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The Financial Side of the Nonprofit Industry



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Disclosure of Uncertain Tax Positions: Are Nonprofits in Compliance?



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As a not-for-profit, tax-exempt organization, one might think that the subject of “uncertain tax positions” does not apply to his or her organization. Think again — some of the basics of operations, including the organization’s tax-exempt status, could create uncertain tax positions that trigger critical reporting obligations.

FIN 48 in a Nutshell

For several years now, the Financial Accounting Standards Board (FASB) has required taxpayers that prepare financial statements according to Generally Accepted Accounting Principles (GAAP) to adhere to Accounting Standards Codification Topic 740, Income Taxes, Subtopic 740-10 — more commonly known as FIN 48. Under FIN 48, taxpayers must disclose information on uncertain tax positions (UTPs).

While FIN 48 applies only to positions related to income taxes, the practices of some nonprofits could trigger the disclosure requirement. To determine whether an organization has UTPs under FIN 48, the organization must engage in a two-step process: recognition and measurement.

- 1. Recognition** – First, identify the tax positions and determine whether, based on their technical merits, it is more likely than not (more than 50 percent likely) that the positions will be sustained upon examination by taxing authorities. Assume that the organization will

be audited by authorities who have all relevant information on the position.

- 2. Measurement** – For each position that fails to meet the more-likely-than-not threshold, measure the amount of potential tax liability, including taxes, interest and penalties. If the aggregate amount of all UTPs is material (that is, the omission or misstatement of the amount could influence the economic decision of users taken on the basis of the financial statements), it must be disclosed in the financial statement footnotes (and, in turn, on Schedule D of IRS Form 990). Where financial statements are consolidated, FIN 48 applies to each of the consolidated entities, and the UTPs are aggregated for the consolidated group to see if disclosure is required.

Remember — FIN 48 applies only to income tax positions. Positions related to sales, use, payroll, excise and other types of taxes are not part of the analysis.

The Exemption Issue

It may seem surprising that a tax-exempt organization could have an uncertain tax position, but uncertainty may exist.

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See “Disclosure.”*

The Benefits of Benchmarking



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The word “benchmark” may strike some as organizational lingo, but the practice of benchmarking often proves valuable for nonprofits. Nonprofits that incorporate financial benchmarks into their operations are better at anticipating negative financial trends and may even see revenues climb, expenses drop and efficiencies improve.

What is Benchmarking?

Benchmarking is an ongoing process of measuring an organization against expectations, past experience or industry norms for productivity and profitability and then making adjustments to improve performance in relation to those metrics. Ideally, nonprofits will consider both:

- **Internal benchmarks** — to monitor and detect trends, based on the organization’s historical results and statistics, as well as expectations, and
- **External benchmarks** — to ascertain where it is thriving and where it lags behind, based on data from peers.

Benchmarking provides essential information for effectively developing and implementing strategic plans. It helps an organization keep a watchful eye on its financial health and determine where costs can be cut and revenues increased. Nonprofits can use benchmarks to demonstrate their efficiency to internal stakeholders such as management and board of directors, and external stakeholders such as donors and grantors.

Benchmarks for Nonprofits

The first step is to define what metrics

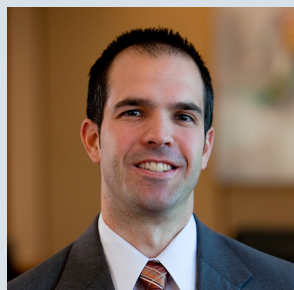
the nonprofit needs to measure. Focus on the metrics that are most critical to the success of the mission and the key indicators of the organization’s financial health and operational effectiveness. For many nonprofits, those metrics will include:

- **Program efficiency (program service expenses / total expenses)**
– This ratio identifies the amount spent on the primary mission, as opposed to administrative and fundraising costs. This ratio is of utmost importance to stakeholders.
- **Fundraising efficiency (unrestricted contributions / unrestricted fundraising expenses)** – How many dollars does the organization collect for every dollar spent on fundraising? The higher this ratio, the more efficient the fundraising. What qualifies as a good ratio depends on the organization’s size, its types of fundraising activities, etc.
- **Operating reliance (program service revenue / total expenses)**
– This ratio indicates whether the nonprofit could pay all of its expenses solely from program revenues.
- **Organizational liquidity (expendable net assets / total expenses)** – How much of the year’s total expenses are considered expendable equity or reserves? The higher the ratio, the better the liquidity.

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Benchmarking provides essential information for effectively developing and implementing strategic plans.

Improving Nonprofit Board Diversity



By Pete Buck, CPA

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Nonprofit board members are ambassadors for the organization. However, a lack of diversity can signal an underlying problem: a disconnect from the community. A nonprofit can improve its funding and program effectiveness when board members reflect the population served, as well as the community. How can a nonprofit evaluate the board for diversity, improve board diversity, and what other options may be available to consider?

Mixing Things Up

The definition of “healthy” diversity will vary from organization to organization, but think of it like this: the more diverse a board is in attributes, the more diverse it will be in thoughts and ideas. This diversity can come in various forms such as: physical, societal or economic. The goal is to mirror the population served in appointees to the board.

If a nonprofit’s bylaws limit the number of board members who can serve at any given time, the organization should consider amending the bylaws to include its commitment to board diversity. Be very careful that the size of the board does not become unwieldy. There are other ways to commit to well-balanced leadership and community input that will be discussed later.

Assessing Skills and Demographics

The first step to a great mix is to ask board members to write their own profiles. In the instructions given (or on the form provided) include the attributes the organization considers important, such as skill sets and a particular

demographic. From this information, it will be clearer what the board may lack.

Look at the group as a whole and assess where the organization lies on the diversity continuum. Imagine a scale from “1” to “5” with “5” displaying the nonprofit’s ideal diversity. Assess the members and give a score. The diversity, or lack thereof, should be obvious.

For example, the board may be underrepresented by females, a certain race, young adults or individuals with a financial background.

Getting the Word Out

Identifying the need for diversity is easy. Figuring out what to do about it can be more difficult. Start with current board members. Communicate the need for diversity (if the need has not been vocalized already). Ask members to dip into their personal and professional networks to help find the right individual(s) for the board.

Also gather input from the community and the organizations that serve it. The chamber of commerce might be a place to start, but there are many options. If a nonprofit lacks the perspective of young professionals, contact a local “young professionals” group in the area or recent college graduates. Does the organization need diversity via a financial perspective? If so, express needs to a local CPA firm.

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See “Diversity.”*

Diversity

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Seeking External Help

If it is difficult to find qualified board members, try a board placement service. Some communities have board training programs for professionals. At the completion of the program, the “graduates” are invited to meet with organizations seeking new board members. This is a great service for both the new board member and the nonprofit.

Professional associations also can be a good recruitment resource. Some state CPA organizations help match accountants with nonprofits that need volunteers. A nonprofit consultant that assists with board placement may also be able to help.

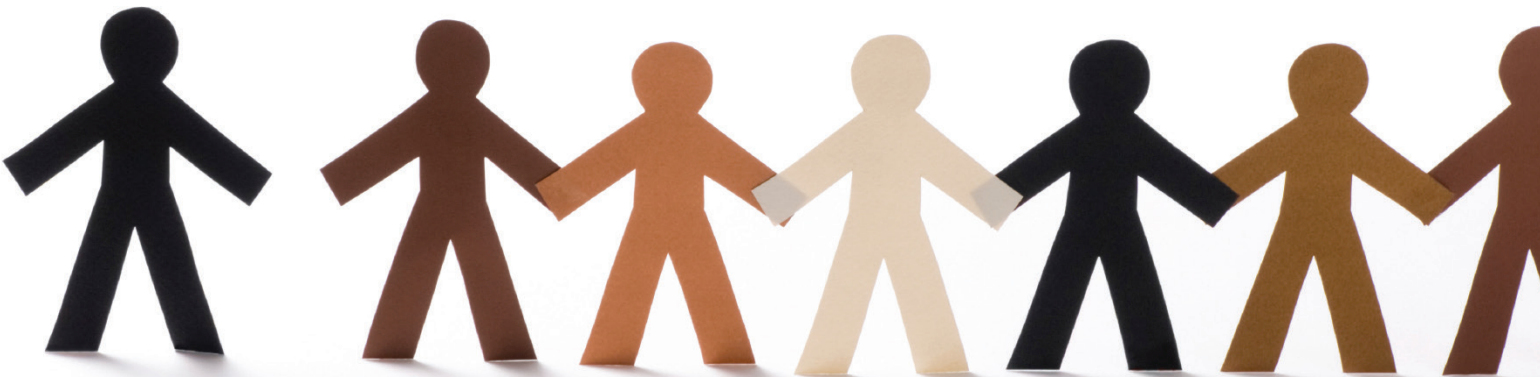
Other Paths to Diversity

If a nonprofit wants to add diversity to its leadership to better mirror the community or communities it serves, but does not want to increase the board size for fear of losing efficiency, rather than waiting until a member of the board ends his or her term, nonprofits can increase diversity by appointing new people to these structures now:

- **An advisory board** – Often considered an “informal” board, an advisory board can bring additional qualifications and demographics to a nonprofit organization. An advisory board is also the perfect training ground for potential leaders.
- **Board committees or subcommittees** – Special projects or areas of interest may warrant recruiting more volunteers to donate time and energy to an organization. If a nonprofit is national, for example, board committees might serve the interests of particular regions or chapters.
- **Focus groups** – Although not a standing structure, focus groups are extremely useful in collecting the opinions of particular demographic groups on targeted topics.

Opportunities, Opportunities

Building an effective board of directors should be a challenge that nonprofits happily face. Every time a board member resigns, an opportunity to continually consider diversity emerges.





Benchmarking

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Also consider benchmarks such as average donor contributions, expenses per member and other ratios that measure trends for liquidity, operating yield, revenue, borrowing, assets and similar metrics. No matter which benchmarks chosen, though, reliable processes will be needed for collecting and reporting the data.

For Comparison's Sake

Comparing the nonprofit's performance to benchmarks allows the organization to zero in on areas with the greatest potential for improvement. Armed with this information, nonprofits may be able to improve performance without making significant changes in operations. Further, when comparing against external benchmarks, performance might be improved by simply adopting best practices used by peers.

Information can be obtained on other nonprofits' metrics from websites such as GuideStar.org and CharityNavigator.org or from commercial software. Information also may be available from state government databases and trade associations. Take steps, though, to compare apples to apples — that the two organizations are truly comparable.

Make It a Team Effort

Some organizations have found it worthwhile to include staff in the benchmarking process. Staff involvement in setting aggressive but attainable benchmarks — and measuring progress — can achieve buy-in and help foster teamwork as the nonprofit moves toward and surpasses its goals. Also include a financial advisor, who can help select the most appropriate benchmarks for the organization and provide advice on how to improve financial and operational performance.

Newsbits

IRS Launches Exempt Organizations Select Check

The Internal Revenue Service (IRS) has developed a new searchable database that allows users check certain information about not-for-profits' federal tax status and filings. The search tool, called "Exempt Organizations Select Check" (<http://apps.irs.gov/app/eos>), consolidates three former search sites into one, providing expanded search capability.

Users can select an organization and check whether it 1) is eligible to receive tax-deductible charitable contributions, 2) has filed a Form 990-N annual electronic notice, and 3) has had its tax-exempt status automatically revoked because it has not filed the required Form 990-series return for three consecutive years. The search results are sortable by name, employer ID number, city, state, country and other categories. The site will be updated monthly, and, while organizations that have lost their tax-exempt status for failing to file tax returns can get reinstated, their names will remain on the list of those that have lost their tax exemptions.

Disclosure

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For example, if a nonprofit generates substantial net income from unrelated business operations, rather than only from operations related to its exempt purpose, it might be considered a taxable entity. The organization's exempt status also could be threatened, and thus uncertain, if:

- Insiders receive excessively high compensation or buy undervalued assets from the organization,
- Management focuses substantial attention on generating unrelated business income,
- The nonprofit engages in substantial lobbying activities; or
- The organization's current activities are unrelated to the activities originally disclosed to tax authorities as the basis of the exemption.

Do not assume that, because a not-for-profit has never been audited, its exempt status would necessarily be upheld in an audit. The above factors and others could cost the organization the exemption.

Unrelated Business Income

Unrelated business income also can create uncertain tax positions. Nonprofits may take numerous tax positions on its taxable income — including what is and is not taxable income. Uncertain tax positions regarding unrelated business income also could include:

- Allocation of expenses against unrelated business income,
- Not filing income tax returns in a state, local or foreign jurisdiction for unrelated business activities conducted in that jurisdiction,
- Apportionment of income earned in other jurisdictions; or
- Deeming an activity that repeatedly generates net operating losses (NOLs) a business activity, and using the NOLs to offset unrelated business income.

The critical question is whether the organization is recognizing too much tax benefit as a result of the tax positions it takes on tax returns for unrelated business income.

FIN 48 and the IRS

With the IRS requiring the reporting of FIN 48 footnotes on Schedule D of Form 990, expect that any UTPs will be targeted in an audit. A financial advisor can help ensure organizations have the appropriate documentation to withstand scrutiny of these positions.



Remember — FIN 48 applies only to income tax positions.



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KSM Not-for-Profit News

KSM's Commitment to the Not-for-Profit Industry:

Our staff is personally, not just professionally, committed to the not-for-profit industry. Many KSM partners and staff members serve on boards, supporting Indiana's not-for-profit organizations through their contributions of time and talent.

- **Lisa Curry** – Named board advisor on the finance committee for Joy's House and named treasurer of the Indiana Mother's Milk Bank board of directors
- **Brian Eadie** – Elected as vice president of Habitat for Humanity of Hamilton County
- **Justin Hayes** – Appointed to the Indiana CPA Society Leadership Cabinet and Diversity Advisory Council
- **Mike North** – Elected as treasurer of The Villages board of directors
- **William Robinson** – Named treasurer of the Kurt Vonnegut Memorial Library
- **Ron Smith** – Elected to the Indiana CPA Society Ethics Committee
- **Kevin Sullivan** – Named to The Julian Center board of directors
- **Casse Tate** – Appointed to the endowment committee at Dress for Success Indianapolis
- **Kirk Taylor** – Elected to the Indy East Asset Development board of directors and serves on their finance committee

For more information about Katz, Sapper & Miller, please visit ksmcpa.com.

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