intermediate Sanctions in order to afford an organization the "presumption of reasonableness" available

to those that comply with the process. These steps would appear to offer a nonprofit organization a path to determining the right course for it to follow in terms of the board member pay question. The information produced can also be extremely useful in communicating the organization's board pay policy. It works far better than a board member confronted with a street corner interview or telephone call from a reporter trying to develop a policy on the spot.

In many respects, the Intermediate Sanctions may be all the legislation/regulation needed to address the question of board pay for exempt organizations.

*For more information, contact Michael Conover, senior director, Specialized Tax Services – Compensation and Benefits, at [wconover@bdo.com](mailto:wconover@bdo.com).*

# INCENTIVES AND DISINCENTIVES FOR CONTRIBUTIONS



By Laura Kalick, JD, LLM in Tax

## WHEN A GIFT IS MADE TO A 501(c)(3) ORGANIZATION, THE DONOR IS ALLOWED A CHARITABLE CONTRIBUTION DEDUCTION. THE CHARITABLE CONTRIBUTION DEDUCTION IS A MAJOR INCENTIVE FOR CHARITABLE GIVING AND IS A SIGNIFICANT SOURCE OF FUNDING FOR CHARITABLE ORGANIZATIONS.

In fact, the Congressional Budget Office (CBO) recently issued a report called *Options for Changing the Tax Treatment of Charitable Giving* (see <http://www.cbo.gov/ftpdocs/121xx/doc12167/CharitableContributions.pdf>) which compared various options including deductions and credits for all taxpayers with and without floors. The study found that if the current deduction was converted to a 15 percent nonrefundable credit for all filers with a two percent of Adjusted Gross Income floor, that contributions to charities (measured in 2006

dollars) would be reduced by \$10 billion and at the same time, the tax subsidy by the Federal government would be reduced by \$24.6 billion, a significant impact.

Other nonprofit organizations do not have the benefit of the charitable contribution deduction in building up their coffers. And although trade associations that are exempt from tax under IRC Section 501(c)(6) may benefit by the business expense deduction their members may take for paying dues that are considered ordinary and necessary

business expenses, the portion of dues expended for lobbying or political activities cannot be deducted. An organization can either notify its members as to the portion of dues that is spent on lobbying or political activity or pay a “proxy tax” on that amount.

IRC 501(c)(4) organizations can lobby to an unlimited degree and can engage in political activities as long as that is not their primary purpose. It may be hard to make the case that a social welfare organization that is exempt under IRC 501(c)(4) is engaging in activities that would allow a donor to deduct a contribution or dues to the organization as an ordinary and necessary business expense. And clearly, a contribution to such an organization does not qualify for the charitable contribution deduction. Not only that, contributors to social welfare organizations may have to pay a gift tax on those contributions.

The IRS has a gift tax noncompliance project where they are reviewing donations to 501(c)(4) organizations. Although donors have annual gift tax exclusions and a lifetime exemption amount, in order to qualify for the exclusion or exemption, the individual must file a gift tax return.

In a separate initiative, the IRS is reviewing the activities of 501(c)(4) organizations in order to determine if those organizations are primarily involved in political activities and/or engaged in prohibited private benefit, both of which could cause the organizations to lose their tax-exempt status.

We will have to watch these IRS initiatives to see their future impact on nonprofit organizations.

For more information, contact Laura Kalick, national director, Nonprofit Tax Consulting, at [lkalick@bdo.com](mailto:lkalick@bdo.com).

# ISSUES IN CHARITABLE GIVING

By Paul E. Hammerschmidt, CPA, MS (Taxation) and Christina K. Patten

Some issues in charitable giving are outlined as follows:

## ► PARTIAL INTERESTS

Over the years some taxpayers have wanted to have their cake and eat it too. They've wanted to make a charitable contribution and still retain property rights that would entitle them to use the property. Taxpayers are subject to a significant number of restrictions that must be complied with before they are entitled to an income tax deduction for gifts of property to a charity. One of these restrictions generally provides that a taxpayer cannot take a charitable contribution deduction for a partial interest in property, i.e., a gift of less than his or her entire interest in the property [IRC Section 170(f)(3)(A)].

## ► FREE USE OF PROPERTY

Under this rule, taxpayers who permit a charity to use their property without a charge (or a minimal charge) are not entitled to a charitable contribution deduction because they are deemed to have made a contribution of a partial interest in property, which is a nonqualifying contribution. For example, a taxpayer who allows a charity to use space in an office building without charge cannot deduct the rental value of that property. Similarly, a generous donor that allows the charity to auction off the use of their vacation home for a week or two receives no deduction for the fair rental value of that property. In addition, the property owner is deemed to have personally used the property during this period for purposes of the restriction on the rental expenses being claimed if personal use exceeds the greater of 14 days or 10% of the number of days the home is rented at fair rental value.

## ► RECENT GIFT TO MIT FROM BOSE FOUNDER

In April 2011, Amar Bose, founder of audio technology company Bose Corp., donated most of the privately held firm's stock to Massachusetts Institute of Technology (MIT). MIT will receive annual cash dividends on

the shares when paid by Bose Corp. and use the payments "to sustain and advance MIT's education and research mission." Gift restrictions prevent MIT from selling the shares which don't carry voting rights in the company. MIT is also barred from participating in management and governance of Bose Corp.

While all the details of the gift are not yet available to the public, the concern among some professionals is that the restriction on MIT's ability to transfer the stock represents a contribution of a partial interest only and therefore is not deductible as a charitable contribution.

## ► FRACTIONAL INTEREST GIFTS

An exception to the partial interest rule is for contributions of an undivided portion of a taxpayer's entire interest in property. Regulations provide that a contribution of an undivided interest will only qualify for a charitable contribution deduction where the charity is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property contributed for the portion of each year that is equal to the organization's undivided interest in the property [IRS Reg 1.170A-7(b)(1)]. For example, if a taxpayer owns 100 acres of land and makes a contribution of 50 acres to a charitable organization, the charitable contribution is allowed as a deduction under Section 170.

This tenants-in-common interest was affirmed by the court (*Winokur v. Commissioner*, 90 TC 733, 4/21/1988). For example, a donor with a substantial art collection may be entitled to a charitable contribution deduction by donating a 10% interest of the collection in year one and an additional 10% in year two. The charity would have the right to possess the entire artwork collection for a number of days proportionate to its ownership interest. Gifts of art or other collectibles have been the most common types of fractional interest gifts. The rules for fractional interest gifts are somewhat complex and include limitations of the income tax deduction available for gifts of artwork.



## ► VALUE OF TIME OR SERVICES

A contributor cannot deduct the value of his or her time or services to a charity. No deduction is allowed for the value of income lost while working as an unpaid volunteer for the charity. A board member or attorney working pro bono, for example, may not deduct the value of their time in connection with services to a charity. These individuals are, however, entitled to a deduction for out-of-pocket expenses they incur in connection with their volunteer efforts for the charity. These expenses would be deductible by the volunteer as charitable contributions.

## ► OUT-OF-POCKET EXPENSES INCURRED BY VOLUNTEERS

A practical problem that has been presented by the statutory provisions relates to out-of-pocket expenses incurred by a taxpayer who does volunteer work for a charity. These expenses have always been deductible as contributions. These may include travel and transportation expenses. The problem is that the charity typically does not know about them.

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## CHARITABLE GIVING

The IRS Regulations provide that the substantiation requirements will be met if the taxpayer:

- Has adequate records to substantiate the amount of the expenses, and
- Obtains a statement from the donee organization describing the services that the taxpayer provided and indicating whether any goods or services were given in consideration (and, if so, their value). [Reg. 1.170A-13(f)(10)].

This means that a volunteer will have to provide the charity with a statement of the services performed so the charity can then acknowledge those services. The charity need not be advised of the amount of the expenses, but it must be informed of the nature of the work done by the taxpayer that required the expenditure (i.e., preparing letters, attending board meetings, entertaining prospective donors). This may seem like unnecessary paperwork but, unfortunately, it will be required if out-of-pocket expenses are to be deducted by the volunteer.

Also, note that a volunteer cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary to free the volunteer to do the work for the organization.

For more information, contact Paul E. Hammerschmidt, director, at [phammerschmidt@bdo.com](mailto:phammerschmidt@bdo.com) or Christina K. Patten, associate, at [cpatten@bdo.com](mailto:cpatten@bdo.com).

# FASB ASU 2011-04 AND ITS EFFECTS ON NONPROFIT ORGANIZATIONS

By Dick Larkin, CPA

**A**ccounting Standards Update (ASU) 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS* was issued to further conform the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) standards relating to fair value measurements. The IASB standards are referred to as International Financial Reporting Standards (IFRS). The principal remaining differences between the two sets of standards involve some terminology, and references to other standards, and matters that do not affect nonprofit organizations.

The following is not a complete summary of ASU 2011-04; rather, it lists those parts of the ASU that are specific to non-public entities – which include most nonprofit organizations. [Reminder: Some nonprofits are considered public entities, if they have conduit debt outstanding in the hands of the general public. See FASB Staff Position 126-1 (codified in Accounting Standards Codification (ASC) 825-10-50).]

ASU 2011-04 exempts non-public entities from the following requirements of ASU 2010-06, *Fair Value Measurements and Disclosures*:

### *Improving Disclosures about Fair Value Measurements:*

- A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements, and describe the reasons for the transfers; and
- From the following proposed requirements included in a draft ASU issued in June 2010 (which is the draft that was issued as ASU 2011-04), there are additional required disclosures, including:
  - Measurement uncertainty inherent in Level 3 inputs;
  - Categorization by input level of assets not reported at fair value (FV), but whose FVs are disclosed in notes (i.e., the disclosures that may be required by Statement of Financial Accounting Standards (SFAS) No. 107 (codified in ASC 825-10-50) for non-SFAS 124 (codified in ASC 958-320) securities).

The other proposed requirements in the June 2010 draft ASU are retained, including:

- Make terminology and clarifying changes to further converge U.S. and International accounting standards
- Clarify that the “highest and best use” concept would only apply to non-financial assets
- Provide guidance on measuring FV of an instrument classified in equity (not normally applicable to nonprofits)

- Provide additional flexibility for measuring FV of assets and liabilities managed in a portfolio on the basis of the entity's net exposure to a particular market risk (interest rate, currency, price) or credit risk of a counterparty
- Expand the prohibition against applying blockage factors at all input levels; and
- Require additional disclosures, including if an asset that is valued using a highest and best use basis, but is not actually being used that way.

ASU 2011-04 will become effective for annual periods beginning after December 15, 2011 - essentially for calendar 2012. Early adoption for annual periods is not permitted.

For more information, contact Dick Larkin, director, BDO Institute for Nonprofit Excellence<sup>SM</sup>, at [dlarkin@bdo.com](mailto:dlarkin@bdo.com).

# 2011 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED



By Tammy Ricciardella, CPA

## ON JUNE 1, THE OFFICE OF MANAGEMENT AND BUDGET (OMB) ISSUED THE 2011 CIRCULAR A-133 COMPLIANCE SUPPLEMENT (THE SUPPLEMENT) DATED MARCH 2011.

The Supplement is available on OMB's website at [http://www.whitehouse.gov/omb/circulars/a133\\_compliance\\_supplement\\_2011](http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2011) in both pdf and Word format. The full version of the Supplement is over 1,500 pages in length. You can download the entire Supplement or sections of the Supplement from the website. The Supplement is applicable to audits of fiscal years that begin after June 30, 2010 and supersedes the 2010 Supplement.

As in the past years, Appendix V lists the changes from the previous Supplement. There were 19 new programs added to the Supplement and five new programs added to the Student Financial Aid Cluster. There is also a summary of specific changes to programs listed by Catalog of Federal Domestic Assistance (CFDA) number. Throughout the Supplement, items that pertain to funds received under the American Recovery and Reinvestment Act (ARRA) are identified in boldface print.

*The following is a summary of some of the major changes from the 2010 Supplement.*

### **New Requirements for the Federal Funding Accountability and Transparency Act (FFATA) of 2006 and subsequent 2008 amendments**

One of the most significant changes to the Supplement is in Part 3, Compliance Requirements, for both Reporting and Subrecipient Monitoring. These sections have been modified to include the new compliance requirements and suggested audit procedures relating to FFATA. FFATA put into place a new federal reporting system for direct recipients of non-ARRA funds that requires the reporting of certain subawards. Under FFATA, a subaward is defined as a legal instrument to provide support for the performance of any portion of the substantive project or program for which a recipient received a grant or cooperative agreement award and that is awarded to an eligible subrecipient.

For grants and cooperative agreements, the effective date of FFATA was October 1, 2010, for all discretionary and mandatory awards equal to or exceeding \$25,000 with a new Federal Assistance Identification Number (FAIN) made on or after that date. A recipient must report each obligating action of \$25,000 in Federal funds for any subawards. The reporting is made to the FFATA Subaward Reporting System (FSRS) and is required to include the date of the subaward, subaward amount, subaward number and other details. The auditor will be selecting a sample of recipient payments for first-tier subawards to determine that all amounts reported are supported by documentation and to determine that the filing was completed in a timely basis.

### **Comparison of ARRA and FFATA Requirements**

The Reporting compliance requirement section in Part 3 also includes a new table that helps auditors distinguish for purposes of the OMB Circular A-133 audit the reporting requirements that apply to reporting by

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## 2011 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED

recipients under ARRA and those that apply to reporting under FFATA.

### Part 4 Applicability of FFATA Reporting

There is a new section entitled Subaward Reporting under the Transparency Act that is now included in each program and cluster in Part 4. This new section notes whether FFATA reporting is "applicable" or "not applicable." There are several reasons why FFATA reporting may not be applicable to a program and/or cluster, such as: (1) there are no subawards under the program, (2) the program is exempt because it is ARRA-funded, or (3) the program is not a grant or cooperative agreement. If you have programs or clusters with both ARRA and non-ARRA funding, the FFATA reporting only applies to the non-ARRA funds.

### Clarification Regarding ARRA Section 1512 Reporting

The Reporting section in Part 3 has been updated to clarify the requirements of the quarterly reporting requirement under Section 1512 of ARRA (Section 1512 reporting). OMB has clarified in the Supplement that when recipients do not have the actual expenditure amounts for the quarter within the 10 days allowed, they must use the "best available data" for the full quarter which can include estimates. So, if a recipient has two months of finalized data and the third month can only be estimated due to the timing of the reporting, this final month can be reported based on estimates. However, the recipient should have a process in place to review the reports they submitted and compare the estimated amounts to the actual finalized results, to determine if there are any material differences that would require that the report be corrected during the continuous correction period. If there are no material differences between the estimates used on the report submitted and the actual finalized results, the recipient does not have to correct a submitted report.

This clarification states that the "lag" method being used by some entities is not acceptable and if used would be considered a compliance finding. OMB did state that the finding would not be considered a material weakness or affect the compliance opinion and would not have questioned costs associated with the finding. The "lag" method is where a recipient

is using the finalized financial data from two months of the quarter but due to not having the final month closed due to the timing, they used the last month of the previous quarter.

### Clarification of Buy American Act Requirements

The Procurement and Suspension and Debarment compliance requirement in Part 3 has been modified to include additional information related to international agreements and the Buy American Act. Entities with funds that are used for purchases of iron, steel and other manufactured goods should review these clarifications.

### Update to Subrecipient Monitoring

The Subrecipient Monitoring compliance requirements in Part 3 have been updated to add the requirement that non-ARRA first-tier subrecipients must obtain DUNS numbers as part of eligibility for a subaward. The update also clarifies that for ARRA awards, a subrecipient is not required to be registered in the Central Contracting Registration (CCR) at the time of the award.

### Contacts for A-133 Audits

A table has been added to the Supplement that provides programmatic contact information for programs by CFDA number to obtain specific information about a federal program or its programmatic requirements. OMB notes that these are program contacts and they are not familiar with the nuances of A-133, so only programmatic questions should be posed to these individuals.

### Disaster Waivers

Appendix VI provides updated information on the waivers and special provisions granted by Federal agencies. Many of the waivers and/or special provisions are directed toward recipients affected by Hurricanes Katrina and Rita in 2005.

### Exclusion of Certain ARRA Programs from the Single Audit Requirement

Included in Appendix VII of the Supplement is a list of ARRA-funded programs that are not covered by the Single Audit requirements, and therefore, are not required to be included in the Schedule of Expenditures of Federal Awards (SEFA) or in the determination of

major programs. This appendix has also been updated to include a list of ARRA programs that are not covered in Parts 4 and 5 of the Supplement but that are potentially subject to an A-133 audit.

### ARRA Findings Requirements

Included in Appendix VII to the Supplement is a paragraph that notes that the details of findings reported for ARRA funds must include explicit identification of the applicable ARRA programs that are affected by the finding.

### Appendix VII Reminders

Appendix VII continues to follow the same guidance introduced in the 2010 Supplement regarding the effect of ARRA expenditures on the major program determination process and the fact that ARRA funds need to be separately identified in the SEFA and on the Data Collection Form. In addition, the clarification remains that an entity cannot be a low-risk auditee if they have not submitted their A-133 reporting package to the Federal Audit Clearinghouse within the nine-month time period. The OMB guidance that recommends that agencies not grant extensions to grantees is repeated again.

It is recommended that organizations review the 2011 Supplement for a full list of changes that may affect them and ensure they have complied with all the applicable compliance requirements.

For more information, contact Tammy Ricciardella, director, at [tricciardella@bdo.com](mailto:tricciardella@bdo.com).

# IRS TARGETING FRINGE BENEFITS FOR INTERMEDIATE SANCTIONS

By R. Michael Sorrells, CPA

According to an IRS tax-exempt official at a recent nonprofit conference, fringe benefits are the most common area in which the IRS is imposing intermediate sanctions under IRC Section 4958. This code section, which applies to 501(c)(3) public charities and 501(c)(4) social welfare organizations, can lead to very expensive excise taxes for organization executives and even members of the governing body in certain situations.

## ▶ TWO WAYS FRINGE BENEFITS CAN LEAD TO INTERMEDIATE SANCTIONS

First, when determining if compensation is reasonable and establishing the “rebuttable presumption of reasonableness” under the

IRC Section 4858 regulations, an organization must take into consideration the value of fringe benefits when calculating the total value of executive compensation. When fringe benefits are not added into the total compensation, then compensation may exceed a reasonable level and the rebuttable presumption may not be legitimate because it is not truly based on the total compensation package.

Secondly, the IRS can impose intermediate sanctions on “automatic” excess benefits. Automatic excess benefits are any compensation amounts which the executive receives that are not reported on either the organization's 990, the employee's W-2 or otherwise documented as approved compensation, i.e., in board minutes or the individual's employment contract. Thus, it is vitally important to account for and properly report all fringe benefits.

The IRS is currently conducting a three-year examination program in the area of employment taxes with some 500 exempt organizations being examined. Proper recording of fringe benefits is certainly going to be an area of interest in these examinations and automatic excess benefits could clearly be a target for improper recording.

Also, organizations should be very careful about their accountable expense reimbursement plans. Lack of proper documentation (receipts and expense reports) can cause a reimbursement to be considered a taxable fringe benefit. Periodic board reviews of CEO expense reimbursements can help assure that both expenses and reimbursements are appropriate.

*For more information, contact Michael Sorrells, national director, Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).*

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE<sup>SM</sup> IN THE NEWS

Members of the Institute are requested to speak on a regular basis at various conferences due to their recognized experience in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking.

### AUGUST

**Lee Klumpp** will be presenting an 8-hour course entitled “The 2011 Revised Yellow Book: Government Auditing Standards” for the Wisconsin Society of CPAs on August 22 in Brookfield, Wisconsin. Lee will also be presenting a course titled “Fraud in the Governmental and Not-for-Profit Environments: What a Steal!” on August 23 in Brookfield, Wisconsin.

### SEPTEMBER

On September 7, **Lee** will be presenting an 8-hour course titled “Top Twelve

Governmental and Nonprofit Accounting and Auditing Issues Facing CPAs” for the Maryland Association of CPAs in Columbia, Maryland.

**Dick Larkin** and **Lee Klumpp** will be presenting an all-day course entitled “Accounting Principles and Practices for Not-for-Profit Organizations” through PESI Law & Accounting in King of Prussia, Pennsylvania on September 16.

**Lee** will be conducting two sessions at the Wisconsin Society of CPAs Not-for-Profit Conference on September 19 in Waukesha, Wisconsin. Lee's sessions are “Advanced Nonprofit Accounting” and “Finance and Fundraising: Playing in the Same Sandbox.”

**Dick** will be presenting his nonprofit accounting and auditing update at the 41st Annual Virginia Accounting & Auditing

Conference in Roanoke, Virginia on September 26 and 27.

**Dick** will be conducting an all-day course titled “Accounting and Audit Update” for the Tennessee Society of CPAs in Memphis, Tennessee on September 29.

### OCTOBER

**Dick** will be presenting a webinar discussing nonprofit financial statements at the Evangelical Council For Financial Accountability on October 13.

**Dick** will be presenting his current update on nonprofit accounting and auditing issues at the VSCPA conference in Virginia Beach, Virginia on October 17 and 18.

**Mike Sorrells** will be teaching a course on Form 990 for the Maryland Association of Certified Public Accountants in Columbia, Maryland on October 17.

# GIFTS OF PROPERTY AND IRS FORMS 8282 AND 8283

By Sandra Feinsmith, CPA

## HAVE YOU RECEIVED A PHONE CALL FROM A DONOR REQUESTING THAT YOUR ORGANIZATION VALUE, COMPLETE AND SEND THEM FORM 8283 FOR THEIR NONCASH CONTRIBUTIONS TO SUBMIT WITH THEIR TAX RETURNS?

Perhaps a donor asked why you sent them a Form 8282 for property that they donated to the organization two years ago that the organization has since sold. Many nonprofit organizations receive questions regarding both the donor's and organization's responsibilities for the completion and filing requirements regarding Forms 8282 and 8283. In this article, we will give a brief overview of Section B of Form 8283 which is the section that is applicable to donee organizations and triggers the filing requirements for Form 8282. We will then discuss the donee organization's responsibilities regarding donors and filing Form 8282.

### ► FORM 8283

Form 8283, *Noncash Charitable Contributions*, is required to be completed when partnerships or individuals claim a noncash charitable contribution deduction in excess of \$500 on their respective tax returns or when a corporation claims a charitable deduction for a gift of property when the deduction is in excess of \$5,000. However, Form 8283 is only required to be *submitted* to the donee organization for signature when the donation is greater than \$5,000 and it consists of property other than publicly traded securities. It is the responsibility of the donor to complete all applicable sections of this form except for the Appraiser and Donee Acknowledgment sections. The form must be filed with the entity or individual's tax return

for the year the property was contributed and first claimed as a deduction.

Section B, Part I, *Information on Donated Property* of Form 8283 is required to be completed by the donor for noncash charitable contributions in excess of \$5,000. In addition, except for certain types of donated property, the donor is required to obtain a written appraisal from an independent appraiser. In certain instances, the donor will be required to attach the written appraisal to their tax return. Types of property included in this section and subject to appraisal include artwork, collectibles, real estate, qualified conservation contributions, equipment and nonpublicly traded securities. Information to be included in this section is a description of the property, an appraisal of fair market value (if appraisal was required), the date acquired by the donor, the donor's cost or adjusted basis, and the amount claimed as a deduction.

Section B, Part II is the *Donor Statement*. This section is to be completed by the donor for each item included in Section B, Part I that has an appraised value of \$500 or less. It is important that the donor clearly identifies these types of items for the donee organization in Part II because the donee is then not required to file Form 8282, *Donee Information Return* (see below) for any items valued at \$500 or less.

Section B, Part III of Form 8283 is the *Declaration of Appraiser*. This is the section that is completed by the appraiser of the property. The appraiser declares in this section that they are not a party to the transaction and meet the requirements to be considered a qualified appraiser.

Part IV of Form 8283 is the *Donee Acknowledgement*. As mentioned earlier, this is the section of the form that the donee nonprofit organization is required to complete and return to the donor. Please note that the donor is only required to complete Part I of Section B regarding the name, identifying number, and description of the donated property and Part II of Section B, if applicable, before submitting the form to the donee organization.

The purpose of this section of the form is to document (1) that the organization acknowledges that it is a qualified organization under the Internal Revenue Code and, (2) the date the property was received by the organization. The form must be signed by an official of the organization authorized to sign the tax returns of the organization. After the organization signs and returns the form to the donor, the donor must complete the form with all required information, including the appraised amount and then provide a copy back to the donee organization for their records.

There are two additional items to note regarding the donee acknowledgement section of Form 8283. If the organization expects that any donated tangible personal property will be used in a purpose unrelated to the organization's function or mission at the time of the donation, the organization should check the "yes" box in Part IV. In addition, the charitable organization is required to affirm that if the organization (or a successor donee organization) disposes of the property within three years after the date the original donee received it, the organization must file Form 8282, *Donee Information Return* with the IRS and send a copy to the donor. As a result

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## GIFTS OF PROPERTY AND IRS FORMS 8282 AND 8283

of the sale or disposition of the property by the donee organization, a donor's charitable contribution deduction may be limited or subject to rules regarding recapture of donation amount.

### ►FORM 8282

As briefly discussed above, Form 8282, *Donee Information Return*, is required to be completed by a donee or successor donee charitable organization that sells or disposes of tangible personal property within three years of the receipt of the donation by the organization. This includes any donated property (other than money or publicly traded securities) if the claimed donation value exceeds \$5,000 per item or group of similar items donated by the donor to one or more donee organizations. This is the property listed in Section B on Form 8283.

### There are two exceptions where organizations do not need to file Form 8282:

1. Items are valued at \$500 or less. The information to determine this comes from Section B, Part II of the donor's original Form 8283.
2. Items that have been distributed or used for the organization's charitable purpose. If the organization used or distributed the item, without receiving consideration in fulfilling the organization's exempt purpose, then no reporting on Form 8282 is required. The IRS instructions give the example of a charity relief organization distributing medical supplies in assisting disaster relief victims.

Normally, organizations are required to file Form 8282 with the IRS and donor within 125 days after the disposition of the property.

At a minimum, organizations are required to provide the organization's name, address and employer identification number (EIN), and complete at least Part III, columns 1, 2, 3 and 4 and Part IV. The other portions of Form 8282 are not required to be completed if the organization does not have the information.

### There are two types of penalties associated with Form 8282:

1. The first penalty is the failure to file penalty. This penalty can be assessed when the organization fails to file the form by its due date, fails to include all required information or includes incorrect information on the form. The penalty is \$50 per form.
2. The second penalty is the fraudulent identification of exempt use property. The organization can be assessed this penalty if in Part III of Form 8282 it stated that tangible personal property donated to the organization was sold, disposed of or exchanged or was used in a way that was related to the exempt purpose of the organization when in fact it had knowledge that it was not intended for this purpose. In this situation, the organization could be assessed a \$10,000 penalty.

### There are also other information requirements that organizations should be aware of regarding Form 8282:

1. If property is transferred to another charitable organization within the three-year period of the date of donation, the organization must provide the following information to the successor donee:
  - The name, address and EIN of the organization.
  - Copy of Section B of Form 8283 received from the donor or preceding donee. The instructions define a preceding donee as the organization or person who gave the donated property to the organization.
  - Copy of the Form 8282 within 15 days after the organization files it with the IRS.
2. Successor donees to whom property was transferred to from the donee organization are required to provide their name, address and EIN to the organization within 15 days of the later of:
  - The date the organization transferred the property, or
  - The date the successor donee received a copy of Section B Form 8283.

Please note that the organization is required to give a copy of Form 8282 to the original donor of the property as well as keeping a copy of Section B of Form 8283 in their records.

### ►SUMMARY

To summarize, there are a number of suggested processes and procedures organizations should adopt to assist with the disclosure and recordkeeping requirements regarding Forms 8282 and 8283:

1. Develop and institute noncash donation acceptance and procedure policies, particularly for tangible personal property items valued at over \$5,000. For example, include sections documenting the process of acceptance of noncash donations over \$5,000, the organization's requirements regarding the donor and Form 8283, the exempt use of donated property, the holding period of property before selling or disposing of it, and the Form 8282 itself.
2. Educate donors regarding their responsibility for the completion of Form 8283 so that there are no surprises for either the organization or the donor.
3. If the donor has questions regarding the deductibility of the donation, direct the donor to consult with their tax advisor.
4. Consult with your tax advisor early in the process regarding any Form 8283 or 8282 questions or filing requirements.

For more information, contact Sandra Feinsmith, tax senior manager, at [sfeinsmith@bdo.com](mailto:sfeinsmith@bdo.com).

# NEW GASB PRONOUNCEMENTS

By Patricia Duperron, CPA

**The following pronouncements from the Governmental Accounting Standards Board (GASB) will be effective for reporting governmental financial statements in upcoming years:**

**GASB Statement No. 59, *Financial Instruments Omnibus***, amends the reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. GASB Statements No. 25 and 43 are amended to remove the fair value exemption for unallocated insurance contracts. These were previously reported using a cost-based measure but are now required to be reported at fair value.

Statement No. 59 also amends Statement No. 31 to indicate that a Rule 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC). Statement No. 31 provided an exception to fair value reporting when the pool had a policy that it would operate in a manner consistent with SEC Rule 2a7. This clarifies that pools must meet all SEC requirements except for filing with the SEC.

Statement No. 59 amends Statement No. 40 to indicate that interest rate risk information should be disclosed only for bond mutual funds and external investment pools and not mutual funds that hold both equity and debt securities. Because interest rate risk is not applicable to equity investments, some governments looked through the fund at the individual investments and this was not the intent of Statement No. 40.

Statement No. 59 amends Statement No. 53 by stating that nonperformance penalty provisions are not derivatives because they do not meet the net settlement criteria and also to provide that certain financial guarantees would no longer be exempt from Statement No. 53. This pronouncement is effective for years ending June 30, 2011.

**GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements***, addresses issues related to service concession arrangements (SCAs), which are a type of public-private or public-public partnership. An SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset in exchange for significant consideration and the operator collects and is compensated by fees from third parties. Examples include toll roads, convention facilities, and parking garages.

The accounting for these SCAs depends on whether the transferor retains control over the facility or not. If control is maintained, the transferor continues to report the facility as its capital asset. If a new facility is created, it is reported by the transferor at fair value along with a corresponding liability that is amortized over the term of the agreement.

If the transferor doesn't meet the control criteria, it will derecognize the facility and report a residual interest based on book value of the facility.

For governments that operate the facility, an intangible asset will be reported and amortized over the term of the agreement. The pronouncement is effective for years ending June 30, 2012.

**GASB Statement No. 61, *The Financial Reporting Entity: Omnibus***, amends GASB Statements No. 14 and 34 regarding the assessment of potential component units to be included in the reporting entity. Certain organizations are required to be included as component units because they are fiscally dependent on the primary government. Statement No. 61 now requires a financial benefit or burden to also be present between the primary government and the potential component for it to be included in the reporting entity. An organization's fiscal dependency does not necessarily imply that

there is a financial benefit or burden to the primary government. The potential for dual inclusion may exist, as an organization may be fiscally dependent on more than one government. The inclusion of this second test could cause some current component units to be disassociated with the primary government.

For organizations that do not meet the financial accountability criteria for inclusion as component units, but are included because it was determined that it would be misleading to exclude them, this Statement clarifies the manner in which that determination should be made and the types of relationships that generally should be considered in making the determination.

Statement No. 61 also changes and adds new criteria for determining whether a component unit should be blended or discretely presented. The new criteria were added to eliminate a current practice of "off-balance sheet" financing. For example, a government hit their debt limit so a separate commission was established to renovate a government-owned building. The commission bought the building, renovated it and leased it back to the government. The renovations were funded with debt guaranteed by the lease. The commission would not be considered a blended component unit under the old rules. The new rules specify that when a component unit has outstanding debt (including leases) that will be repaid by the primary government, it must be included as a blended component unit. Statement No. 61 will be effective for the year ending June 30, 2013.

**GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements***, incorporates into the GASB's authoritative literature certain accounting and reporting guidance that is included in the following original pronouncements (excludes subsequent amendments). These pronouncements, issued on or before November 30, 1989, do not conflict

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## NEW GASB PRONOUNCEMENTS

with or contradict the following GASB pronouncements:

1. FASB Statements and Interpretations (through FAS 102 and FIN 38)
2. Accounting Principles Board Opinions (through APB Opinion 31)
3. Accounting Research Bulletins (through ARB 51)

Statement No. 62 also eliminates the election provided in paragraph 7 of GASB Statement No. 20 for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. In practice, this option was seldom elected. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements. This pronouncement will be effective for years ending December 31, 2012.

### ▶PROPOSED GASB TOPICS

**GASB Proposed Statement (*Exposure Draft*) *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*** will change the financial statement presentation by including two new concepts that were introduced in GASB Concept Statement No. 4. Deferred outflows are consumptions of net assets that are applicable to a future reporting period. Deferred inflows are acquisition of net assets that are applicable to a future reporting period. This does not include items like prepaid rent or deferred revenue because net assets have not been consumed or acquired. Deferred outflows should be reported in financial statements in a separate section following assets. Deferred inflows should be reported in a separate section following liabilities. This pronouncement will be effective for years ending June 30, 2012.

GASB has issued *Preliminary Views, Pension Accounting and Financial Reporting by Employers*. The significant change when this pronouncement is issued will be the requirement to record the unfunded pension obligation in the government-wide financial statements. Currently, this amount is not recorded in the financial statements but is only disclosed in the footnotes. However, the liabilities for unfunded pension and other post-employment obligations are recorded by private companies and nonprofits and the governmental employer is responsible for the obligation to the extent that sufficient assets have not been set aside in a pension plan. The numbers currently being reported for these amounts are quite large, making this a very controversial subject for local governments that are already struggling.

For more information, contact Patricia Duperron, director, at [pduperron@bdo.com](mailto:pduperron@bdo.com).

## OTHER ITEMS TO NOTE....

### Schedule H - Hospitals

The IRS has just issued Announcement 2011-37, which indicates that Part V, Section B (Part V.B) of Schedule H, Hospitals, of the 2010 Form 990, Return of Organization Exempt From Income Tax, is optional for the 2010 tax year. This announcement came after protest from many groups regarding the issuance of the new schedule provisions before the IRS had even issued draft regulations on the new requirements. It is important to note that even though the particular section of the form will be optional, hospitals must still be in compliance with the new requirements.

### Charitable Contributions and the FCPA

The U.S. Foreign Corrupt Practices Act (FCPA) prohibits making any "payment" to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to any person. This applies not only to business transactions, but also to charitable contributions or grants made outside the United States by persons who are subject to U.S. jurisdiction. Issues may arise if a foreign official has a direct or indirect financial interest or other interest in a charitable donation or has requested that the donation be made to a particular charity. Entities must be careful when a charitable contribution or

grant is provided to ensure that there is no direct or indirect benefit received by a foreign official in return, so as to insure there is no violation of the FCPA. Organizations should implement an appropriate review procedure for charitable contributions and grants to avoid any undue risk.

### Loss of Tax Exemption

As discussed in the December 2010 *Nonprofit Standard* article, "Preserving and Restoring Exempt Status," on June 8, 2011 the IRS released the list of organizations that have automatically lost their tax-exempt status because they did not file legally required annual reports for three consecutive years (IR-2011-63). They also issued the expected final guidance on how organizations can apply for reinstatement of their tax-exempt status, including retroactive reinstatement; how to apply transition relief for certain small tax-exempt organizations; and how contributors may rely on Publication 78 or on the IRS Business Master File extract for purposes of deducting contributions and making grants.

### Certain Financial Professionals Have FBAR Deadline Extended

The IRS and the Financial Crimes Enforcement Network (FinCEN) announced

on May 31 that a small subset of individuals with only signature authority required to file the Report of Foreign Bank and Financial Accounts (FBARs) will receive a one-year extension beyond the upcoming filing date of June 30, 2011. In February 2011, FinCEN published a "Final Rule" that amended the Bank Secrecy Act (BSA) regulations and addressed the scope of the persons that are required to file reports of foreign financial accounts. Due to the many questions regarding exceptions under the Final Rule, the extension was put in place to allow these questions to be resolved. Notice 2011-1 extends the deadline until June 30, 2012 for an employee or officer of a covered entity [§1010.350(f)(2)(i)-(v)] who 1) has signature or other authority over and no financial interest in a foreign financial account of another entity more than 50 percent owned, directly or indirectly, by the entity (a "controlled person"); and 2) who has signature or other authority over and no financial interest in a foreign financial account of the entity or another controlled person of the entity. Frequent updates, clarifications and changes to FBAR requirements are expected up through the June 30 deadline. Please consult your tax advisor.

# GAMBLING WITH YOUR TAX EXEMPTION?

## IRS Guide Highlights Important Exempt Issues



By Joyce Underwood, CPA

### GAMING CAN HAVE AN IMPACT ON AN ORGANIZATION'S EXEMPT STATUS AND REQUIRES SPECIAL RECORDKEEPING AND REPORTING FOR THE UNIQUE ACTIVITIES THAT SURROUND THESE EVENTS INCLUDING INCOME, EMPLOYMENT AND EXCISE TAXES.

**G**aming has become more visible with the addition of Schedule G in the revised Form 990. IRS updated its Publication 3079, *Tax-Exempt Organizations and Gaming*, late last year to provide current guidance. Gaming is often added to facilitate socializing and fundraising amongst a group with a common interest and is frequently included at exempt organizations' fundraising special events.

#### ►EXEMPTION ISSUES

Although a gaming activity may provide funds to pay expenses associated with the conduct of exempt activities, gaming itself often doesn't further an exempt purpose. A Section 501(c)(3) organization is organized for a certain exempt purpose and should not devote a substantial amount of its resources to an unrelated activity. A charity conducting gaming as an insubstantial part of its activities will not ordinarily jeopardize its tax-exempt

status but may be subject to the tax on unrelated business income. Additionally, public charities often must meet a public support test to avoid classification as a private foundation. If the organization receives too much of their financial support from a limited number of sources or from an unrelated trade or business such as gaming they may fail the "public support" test and be classified as a private foundation.

Other nonprofits may also jeopardize their exemption status if gaming becomes the organization's primary activity. Gaming income may be subject to tax on unrelated business income. For example, social clubs and fraternal organizations may engage in gaming involving only members without jeopardizing their exempt status. Because gaming is recreational and social, the income a Section 501(c)(7) social club receives from gaming activities limited only to its members is considered exempt function income and is not subject to tax. On the other hand, if income received from gaming activities is open to nonmembers and is part of the social club's gross income, then it is subject to unrelated business income (UBI) tax. Social clubs endanger their exempt status when receipts from nonmembers become substantial.

#### ►UBI TAX ISSUES

There are three conditions that define gaming as a primary activity of an unrelated trade or business:

1. Gaming is generally considered a "trade or business" if it generates revenue.
2. Gaming is considered "regularly carried on" if it is conducted with a frequency and continuity similar to comparable activities of a non-exempt organization and if pursued in a manner similar to commercial gaming activities, but can exclude those that occur only occasionally or sporadically.
3. Gaming is not per se an exempt activity, although it sometimes can be one where the exempt function includes social or recreational activities.

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## GAMBLING WITH YOUR TAX EXEMPTION?

Publication 3079 provides a handy flow chart to assist with the determination. Even if the gaming activity is taxable UBI, there are certain exemptions outlined in Publication 3079. These exemptions include certain bingo games; activities conducted with substantially all volunteer labor; qualified public entertainment activities; and games of chance conducted in North Dakota. (This excludes social clubs, as they are taxed on all nonmember income.)

### ►RECORDKEEPING AND REPORTING ISSUES

Organizations that conduct gaming activities must maintain records of gross receipts from gaming, prize payouts, and other related disbursements to substantiate information submitted on the exempt organization returns. Records are kept under the same statute of limitation rules that govern other businesses. Because gaming can generate substantial income, often in cash, close control and oversight of the operations is needed, and care should be taken to ensure funds are not diverted to individuals or private interests. Segregation of duties and internal controls are important. State and local laws may require their own specific recordkeeping, reporting and internal control requirements, as well.

### ►GAMING ACTIVITY WORKERS

Many states and localities require that exempt organizations use all (or substantially all) volunteer labor to conduct their games in order to qualify for a license. Care should be taken to ensure if a worker is compensated that they are classified appropriately as an employee, contractor or volunteer. Volunteers recognized with awards or gifts of non-cash items of nominal value, such as turkeys or hams around the holidays, would not constitute taxable wages. However, cash items, including gift certificates as well as any other taxable fringe benefit, would be a payment of taxable compensation, and if a volunteer is subject to the organization's right to direct and control, the amounts are wages. All pay that you give to an employee for services performed is considered wages and is subject to federal employment taxes unless an exception applies. The pay may be in cash or in other forms. It includes salaries,

bonuses, commissions and fringe benefits. Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair market value of such payments at the time that they are provided is subject to employment taxes. This excludes expense reimbursements under an accountable plan. Tips that gaming activity workers receive from players, whether cash or non-cash, are taxable income.

### ►WITHHOLDING AND ANNUAL REPORTING

If your organization's gaming workers are employees, you are responsible for withholding and paying employment taxes and filing and furnishing the required employment tax forms and information returns. An employee who receives tips should keep a daily tip record so that he or she can accurately report tips to the employer and on his or her tax return. If your organization employs independent contractors, it does not have to withhold or pay taxes unless required under backup withholding. Use Form 1099-MISC to report payments to independent contractors, including fees, salaries, commissions, prizes, and awards for services performed as a nonemployee. If you pay the winner or winners of a game more than a certain amount, you must report the amount and information about the winners to the IRS on Form W-2G. The threshold amount at which winnings become reportable often depends on the type of game involved. In determining whether the threshold is met, you may reduce the winnings by the amount of the wager. Generally you must withhold income tax from a payment of winnings when the proceeds from the wager are more than \$5,000. There are also wagering and occupational excise taxes that may apply.

### ►TAX RETURN

Subject to certain thresholds, your annual Form 990 will require you to complete and attach Schedule G, Supplemental Information Regarding Fundraising or Gaming Activities, which includes the following reporting:

1. Gross revenues from bingo, pull-tabs/instant bingo, and other types of gaming;
2. Cash and non-cash prizes paid for each type of gaming;

3. Rent or costs of facilities and other direct gaming expenses;
4. Percentage of your organization's games operated in your own facilities and in outside facilities;
5. Percentage of volunteer labor for each type of gaming;
6. States in which you operated gaming activities and the states in which your organization holds gaming licenses;
7. Revocation, suspension or termination of any of your organization's gaming licenses;
8. Amount of mandatory charitable distributions from gaming proceeds required under state law, or the amount of proceeds spent on your organization's own exempt activities;
9. Names and addresses of the gaming manager and the person who prepares your gaming/special events books and records; and
10. Information about third parties with which your organization has contracts to receive gaming revenue.

### ►STATES

There are also many state and local gaming licensing requirements for which an organization should contact the appropriate agencies. Gaming may be legal or illegal.

*For more information, please contact Joyce Underwood, director, at [junderwood@bdo.com](mailto:junderwood@bdo.com).*

# NONPROFIT EXPENSE ALLOCATION

By Lee Klumpp, CPA

Over the past fifteen years, there has been more pressure on nonprofits to conform to the expectation set by stakeholders to keep overhead expenses (supporting services activities) down and therefore maximize the use of unrestricted and temporarily restricted funds that can be used on programmatic activities.

The Internal Revenue Service (IRS) requires that nonprofit organizations allocate their expenses on their Form 990 into three categories: Program, Management/General, and Fundraising. However, generally accepted accounting principles allow for costs to be allocated by program service and supporting service categories with multiple functional areas in each category.

The vast majority of nonprofit organizations allocate costs directly to the function, which is the simplest and most transparent technique. A few use indirect cost allocation methodologies for some or all of their expenditures by entering all their expenses into one or more cost center or categories (know as an overhead pool), and then reversing out the expenses based on an allocation methodology to other functional categories.

The main reason for wanting to understand a nonprofit organization's expense structure is to understand the cost related to the activities that allow the nonprofit organization to carry out its mission. Each nonprofit organization is very different in how it accomplishes its mission and performs its programmatic and supporting services activities. In some cases these differences are cultural and in other cases they are structural related to how the nonprofit organization was originally set up and formed. Additionally, over the past ten years, there has been push back from many funders on paying for supporting services. In some cases, some funders have either paid for a very small percentage of supporting services or not paid for supporting services at all. Not recapturing the cost related to supporting programmatic services can be shortsighted and can in some cases



cripple nonprofit organizations and make them not only inefficient but ineffective. The reason for this is that it is hard to raise funds that are unrestricted and can be used for general operating activity. If all funds raised are applied directly to programmatic activities, it will still have to be determined as to where the funds will come from for the children's after school program supplies; facility management (including janitorial work, repairs and maintenance); and the accounting and reporting of the program to funders. Supporting programmatic activities is important, but a certain amount of supporting services are required for an organization to be in good operating order.

## ►FUNCTIONAL EXPENSE CATEGORIES

### Programmatic Activities

The number of functional reporting categories for programmatic services varies by nonprofit organization according to the nature of the services rendered by the nonprofit. There is no specific limit to how many categories a nonprofit can have. A nonprofit may only have one functional classification and that may adequately portray their programmatic activities. However, in most cases, a nonprofit will have several separate and identifiable programmatic services that relate to its mission, goals and objectives of the nonprofit. The reason for functional reporting is to provide funders and other readers of the

financial statements information on how funds have been expended to provide services to participants or beneficiaries.

A nonprofit organization may also have various kinds of supporting service activities, such as management and general, fundraising, and membership development. A single functional reporting classification is usually not adequate to portray each kind of supporting service that a nonprofit may have. A nonprofit organization will have at least management and general and fundraising supporting services but it may have others depending on how the nonprofit organization's structure is set up. It would be extremely rare for a nonprofit organization not to have fundraising expenses. Some nonprofits show disaggregated information for each kind of supporting service. For example, fundraising expenses and the corresponding support that is obtained may be reported separately for each kind of fundraising activity undertaken, either on the face of a statement of activities or in the notes to the financial statements.

### Management and General Activities

Management and general activities are activities that are not identifiable with a single programmatic or supporting service (i.e., fundraising, or membership-development activity) but that are indispensable to the conduct of the nonprofit organization's activities, mission and existence. These activities include such services as oversight,

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## NONPROFIT EXPENSE ALLOCATION

business management, general recordkeeping, budgeting and financing; soliciting funds other than contributions, such as exchange transactions and government contracts; disseminating information to inform the public of the nonprofit's stewardship of contributed funds; announcements regarding appointments and the annual report; and all management and administration activities except for direct conduct of program services or fundraising activities.

The costs of oversight and management usually include the salaries and expenses of the governing board, the CEO of the nonprofit organization, and the supporting staff. If staff spends a portion of their time directly supervising programmatic services or categories of other supporting services, a certain portion of their salaries and related benefit expenses should be allocated among those functions. There should never be an occasion where management and general activities are not included on the statement of activities because there are certain costs that are incurred for a nonprofit organization just to turn on the lights and open the doors every day.

### Fundraising Activities

Fundraising activities are those that are undertaken to induce potential donors to contribute money, securities, services, materials, facilities, time, or other assets. The financial statements of a nonprofit organization should disclose total fundraising expenses on the statement of activities or in the footnotes to the financial statements.

Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 958-720-45 provides a further description of fundraising activities, which includes publicizing and conducting fundraising campaigns; maintaining donor mailing lists; conducting special fundraising events; preparing and distributing fundraising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others. Fundraising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in the "Contributions Received" subsection of FASB ASC 958-605-25.

### Membership-Development Activities

Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities.

## ▶ALLOCATION OF EXPENSES

Some expenses are directly related to and can be assigned to a single program, service or supporting activity. Other expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. These expenses should be allocated among the appropriate functions. Examples include a direct mail solicitation that combines fundraising with program activities, salaries of persons who perform more than one kind of service, and the rental of a building used for various programs and supporting activities.

### Direct Identification vs. Allocation Methods

Direct identification of a specific expense is the preferable method of charging expenses to various functions. For example, travel costs incurred in connection with a programmatic activity should be assigned to that program. If direct identification is impossible or impracticable, then an allocation is appropriate. Expense allocation techniques are utilized by all types of entities, nonprofit and for-profit alike. The reasonable allocation of expenses among a nonprofit's functions may be made on a variety of bases. Objective methods of allocating expenses are preferable to subjective methods. The allocation may be based on related financial and/or nonfinancial data. Additionally, you may find that the guidance found in the U.S. Office of Management and Budget Circular A-122 may also be helpful in developing a methodology for your nonprofit organization to use in allocating expenses.

One misconception that lots of nonprofit organizations have is that occupying and maintaining a building is not a separate supporting service activity; however, FASB ASC 954-720-45-25 specifically states that it is. Additionally, expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated among the nonprofit organization's functions based on the square footage of space occupied to

each programmatic and supporting service activity. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made. These costs may also be allocated based on the distribution of personnel costs or head counts.

Per FASB ASC 958-720-45-24, interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible. Interest costs that cannot be allocated should be reported as part of the management and general function.

A nonprofit organization should evaluate its expense allocation methods on a periodic basis to ensure that the assumptions used are still relevant and appropriate. The evaluation may include, for example, a review of the time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage. The expense allocation methods should be reviewed by management and revised when necessary to reflect significant changes in the nature or level of the organization's current activities.

As you can see, there are many options for functional expense allocation and reporting and there is no single answer on what is appropriate for all organizations. Each organization should review their costs and activities to establish a functional reporting process that is transparent and that is based on a sound reporting methodology. It is critical that expense allocation methodologies represent the activities of your organization, result in fair and reasonable allocations and be applied on a consistent basis.

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### BDO NONPROFIT & EDUCATION PRACTICE

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THE NEWSLETTER OF THE BDO NONPROFIT INDUSTRY PRACTICE

# NONPROFIT STANDARD



## GOVERNANCE – STILL HIGH ON THE IRS RADAR SCREEN: AUDIT CHECKLIST ON GOVERNANCE NOW IN SERVICE

By R. Michael Sorrells, CPA

By now, it should come as no surprise that nonprofit governance is high on the list of IRS interest areas. This interest has, of course, been spurred on by Senate Finance Committee hearings and some highly publicized exempt organization governance failures which helped to put a black mark on the entire nonprofit sector. However, Congress was not able to (or chose not to) pass any legislation mandating particular governance structures or policies. A backdoor, friendlier approach was taken instead. In its major revision of the Form 990, the IRS now asks a significant number of questions about governance, policies and disclosures. Although almost all of these questions have no right or wrong answer legally, most organizations have strived to answer most in a way that

creates the best image of the organization as a well-governed entity. Since the Form 990 is a public document, this is probably a wise course of action. It is also easy to imagine that a lot of no answers to what are essentially best practice questions might encourage the IRS to send its auditors around.

As part of this new emphasis on good governance, the IRS has now mandated that a governance checklist be completed by its revenue agents as part of every examination of 501(c)(3) public charities (after September, 2009). The stated purpose of this checklist is to provide data for a long term study. Whether or not that study will lead to legislation or more detailed guidance is certainly subject to conjecture.

The checklist has 28 questions and a four-page set of instructions for the agent. While a lot of

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# FORM 990-T AND LOSSES: FROM THE IRS VIEWPOINT



By: **Sandra Feinsmith, CPA**

The IRS is taking a close look at tax exempt organizations that engage in unrelated business activity but rather than reporting taxable income, are instead reporting large loss carryforwards. The IRS has already begun to look at this issue with the release of its compliance questionnaire that was sent out to 400 colleges and universities. The IRS noted that many of the colleges and universities' Forms 990-T were showing large losses after expense allocations.

In this article, we will discuss three areas of particular interest to the IRS when looking at losses on Form 990-T:

1. Profit motive of the activity
2. Dual use facility expense allocations
3. Exploited activities

## ► PROFIT MOTIVE OF THE ACTIVITY

One of the areas that the IRS is looking at when examining the large losses is the profit motive of the activity. The "Profit Motive Test"

came from rulings and case law that occurred in the 1980s and 1990s. When applied, this test eliminates deductions for losses from activities that lack a profit motive.

IRS Code Section 512(a)(1) defines unrelated business taxable income as "gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions which are directly connected with the carrying on of such trade or business." This section of the Code allows organizations to offset the income and gains from one unrelated activity against the losses generated by another unrelated activity.

However, as noted in the definition, the losses must be generated by a trade or business, which is defined as an activity that is carried on for the production of income and has the other traits of a for profit organization. In other words, an organization must engage in the activity with the primary goal of generating a profit.

Organizations reporting large losses on their Form 990-T are at risk of IRS applying the profit motive test to their activities. This may result in the losses from the activity being

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE IN THE NEWS...

*Members of the Institute are requested to speak on a regular basis due to their recognized leadership in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking.*

**Lee Klumpp** will be the presenter for two separate eight-hour courses for the Georgia State Society of Certified Public Accountants. He will be presenting *Governmental and Nonprofit Annual Update*, discussing the latest accounting requirements for these entities on July 8th in Gainesville, Georgia, and on July 9th he will present *Nonprofit Accounting and Reporting: From Start to Finish*, discussing the basics on nonprofit accounting in Duluth, Georgia.

Lee will also present an eight-hour program in New York for the New York State Society of Certified Public Accountants, entitled *Audits of HUD-Assisted Projects*, that will discuss the requirements of HUD audits and the latest developments on August 13, 2010.

Lee will conduct an eight-hour course for the Maryland Society of Certified Public Accountants, entitled *Audits of 403(b) Plans: A Challenging New Area*, in Laurel, Maryland, on September 14th.

**Laura Kalick** will be speaking about ASC 740-10 (previously known as FIN 48) at the ASAE Legal Symposium on September 24, 2010.

**Mike Sorrells** will present *Update on Tax Issues Facing Nonprofit Organizations* at the Virginia Society of Certified Public Accountants (VSCPA) Accounting and Auditing Conference in Roanoke, Virginia, on September 27, 2010.

**Dick Larkin** will also be presenting *Nonprofit Accounting and Auditing Update* at the VSCPA's Accounting and Auditing Conference in Roanoke, Virginia, on September 28, 2010.

**Lee Klumpp** will present at the Greater Washington Society of Certified Public Accountants on September 29, 2010, on the topic of frequent frauds found in governments and not-for-profits.

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## IRS VIEWPOINT

disallowed due to the IRS assertion that the organization did not engage in the activity with the primary purpose of generating income or profit.

In looking at these losses, the IRS has adopted a facts and circumstances approach to determine whether or not an activity is a trade or business. Various areas that might indicate to the IRS that an activity does not have a profit motive include:

1. No formal business plan or contracts for the activity
2. Expenses almost always exceed any income from the activity
3. Many years of losses
4. No adjustments to cost, expenses or pricing to lower the losses

Another item to be aware of is the IRS treatment of offsetting losses from one set of unrelated activities against the income from other unrelated activities. It has been the IRS approach to look at each one of these activities as its own separate trade or business and make the determination on whether or not each one of these has or does not have a profit motive. Using this methodology, the IRS has taxed profitable activities while disallowing the ones with losses.

### ▶ DUAL USE OF FACILITIES

Another area of focus by the IRS regarding losses reported on Form 990-T involves the expense allocation and deductions for the dual use of facilities and personnel. Under IRS Regulations 1.512(a) – 1(a), an organization is allowed to deduct an expense that is directly connected to an unrelated trade or business if it has a “proximate and primary relationship” to that unrelated trade or business. The Regulations further discuss this relationship regarding expenses directly related to unrelated business activities and expenses from the dual use of facilities or personnel.

The Regulations state that the expense allocation between the dual uses must be “reasonable.” However, “reasonable” has been subject to interpretation and litigation. Some guidance may be found in *Rensselaer Polytechnic Institute (RPI) v. Commissioner of Internal Revenue (1983/1984)*. In this case, RPI interpreted “reasonable” to mean that fixed costs as well as depreciation and overhead expenses that could not be associated

directly with exempt student uses nor non-exempt commercial for-profit uses should be allocated based on percentage of total use, ignoring periods when the facility was idle. RPI prevailed. However, the Commissioner, to this day, contends that the basis of allocation should have been all time the facility was available for use, which would substantially reduce the amount of expenses and losses that could be used to offset unrelated business income.

With the lack of clarity on the issue, it is up to the organization and the IRS to come to some type of negotiated settlement on their own regarding such matters should the issue be brought to light during an audit.

### ▶ EXPLOITED ACTIVITIES

The third area of focus regarding loss reporting on Form 990-T involves the calculation and reporting of expenses from exploited exempt activities. These types of activities occur when an organization generates intangible assets in performance of its exempt activity that are exploited in a commercial manner and does not contribute to an organization's exempt purposes. Examples of these types of activities discussed in the IRS regulations include advertising income from an educational organization's journal or a scientific organization's endorsement of laboratory equipment.

For these types of activities, the IRS requires that organizations report and complete two separate calculations of net income from the activities – one from the taxable activity, and one from the exploited activity.

Under IRS Regulations 1.512(a) - 1(d), if the taxable activity has net income, any losses from the exploited activity can be used to offset the net income from the taxable activity to the extent of net income. The exploited activity is not allowed to create a net operating loss for the taxable activity. However, if the taxable activity shows a loss, that loss is what is required to be reported on Form 990-T.

The IRS is concerned that organizations are not observing the rules regarding the expense deduction limitations and are putting excess expenses on page 1 of Form 990-T under deductions not taken elsewhere on Form 990-T.

## DID YOU KNOW...

- The updated and much-improved Charities and Nonprofits section on the IRS website ([irs.gov](http://irs.gov)) is now the largest section on the website! It contains over 1,600 pages of information, most of which is quite useful.
- There are almost 1.6 million tax-exempt organizations in the US, including almost 1 million public charities. These nonprofits accounted for 8.1 percent of wages and salaries in 2006.
- Public charities reported over \$1.4 trillion in total revenues and nearly \$1.3 trillion in total expenses for 2007.
- Approximately 26.4 percent of Americans over the age of 16 volunteered through or for an organization in the year-ended September 2008.
- Across all sectors (including nonprofits), the IRS estimates there is a \$54 billion-tax shortfall in payroll tax collections between what was filed and what should have been filed if everyone had filed correctly. This is why the IRS is launching a multiyear Employment Tax Research Project which includes 500 nonprofit examinations each year.

### ▶ CONCLUSION

With the increasing scrutiny by the IRS in this area, organizations with unrelated business activities generating losses on their Form 990-T should look closely at the following areas:

- Look at each of your activities' profit motive. Document why the activity is generating losses (i.e. start up mode, meant to run a loss, etc.).
- For dual use of facilities expense allocations, look at and document the methodology used in the calculation. Is it reasonable? Is it consistent with relevant tax court rulings or the IRS's interpretation?
- For exploited exempt activities, make sure the organization is in compliance with the expense limitation rules.

For more information, contact Sandra Feinsmith, Senior Tax Manager, at [sfeinsmith@bdo.com](mailto:sfeinsmith@bdo.com).



# MANAGEMENT'S ROLE IN VALUING ALTERNATIVE INVESTMENTS WITH NAVs

By **Tammy Ricciardella, CPA**

**A**lternative investments held by nonprofit organizations present a challenge to management for many reasons. One of the most significant is the responsibility that management has to determine the fair value measurements for these investments and draft the required footnote disclosures. This process can be very challenging depending on the nature and number of the alternative investments held by an organization.

FASB issued Accounting Standards Update (ASU) 2009-12 entitled, "*Investments in Certain Assets That Calculate Net Asset Value per Share*," and a series of 10 AICPA questions and answers (TIS Sections 2220.18-27) that will make the process of valuing these assets somewhat easier in certain circumstances. ASU 2009-12 permits the use of net asset value (NAV) as a practical expedient that can be used to measure fair value in certain scenarios. In order to utilize NAV the alternative investment fund must comply with the FASB's standards for investment companies and the investor cannot have initiated plans to sell the investment in the near term at a price that will probably be different than the NAV.

This ASU was issued because some organizations were adjusting reported NAV for their assessment of liquidity and marketability. The ASU was issued to give you the option to use the NAV under certain conditions. However, all the other requirements related to understanding how the NAV was computed and the due diligence required to be performed by management are still required even if management determines that using the NAV is appropriate.

Management should obtain information from the fund manager as to how the funds they are invested in are valued. Management should understand the methods used by the fund manager to compute fair value. An understanding is necessary before management can evaluate whether this valuation is appropriate. Management must understand the reason alternative investments are being utilized in the portfolio, the underlying investments, and the method and significant assumptions used by the fund manager to value these underlying investments.

Steps that management should take to fulfill their responsibility regarding the valuation of alternative investments include:

- What is the NAV of each investment and as of what date was it computed? This

information is generally provided by the fund manager.

- Does the fund comply with the FASB standards for investment companies? Management needs to review the financial statements and auditor's opinion for the fund.
- If management determines that the fund complies with the FASB investment company standards, management needs to determine if there are any adjustments that need to be made to NAV because the NAV is not computed as of the entity's year end.
- If management determines that the fund does not comply with the FASB investment company standards, they need to ascertain if it is possible to adjust the NAV or if they must use alternative valuation methods.
- Management needs to determine if they have the ability to redeem the investment at NAV in the short term and what the entity's plans are for either holding or selling the investment. An alternative investment that can be redeemed at NAV in the short term may be classified as a level 2 investment in the footnote disclosures. However, if management has already initiated plans as of the measurement date to sell the alternative investment at a price that will differ from the NAV then they cannot use NAV to measure fair value.

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## MANAGEMENT'S ROLE

### Consideration of whether the fund complies with the investment company standards:

Generally those alternative investments that calculate NAV per share and report this information to their investors include, but are not limited to, hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds and funds of funds. FASB ASC 820-10-35-59 permits the use of the NAV as a practical expedient if the NAV is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date. How does management do this?

Management must independently evaluate the fair value measurement process utilized by the fund manager to calculate the NAV. This is a professional judgment and includes determining that the fund manager has an effective process and related internal controls in place to estimate fair value of the investments. The steps management uses may include various stages of due diligence which are designed to understand the fair value estimation process used by the fund. Other factors to consider are:

- The use of independent third party valuation experts by the fund;
- The portion of the underlying securities held by the fund that are traded on active markets;
- The professional reputation and standing of the fund's auditor and the qualifications, if any, of the auditor's report;
- Fund's history of significant adjustments to NAV;
- Findings in the fund's advisor or administrator report; and
- Comparison of historical realizations to the last reported value.

### Adjusting NAV When it is Not as of the Entity's Measurement Date:

NAV provided by the fund manager is not as of the entity's measurement date. Now what?

First, management may request that the fund manager provide a supplemental NAV calculation consistent with ASC 946 as of the measurement date. If this cannot be obtained, management needs to assess whether they should roll forward or back the NAV provided for such factors as:

- Additional investments or capital contributions that have occurred after the date of the reported NAV;
- Distributions or partial redemptions received by the entity since the reported NAV;
- Management has become aware of changes in the value of the underlying investments since the reported NAV;
- Market changes or other economic conditions that have changed that would affect the value of the portfolio after the reported NAV; and
- Changes that have occurred in the composition of the underlying investment portfolio of the fund after the reported NAV date.

### What if management determines that the NAV was not calculated in accordance with ASC 946?

In these cases, management should apply the general measurement principles of FASB ASC 820 instead of using the NAV provided. Often times this occurs when the funds appear to function in a manner similar to investment companies but they do not meet the definition of an investment company provided in FASB ASC 946-10-15-2 and the funds do not issue financial statements using measurement principles in FASB ASC 946. Management needs to determine whether they can obtain valid information from the fund that they can utilize to estimate fair value based on NAV or whether a fair value based NAV can be obtained from the fund. There are cases where management may be able to obtain data to estimate an adjustment that include the following situations:

- NAV is reported on a cash basis. Management could estimate fair value of each underlying investment by obtaining additional information from the investee manager.
- The NAV utilizes blockage discounts. Management could estimate the adjustment to NAV required to remove the blockage discount based on additional information from the investee manager.
- NAV is not adjusted for the impact of unrealized carried interest or incentive fees. Management could estimate the impact of these items and estimate the NAV.

## Electronic Filing of Form 5500s Now Required

Beginning January 2010, all Form 5500s *Annual Return/Report of Employee Benefit Plan*, except 2008 plan year filings, are now required to be submitted by the plan sponsor via the Department of Labor's ("DOL") new electronic filing system called EFAST2. Paper copies of the Form 5500, other than 2008 plan year filings, will not be accepted by the government.

Now that EFAST2 is up and running, each individual who signs a Form 5500 on behalf of the plan sponsor and/or the plan administrator will need to go to the DOL website and register for electronic signing credentials, which will enable the appropriate individual to electronically sign the Form 5500 and submit it through EFAST2. The DOL is planning to send post card notifications inviting Form 5500 signers to apply for their personal credentials but there is no need to wait. Form 5500 signers can log on today and get credentials at, <http://www.efast.dol.gov/portal/app/welcome?execution=e1s1>.

Instructional tutorials for EFAST2 are also available on the DOL website at, <http://www.efast.dol.gov/training/EFAST2%20Tutorial%20Menu.html>. Once there, click on "Register" for a demonstration of how to obtain signing credentials.

In cases where management finds that it is not practicable to calculate an adjusted NAV because sufficient information is not available or they are not in a position to reasonably evaluate the information that is available and estimate values in accordance with FASB ASC 946 then the entity cannot utilize the practical expedient. Management also has the option to elect not to utilize the practical expedient and apply the general measurement principles of FASB ASC 820 instead.

For more information, contact Tammy Ricciardella, Assurance Director, at [tr Ricciardella@bdo.com](mailto:tr Ricciardella@bdo.com).

# ACT RELEASES REPORT ON ONLINE TOOL FOR COMPENSATION

By Joyce Underwood, CPA

On June 9, 2010, the Internal Revenue Service's Advisory Committee on Tax Exempt and Government Entities (ACT) recommended that the IRS provide additional assistance to charities in setting executive compensation through their *Report of Recommendations, Exempt Organizations: Getting It Right – An Online Guide to Setting Executive Compensation for Charities*. ACT describes their creation as an online instructional tool in the form of a webinar or tutorial to provide "step-by-step, plain language advice for managers, boards and advisors of charities to assist them in a wide range of areas, including: developing internal procedures and compensation comparables, reporting salary information in their IRS Form 990 filings, and maintaining appropriate records necessary to meet the rebuttable presumption of reasonableness and comply with the regulations promulgated pursuant to Section 4958."

IRS, legislators and the public have shown a great deal of interest in recent years in compensation of executives for all types of entities, including exempt organizations. Newspapers often herald the outrageous news of the latest charity that appears to have excessive compensation and the new Form 990's expanded disclosures of compensation are expected to lead to even more scrutiny. Since Congress has granted the IRS tools to police the reasonableness of compensation through intermediate sanctions allowing application of excise taxes and the authority to invoke the private benefit or private inurement doctrines to revoke a charity's tax-exempt status, the Section 4958 sanctions address situations where compensation is deemed excessive and provide a structure for corrective action. They also provide procedures that taxpayers may follow to establish reasonable processes around compensation-setting practices. ACT's new tool is intended to better explain the rules and help organizations put into place appropriate measures to manage compensation.

It should be noted that recent IRS compliance studies on executive compensation, colleges and universities, and hospitals have provided IRS insight into the application of Section 4958. While in many instances the rules appear to have been followed, IRS wonders if the resulting compensation is truly appropriate as many organizations place compensation in the 90th percentile. Additionally, legislators have raised questions about the existing rules and have had such suggestions as to eliminate the safe harbor of the rebuttable presumption of reasonableness standard or to require detailed internal procedures and require compensation comparables to be disclosed as part of the Form 990 that is available for public inspection. No action has gone forward in these areas, but it is a subject that may see further attention. In the interim, IRS and the exempt organization community are working together to educate and improve communication in this area.

The June ACT report indicates the areas covered by this tool include the intermediate sanctions, revocation of tax-exemption, taxation of fringe benefits, and compensation-related disclosures required by the Form 990. Other areas addressed are compensation and audit issues relevant to churches and compensatory, below-market rate loans. With regard to the intermediate sanctions, it addresses the basic rules, the rebuttable presumption and automatic excess benefits. Because state law requirements for setting executive compensation have significant overlap with the federal tax law rules (particularly the requirements for satisfying the rebuttable presumption under the intermediate sanctions), the tool addresses the process for setting compensation from the governing board's standpoint and specific state law requirements. Also discussed are ten common pitfalls that organizations often encounter when setting executive compensation. This tool is designed to offer some best or preferred practices drawn from experts who regularly advise organizations on setting compensation.

## UPDATE ON CELL PHONES

On April 14, 2010, the House firmly passed H.R. 4994, the Taxpayer Assistance Act of 2010. The bill includes a provision that would ease the cumbersome cell phone recordkeeping requirements. Existing tax law treats cell phones as "listed property" and requires the value of an employer provided cell phone to be either included in an employee's income to the extent that the employee does not pay for the phone or excludes it as a working condition fringe benefit. To exclude the value of the business related use of a cell phone from taxable income employers and employees must substantiate the business use portion of the phones which can be time consuming and difficult. An exempt organization could have an excess benefit transaction if such income is not reported. If the bill becomes law, organizations would no longer have to keep detailed records substantiating the use of such phones. With the bill now passed by the House, it goes before the Senate, where it has been referred to the Senate Finance Committee which now needs to approve it before the full chamber considers it. If passed by the Senate it goes to the President for signature, who is expected to sign it. The new provision is expected to be retroactive to January 1, 2010.

ACT's tool uses an informal voice with an effort towards education and humor to encourage reception to this new application. IRS has not announced yet if it will implement this suggested tool. The report, along with screen samples from the tool, is available on the IRS website: <http://www.irs.gov/charities/article/0,,id=98353,00.html>

For more information, contact Joyce Underwood, Director, Nonprofit Tax Services, at [junderwood@bdo.com](mailto:junderwood@bdo.com).

# TAX REFORM MAY BE ON THE HORIZON FOR NONPROFIT ORGANIZATIONS

By Laura Kalick, JD and LLM in Tax

In the current economic climate, nonprofit organizations should watch for legislative initiatives that could have an impact on them. Since the government is looking for ways to raise revenue, it is possible that the government subsidy to tax exempt organizations could be cut back. The government subsidy consists of several elements. First, revenue of tax exempt organizations is generally exempt from tax to the extent it is received as a contribution, generated by a related activity or meets an exception or modification in the Internal Revenue Code that prevents it from being taxed. Investment income is for the most part not taxed, allowing nonprofit organizations to build substantial endowments. The government also subsidizes section 501(c)(3) organizations by allowing donors to take charitable deductions for gifts to these organizations. Section 501(c)(3) organizations also have the benefit of being able to obtain low rate financing through tax exempt bonds, the income on which is tax exempt to the holder of the bond. All of these provisions result in lost tax revenue to the Federal government.

## ► CHARITABLE GIVING

One legislative proposal that could surface is to cap the value of itemized deductions, including the charitable contribution deduction, to 28 percent. In addition, changes to income tax rates and estate tax rates can have an impact on charitable giving.<sup>1</sup> Other proposals could surface as the result of studies that are underway at IRS and other government agencies.

## ► IRS STUDIES

For example, the IRS had undertaken a study of the hospital industry that focused on compensation practices and also the provision

of charity care and community benefits. In part due to the hospital study, Congress just enacted new Internal Revenue Code section 501(r) that would require tax exempt hospitals to assess community needs every three years and certain other requirements in order to maintain 501(c)(3) tax status.<sup>2</sup>

IRS is now completing a compliance project on colleges and universities, one of the largest and most complex segments of the nonprofit industry and the results of the study may provide a framework for Congress to enact legislation for nonprofits in general. The IRS Exempt Organization Colleges and Universities Compliance Project Interim Report (Report) was issued May 7, 2010, with preliminary findings based on responses from a sampling of 400 small, medium and large colleges and universities in both the public and private sectors. The main areas of focus of the project are: compensation, endowments and investments, and unrelated business income. Some of the results were as follows:

## ► COMPENSATION

There have been concerns that nonprofit executives are receiving pay that is too high at the cost of the taxpayers. The Report indicated that compensation of the highest paid officer, director or key employee of large universities averaged \$428,000 per year and these persons were usually the president or chancellor of the college or university. Large universities' highest paid employees other than officers, directors and key employees averaged pay of \$798,000 per year and were either faculty members or sports coaches.

The Report found that more than half of the organizations reported using the rebuttable presumption<sup>3</sup> procedure to establish executive compensation. The rebuttable presumption shifts the burden of proof to IRS to prove that compensation is unreasonable if the organization is audited. The procedure requires that an independent governing

IRS is now completing a compliance project on colleges and universities, one of the largest and most complex segments of the nonprofit industry and the results of the study may provide a framework for Congress to enact legislation for nonprofits in general.

body determine compensation based on comparable data and contemporaneously document the decision making process. For-profit comparables can be used as well as nonprofit data. Senator Grassley, ranking minority member of the U.S. Senate Finance Committee, had proposed an amendment to one of the iterations of the healthcare reform bill to eliminate the rebuttable presumption, but then withdrew the amendment. It is possible that such a proposal may surface again in the future because many think that the rebuttable presumption serves to increase compensation of nonprofit executives and at the same time to put IRS at an unfair disadvantage to enforce the tax laws.

## ► ENDOWMENTS

The IRS and Congress are concerned about how tax exempt organizations invest their endowments and also how they use their endowments. Are organizations just piling up money or are they actually using the money for exempt purposes? When the return on investments was much greater a few years ago, this was a much greater concern than it may be today. Also, the Report indicates that a large segment of the sampling of the colleges and universities have foreign investments and alternative investments in their portfolios, areas that Congress is looking into in general.

<sup>1</sup> See Congressional Research Service (CRS) Report, 'Tax Options for Financing Health Care Reform' (April 8, 2010), BNA Daily Tax Report & TaxCore and CRS Report, 'Charitable Contributions: The Itemized Deduction Cap and Other FY2011 Budget Options' (March 22, 2010)

<sup>2</sup> See the Patient Protection and Affordable Care Act, signed into law on March 23, 2010, Pub. L. No. 111-148 (the "Act")

<sup>3</sup> See IRC 4958, the Intermediate Sanctions provisions

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## TAX REFORM

As far as legislation in this area there had been rumor of requiring a minimum payout each year similar to private foundations. However, at this point it appears that such a proposal will not be forthcoming because it could have the adverse effect of establishing a ceiling rather than a floor on spending and it may be wiser to leave these financial decisions to the institutions themselves.

However, another aspect of the use of endowments has been raised and that is "indirect arbitrage," where colleges and universities borrow money at a low rate through the use of tax exempt bond proceeds and then earn money on endowments at a higher rate. If Congress somehow required organizations to use their own money and not borrow, this could reduce the number of outstanding tax exempt bonds, thus resulting in a revenue gain to the Federal government.<sup>4</sup>

### ▶ UNRELATED BUSINESS INCOME AND EXPENSES

Finally, the IRS College and University Questionnaire used in the compliance project asked numerous questions about activities of colleges and universities in four areas: advertising, corporate sponsorship, rentals and other. There were also numerous questions regarding expenses associated with these activities. The Report indicates that in many cases colleges and universities reported conducting an activity that was not reported on their Form 990-T and that this will be an area of further study. It has been reported that at least 30 schools that had participated in the survey are now under IRS audit.

The Report points out that many exempt organizations receive opinions from counsel to determine if an activity is related or unrelated. However, many organizations do not report net unrelated business income because of the expenses that they use to offset the income. The IRS Questionnaire asked questions about expenses from activities that generate losses year after year. IRS takes the position that in order for there to be an unrelated trade or business there must be a profit motive and if there are constant losses there may not be the requisite profit motive; therefore, expenses from loss activities may not be unrelated trade or business losses which could

## OMB 2010 COMPLIANCE SUPPLEMENT STATUS

By Tammy Ricciardella, CPA

The Office of Management and Budget (OMB), usually releases its annual edition of the OMB Circular A-133 Compliance Supplement (the Supplement) in the spring. The issuance of the 2010 Supplement has been delayed due to the inclusion of new programs and clusters and new guidance on The American Recovery and Reinvestment Act of 2009 (Recovery Act) requirements. In the interim, OMB has provided the AICPA's Governmental Audit Quality Center and certain other stakeholder groups with a draft version of the Supplement so both auditors and auditees can begin reviewing some of the significant changes that have been added in the Supplement. OMB has stressed that this document is a draft and that it is subject to change. The draft Supplement can be accessed at <http://www.aicpa.org/interestareas/governmentalauditquality/resources/pages/draft2010compliance-supplement.aspx>.

The draft 2010 Supplement includes the normal changes made by OMB each year related to new programs and required compliance procedures and are summarized as they have been in the past in Appendix V, *List of Changes*, for the 2010 Compliance Supplement. Many of the critical changes made in 2010 are summarized in Appendix VII, *Other OMB Circular Advisories*. These include changes to the major program determination process and other guidance both for situations where an auditee has expended funds relating to the Recovery Act and for other situations.

be used to offset other unrelated trade or business income. Although not necessarily on the immediate horizon, future legislative proposals could include bright line tests for the use of expenses from loss activities and also what constitutes a reasonable allocation for purposes of allocating expenses between related and unrelated uses.

### ▶ CONCLUSION

It is hard to predict how or whether Congress will legislate in the nonprofit arena. Various

In addition, OMB has recently issued a memorandum to federal agencies titled, M-10-14, *Updated Guidance on the American Recovery and Reinvestment Act* (the memo). This memo advises Federal agencies to no longer grant extension requests to auditees for late single audit filings with the Federal Audit Clearinghouse for fiscal years 2009 through 2011. Appendix VII of the draft 2010 Supplement emphasizes this guidance and explains that beginning with audits covered by the draft 2010 Supplement an auditee cannot be considered a low-risk auditee if either it's 2008 or 2009 single audit was submitted late. The current filing deadline is nine months after the entity's year end.

There is a placeholder in Part III of the draft 2010 Supplement that will be completed once audit procedures regarding Section 1512 reporting filed by auditees as required by the Recovery Act are finalized. At this point, we do know that the job information in the 1512 reporting will not be part of the A-133 audit. Audit procedures will be focused on the reporting of the Recovery Funds received and expended. The final requirements will be incorporated into the final version of the 2010 Supplement.

It is anticipated that the final Supplement will be issued by June 30th.

For more information, contact Tammy Ricciardella, Assurance Director, at [tricciardella@bdo.com](mailto:tricciardella@bdo.com).

government reports provide some insight as to what future action may be taken. In the meantime, affirmative action should be taken by organizations to be in compliance with the tax laws and maintain sound financial practices as the best defense against future actions.

For more information contact Laura Kalick, National Tax Consulting Director, at [lkalick@bdo.com](mailto:lkalick@bdo.com).

<sup>4</sup> See Tax Arbitrage by Colleges and Universities, April 2010, a CBO Study

# DOCUMENT CORRECTION PROGRAM FOR NON-QUALIFIED DEFERRED COMPENSATION SUBJECT TO IRC §409A

By **Derrick Neuhauser** and  
**Yolanda Scannicchio**

**M**any of our tax-exempt clients have long-standing executive directors that more than likely have Internal Revenue Code (IRC) Section (§) 457(f) plans, which allow tax-exempt organizations to provide nonqualified deferred compensation to a select group of management or highly compensated employees. IRC §457(f) and other non-qualified deferred compensation arrangements provided by both for-profit and tax-exempt organizations are subject to IRC §409A regulations. In Notice 2010-6, the Internal Revenue Service (IRS) announced a new document correction program for deferred compensation plans that are in violation of IRC §409A.

On April 10, 2007, the final regulations under IRC §409A were announced and a deadline of January 1, 2009, was set for operational and documentary compliance. The final regulations are applicable to both for-profit and nonprofit organizations. IRC §409A generally provides for the acceleration of the recognition of income and imposition of an excise tax on participants in deferred compensation programs in those cases where the participant is deemed to have the ability to control the timing of the receipt of the deferred compensation. The IRS, recognizing that compliance with IRC §409A could be complicated, provided taxpayers with the ability to correct certain types of operational failures in Notice 2008-113; however, that Notice did not give taxpayers the ability to correct failures in the underlying documents.

Although the nonprofit entity itself is not subject to IRC §409A, the officers of the organization are. Failure to comply could subject executives to immediate taxation, a 20 percent excise tax and interest penalties. As mentioned above, IRC §457(f) plans are regulated by IRC §409A. In addition, many nonprofit entities have other compensation arrangements that should be reviewed, such

as bonus and incentive plans where the bonus is paid in the year after it was earned, severance arrangements, Supplemental Employee Retirement Plans and arrangements that provide for "gross-up" payments.

Notice 2010-6 gives a taxpayer the ability to bring its underlying plan documents into compliance with IRC §409A by December 31, 2010, so long as any operational issues are also corrected under Notice 2008-113. If the terms of Notice 2010-6 are satisfied, the Service will not impose the sanctions contained in IRC §409A. However, in certain cases, compliance with Notice 2010-6 will result in a reduced level of income recognition and related excise tax.

It is possible for the definition of certain terms in a plan to conflict with the definition of those terms in IRC §409A. The Notice gives the plan the ability to amend those terms (the IRS uses as examples the terms "change in control," "disability," and "separation from service"), although some of the amendments can be made only on a prospective basis. The Notice also indicates that certain ambiguous plan terms which are often found in the discussion of distributions from the plan, such as "as soon as reasonably practicable," will not cause the plan to fail to satisfy IRC §409A's requirements if the plan, in operation, satisfies the terms of IRC §409A.

If a plan which fails to satisfy the requirements of IRC §409A is eligible for correction under Notice 2010-6, and the plan is corrected on or before December 31, 2010, the plan will be treated as having been corrected on January 1, 2009, and any requirement of income inclusion under IRC §409A as a condition of the relief will not apply. However, Notice 2010-6 also provides that this transition relief will apply only if any payment made before December 31, 2010, that would not have been made under the corrected provision, will be classified as an operational failure and thus subject to the provisions of Notice 2008-113. The benefits of Notice 2010-6 will

not be available to taxpayers that are under examination on an IRC §409A-related issue.

While many non-profit organizations have already undertaken plan reviews, there is value in making an additional review, particularly in light of the specific issues that have been addressed in Notice 2010-6. If violations are found, corrections can still be made before the end of this year to mitigate penalties.

*Please contact the Compensation and Benefits practice if you have further questions. Derrick Neuhauser, Senior Manager, [dneuhauser@bdo.com](mailto:dneuhauser@bdo.com), and Yolanda Scannicchio, [yscannicchio@bdo.com](mailto:yscannicchio@bdo.com).*

## FBAR (Foreign Bank Account Reporting)

Form TDF 90-22.1, Report of Foreign Bank Accounts, was due on June 30, 2010, for organizations and other entities which maintained foreign accounts during the year ended December 31, 2009. Persons with signing authority over such accounts have until June 30, 2011, to file the FBAR form for tax years ended December 31, 2010, and earlier. Organizations with foreign comingled funds that are mutual funds were required to file the FBAR form for the year ended December 31, 2009, and prior years by June 30, 2010. See the March 2010 *Nonprofit Standard* for more details. Organizations that missed the filing deadline should consult with their tax advisors.

# NONFINANCIAL ASSETS AND LIABILITIES – WHAT DO I NEED TO KNOW?

By Lee Klumpp, CPA

Now that we are in 2010 the deferral of applying Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*, (formerly Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*) for nonfinancial assets and nonfinancial liabilities in interim or annual financial statements has now expired and the guidance is now in effect. Nonprofit organizations are now required to reflect the fair value of nonfinancial assets and nonfinancial liabilities in their financial statements.

## ▶ WHAT DOES THIS REALLY MEAN?

As of December 31, 2009, nonprofit organizations may be required to disclose fair value measurement information in the financial statements for certain nonfinancial assets and liabilities, such as other real estate owned, goodwill or pension obligations.

For purposes of the application of ASC 820, nonfinancial assets and nonfinancial liabilities

include all assets and liabilities other than those meeting the definition of a financial asset or financial liability. Financial assets are defined as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- Receive cash or another financial instrument from a second entity.
- Exchange other financial instruments on potentially favorable terms with the second entity.

Nonfinancial assets include land, buildings, equipment, use of facilities or utilities, materials and supplies, intangible assets or services. An example of a nonfinancial asset is when a nonprofit organization receives a donor contribution of an asset that does not have a readily marketable value and it meets the definition of a nonfinancial asset. An example would be when a donor contributes a building to a nonprofit organization to be used for the organization's program activities. The building does not have a readily determinable market value and; therefore, would require an appraisal to determine its fair value. The asset would then be recorded at fair value at the time of the contribution to organization.

A financial liability is defined as a contract that imposes on one entity an obligation to do either of the following:

- Deliver cash or another financial instrument to a second entity.
- Exchange other financial instruments on potentially unfavorable terms with the second entity.

Nonfinancial liabilities are generally not an issue for a nonprofit organization but an example of a nonfinancial liability would be if a nonprofit organization makes an unconditional promise to contribute land to another nonprofit organization and has not yet transferred title of the land at the statement of financial position date. The nonprofit organization would need to record a grants payable, which would be a nonfinancial liability.

The FASB has issued guidance noting that lease classifications and measurements are excluded from the provisions of ASC 820.

This standard will not really be an issue for most nonprofits unless your organization is entering into a merger or doing an acquisition, disposing of an activity or long-lived asset, or your organization has intangibles such as goodwill. If you have any of these activities you should consult with your financial advisor regarding the impact of this standard on your financial statements.

For more information contact Lee Klumpp, Senior Manager, at [lklumpp@bdo.com](mailto:lklumpp@bdo.com).

## ITEMS TO WATCH...

**Tax Legislation: Extenders** – extensions of expiring beneficial laws that impact exempt organizations are still pending. Charitable extenders potentially include provisions for:

- IRA contributions to charity,
- favorable basis adjustments for S-corporations making contributions of property,
- conservation contributions of real property,
- contributions of computer inventory,
- contributions of food inventory,
- contributions of book inventory to public schools, and
- extension of special rules for interest, rent, royalties, and annuities received by an exempt entity from a controlled entity.

The House passed "American Jobs and Closing Tax Loopholes Act" (H.R. 4213) that includes these provisions, but the Senate has yet to agree.

Time will tell if any will become law. If they do become law, the provisions would likely be retroactive to January 1, 2010.

### Congress Seeking to Reform Government Auditing

Illinois Congresswoman Melissa Bean (D) introduced H.R. 5018 (the Bill), the *Government Audit Reform Act*, which is to amend the Single Audit Act of 1984 to address issues related to the quality of single audits. This bill is co-sponsored by Texas Congressman Mike Conway (R).

This bill is based on the findings in the President's Council on Integrity and Efficiency's (PCIE) single audit sampling report in 2007. The report found that there were a significant amount of single audits that were performed that were unacceptable or had limited reliability.

The legislation would enact recommendations made by GAO in its report issued in response to the PCIE single audit sampling report to address problems with the single audit.

The Bill has been referred to the House Committee on Oversight and Government Reform, where it awaits action and deliberation.

### GAO to Release Exposure Draft on 2011 Revised Yellow Book

The Government Accountability Office (GAO) officials have announced that they plan to release an exposure draft on the 2011 revisions to the *Government Auditing Standards* (Yellow Book) sometime this summer, and plan to issue the final version by June 2011.

The proposed revised Yellow Book would include a principle-based approach to the independence standards and clarify continuing education requirements for those involved in Yellow Book engagements to ensure that those participating in such engagements be qualified and maintain professional competence. The GAO has also proposed expansion of its quality control and assurance requirements in the Yellow Book.

# IRS REVOKING EXEMPTIONS FOR NONFILING

May 17, 2010, marks the first date IRS can revoke exemptions for nonfiling—starting with calendar year organizations failing to file for 2007–2009. In 2006 The Pension Protection Act put into place law that requires the IRS to revoke organizations' tax exemptions for not filing. Intended to clear the rolls and get a more accurate summary of existing organizations by requiring all organizations to provide certain information to IRS to retain their exemption, most tax-exempt organizations, other than churches, must submit a yearly 990 filing with the IRS. If an organization does not file as required for three consecutive years, the law provides automatic loss of tax-exempt status. Loss of exempt status means an organization must file income tax

returns and pay income tax, and donations to 501(c)(3)s are no longer deductible by donors. A new application for exemption would need to be filed and it would apply from the date approved forward.

Despite an extraordinary outreach effort to the tax-exempt sector on the law's new filing requirements, which includes the new electronic Form 990-N e-Postcard for eligible small organizations, many of these smaller organizations are not aware or just learning of the deadline. Now that the May 17th filing deadline has passed, IRS indicates many small tax-exempt organizations have not filed the required information return in time. They have posted a notice that they want to reassure these small organizations

that the IRS will do what it can to help them avoid losing their tax-exempt status, and will be providing additional guidance in the near future on how it will help these organizations maintain their important tax-exempt status — even if they missed the May 17th deadline. The guidance will offer relief to these small organizations and provide them with the opportunity to keep their critical tax-exempt status intact. Internal Revenue Code Section 6033(j)(3) grants IRS the discretion to reinstate an organization's exempt status retroactively if they can show reasonable cause for not filing. Organizations that missed the deadline are urged to go ahead and file even though the May 17th deadline has passed.

## ▶CONTINUED FROM PAGE 1 AUDIT CHECKLIST

these questions mirror those already on the Form 990, some go a little deeper in detail and others are entirely new. Key questions and areas include:

- Does the organization have a written mission statement that reflects its *current* 501(c)(3) purpose? Agents are instructed to answer “no” if there is no mission statement or the mission statement is not aligned with the current activities of the organization.
- In addition to asking to whom the organization's articles and bylaws are provided and how large is the governing body, it asks if the bylaws have requirements as to the board's composition, duties, qualifications and voting rights.
- How often did a quorum of the board meet during the year and how often did the full board meet? It follows this by asking if the number of meetings met or exceeded the meeting requirements of the bylaws.
- With regard to compensation for officers, directors and key employees, the questions about advance approval and documentation by an independent authorized body and use of comparability mirror similar questions on the new Form 990. However, the checklist goes on to ask exactly what kinds

of organizations are used for comparison (exempts, government, for-profit, etc.)

- Does effective control of the organization rest with a single person or select few individuals? The agent instructions say that this should be answered “yes” if the board typically defers to a small group or an individual on the board—seemingly a subjective question for the agent to answer. As with the Form 990, disclosure of business and family relationships among board members is required.
- In addition to the now standard Form 990 question about having a written conflict of interest policy and whether annual disclosures are required, the checklist asks if the policy addresses recusals. If there were any actual conflicts disclosed, was the organization's policy adhered to?
- In the area of financial oversight, questions address policies and procedures to assure that assets are used consistent with the organization mission. How often did board members get written reports on financial activities and how often were finances discussed?
- Was an independent accountant's report issued and was it discussed by the board?

Was a management letter issued and was it reviewed by board or committee? Were any of the accountant's recommendations adopted?

- Is there is a document retention and destruction policy (same as the Form 990 question) and did the organization adhere to the policy?
- The checklist concludes by asking if the examination was hindered by a lack of necessary documentation.

**Conclusion:** This checklist provides excellent insight into what the IRS may consider as the most significant governance issues. It certainly delves much deeper than the Form 990 questions with which many organizations wrestled. Charities may wish to complete this checklist on their own as a self-assessment tool, to see how they might stack up in an audit situation. The complete checklist and agent instructions are available at <http://www.irs.gov/charities/article/0,,id=216068,00.html>.

For more information, contact Michael Sorrells, BDO National Director Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).

## WEBINARS

The following schedule lists planned webinars that BDO will be hosting over the next few months. These webinars are free, CPE-qualified webcasts that are offered on various topics. As a recipient of the *Nonprofit Standard* you are also on the mailing list for the invitations to these webinars. As the date of each webinar approaches you will receive an invitation with further information on the webinar content and enrollment options.

**We hope you and your colleagues will plan on participating in many, if not all, of these sessions.**

### JULY 2010

July 7 / 12:30-2:00 ET

#### **Single Audit – How Will Your Organization Be Affected by the American Recovery and Reinvestment Act and the New Regulatory Requirements?**

CPE: 1.5 Governmental Accounting  
Specialization: Yellow Book

July 28 / 12:00-2:00 ET

#### **Fair Value Accounting for Nonprofits – What You Need To Know**

CPE: 2.0 Accounting  
Specialization: Yellow Book/Technical

### SEPTEMBER 2010

September 28 / 12:00-2:00 ET

#### **Nonprofit Mergers and Acquisitions – Applying the New Guidance**

CPE: 2.0 Accounting  
Specialization: Yellow Book/Technical

BDO also conducts various live seminars throughout the country on topics that are of specific interest to nonprofit organizations. These seminars are offered free of charge and are CPE-qualified. Contact your local office for seminars that are being conducted locally or check our website: [www.bdo.com/events](http://www.bdo.com/events) for further details.

## BDO NONPROFIT PRACTICE

For 100 years, BDO has provided services to the not-for-profit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the not-for-profit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our not-for-profit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful not-for-profit organization.

In addition, BDO's Institute for Nonprofit Excellence<sup>SM</sup> (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's not-for-profit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to not-for-profit accounting and business management.

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Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

**NOTE:** Due to the large number of current topics covered in this edition, the follow-up to the March 2010 article entitled "Effective Policies – Building the Foundation of Your Organization" will appear in the next issue of the *Nonprofit Standard*.

# NONPROFIT **STANDARD**



## MOVING TOWARDS CLARITY – IRS RELEASES 2009 FORM 990 CHANGES

By Joyce Underwood, CPA

With the first year of filing the new Form 990 well on its way, the Internal Revenue Service (IRS) has released the revised 2009 forms for calendar year 2009 and fiscal year 2010 returns. In addition to improving the wording of the trigger questions, revising definitions, and clarifying many instructions, IRS has attempted to guide organizations in preparing a more complete return. Among the top errors reported on 2008 forms was the omission of Schedule O which requires certain disclosures from all organizations. IRS has added instructions to elicit a more complete filing and ensure all necessary disclosures are made.

### ► EXISTING ITEMS EFFECTIVE 2009

**990-EZ:** The thresholds for organizations allowed to file the short form 990 are reduced in 2009 requiring more organizations to complete the full revised form. Most organizations with annual gross receipts for tax year 2009 less than \$500,000, and total assets at the end of year less than \$1,250,000 can file Form 990-EZ. (2008 amounts were \$1,000,000 and \$2,500,000, respectively.)

**FIN 48:** With the end to the deferral period for FIN 48, *Accounting for Uncertainty of Tax Positions* (now called Accounting Standards Codification (ASC) 740-10), most organizations will now be required to include the text of the footnote disclosure in the 990 as part of Schedule D. IRS clarified that any portion of the FIN 48 footnote that addresses only the filing organization's liability must be

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Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

# FOREIGN ACCOUNT REPORTING – MORE IRS GUIDANCE IS HERE!

By R. Michael Sorrells, CPA

As we have reported previously\*, Treasury and the IRS have greatly stepped up enforcement of the filing requirements for Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* ("FBAR"). Penalties for non-compliance are steep: \$10,000 per occurrence. There is generally a filing requirement for both organizations with such accounts and individuals with signature authority (but no financial interest in) a foreign financial account. The FBAR report is filed on a calendar year basis and is due annually on June 30.

There has been confusion as to exactly what constitutes a foreign account and often a lack of compliance especially on the part of those with signature authority. The rules are the same for both for-profit entities and nonprofit organizations. In August 2009, the IRS issued Notice 2009-62 which extended until June 30, 2010 the filing due date for individuals with signature authority (but not a financial interest) in a foreign financial account *or* with signature authority or a financial interest in a foreign commingled fund. Many comments were received after this notice was issued, and the IRS has released additional guidance at the end of February 2010 in Notice 2010-23.

**Notice 2010-23 provides** relief in several key areas: First, it extends the filing date for persons with signature authority over (but not a financial interest in) a foreign financial account until June 30, 2011. This applies to calendar year 2010 and all prior years. Thus, individuals who may not have been aware of an individual FBAR filing requirement, have an opportunity to catch up without penalty.

Secondly, this notice modifies the guidance from Notice 2009-62 for persons (including organizations) with *either* a financial interest or signature authority over a foreign comingled fund that is a mutual fund. The date for filing these FBAR returns is June 30, 2010 for 2009 and prior years. However, the IRS made it clear in the new guidance that

*it will not require other types of commingled funds including foreign hedge funds or private equity funds to file the FBAR.* This clears up a significant area of uncertainty that caused many organizations to protectively file FBAR's for hedge funds and private equity funds in the prior year. Thus, there is a penalty-free catch up period for filing FBARs for foreign mutual funds for both organizations and those with signature authority, and clear guidance that other types of funds do not require filing. However, this notice does not address whether passive foreign investment companies (PFICs) are covered by the FBAR rules.

Lastly, Notice 2010-23 says that organizations or individuals who qualify for relief under this notice may answer "no" to the question on their tax return (990 for nonprofits or 1040 for individuals) about existence of foreign interests or signature authority if their only interests are accounts that have been granted relief. This is important as it tells the IRS not to be looking for an FBAR in these situations.

**Announcement 2010-16** extends an earlier Announcement (2009-51), which provided that only "United States persons" as defined in the FBAR instructions are required to file FBAR. The FBAR instructions state that US persons are (1) citizens or residents of the US, (2) domestic partnerships, (3) domestic corporations, or (4) domestic estates or trusts.

**Proposed Regulations** for FBAR reporting rules were issued by the Treasury Department on February 25, 2010. Although the IRS administers the FBAR rules, the rules actually come under Title 31 of the US Code as part of federal banking law. The proposed regulations (1) clarify who is a required filer (defining who is a US person) and which types of accounts are reportable, (2) exempt certain taxpayers with only signature authority from filing, and (3) provide rules intended to prevent US persons from avoiding the filing requirements. It is important to note that these are only proposed regulations at this time and do not carry the authority of law.

On March 18th, President Obama signed the HIRE Act into law. Among its many provisions is a general requirement for heightened reporting and disclosure by foreign financial institutions with US account holders. Foreign institutions that do not comply with the heightened reporting are required to withhold 30% from payments to US account holders. *Fortunately, the Act specifically excludes exempt organizations from these additional requirements.* Thus, the foreign reporting provisions of the HIRE Act are not applicable to nonprofits (although the FBAR reporting is still very much in effect!).

**Conclusion:** While the new guidance does not totally resolve all the issues with FBAR reporting, it does go a long way towards clarification in some important areas, most significantly with regards to foreign hedge and private equity funds, which are clearly now excluded from the FBAR reporting requirements. Organizations should take a fresh look, with assistance from their financial advisors, at all foreign holdings to determine which will require reporting either by the organization itself or by organization managers with signature authority. It is extremely important for any individual in an organization with signature authority over a foreign account to be aware of the rules and to take care of their individual filing requirements by the extended "grace periods" allowed by the IRS. For these individuals, this is an opportunity to voluntarily comply for prior years without penalty.

There clearly will be further developments in this area, so organizations are urged to stay tuned on this topic.

For more information contact Mike Sorrells, National Director Nonprofit Tax Services at [msorrells@bdo.com](mailto:msorrells@bdo.com)

\* See the December 2009 issue of the *Nonprofit Standard* for the previous article on this topic.

# SFAS 157 FAIR VALUE MEASUREMENTS – ADDITIONAL NOT-FOR-PROFIT PERSPECTIVES



by Dick Larkin

## NOW THAT SFAS 157 HAS BEEN IN EFFECT FOR A WHILE, IT IS WORTHWHILE TO DISCUSS A FEW PRACTICAL ISSUES THAT OFTEN ARISE DURING ITS IMPLEMENTATION.

### ► FIRST A FEW REMINDERS:

Nonprofit organizations use fair value accounting when they are:

- (1) required by certain accounting standards to use fair value for certain transactions and balances, and
- (2) permitted by certain other accounting standards to use fair value for certain other transactions and balances,

Determination of fair value is governed by Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, (now codified in Topic 820 of the FASB Accounting Standards Codification (ASC)) and

its several related FASB staff positions. It is important to remember that SFAS 157 does not itself ever mandate the use of fair value accounting.

### SFAS 157 mentions three valuation techniques:

- market for identical or comparable items
- future income (discounted)
- replacement cost.

and three levels of a hierarchy of inputs:

- Level 1 (para. 24-27) – quoted prices in active markets for identical items
- Level 2 (para. 28-29) – observable inputs other than quoted market prices
- Level 3 (para. 30) – unobservable inputs.

Nonprofits are especially likely to need to apply this statement in connection with:

- Non-cash contributions received and made, (includes both items which will be capitalized on the balance sheet, and donated services and use of property which flow through the income statement), per SFAS 116 (ASC 958-605)
- Non-marketable (so-called 'alternative') investments, per Chapter 8 of the audit guide (ASC 958-325)
- Acquisition accounting under SFAS 164 (ASC 958-805) for a combination, and
- Any asset or liability for which the fair value option is elected under SFAS 159 (ASC 825).

Balance sheet items for which SFAS 159 is most likely to be elected, and which are likely to require additional effort to determine their fair value, are pledges and loans receivable and payable. For long-term receivables and payables discounted to present value under APB 21 (ASC 835), the effect of using fair value is to unfreeze the interest rate used to compute the discount. Under APB 21 the interest rate is set at the inception of the agreement and is not changed over the life of the agreement; under SFAS 157 the interest rate is adjusted each period to a current rate.

Non-cash contributions are required to be valued at fair value by SFAS 116, and, even if alternative investments are not reported at fair value in the balance sheet, SFAS 107 (ASC 825) may require disclosure of their fair value in a footnote.

FASB is also considering further changes in measurement principles for financial instruments generally. At a meeting in July, 2009, the Board agreed to propose a model to improve financial reporting for financial instruments.

### The Board reached the following decision:

*... to propose that all financial instruments will be presented on the balance sheet at fair value with changes in value recognized in net income or other comprehensive income with an optional exception for [its] own debt in certain*

# EFFECTIVE POLICIES – BUILDING THE FOUNDATION OF YOUR ORGANIZATION



By Lee Klumpp, CPA

**P**olicies are guidelines that regulate organizational action and control the conduct of individuals within an organization and ensure that an organization has the foundation to accomplish its mission. Procedures on the other hand describe the normal operating method and provide the protocol for implementation of the policies or the “how to.” Both policies and procedures are required by all organizations in order to operate efficiently, avoid confusion among employees, and ensure that an organization is in compliance with its legal and regulatory requirements. In this article we will explore the best practices for developing sound and effective policies for an organization.

The day-to-day operations of an organization are managed by every member of the organization’s leadership team (management team) except for the board of directors. The management team members are the ones that are responsible for an organization’s operations and the boards of directors’ are responsible for providing the monitoring and oversight process in order to carry out their fiduciary duty related to the organization. It is important that this concept of division of responsibilities be understood by all parties. If a board of directors is not involved in the organization (therefore hands off or providing

the rubber stamp) that is almost as bad as a board of directors that micro manages an organization. In either of these cases the individual board members are opening themselves up to substantial risk and exposure as well as putting the organization at risk. The management team is responsible for developing the organization’s policies and ensuring that they are developed, designed, implemented, and carried out in the day-to-day operations of an organization. The board of director’s key responsibilities, besides those described above, is to provide vision, strategic thinking, and planning for the organization.

Management has a wide variety of responsibilities as discussed above, which includes not only the operation of the organization and development of programmatic policies in order to accomplish the mission but also to develop policies related to fiscal controls, physical security, behavioral policies (code of conduct, conflict of interest and ethics), human resources, administrative, and information technology, including social media. When developing policies in these areas it is important to be concise without strangling innovation. Many staff complain that their organization’s policies are too burdensome, confusing or too time consuming to work through. This can cause a culture in which policies are ignored completely by individuals within the organization and therefore the organization

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE IN THE NEWS...

*Members of the Institute are requested to speak on a regular basis at various conferences due to their recognized expertise in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking.*

**Mike Sorrells** will be presenting an update on nonprofit tax issues at the Maryland Association of CPA’s 2010 Government and Not-for-Profit Conference on April 30, 2010 in College Park, Maryland.

**Lee Klumpp** will also be presenting on the American Reinvestment and Recovery Act at the Maryland Association of CPA’s 2010 Government and Not-for-Profit Conference on April 30, 2010 in College Park, Maryland.

**Laura Kalick** will be presenting *Trade Associations, 501(c)(4) and 527 Organizations Activity Update* at the BNA Political Law Compliance after *Citizens United* Conference on May 6, 2010.

**Dick Larkin** will be conducting a three hour presentation at the AICPA National Not-for-Profit Conference in DC on June 16, 2010 at the pre-conference session on overall topics of interest to not-for-profits and a GAAP update.

**Lee Klumpp** will be the presenter for two separate eight hour courses for the Connecticut Society of CPA’s at their Education Center in Rocky Hill, Connecticut. On June 7 he will present *Audits of 403(b) Plans: A Challenging New Audit Area* and on June 8, 2010 he will present *Applying OMB A-133 to Nonprofit and Governmental Organizations*.

**Lee** will also be presenting an accounting and auditing update for nonprofit organizations at the Not-for-Profit Conference of the Nebraska State Society of CPA’s in Lincoln, Nebraska on June 24, 2010.

# EMPLOYEE BENEFITS SECURITY ADMINISTRATION'S (EBSA) 2010 PRIORITIES

By Bob Lavenberg

Recently the Department of Labor's (DOL) EBSA revealed its priorities for 2010 and at the top of the list is enforcement relating to the timely remittance of employee deferral contributions to defined contribution plans.

The DOL requires that employee deferral contributions and loan repayments be remitted to retirement plans on the earliest date on which they can be reasonably segregated from the company's general assets. Failure to remit such employee contributions and loan repayments to the plan in a timely manner results in a breach of fiduciary duty and is considered to be a prohibited loan to the company. The transactions must be separately reported to the DOL and may result in the payment of lost earnings, excise taxes and penalties by the company, not the plan.

On January 14th, the EBSA issued final regulations setting forth a "safe harbor" for the remittance of employee deferral contributions

and loan repayments by small plans (those with under 100 eligible participants). In order to comply with the safe harbor, these contributions and repayments must be received by the plan "not later than the 7th business day following the day on which such amount is received by the employer (in the case of amounts that a participant or beneficiary pays to an employer), or the 7th business day following the day on which such amount would otherwise have been payable to the participant in cash."

Historically, the DOL has penalized plan sponsors for untimely remittance of employee contributions and loan repayments. However, in a speech on September 14, 2009, at the 2009 American Society of Pension Professionals and Actuaries/DOL Speaks conference in Washington, D.C., the new head of EBSA, Assistant Secretary of Labor Phyllis Borzi, emphasized the DOL's commitment to enforcement activities such as a "contributory plan criminal project" to prosecute violators who fail to forward employee contributions to employee benefit plans. **This program is designed "to target the most egregious and persistent violations and to protect the most vulnerable employee populations by pursuing criminal prosecution of individuals who commit crimes involving contributory health and retirement plans."**

Examples of violations that would fall under this enforcement project include embezzlement of plan funds, including those who withhold money from worker paychecks without depositing them into the plan, and knowingly filing false Form 5500s.

Among the other priorities in 2010, the EBSA also plans to address 401(k) fee disclosure, investment advice regulations and issues regarding target-date funds used as qualified default investments.

## FIN 48 Update for Nonprofit Organizations

By Laura Kalick

Nonprofit organizations are now beginning the process of documenting tax positions. Material uncertain tax positions will have to be disclosed in a footnote to the financial statements and that footnote is now required to appear on Schedule D of Form 990. Most organizations were not required to implement FIN 48 (now called ASC 740-10) until years ending on December 31, 2009 or later. Thus, all nonprofits that have not previously implemented this provision will have to do so soon.

What does the organization have to document? Since tax exemption itself is a tax position, an organization must document the certainty of exemption. Since the IRS granted exempt status based on representations made in the application for exemption, a good place to start might be to look at the original Form 1023 or 1024 and document that the organization is doing what it said it was going to do. An inventory of revenue streams can be found on the Form 990 in the section that describes income producing activities. An organization should document that the characterization of those items is appropriate and that it would be more likely than not to be sustained if the organization was audited by taxing authorities. FIN 48 is applicable to tax positions at the federal, state and local and international levels. Alternative investments should be reviewed not only for federal unrelated business income tax issues but should also be reviewed for state tax issues. Finally, an organization should look closely at the expenses that have been used to offset unrelated trade or business income, especially when those expenses come from activities that consistently generate losses.

See the full article on this issue at [www.bdo.com/industries/nonprofit/FIN48UpdateforTaxExempt.pdf](http://www.bdo.com/industries/nonprofit/FIN48UpdateforTaxExempt.pdf).

For more information contact Bob Lavenberg, National Employee Benefit Plan Practice Leader at [rlavenberg@bdo.com](mailto:rlavenberg@bdo.com).

For more information contact Laura Kalick, Tax Director, Institute for Nonprofit Excellence at [lkalick@bdo.com](mailto:lkalick@bdo.com).



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## IRS RELEASES 2009 FORM 990 CHANGES

provided verbatim, however the organization can summarize the filing organization's share of liability when it's part of a consolidated footnote.

### ►EXPANDED REPORTING

As previously announced, organizations filing Schedules H and K must complete all parts of these schedules for the 2009 tax year.

**Schedule H** – Beginning this year, IRS requires an organization to report information about whether the hospital is providing sufficient care to needy individuals and/or other community benefits to justify its tax-exempt status; and to provide information about management companies and joint ventures in which the organization is a participant. For this schedule, a *hospital* is a facility that is required to be licensed, registered, or similarly recognized by a state as a hospital. The schedule is required even when a hospital is operated through a disregarded entity or a joint venture treated as a partnership for tax purposes. If an organization operates multiple hospitals, or files a group return for a group that operates one or more hospitals, only one Schedule H should be completed by aggregating the information from all the hospitals. Medical facilities operated as a joint venture or partnership should be reported in Part IV.

Schedule H is not filed for a hospital located outside the U.S., nor by hospitals that are operated by a separate tax-exempt entity or an organization taxable as a corporation for federal tax purposes (unless included in a group exemption).

**Schedule K** – This schedule is required to report each outstanding tax-exempt liability that had an outstanding principal amount in excess of \$100,000 as of the last day of the tax year, and was issued after December 31, 2002. Bonds issued after December 31, 2002, to refund bonds issued before January 1, 2003 have special reporting rules. These refunding bonds are subject to the reporting requirements of Parts I, II, and IV; however, Part III does not need to be completed.

The Schedule K is used to provide certain information on outstanding liabilities associated with tax-exempt bond issues. Generally, the IRS wants to confirm that organizations issuing tax-exempt bonds are



maintaining the proper records and are not circumventing arbitrage requirements with their investment of the proceeds. The IRS is also concerned that arrangements with respect to bond-financed property may result in private business use.

The filing organization may complete Schedule K using the same period as the Form 990, or it may use any other 12-month period or periods selected by the organization and used consistently for an obligation for purposes of Schedule K and computations in accordance with the requirements under IRC Sections 141–150. For 2009 only, the filer should include on Part II, line 5 the cumulative amount of bond proceeds used to pay fees for credit enhancement that are taken into account in determining the yield on the issue for purposes of Code section 148(h).

### ►CHANGES AND CLARIFICATIONS TO FORM

During the 2008 filing season IRS released a series of Frequently Asked Questions (FAQ) to provide clarification of the instructions on areas including compensation, foreign activities, transactions with interested persons, and related entities. These FAQs have been incorporated into the new form and schedules.

Codes for Part III, Statement of Program Services Accomplishments, are still not

developed and remain deferred; however, the business activity codes for Part VIII, Statement of Revenue, can now be completed based on NAICS codes so they can more closely match the revenue types.

IRS clarifies that changes in organization activities and organizational documents should be described on the 990, rather than provided in a letter to EO Determinations section.

Many organizations were disconcerted that a consolidated audit prevented them from describing themselves as audited for 990 purposes. A question has been added for organizations to indicate they are included in a consolidated financial statement audit.

Part V of the 990 covering IRS filings and compliance now includes better information regarding how to answer the questions in this section and on handling compensation through related organizations and reporting agents.

Part VI on governance issues is reorganized somewhat and instructions clarify how to appropriately respond and disclose necessary information.

Penalties: IRS requires full compliance and, for years beginning after 2006 new law allows IRS to revoke tax-exemption for an organization that is required to file a 990 form and fails to do so for three consecutive years. Most

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## FAS 157 FAIR VALUE MEASUREMENTS

*circumstances, which will be measured at amortized cost. ....*

The main effect of this proposal will be to change SFAS 115 applicable to for-profit organizations. However it would also presumably remove the options for reporting non-SFAS 124 investments (see ASC 958-325) that nonprofits now have, under the AICPA audit guide for not-for-profits, to use either fair value or another method (the other method - either cost or the lower of cost or fair value - varies depending on what type of organization is involved).

**AICPA Issues Paper** - In January 2010, the AICPA issued a draft of an issues paper designed to provide practical guidance in implementation of the fair value standards in SFAS 157 (ASC 820-10-35) as they apply to three areas peculiar to nonprofits:

- Pledges (promises to give)
- Beneficial interests in perpetual third-party trusts

- Split-interest agreements such as lead trusts, remainder trusts, and charitable gift annuities

**Parts of this paper are fairly straightforward; parts of it are very theoretical. Briefly, with respect to:**

I. - Pledges, it observes that two of the three methods of measuring fair value (cost and market) are not going to be useful or practical to use for pledges. By elimination, the present value of future cash flows approach is the one that is normally going to be used, which is consistent with existing practice. The paper discusses the determination of an appropriate discount rate and its relation to the assessed risk of collectibility of the pledge.

II. - Perpetual trusts, it refers to the guidance in Chapter 6 of the AICPA audit guide for not-for-profits, which indicates that the fair value of the beneficial interest is normally best measured by the fair value of the assets in the trust, absent indications to the contrary.

III. - Split-interests, it includes a lengthy theoretical discussion of the various aspects of measuring these agreements. The subject is complicated by the great variety of types of agreements, the variety of payment schemes contained in such agreements, the need to value both the assets and the liability under the agreements, and the number of variables affecting the value such as: life expectancy, discount rate, estimates of future return on the trust assets, type and potential variability of payments to the life tenant, valuation of the assets underlying the agreement, form of trust management (i.e., sometimes the charitable beneficiary is also the trustee; sometimes not), etc.

Comments on the draft were due in March.

*For more information contact Dick Larkin, Director, Institute for Nonprofit Excellence at [dlarkin@bdo.com](mailto:dlarkin@bdo.com).*

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## IRS RELEASES 2009 FORM 990 CHANGES

organizations must at least file a 990-N, or risk loss of exemption. Also, IRS clarifies that an organization that files an incomplete return by failing to complete a required line or omitting a required disclosure or schedule can be subject to penalties. Penalties also apply if information is incorrect, and can be imposed on both the responsible person and tax preparer.

### ▶IMPACT OF NEW FORM

The government, press and others are looking closely at the new Form 990. Although no section of the form is expected to trigger an IRS audit, IRS is using information from the new form to focus attention on key compliance and exemption areas. Current activities by IRS regarding compensation,

overseas operations, revenue streams, UBIT, and lobbying and political activity are ongoing. The new form's format is also guiding organizations to readdress their status for public support purposes, and some organizations are now finding they have or may become a private foundation.

The new form will continue to challenge organizations and their preparers, but as implications of the disclosures become clearer and more returns become public, a better understanding of required disclosures and best practices will be established. IRS continues to focus on education and guidance and has a variety of materials available online.

BDO has many resources available to assist you with preparing the new IRS Form 990.

We are working closely with our clients and friends to share our knowledge and to help organizations understand the issues underlying their annual exempt organization return. Please feel free to contact us if you have any questions.

For a more detailed list of IRS changes see the IRS summary at: <http://www.irs.gov/charities/article/0,,id=218938,00.html>

*For more information contact Joyce Underwood, Director, Nonprofit Tax Services at [junderwood@bdo.com](mailto:junderwood@bdo.com).*

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## EFFECTIVE POLICIES

develops a vast difference between the written policies and the actual policies within which the organization operates. In most of these cases, the policies were not developed correctly in the first place with little effort put on the effectiveness and efficiency of the policies when they were written. There is no one correct set of rules or methodology for developing policies for an organization. An organization's policies should be developed specifically for that organization taking into consideration its size, number of employees, segregation of duties, employees' workloads, consideration of fraud and abuse, and compliance with laws and regulations.

A key element to remember about policies is that employees and other stake holders look to senior management and even the board of directors to be a model of behavior (tone from the top). If the leaders do not follow the prescribed policies then others will believe they do not have to follow the policies either. A perfect example is that of an Executive Director who wears jeans to the office against the organization's prescribed policy. Within several months very few people will be following the prescribed dress code. The unofficial dress code being set by the Executive Director will prevail. Individuals in the work force will follow the leader and ignore the official policies. If the policy is worth having then it is worth having everyone follow it from the top of the organization down to every single employee. Once you start to deviate from a prescribed policy it is very hard to get back on the right course.

### Some of the key considerations in developing strong and effective organizational policies are:

- Involve the people affected by the policies in the development phase to the maximum extent possible.
- Document all policies and make them available to all employees. With today's technology this is very easy to accomplish through the use of an intranet site and web portals. Using technology to disseminate the organization's policies allows individuals at different sites easy access to the most current version of the organization's policies. Additionally, having the organization's policies in a manual that is computerized and maintained centrally makes updating the organization's policies relatively easy.

- Obtain an employee's written acknowledgment affirming that they have read the policies and understand them and accept the responsibility to adhere to them as a condition of employment.
- Make sure that you use one consistent format in documenting the organization's policies.
- Assign effective dates to all newly issued policies and affix the date to the document in order to be able to track when the policies became effective. This can be very important for documentation purposes and discussions with employees that are not following a prescribed policy.
- Write all policies clearly and concisely. The key is to avoid language that uses vague terms or language that is confusing. If you need to use terms that are specific to the organization or that are based on a specific discipline (i.e. accounting or finance) provide definitions for those terms.
- Provide training sessions for all employees in order to ensure that they are aware of the policies. Additionally, keep in mind that these training sessions need to occur on a regular basis as your staff expands or turns over and when there are significant changes to an organization's policies.
- The management team should consider the risk of fraud that the organization might be vulnerable to as policies are developed. The key thought process here is "what could go wrong" in the transaction streams and processes. Questions like this will go a long way in the development of sound and effective policies to prevent fraud and other abuse.
- Everyone needs to go the doctor from time to time for a check-up and an organization's policies are no different. An organization's policies need to be reviewed on a regular basis to ensure that the policies have stayed current with the needs of the organization and the current environment.

### Some potential sources of feedback on the effectiveness of your policies are:

- External auditors;
- Internal audit procedures;
- Audits by funding sources;
- Feedback from contributors and grantors;

- Supervisors or employees bringing weaknesses to the attention of management;
- New Board Members' or managers' input; and
- Known reported instances of fraud and/ or abuse.

When the various types of feedback are received the management team must take them seriously. Consideration should be given to the feedback received from these sources and any necessary updates to policies should be made.

At first glance this may look like a daunting endeavor; however, to avoid feeling overwhelmed, management teams are advised to look at the key processes at each level of their organization as a start. As you go through this process it may be important for the management team to look for insight and direction by reading articles and other literature on the topic, attending seminars, and seeking the help of professionals and consultants in this area. It is important that no matter how you gather the information and insight to develop your organization's policies, at the end of the day they are your organization's policies and the management team needs to take responsibility for them.

The needs, requirements, and circumstances for designing and developing an organization's policies vary from organization to organization, and even within an organization that may be complex. At the same time, addressing and applying the information discussed in this article is the first step in designing appropriate policies for an organization. The next step is the design and implementation of effective procedures to carry out the policies and provide the organization with strong internal controls. Stay tuned for a discussion of this process in the next edition of the *Nonprofit Standard*.

For more information contact Lee Klumpp, Senior Manager at [lklumpp@bdo.com](mailto:lklumpp@bdo.com).

## WEBINARS

The following schedule lists planned webinars that BDO Seidman will be hosting during 2010. These webinars are free, CPE-qualified webcasts that are offered on various topics. As a recipient of the *Nonprofit Standard* you are also on the mailing list for the invitations to these webinars. As the date of each webinar approaches you will receive an invitation with further information on the webinar content and enrollment options.

**We hope you and your colleagues will plan on participating in many, if not all, of these sessions.**

### APRIL 2010

April 27 / 12:00 ET

#### **2010 Nonprofit Tax Update – What the IRS Has In Store**

CPE: 1.0 Accounting & 1.0 Tax

Specialization: Technical

### MAY 2010

May 27 / 12:00 ET

#### **Single Audit – How will your Organization be affected by the American Recovery and Reinvestment Act Funds and What Are the New Regulatory Requirements?**

CPE: 2.0 Accounting/Governmental

Specialization: Yellow Book

### JUNE 2010

June 2 / 12:00 ET

#### **Executive Compensation for Nonprofits – What Do You Need to Know?**

CPE: 2.0 Personnel/HR

Specialization: Technical

June 9 / 12:00 ET

#### **Fair Value Accounting for Nonprofits – What Does It Really Mean?**

CPE: 2.0 Accounting

Specialization: Yellow Book/Technical

### SEPTEMBER 2010

September 8 / 12:00 ET

#### **Nonprofit Mergers and Acquisitions – Applying the New Guidance**

CPE: 2.0 Accounting

Specialization: Yellow Book/Technical

### UPCOMING 2010

TBD\* / 12:00 ET

#### **403(b) Retirement Plans – Navigating through the new Audit and Regulatory Filing Requirements**

CPE: 2.0 Audit

Specialization: Technical

BDO Seidman also conducts various seminars throughout the country on topics that are of specific interest to nonprofit organizations. These seminars are offered free of charge and are CPE-qualified. Contact your local office for seminars that are being conducted locally or check our website: [www.bdo.com](http://www.bdo.com) for further details.

\* The date this session will be offered has not yet been determined. Keep an eye out for an invitation to this event once the date is set.

## BDO NONPROFIT PRACTICE

For 100 years, BDO has provided services to the not-for-profit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the not-for-profit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our not-for-profit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful not-for-profit organization.

In addition, BDO's Institute for Nonprofit Excellence<sup>SM</sup> (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's not-for-profit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to not-for-profit accounting and business management.

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THE NEWSLETTER OF THE BDO NONPROFIT INDUSTRY PRACTICE

# NONPROFIT **STANDARD**



## THE EVER CHANGING REGULATORY ENVIRONMENT OF THE FEDERAL GOVERNMENT

By Lee Klumpp, CPA

The regulatory environment for those who receive federal funds is constantly changing these days. Some might say that the changes are related to current political and regulatory agendas being pursued. However, if you really take a look at the changes, a significant number of them have been in the name of accountability and transparency, which is a good thing. We seem to have forgotten about the days prior to the *Single Audit Act of 1984* when each federal agency had the authority to require an audit of each federally funded program or activity; there was no coordination among the federal agencies or sometimes even departments of the same agency, causing audit overlaps and

organizational inefficiencies. For example, a nonprofit organization receiving funds from three different federal agencies could have been subjected to three different audits, performed by three different auditors consecutively or worse yet you could have had all three auditors simultaneously. At least, from this perspective, we can say we are better off today. This article discusses some of the current projects and agendas of the Office of Management and Budget and the U.S. Government Accountability Office.

### ► THE OFFICE OF MANAGEMENT AND BUDGET

The Office of Management and Budget (OMB) has introduced two initiatives that they hope

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## REGULATORY ENVIRONMENT OF THE FEDERAL GOVERNMENT

will help reduce fraud and improper payments made to nonprofit organizations, for-profit entities and individuals. The purpose of these initiatives is to cut government waste and create a more transparent government that is responsive to the American public, according to OMB Director Peter R. Orszag.

In June, President Barack Obama issued an executive memorandum for the first initiative directing the creation of a *Do Not Pay List*, which would be a single source to help all federal agencies check the status of a potential receiver of federal funds in order to prevent improper payments. Oftentimes, a federal agency does not check all the databases that the government has or finds it hard to do so. This prevents agencies from verifying information that they need to use in determining if the payment is allowed under federal regulations, for example, whether an individual is alive or dead, or if a contractor had been suspended or debarred.

The *Do Not Pay List* will allow federal agencies to access this information in a more timely and cost effective manner and will help reduce improper payments made by the government and help save taxpayer dollars. Every year the federal government pays out tens of millions of dollars in benefits to nonprofit organizations, for-profit entities and individuals that have been suspended or disbarred, who are dead, fugitive felons or those in jail and who are not eligible for benefits or payments.

The second initiative deals with technology that was developed by the Recovery Accountability and Transparency Board (RATB) to ensure that American Recovery and Reinvestment Act (ARRA) funds were spent and not wasted through fraud, error or abuse. This technology consists of fraud-mapping tools that leverage the latest technologies in data capture and analytics to identify potential fraud and error. These tools collect significant quantities of real-time information that then gets analyzed to identify indicators of possible fraud or error.

In a recent Bloomberg News article regarding the RATB's Recovery Operations Center, the article stated that the "RATB's aim is to catch fraud before it happens." The RATB's Operations Center uses digitized maps to analyze data that show what areas of the

country are receiving federal spending. The tools look like Doppler radar systems for detecting fraud, waste and abuse. One map aggregates contract spending and crime levels, while the other maps focus on foreclosure rates and reported fraud. The data helps guide the RATB's team of analysts to which projects might deserve additional scrutiny and consideration.

I had the distinct pleasure of co-presenting with Glen Walker, Executive Director of the RATB, at the Maryland Association of CPAs 2010 Government and Not-for-Profit Conference this past May and started wondering after his presentation when such a broad-reaching fraud-detection system would start finding its way into other government agencies and why it took a terrible recession and the American Recovery and Reinvestment Act to develop it to begin with. It looks like that time may have finally come.

At this year's National Grants Management Association's Annual Training Conference, Ken Dieffenbach, Senior Special Agent with the U.S. Department of Justice, Office of the Inspector General, Fraud Detection, presented a session on *Preventing Fraud in Grant Funded Programs*. During his presentation Special Agent Dieffenbach discussed that the federal government will likely consider adding language to Office of Management and Budget circulars covering grants and cooperative agreements that will require grantees to inform inspector generals about potential fraud. This language is already contained in the American Recovery and Reinvestment Act that currently affects all programs receiving funds under the stimulus program.

This is important to the federal government at so many levels. Prior to ARRA, if a nonprofit organization became aware that an employee had committed fraud or was stealing funds from the nonprofit organization or lying on their timesheets, it did not have to step forward and report the instance to the federal government. There are a couple of exceptions to this statement where specific federal agencies such as the Department of Labor have written the requirement to report fraud into the code of federal regulations for their agency. Language may be added to the various OMB circulars that will require all fraudulent acts committed with federal money to be



reported. ARRA currently requires that all grantees and subgrantees promptly refer to the appropriate inspector general "any credible evidence that a principal, employee, agent, contractor, subgrantee, subcontractor or other person has submitted a false claim under the False Claims Act or has committed a criminal or civil violation of laws pertaining to fraud, conflict of interest, bribery, gratuity or similar misconduct involving those funds." As part of his comments Special Agent Dieffenbach stated that "by expanding this requirement to all grants it may spur more grantees to look at their internal controls and other processes on a regular basis to avoid potential areas of fraud."

### ►U.S. GOVERNMENT ACCOUNTABILITY OFFICE

At the Association of Government Accountants 59th Professional Development Conference and Exposition in Orlando, Florida in July, Gene L. Dodaro, Acting Comptroller General of the U.S. Government Accountability Office (GAO) was a featured speaker and spoke on *Anticipating and Meeting Accountability Challenges in a Dynamic Environment*. Mr. Dodaro stated that the GAO has several Single Audit Recommendations that it is currently making in order to leverage the Single Audit as an effective oversight tool for monitoring the federal funds that are disbursed to grantees and sub grantees such as the following:

► Read more on next page

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## REGULATORY ENVIRONMENT

- Move to earlier reporting on internal controls;
- Focus on ARRA programs;
- Give relief for low-risk programs;
- Fund more timely, effective Single Audits; and
- Provide timelier Single Audit guidance and federal agency decisions on corrective action plans.

We have noted that the GAO has recommended for congressional consideration that the Single Audit Act be amended or that Congress enact new legislation to address many of the items noted above. How these recommendations will play out with Congress, Office of Management and Budget and other federal agencies at this time we cannot predict but we will keep you informed.

In addition, as stated in the June 2010 issue of the *Nonprofit Standard*, the GAO has released an exposure draft of the revisions to the *Government Auditing Standards* (Yellow Book). The proposed revised Yellow Book would include a principle-based approach to the independence standards and clarify continuing education requirements for those involved in Yellow Book engagements to ensure that those participating in such engagements be qualified and maintain professional competence. The GAO has also proposed expansion of its quality control and assurance requirements in the Yellow Book. The GAO has released the following timeline for the revision as follows:

- Exposure Draft of 2011 Revision of GAGAS: August 2010
- Comments due on the exposure draft: October and November 2010
- Issue 2011 Revision of GAGAS: February – March 2011
- The effective date is still to be determined.

You may access the exposure draft at <http://www.gao.gov/new.items/d10853g.pdf>.

We will keep you informed on the progress of the revised Yellow Book as it moves forward through the exposure process.

For more information contact Lee Klumpp, assurance director, at [lklumpp@bdo.com](mailto:lklumpp@bdo.com).

## BDO INSTITUTE FOR NONPROFIT EXCELLENCE IN THE NEWS...

Members of the Institute are requested to speak on a regular basis at various conferences due to their recognized expertise in the industry. The following is a list of some of the upcoming events where you can hear BDO Institute professionals speaking.

**Laura Kalick** will be speaking at the American Health Lawyers Association on October 11 on the topic of identifying unrelated business income in the healthcare setting in Arlington, Virginia.

**Lee Klumpp** will be the presenter for two eight hour courses for the Illinois Society of Certified Public Accountants in Chicago, Illinois. He will be presenting *Applying A-133 to Nonprofits and Governmental Organizations* on October 25 and on October 26 he will be presenting *Right the First Time: Cases in Not-for-Profit Accounting and Auditing*.

**Dick Larkin** and **Lee Klumpp** will be presenting at the PESI Law & Accounting Not-for-Profit Conference on October 28 and 29, 2010 in Las Vegas, Nevada. The conference highlights best practices related to board governance, discussion of the changing landscape related to nonprofit accounting standards and the changing regulatory environment for nonprofits.

**Dick Larkin** will be presenting *Right the First Time: Cases In Not-For-Profit Accounting and Auditing* on November 4, 2010 for the Maryland Society of CPAs in Frederick, Maryland. This course is designed to improve one's understanding of key nonprofit accounting and reporting requirements.

**Mike Sorrells** will present *Nonprofit Tax Developments* at the Virginia Society of Certified Public Accountants Accounting and Auditing Conference in Virginia Beach, Virginia on November 18 and 19, 2010. **Dick Larkin** will present *Nonprofit Accounting and Auditing Update* at this conference.

**Mike** will present a course on the Federal Form 990 at the Maryland Association of Certified Public Accountants in Towson, Maryland on November 22, 2010.

**Lee** will be the presenter for two eight hour courses for the Oklahoma State Society of CPAs in Oklahoma City, Oklahoma. He will be presenting *Applying A-133 to Nonprofits and Governmental Organizations* on November 22 and on November 23 he will be presenting *Frequent Frauds Found in Governments and Not-for-Profit Organizations*.

**Lee** will also be the presenter for two eight hour courses for the Virginia Society of CPAs in Springfield, Virginia. He will be presenting *Studies on Single Audit and Yellow Book Deficiencies* on November 29 and on November 30 he will be presenting *Fair Value Accounting: A Critical New Skill for All CPAs*.

**Mike** will be presenting *IRS Workplan* at the Greater Washington Society of Certified Public Accountants Not-for-Profit Organization Symposium being held on December 13 and 14, 2010. **Dick Larkin** will also be presenting *GAAP Update* at the Symposium.

**Lee** will be teaching a course at the Tennessee State Society of CPA's on December 16 on the topic, *Annual Update for State and Local Governments and Not-for-Profits* in Nashville, Tennessee.

# SHOULD YOUR ORGANIZATION MAKE THE 501(h) LOBBYING ELECTION?

By Laura Kalick

If you are an executive of an Internal Revenue Code (IRC) 501(c)(3) public charity that engages in any legislative activity, you should consider whether the organization should make the IRC section 501(h) election. If an IRC 501(c)(3) public charity engages in "substantial" lobbying activities its exempt status could be revoked.<sup>1</sup> As to what is "substantial," there is no clear definition. The 501(h) election allows a 501(c)(3) public charity to use a bright line expenditure safe harbor instead of the facts and circumstances test in determining whether an organization is engaged in substantial lobbying.

In the absence of making the 501(h) election, the test for permissible levels of lobbying is a facts and circumstances test and includes factors such as volunteer labor and does not even have a clear definition of lobbying. For example, if an organization has two out of two hundred employees that are lobbying on its behalf, lobbying might not sound like a substantial activity. However, if each year the organization spends substantial time organizing thousands of volunteer members to conduct Congressional visits lobbying for the organization's causes, the facts and circumstances may point toward substantial lobbying activities. Likewise, a small new organization with no employees could be considered to be engaged in substantial lobbying activities when the board of directors lobbies for appropriations to fund the organization's programs.

If an organization makes the 501(h) election, only the lobbying expenditures are counted toward the limit, not activities by volunteers. There are also clear definitions in the Internal Revenue Code Regulations as to which activities are actually lobbying. Furthermore, based on a sliding scale formula that takes into account how much an organization spends on its exempt purpose activities, an organization may be able to spend up to \$1 million on

lobbying. Therefore, unless an organization is very large and spending over a million dollars would not be considered substantial, the election may make sense.

Lobbying can be either direct or grassroots. Direct lobbying is contacting legislators or their staffs about specific legislation and reflecting a view on the legislation. Legislation is defined broadly as Federal or state or local laws including budgets and appropriations, Constitutional amendments, confirmation of nominees for office and treaties that must be ratified by Congress. Legislation includes both legislation that has already been introduced in a legislative body and specific legislative proposals that the organization either supports or opposes.

Lobbying also includes grassroots lobbying which is defined as an attempt to influence legislation through a communication with the general public that urges the public to contact legislators in support of or in opposition to legislation. There is a separate sub-limit on grassroots lobbying for organizations that have made the section 501(h) election.

Under the 501(h) election, IRC 4911 provides that the allowable amount of all lobbying expenditures (direct and grassroots combined) is limited to the sum of (1) 20 percent of the first \$500,000 of the organization's exempt purpose expenditures for the year, (2) 15 percent of the next \$500,000 of such expenditures, (3) 10 percent of the third \$500,000 of such expenditures, and (4) 5 percent of any additional such expenditures with total expenditures not to exceed \$1 million no matter how large the budget.

Grassroots lobbying is subject to a separate limitation, equal to 25 percent of the overall permissible lobbying amount.

In order to prevent organizations from avoiding the dollar limitations of section 501(h) by forming related entities, certain

affiliated 501(c)(3) organizations under common control are treated as one organization for the purpose of applying the section 501(h) tests. However, if there is an affiliated organization that can engage in unlimited lobbying, such as a 501(c)(4) or 501(c)(6) organization, these organizations are not grouped together for the limit. Forming a related 501(c)(4) or (c)(6) is very common for exactly this reason.

If lobbying expenditures in any one year exceed the allowable amounts under section 4911, then a penalty excise tax is imposed on the organization equal to 25 percent of the excess lobbying expenditures. If the organization's lobbying expenditures over a four-year period are more than 150 percent of the allowable amounts, then not only will the organization be subject to the excise tax penalties under section 4911, but the organization may lose its tax-exempt status.

## ► CONCLUSION

The rules on lobbying are very complicated and an organization could easily cross the blurred lines of what constitutes substantial lobbying activities. Organizations should consider the bright line tests of IRC 501(h) and also forming affiliates that can engage in unlimited lobbying if the limits of 501(h) are too low. Regardless of whether the organization has made the section 501(h) election, Congress and the states have rules regarding the registration of lobbyists and organizations must be mindful of these rules as well.

For more information contact Laura Kalick, JD, LL.M. in Tax, National Tax Consulting director, at [lkalick@bdo.com](mailto:lkalick@bdo.com).

<sup>1</sup> If a private foundation engages in lobbying activities, even if the lobbying activities are insubstantial, the foundation and its managers may be subject to penalty excise taxes, unless certain exceptions apply.

# HEALTHCARE REFORM: CHALLENGES AHEAD FOR U.S. EMPLOYERS

By Karen Fitzsimmons, CPA

## THE ENACTMENT OF THE RECENT HEALTHCARE REFORM LEGISLATION WILL AFFECT AND PRESENT CHALLENGES FOR EVERYONE FROM HEALTHCARE PROVIDERS, INSURANCE COMPANIES, AND EMPLOYERS TO INDIVIDUALS.

Employers will need to prepare in order to manage through the new mandates, changing tax implications and potential shifts in cost. One major cost shift is the expansion of the State Children's Health Insurance Program (SCHIP) providing coverage to more children. The Patient Protection and Affordable Care Act's (The Act) primary goals are to expand coverage to Americans without health insurance, lower the costs of providing healthcare, and put in place reforms to improve the overall quality of the delivery of healthcare. The following is a summary of what the Act will do and when.

### ► WITHIN ONE YEAR

- It will provide a \$250 rebate to Medicare prescription drug plan beneficiaries whose initial benefits run out.

### ► AFTER 90 DAYS

- It will provide immediate access to high-risk insurance pools for people who have no insurance because of preexisting conditions.

### ► AFTER SIX MONTHS

- It will bar insurers from denying people coverage when they get sick.
- It will prevent insurers from denying coverage to children who have preexisting conditions.
- It will bar insurers from imposing lifetime caps on coverage.
- It will require insurers to allow young people to stay on their parents' policies until age 26.

### ► BY 2011

- It will require individuals and small group insurance plans to spend at least 80 percent of premium dollars on medical services. Large group plans would have to spend at least 85 percent.

### ► BY 2013

- There will be increases in the Medicare payroll tax and it will be expanded to dividends, interest and other unearned income for singles earning more than \$200,000 a year and joint filers making more than \$250,000.

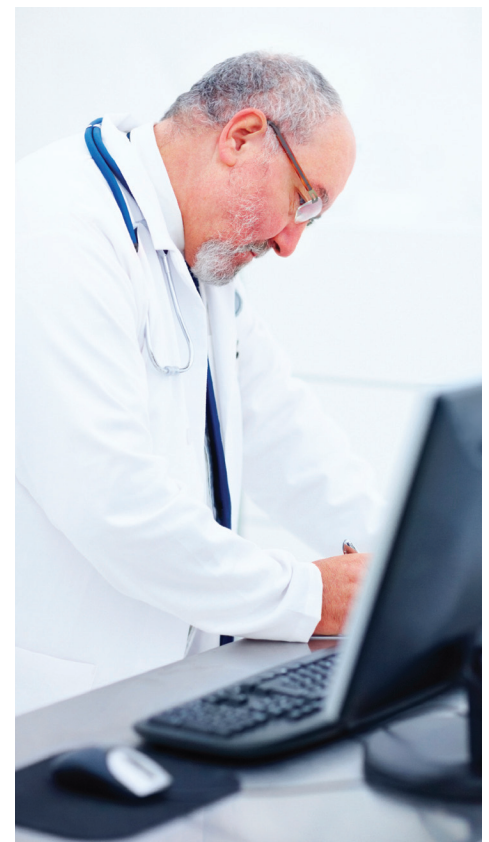
### ► BY 2014

- It will provide subsidies for families earning up to 400 percent of the poverty level to purchase health insurance.
- States would be required to set up new "exchanges," or insurance marketplaces, that would offer a variety of healthcare plans for small businesses and individuals who do not get coverage from their employers
- The Act will require most employers to provide coverage or face penalties.
- The Act will require most people to provide coverage or face penalties.

### ► BY 2019

The Act will have expanded insurance to an estimated 32 million people.

For more information, contact Karen Fitzsimmons, assurance partner, at [kfitzsimmons@bdo.com](mailto:kfitzsimmons@bdo.com).



## NEW HEALTH CARE TAX CREDIT

Under a provision of the recently passed Patient Protection and Affordable Care Act, certain small tax exempt organizations will be eligible for a tax credit for health care insurance expenses beginning in 2010. The credit is not insignificant: for tax years 2010 to 2013, the maximum credit is 25% of premiums; in 2014 the maximum increases to 35%. The maximum credit goes to smaller employers—those with 10 or fewer full-time equivalent employees (FTEs) and paying annual average wages of \$25,000 or less. The credit is completely phased out for employers that have 25 FTEs or average wages of \$50,000 or more.

The IRS has just issued a draft of Form 8941 which will be used to calculate the credit. A revised 990-T will be used to claim the credit (even for organizations that do not otherwise have to file Form 990-T). The draft Form 8941 can be viewed at <http://www.irs.gov/pub/irs-dft/f8941--dft.pdf> (although draft instructions are not yet available).

# RECENT ACCOUNTING STANDARDS UPDATES AND EXPOSURE DRAFTS ISSUED



By Richard F. Larkin, CPA

The following is a summary of several recently issued accounting standards updates (ASU) and exposure drafts.

## ►ASU

SFAS 157 and its various amendments require extensive disclosures, including new disclosures required by **ASU 2010-06**. These include:

- A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value (FV) measurements and describe the reasons for the transfers; and
- In the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present information about purchases, sales, issuances, and settlements separately (gross rather than net).

In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures:

- For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and
- A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early application is permitted.

## ►PROPOSAL

### All Financial Instruments at Fair Value

In July 2009, the Board agreed to propose a model to improve financial reporting for

financial instruments. The Board reached the following decision:

*... to propose that all financial instruments will be presented on the balance sheet at fair value with changes in value recognized in net income or other comprehensive income with an optional exception for own debt in certain circumstances, which will be measured at amortized cost. ....*

While the main effect of this proposal will be to change SFAS 115, it would also presumably remove the options that nonprofits now have under the audit guide for non-SFAS 124 investments.

In May 2010, FASB issued a proposed ASU (Exposure Drafts (ED)) that would largely implement this decision. A list of its proposed effects appears on page 15.

## ►PROPOSAL

In June 2010, FASB issued another proposed ASU that would amend FAS 157; that would:

- make terminology and clarifying changes to further converge U.S. and International accounting standards;

► Read more on next page

►CONTINUED FROM PAGE 6

## RECENT ACCOUNTING STANDARDS UPDATES

- clarify that the ‘highest and best use’ concept would only apply to non-financial assets;
- provide guidance on measuring FV of an instrument classified in equity (not normally applicable to nonprofits);
- provide additional flexibility for measuring FV of assets and liabilities managed in a portfolio on the basis of the entity’s net exposure to a particular market risk (interest rate, currency, and price) or credit risk of a counterparty;
- expand the prohibition against applying blockage factors at all input levels; and
- require additional disclosures, including:
  - measurement uncertainty inherent in Level 3 inputs;
  - if an asset that is valued using a highest and best use basis, but is not actually being used that way; and
  - categorization by input level of assets not reported at FV, but whose FVs are disclosed in the notes.

### ►AICPA ISSUES PAPER

In January 2010, the AICPA issued a draft issues paper intended to provide additional implementation guidance for applying SFAS 157 in three areas:

- Unconditional promises to give cash (pledges);
- Beneficial interests in perpetual trusts; and
- Split-interest agreements.

As of August, it has not yet been issued final.

### ►PROPOSED ASUs

In addition, FASB has issued the following ASU related to additional disclosures needed with regard to receivables that is amending Accounting Standards Codification (ASC) Topic 310. This ASU applies to all organizations.

This ASU was issued in July 2010, and is effective for nonpublic entities for periods ending on or after December 15, 2011 (essentially calendar 2011 and later); for public entities, certain disclosures are effective one year earlier.

It requires additional disclosures about the allowance for credit losses and the credit quality of financing receivables.

Many of the requirements do not apply to most trade accounts receivable due within one year, and the statement excludes unconditional promises to give (pledges), as well as debt securities.

It includes loans receivable, which is where its main effect on the nonprofit sector is expected to be – particularly loans to students and faculty made by educational institutions, and loans to churches and other religious organizations made by religious denominations and other higher-level religious entities.

The purpose of the statement is to enhance disclosures about the nature of credit risk inherent in a portfolio of financing receivables, how that risk is analyzed and assessed in arriving at the allowance for credit losses, and the changes and the reasons for those changes in the allowance.

The required disclosures are very complex and detailed; organizations with affected receivables need to study the statement carefully to assess its effects on their financial statement footnotes.

In addition, FASB has issued an exposure draft to amend ASC Topic 450 related to accounting for loss contingencies. This exposure draft will apply to nonprofits.

The exposure draft was issued in July 2010 and comments were due in August. FASB has indicated that a final statement is anticipated in the third quarter of this year, with an effective date for nonpublic entities of fiscal years beginning after December 15, 2010 (essentially calendar 2011 and later). The effective date for public entities is calendar 2010.

It deals only with disclosures (nonpublic entities are permitted to make slightly fewer disclosures). In addition to its obvious applicability to litigation, it will also apply to subjects such as environmental remediation, asset retirement obligations, product warranties, guarantees, and contingencies related to business combinations. It will not apply to uncertain tax positions (already well covered by ASC 740, formerly FIN 48), or employee benefits (covered by various other standards) – except that it will apply to a potential liability that would be incurred upon

The required disclosures are very complex and detailed; organizations with affected receivables need to study the statement carefully to assess its effects on their financial statement footnotes.

withdrawal from a multi-employer benefit plan.

The proposal would not eliminate any existing requirements, but it would add new requirements to disclose information about the nature of loss contingencies, their potential magnitude, and the potential timing (if known). Thus it is proving controversial because of the effect it may have on auditors’ communications with attorneys, and disclosure of information about litigation that, while it may be publicly available in court records, distribution of which most defendants would probably prefer to keep as limited as possible, such as the contentions of the parties, amounts of claims, and possible insurance recoveries.

Aggregation of information about similar types of contingencies will be permitted. Information about certain potentially severe, remote loss contingencies will be required. When assessing materiality, possible insurance recoveries would not be considered.

For more information, contact Dick Larkin, director, Institute for Nonprofit Excellence, at [dlarkin@bdo.com](mailto:dlarkin@bdo.com).

# UNCERTAIN TAX POSITIONS: LESSONS LEARNED AND A LOOK FORWARD



By R. Michael Sorrells, CPA

**A** SC 740-10, *Accounting for Uncertainty in Tax Positions* (formerly FIN 48) was required to be implemented by “public” non-profits, such as those with certain tax-exempt bonds for years beginning after December 15, 2006. However, the vast majority of nonprofit organizations were allowed to defer this requirement until years beginning after December 15, 2008 (generally calendar year 2009 and fiscal years beginning in 2009). This is mandatory for all organizations who issue financial statements in accordance with generally accepted accounting principles.

Thus, we now have had a significant amount of experience in implementing this provision (which we will refer to as FIN 48 in this article, as that is how most folks still label it). We have described the basics of FIN 48 in previous *Nonprofit Standard* articles and an article by Laura Kalick (available on BDO.com in the Nonprofit Industry section) and will not be rehashing those points here. We will be discussing some of the issues that we have seen and how we have addressed them as well as taking a look at subsequent years.

## ► LACK OF ADEQUATE TOOLS

Since FIN 48 applies to for-profit entities as well as nonprofits, firms such as BDO had developed checklists and procedures over the past several years. We found that these tools were somewhat inadequate for analyzing the tax positions for nonprofits since the issues

were so different. We have had to develop a completely new comprehensive procedural model and checklists which we recently have unveiled internally. These tools provide standardization to the process and ensure that issues are not missed.

## ► CONVINCING NONPROFITS THAT THEY HAVE TAX POSITIONS

Many organizations would say something like: “We’re a tax exempt nonprofit, so this is a no-brainer—we don’t have tax positions.” In many cases, it was a real task to convey the idea that their very exempt status, as well as each income stream, is, in fact, a tax position that requires analysis before the organization can say that there are no uncertain tax positions.

## ► COMPLEXITY OF ANALYSIS REQUIRED

Even some not-so-large organizations were surprised with how many issues they had to address. If there are a lot of significant revenue streams, it gets complicated. Add on some alternative investments and the level of analysis required really escalates.

## ► SOME OF THE MORE SIGNIFICANT ISSUES DISCOVERED

- Pass-through income reported on K-1’s or from foreign investments sometimes contained elements of unrelated business income (UBI) of which the organization was not aware. Some K-1’s did not properly report UBI or did not bother reporting it because the organization was not identified as an exempt organization on the K-1.
- State unrelated business income tax (UBIT) returns were not being filed. Organizations often don’t realize they have state nexus due to multi-state operations or employees; or have pass-through UBI from K-1’s that is generated from operations in one or more states outside of their home states.

- Organizations with foreign operations often have little knowledge of tax filings and payments required by foreign jurisdictions.
- Mission “creep”. Organizations claiming that certain activities are related to their exempt purposes, but these activities bear little relation to the exempt activities for which they were granted exemption as described on Form 1023 or 1024.
- UBIT calculations prepared the same way for years with no changes. Often, the activities have changed significantly or the method of expense allocation is outdated due to changes in general ledger coding.
- Huge net operating losses that get bigger each year and just keep getting carried forward without considering whether such losses might be disallowed because the activity is not being carried on with an expectation of profit or because the expense allocations are too aggressive.
- Analysis of “royalty” contracts revealing that some contain requirements for significant activity on the part of the nonprofit; possibly making the revenue non-passive and UBI.
- Corporate sponsorship payments with significant return benefits to the sponsor being booked entirely as donations, when in fact they may contain elements of UBI.

## ► LOOKING FORWARD

The first year of implementation does require a significant amount of effort that simply cannot be avoided. Subsequent years will be a lot easier. Organizations should review the prior year analysis and update for new activities and activities that were discontinued.

Overall, while we have seen very few material, uncertain tax positions, this analysis has provided many organizations a much needed UBI and operational review and helped them to become aware of a wide variety of tax issues. This then has enabled many of them to get their tax house in order before the IRS comes knocking on the door with an examination document request.

For more information, contact Michael Sorrells, BDO National Director Nonprofit Tax Services, at [msorrells@bdo.com](mailto:msorrells@bdo.com).

# FASB LEASE EXPOSURE DRAFT – AUGUST 2010: EFFECTS ON NONPROFIT ORGANIZATIONS

By Richard F. Larkin, CPA

The Financial Accounting Standards Board (FASB) (in conjunction with the International Accounting Standards Board) has issued its long-awaited exposure draft on accounting for leases. While implementation of the proposed standard will likely not have a major impact on the statement of activities of most lessees, its effects on the balance sheet (statement of financial position) will often be significant.

This proposed standard will apply to all organizations – including nonprofits, and to all leases (with minor exceptions – see below).

There is no proposed effective date stated in the draft; that will be determined after the exposure period. Since the exposure period ends December 15, 2010, the effective date is not likely to be earlier than calendar 2012.

The main effect will be to require lessees to account for all leases in much the same way as capital leases are currently treated – i.e., by recording an asset, largely offset by a liability. Thus the effect on net assets will, in most cases, be minimal. However there can be a significant effect on ratios such as debt to equity and others of that type. Organizations should promptly determine at least the approximate effect on any covenants to which they are subject, including covenants in both debt and grant agreements (many grants to nonprofit organizations include covenants of types similar to those usually found in debt agreements).

One aspect of the proposed accounting that is likely to prove challenging for many nonprofits is the requirement for lessees to use their incremental borrowing rate (or the interest rate implicit in the lease, if determinable by the lessee) to discount the long-term obligation to make lease payments. As is often the case, FASB has written this requirement with for-profits in mind – assuming that all lessees know their borrowing rate, which is likely true for most for-profit entities. However many – especially smaller – nonprofits have

never borrowed, and some of these probably are in a financial condition that would make it virtually impossible for them to borrow, so they would not know, and often could not determine this rate. They may also not be able to determine the rate the lessor has used to set the lease payments, or, in some cases, that rate may not be appropriate for the lessee to use.

It is hoped that FASB will provide some guidance to help with this problem.

The following is from the introduction to the exposure draft:

## ►WHAT ARE THE MAIN PROPOSALS?

This exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources and leases of some investment properties. For leases within the scope of the proposed guidance, this means that:

- (a) a lessee would recognize an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.
- (b) a lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:
  - (i) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or
  - (ii) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- (a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- (b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- (c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components.... *[deleted words applicable only to IFRS.]*

For leases of 12 months or less, lessees and lessors would be able to apply simplified requirements.

The exposure draft also proposes disclosures based on stated objectives, including disclosures about the amounts recognized in the financial statements arising from leases and the amount, timing and uncertainty of cash flows arising from those contracts.

For more information contact Dick Larkin, director, Institute for Nonprofit Excellence, at [dlarkin@bdo.com](mailto:dlarkin@bdo.com).

# ESTABLISHING EFFECTIVE PROCEDURES FOR A NONPROFIT

By Lee Klumpp, CPA

As part of our ongoing series on Nonprofit Governance, this article discusses best practices in designing and developing an organization's procedures to support its overall policies and the internal control of the organization. Remember like policies, internal controls and procedures vary from organization to organization.

Sometimes organizations get caught up in the different types of policies. There are broad sweeping policies that are entity wide and support the mission and strategic plan of the organization for which the Board is responsible and then there are other policies that are more operational oriented for which management is responsible. Understanding the different types of policies is key to developing well designed and effective procedures to manage a nonprofit organization. The management team is responsible for developing the organization's procedures to carry out the day-to-day operations of an organization. The Board of Directors' key responsibility is to provide vision and strategic thinking and planning for the organization and provide the monitoring and oversight process in order to carry out their fiduciary duty. It is important that this concept of division of responsibilities be understood by all parties.

There is not a one size fits all method for designing, establishing and implementing effective procedures to carry out the policies of the organization and provide the organization with strong internal controls.

## ► THE DIFFERENCE BETWEEN INTERNAL CONTROL AND PROCEDURES

Internal control is a process, which is affected by people. It's not merely policy, manuals, and forms, but people at every level of an organization. Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an organization's management and Board of Directors that

an error or misstatement will be caught by an employee during the course of doing their job and be corrected on a timely basis. Internal control is geared to the achievement of objectives in one or more separate but overlapping categories discussed below.

The Committee of Sponsoring Organizations (COSO) defines internal control as a process, effected by an entity's Board of Directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

It is important to remember that internal controls involve human action, which introduces the possibility of errors in processing or judgment. Additionally, we must keep in mind the human component of internal controls since in almost every major fraud since the beginning of time, collusion among employees or coercion by top management has been a factor.

## ► THE FIVE COMPONENTS OF THE COSO FRAMEWORK

The COSO internal control framework consists of five interrelated components derived from the way management runs an organization. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization. The five components are the following:

**Control environment:** The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the tone from the top, integrity, ethical values, management's operating style, delegation of authority



systems, as well as the processes for managing and developing people in the organization.

**Risk assessment:** Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives and thus risk assessment is the identification and analysis of relevant risks to the achievement of assigned objectives. Risk assessment is a prerequisite for determining how the risks should be managed.

**Control activities:** Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address the risks that may hinder the achievement of the organization's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and most importantly segregation of duties.

**Information and communication:** Information systems play a key role in internal control systems as they produce reports, including operational, financial and compliance-related information, that make it possible to run and control the activities of the organization. In a broader sense, effective

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## ESTABLISHING EFFECTIVE PROCEDURES

communication must ensure information flows down, across and up the organization. For example, formalized procedures exist for people to report suspected fraud. Effective communication should also be ensured with external parties, such as members, customers, suppliers, regulators and other stakeholders about related policies.

**Monitoring:** Internal control systems need to be monitored, which is the process of assessing the quality of the system's performance over time. This is accomplished through ongoing monitoring activities or separate evaluations. Internal control deficiencies detected through these monitoring activities should be reported upstream and corrective actions should be taken to ensure continuous improvement of the system.

The policies and procedures of an organization are widely recognized as an essential component of internal control. The policies and procedures manual of an organization should include everything needed to implement accounting policies and procedures for increased internal control over your Finance, Accounting, Computer and IT, and Human Resources processes.

### ►HOW TO DEVELOP PROCEDURES TO SUPPORT INTERNAL CONTROL

The process of developing, documenting and implementing organizational procedures to support the organization's policies and internal control should not be taken lightly. An organization's policies and procedures are the fundamental groundwork of the organization's internal control. It is important that each organization design, document and implement a sound internal control process.

Once your organization has developed and documented its policies and procedures to establish its internal control and the organization and the management team has implemented the policies and procedures that form the internal controls then it must also make the commitment to monitor the activities as well.

Failure to fully implement or implement haphazardly sends a message to employees

that the controls are not important or even worse that policies and procedures only need to be followed when someone is looking over your shoulder. There needs to be only one message, which is internal control represents the policies and procedures of the organization and that they need to be followed to the letter of the law no matter what the circumstances. The tone from the top needs to be "do the right thing always." However, there is one exception; if the policies and/or procedures are not working effectively then there needs to be a process in which a member of the organization can raise the question in a manner where their concern can be looked upon as a contribution to the organization.

### What are the benefits of strong procedures?

- Reduce or eliminate misinterpretation of the organization's critical policies and procedures.
- Feel more confident about covering legal issues like conflict of interest.
- Help an organization manage its fraud risk.
- Assert control over the organization's assets.
- Help identify signals that raise the red flag when a policy or procedure needs to be changed.

There are several keys things to consider in developing and documenting effective procedures and internal control for an organization.

**Keep It Simple** – Procedures should document the overall process being executed and the key internal control. It is not necessary to document every single step and detail of a transaction process. That level of detail information belongs in accounting work instructions or training materials. By including such low level minutia and details the procedures manual becomes overly long and confusing, which is a sure way to ensure that the procedures will neither be used nor followed.

**Use Flow Charts and Graphics Where Possible** – Graphics can illustrate the transaction process flow, inputs/outputs, and important relationships or risks that are not easily conveyed in text. We have all heard the saying that a picture is worth a thousand words; using graphics can improve simplicity and usability of an organization's

There needs to be only one message, which is internal control represents the policies and procedures of the organization and that they need to be followed to the letter of the law no matter what the circumstances. The tone from the top needs to be "do the right thing always."

procedures manual, which can lead to better understanding of the transaction process flow and the internal control.

**Be Consistent** – Process transaction flows and procedures should be consistent in format and design, and especially the use of language and terms. Specific language and terms that are used in the procedures manual should be highly recognizable and familiar to the organization as a whole. If there are technical terms used, consider defining them in a glossary.

**Maintain Them** – Manuals need to be kept up-to-date. A change in the process means a change in the procedures manual; make sure that changes are documented in a timely manner.

**Communicate** – Procedures must be communicated to all affected parties through training, meetings or other types of communication or events. Then, regular internal reviews/audits are needed to ensure that personnel are aware of the accounting procedure and the process requirements.

A strong control environment set by the Board of Directors and the key members of the management team clearly sets the tone from the top for which there are several benefits,

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## ESTABLISHING EFFECTIVE PROCEDURES

one of which is to clearly communicate the expectations and core values of the organization to all members of the staff, including volunteers.

Several questions that Board of Directors and members of the management team should be able to ask themselves are as follows:

- If someone outside the organization were to ask a member of the Board of Directors or a member of the management team, what is the risk of fraud within the organization, would he/she be comfortable saying the risk is low? If not, why not?
- Does the Board of Directors and/or the members of the management team regularly consider whether there is anything about the organization and its operations that it would be embarrassed to read about – and know that its donors/members are reading about – on the front page of the local newspaper?
- The Board of Directors and/or members of the management team should identify risks specific to their organization. They should ask themselves the question: What could go wrong? Some of the areas that they should think about are as follows:
  - Fraudulent financial reporting – Understand why/how financial information might be misstated. What motivation would someone have to misstate financial information?
  - Theft of assets – Are there adequate safeguards and internal controls established and enforced to ensure that assets are not misappropriated?

It is not possible to take into account every procedure and internal control within the confines of this article, but we have included three areas that seem to come up on a regular basis.

### ►SEGREGATION OF DUTIES

- There should be a policy and a process to ensure that all employees take vacation regularly, during which time their duties should be performed by others.
- There should be separate individuals involved in the initiation, review, and approval process of all key transactions and reconciliations such as the following:
  - Contributions
  - Cash receipts
  - Cash disbursements
  - Compliance with donor restrictions

- Government grants, especially: time records, procurement procedures, allowable costs, subrecipient monitoring, and reporting
  - Purchasing (competitive bid requirements, conflict of interest consideration, etc.)
- Procedures to ensure that goods and services are provided only to those who have paid for them, i.e., admission to events (concerts, conferences, meetings, classes, dinners, etc.), sending of member publications, issuance of diplomas and transcripts, treatment in clinics, etc.
- Management should also give appropriate consideration to internal control over activities outside the financial function. Although such weaknesses are not directly related to financial transactions, they can result in severe financial consequences if not addressed (i.e. failures include control of human organ transplants to ensure proper blood type match, and misbehavior of organization staff/volunteers with respect to children).

### ►INVESTMENT MANAGEMENT

- Each organization should have a formal documented investment policy that is reviewed by the investment committee on a regular basis, approved by the investment committee and the Board of Directors, and communicated to all advisors and managers.
- All investment managers and advisors should be vetted by the Investment Committee but approved by the Board of Directors.
- The Investment Committee should regularly monitor and review results of the actual investments as reported by the advisors and managers and compare the results to benchmarks established by the committee.

### ►INFORMATION TECHNOLOGY

- There should be controls in place to restrict access (authorized and unauthorized) to equipment, programs, and data and define who is permitted access to what equipment and programs.
- There should be procedures in place to establish and monitor user passwords and ensure that they are changed regularly.

## REGULATION OF TAX EXEMPT BONDS

The regulation and oversight of the municipal debt and bond market is performed by the Municipal Securities Rulemaking Board (MSRB). One of MSRB's top initiatives has been the development of the Electronic Municipal Market Access (EMMA) website. On July 1, 2009, the MSRB began collecting disclosure documents from municipal issuers around the country and posting them for public access. As a result, EMMA is a complete repository of municipal bond disclosure documents. Nonprofit organizations with bonds should be aware that their data may be posted and available on the EMMA website. Nonprofit organizations with bonds should visit the EMMA website, <http://www.emma.msrb.org> to determine if information related to their debt is posted there. Organizations should also consider the impact this may have on determining the date through which subsequent events should be examined as publication of financial statements on the EMMA website are available to the public. The *Nonprofit Standard* will discuss this issue and the other details of the bond market in more detail in the December issue.

- Establish a disaster recovery plan to safeguard the organization's data and test the plan on a regular basis.

The design, implementation and operation of an organization's policies and procedures that make up the internal control system vary from organization to organization and there is not a one size fits all answer for what would work best in your organization. However, with careful planning and consideration of the concepts discussed in this article you will have a basis for designing an effective internal control system for your organization.

For more information contact Lee Klumpp, director, at [lklumpp@bdo.com](mailto:lklumpp@bdo.com).

# OTHER NOT-FOR-PROFIT TAX ITEMS IN THE NEWS

By Joyce Underwood, CPA

## Cell Phone Change to Become Law September 23, 2010

The House passed, and the President is expected to sign, H.R. 5297, the *Small Business Jobs Act of 2010*. This bill includes the provisions discussed in our June *Nonprofit Standard*, removing cell phones from the definition of listed property which eliminates the onerous recordkeeping to substantiate business use of a cell phone. Lack of substantiation and not including personal use as income to an employee under prior rules could result in an automatic excess benefit transaction and possible application of intermediate sanctions on exempts. When signed into law, the de-listing will be retroactive to January 1, 2010.

## IRS Offers Relief to Small Charities at Risk of Losing Exempt Status

The IRS announced it will provide one-time relief for small organizations to help them comply with the new rules that revoke an organization's exempt status for failing to file a return for three years. There is an extension to Oct. 15th for the 990-N e-postcard filing, and a voluntary compliance program (VCP) for 990-EZ filers. VCP provides for reduction of penalties with payment of a compliance fee.

## Updated IRS Publications on Charitable Contributions and Gaming

A revised version of Publication 1771, *Charitable Contributions Substantiation and Disclosure Requirements* has been released and explains the federal tax law, including recordkeeping and substantiation rules, for organizations such as charities and churches that receive tax-deductible charitable contributions and for taxpayers who make contributions. Sample language is provided for each type of acknowledgement. The IRS also released a revised version of *Publication 3079, Tax-Exempt Organizations and Gaming*, describing the impact on an organization's exempt status and requirements for special recordkeeping and reporting for the unique

activities that surround gaming events including income, employment and excise taxes. The publication also includes a calendar with due dates for all the possible filings that may be required by gaming operations. Both publications are available on the IRS website, [www.irs.gov](http://www.irs.gov).

## IRS Finalizes Guidance on Excise Tax on Prohibited Transactions

The IRS has issued final regulations on entity-level and manager-level excise taxes, and disclosure and return obligations for organizations participating in prohibited tax shelter transactions.

## Medical Community Expresses Concerns and Submits Comments to IRS on Additional Requirements for Tax-Exempt Hospitals

Many organizations have provided public comments on the new requirements under IRC section 501(r), (Notice 2010-39), regarding community health needs assessments and strategic plans submitted to IRS under the July 22 deadline, expressing concern on timing and practical considerations.

## IRS' Taxpayer Advocacy Service (TAS) Submits Mid-Year Report to Congress

In July, IRS' organization that protects taxpayers submitted a report to Congress that identified priority issues IRS will address during this coming fiscal year. There is concern about the adequacy of IRS resources, especially when health care reform is implemented, and the report indicates particular emphasis on 1) taxpayer services – outreach and education, 2) new business and tax-exempt reporting requirements, and 3) IRS collection practices.

## Lawmakers Question Offshore Investment of Funds

In July, Senate Finance Committee members questioned the Boys & Girls Clubs on why the national organization has invested in offshore investments while local clubs struggle without adequate funding. Committee members

questioned why the government should provide funding when investments are made offshore.

## NYSBA Report to Congress

In August, the New York State Bar Association submitted a report on the imposition of income tax under IRC Section 514 on debt-financed income of tax exempts, recommending a revision of the rules to simplify them and eliminate the need for exempts to structure investments using offshore investment fund vehicles as feeders or blockers.

## IRS to Eliminate Paper Coupon Method for Tax Deposits

IRS plans to require income, excise, payroll and other taxes to be paid electronically beginning January 1, 2011. The IRS issued proposed regulations in August to eliminate the use of the paper coupons and force the use of the Electronic Federal Tax Payment System (EFTPS) because the Treasury Department will no longer maintain the paper coupon system after December 31, 2010. Although taxpayers who have a de minimus tax liability would be able to pay the amount with their return, all other taxpayers would be required to pay electronically. After a brief comment period the rules are expected to be finalized before the end of 2010.

For more information contact Joyce Underwood, director, Nonprofit Tax Services, at [junderwood@bdo.com](mailto:junderwood@bdo.com).

# FINAL 2010 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED

By Tammy Ricciardella, CPA

The Office of Management and Budget (OMB) issued the final 2010 *Circular A-133 Compliance Supplement* (the Supplement) dated June 2010. The Supplement is available on OMB's website at [http://www.whitehouse.gov/omb/circulars/a133\\_compliance\\_supplement\\_2010](http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2010) in both a pdf and word format. The full version of the Supplement is over 1,400 pages in length. You can download the entire Supplement or sections of the Supplement from the website. The Supplement is applicable to audits of fiscal years that begin after June 30, 2009.

As in past years, Appendix V lists the changes from the 2009 Supplement dated March 2009 and Addendum #1, dated June 30, 2009. Appendix V also includes changes from the draft 2010 Supplement dated March 2010 that was issued to help organizations and auditors plan for the upcoming audits. The final version includes more details on Recovery Act reporting requirements and updated program clusters. Throughout the Supplement items that have changed from the draft 2010 Supplement are identified in boldface print. The following is a summary of some of the changes from the draft Supplement.

## ►REPORTING

As noted in our June 2010 issue of the *Nonprofit Standard*, Part III – Compliance Requirements related to Reporting for funds received under the American Recovery and Reinvestment Act (ARRA) was not completed in the draft Supplement issued. The Supplement includes a new Section, III.L.4 Section 1512 ARRA Reporting, that helps organizations and auditors determine whether ARRA Section 1512 reporting requirements apply to a specific program or cluster.

This section in the Supplement is only applicable to awards received by direct federal funding (prime) recipients. The Supplement includes excerpts from the OMB document M-09-21, *Implementing Guidance for the Reports on Use of Funds Pursuant to the American Recovery and Reinvestment Act of 2009* related to the reporting requirements

under ARRA. (OMB has issued other documents that provide guidance on the reporting requirements under ARRA and these can be found on their website at [http://www.whitehouse.gov/omb/recovery\\_default/](http://www.whitehouse.gov/omb/recovery_default/).) Under Section 1512 of ARRA, recipients must report on the use of ARRA funds no later than the 10th day after the end of each calendar quarter. The recipient reports must include the following detailed information: total amount of funds received; and of that the amount spent on projects and activities and details on sub-awards and other payments. The list of projects and activities funded should be by name and include a description of activity/project, the completion status and estimates of the jobs created or retained.

All Section 1512 reports are required to be submitted through [www.FederalReporting.gov](http://www.FederalReporting.gov). All Section 1512 reports that are submitted will be made available to the public through [www.Recovery.gov](http://www.Recovery.gov) as well as on individual Federal agency recovery websites.

The final reports will be subjected to testing by auditors in accordance with guidance in the Supplement. The auditor will be responsible for testing the underlying data in these reports and verifying that the key data elements were presented in accordance with the required or stated criteria and methodology and ensure the accuracy and completeness of the 1512 reporting. Auditors will also be responsible for determining whether a recipient who passed through funds has a process to monitor the accuracy of subrecipient reporting. This is required even in cases where the recipient may have delegated the 1512 reporting to a subrecipient.

The final version of the Supplement answers the question about the auditor's responsibility with regard to the job creation and retention information required to be included in the 1512 reporting. The final resolution is that the "number of jobs" is a required data element on the 1512 reports but auditors will not be required to test this as part of their compliance work performed on the 1512 reporting.

## ►PROCUREMENT AND SUSPENSION AND DEBARMENT

The revisions to the Supplement include provisions that ARRA funds are prohibited from being used to fund a project for the construction, alteration, maintenance, or repair of a public building or work unless all the iron, steel and manufactured goods used in the projects are produced in the United States. ARRA provides for a waiver of these terms only in certain specified circumstances. Recipients of ARRA funding that is being used in these types of projects should maintain documentation that all the goods used were produced in the United States unless they have documentation of specific waivers.

## ►SUBRECIPIENT MONITORING

The Supplement contains specific new procedures to be followed by all organizations with subrecipients. All recipients should inform their first-tier subrecipients about the requirement to register with the Central Contractor Registration (CCR), obtain a Dun and Bradstreet Data Universal Numbering System (DUNS) number and to keep that information up to date as part of a Recovery Act award. Recipients that pass-through funds should ensure that subrecipients have current CCR registrations prior to making subawards and perform periodic checks to make sure subrecipients have updated their information. Auditors are required to test that recipients have performed these procedures.

## ►SPECIAL TESTS AND PROVISIONS

In Part III of the Supplement in the special tests and provisions section the following requirements are included in the Supplement related to ARRA funds.

- An organization who has received funds under ARRA must track these funds separately from other grant awards.
- Recipients who make subawards must inform the subrecipient of the federal award number, CFDA number, amount of ARRA funds received, the requirement to track

► Read more on next page

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## FINAL 2010 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED

these funds separately in the accounting system and require that subrecipients provide appropriate identification in their Schedule of Federal Expenditures and Data Collection form of these ARRA amounts.

Auditor must verify that the recipient has complied with these requirements.

Organizations should be aware that the Supplement reinforces the fact that OMB has

advised all federal agencies that they should not grant any single audit extension requests for fiscal years 2009 through 2011. This becomes critical because OMB has urged that in order for an organization to be considered a low-risk auditee for the current year, the prior two years audits must have met the requirements of OMB Circular A-133, including timely report submission to the Federal Audit Clearinghouse by the due date.

It is recommended that organizations review the Supplement for a full list of changes that may affect them and ensure that they have complied with all the applicable compliance requirements.

*For more information, contact Tammy Ricciardella, assurance director, at [tr Ricciardella@bdo.com](mailto:tr Ricciardella@bdo.com).*

## APPENDIX – RECENT ACCOUNTING STANDARDS UPDATES

### Effects of Proposed ASU (May 2010) on Nonprofit Organizations' Use of Fair Value (FV) for Financial Instruments

Item	Present method of valuation (unless FAS 159 has been adopted for the item)	Effect of this ED	Change?
Cash & equivalents	Face value, which is assumed to be FV	No change	No
Investment securities covered by FAS 124	Quoted market price (excluding purchase commission and fees)	Already at FV, per SFAS 124	No
<b>Non FAS 124 investments that are:</b>			
Financial instruments, (except investment in affiliates)*	Various, see paragraph 18 of SFAS 157, and permitted alternatives per Appendix A to Chapter 8 of the AICPA Audit Guide	Required to use FV	<b>Yes</b>
Not financial instruments **	Same as above	None; only applies to financial instruments	No
<b>Assets and liabilities of an acquiree under SFAS 164</b>			
<b>Investment in affiliates not meeting criteria for consolidation (SOP 94-3):</b>			
Carried at equity	Various, see paragraph 18 of SFAS 157; also adjust for liquidity constraints, if any	Excluded from scope of ED (paragraph 4e), but see ***	<b>Maybe</b>
Not carried at equity	Same as above	Required to use FV	<b>Yes</b>
Derivatives	Amount required to cancel the contract	No change; already at fair value, per SFAS 133	No
Beneficial interests in 3rd-party irrevocable trusts	Current FV of assets in trust	No change	No
<b>Earned income receivable (sales, investment income), and accounts payable and accrued expenses ****</b>			
Short-term (<1 year)	Normally, face value (amortized cost)	May report at amortized cost	No
Other	Normally, face value (discounted)	Required to use FV	<b>Yes</b>
Contributions (pledges) receivable/payable	Present value of estimated future cash flows, using the historical interest rate	Excluded from scope of ED by paragraph 4n	No
Assets and obligations under split-interest agreements	Present value of estimated future cash flows, using a current interest rate	For most, no change; already at FV	Mostly, No
Loans receivable and payable (except mortgages payable – see next item)	Amortized cost, adjusted to reflect debtor's risk	Required to use FV	<b>Yes</b>
Mortgages payable	Amortized cost	Permitted to use amortized cost if criteria in paragraphs 21 and 28 are met	Normally, no
Notes and bonds payable	Face value, adjusted for debtor's risk	Required to use FV	<b>Yes</b>

\* – non-marketable equity securities, mortgage notes, partnership interests, etc.

\*\* – property, collectibles, etc.

\*\*\* – criteria for use of equity method are changed; see paragraph 130

\*\*\*\* – other than: (1) compensation-related items (excluded from ED by paragraph 4c), and (2) most obligations under leases (excluded from ED by paragraph 4i)

## WEBINARS

The following schedule lists planned webinars that BDO will be hosting over the next few months. These webinars are free, CPE-qualified webcasts that are offered on various topics. As a recipient of the *Nonprofit Standard* you are also on the mailing list for the invitations to these webinars. As the date of each webinar approaches you will receive an invitation with further information on the webinar content and enrollment options.

**We hope you and your colleagues will plan on participating in many, if not all, of these sessions.**

### OCTOBER 2010

October 1 / 12:00-2:00 ET

#### Merger and Acquisition for Nonprofit Organizations – A Look at the New Accounting Guidance

Lee Klumpp/Dick Larkin  
CPE: 2.0 Accounting

### NOVEMBER 2010

November 3 / 12:00-2:00 ET

#### Governance: A Changing Landscape for Nonprofits

Lee Klumpp/ Mike Sorrells  
CPE: 2.0 General

November 17 / 12:00-2:00 ET

#### Fraud and Its Effect on Nonprofits

Lee Klumpp/Dick Larkin  
CPE: 2.0 Audit and Accounting

### DECEMBER 2010

December 8 / 12:00-2:00 ET

#### The BDO Annual Nonprofit Audit and Accounting Update

Lee Klumpp/Dick Larkin  
CPE: 2.0 Audit and Accounting

### JANUARY 2011

January 27 / 12:00-2:00 ET

#### The BDO 2011 Annual Nonprofit Tax Update

Mike Sorrells/Laura Kalick/Joyce Underwood  
CPE: 2.0 Tax

BDO also conducts various live seminars throughout the country on topics that are of specific interest to nonprofit organizations. These seminars are offered free of charge and are CPE-qualified. Contact your local office for seminars that are being conducted locally or check our website: [www.bdo.com/events](http://www.bdo.com/events) for further details.

### BDO NONPROFIT PRACTICE

For 100 years, BDO has provided services to the not-for-profit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the not-for-profit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our not-for-profit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful not-for-profit organization.

In addition, BDO's Institute for Nonprofit Excellence<sup>SM</sup> (the Institute) has the skills and knowledge to provide high quality services and meet the needs of the nation's not-for-profit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to not-for-profit accounting and business management.

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Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.