Profitable **Solutions** *for* **Nonprofits**

Summer 2010

KATZ, SAPPER & MILLER
Certified Public Accountants

800 East 96th Street
Suite 500
Indianapolis, IN 46240

Phone: (317) 580-2000
Fax: (317) 580-2117

What will an auditor want to know?

Meeting 403(b) plan audit requirements

Many not-for-profits are now anticipating the first audits of their 403(b) retirement plans since new IRS and Department of Labor (DOL) regulations kicked in at the start of 2009. The new rules require an annual audit of plans with 100 or more participants. So what kind of questions can you expect from the plan's auditor?

DISCUSSING CHANGES

Typically, an auditor will want to know if any plan amendments have been adopted or become effective for the year under audit, or after the plan's year end. The auditor also is likely to ask if there's been any change in the plan's status — for example, changes sparked by mergers, spin-offs or partial terminations.

Also relevant is whether your nonprofit expects to change or terminate its plan, and if its financial condition has worsened in the last year. Some other questions you might be asked include:

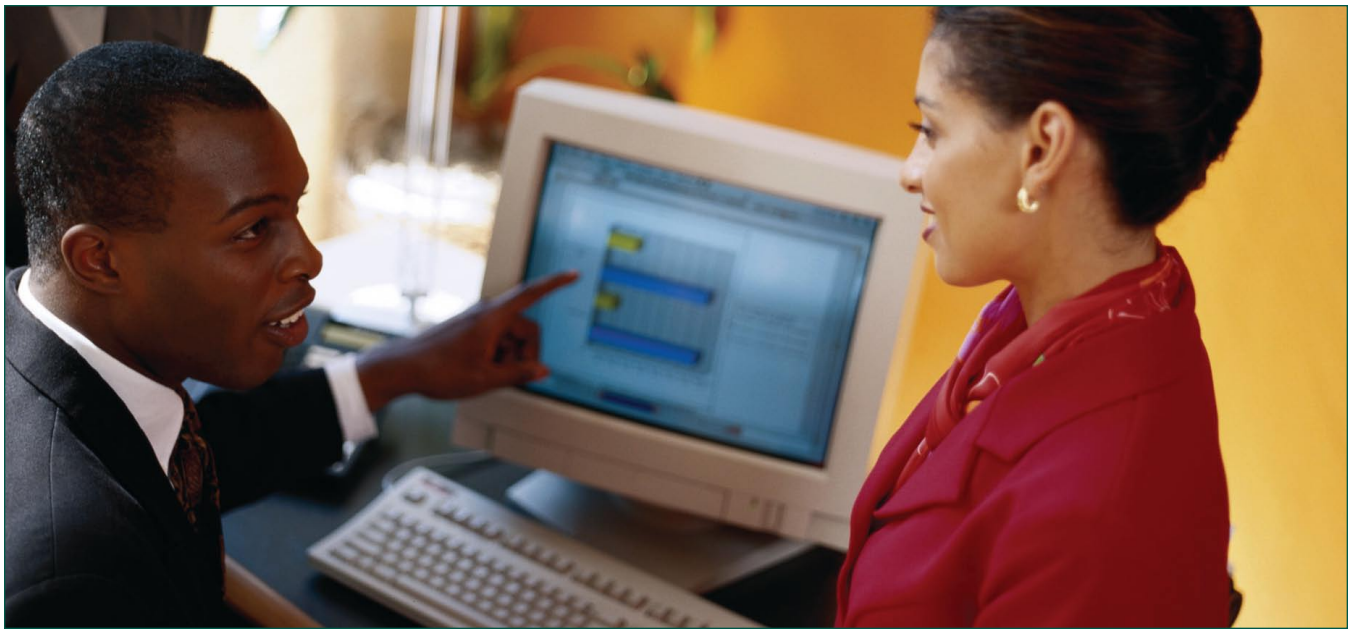
- Have you, as the plan sponsor, had any communication from your auditors about material weaknesses or significant deficiencies in your internal controls?
- Have there been any significant changes in your workforce during the year under audit?
- Have there been any changes to investment policies or practices?

An auditor also might ask if there have been any participant complaints or inquiries from the IRS or the DOL during the current or prior plan years.

COMMUNICATING ABOUT REPORTING, GOVERNANCE

The auditor also is likely to request information about plan reporting and governance. Who prepares your Form 5500s and plan financial statements? What are their qualifications and experience, and which department is involved with drafting the financial statements? Also, who's responsible for reconciling third-party records and reports?

Other possible questions might concern the preparation of a trial balance of the plan's financial activity, the review of financial statements and disclosures, and communication protocol for those charged with plan governance concerns, auditor independence discussions, internal control communication and fraud risk concern.



FILING DEADLINES: FORM 5500

Not-for-profits with 403(b) plans are approaching their first required filing of a more comprehensive IRS Form 5500, "Annual Return/Report of Employee Benefit Plan." Previous Form 5500s didn't include information on funding and investments, for example. Plans with a year end of Dec. 31, 2009, must file IRS Form 5500 by July 31, 2010 (with an extension: Oct. 15, 2010). For plans with a year end of June 30, 2010, the form must be filed by Jan. 31, 2011 (with an extension: April 15, 2011). And for plans with a year end of Sept. 30, 2010, Form 5500 is due April 30, 2011 (with an extension: July 15, 2011). Your financial advisor can help you prepare the form.

MONITORING YOUR SERVICE PROVIDER

The auditor also will be interested in your service provider's activities and related controls. During the year under audit, he or she may inquire whether there have been any changes in the service provider's management or internal systems (payroll, human resources, in-house recordkeeping and so on). Other questions might include: Who reviews service-provider activity to determine whether services are compliant with agreements and contracts? And who performs due diligence when a change in service providers is contemplated?

PREVENTING FRAUD

A portion of the audit is likely to revolve around fraud risks. The auditor will want to know whether plan management has identified any fraud risk factors related to the plan as part of its overall internal control system. And, if so, how is plan management addressing the risk? Other questions could include:

- Is there a written fraud prevention policy for the plan?
- Does plan management routinely investigate accounting, analytical or operational anomalies?
- Does management use the organization's internal audit function to address fraud risk?

Another relevant issue you may be asked about is whether management has communicated to the audit committee (or an equivalent) the specific fraud risks facing your organization and the 403(b) plan, and how they're being addressed.

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BEING PREPARED

In addition to answering the questions above, your auditor will request various supporting documents. Your auditor will be able to provide a list of the documents you need to prepare or provide. No organization likes to be audited, but it's likely to go smoothly if you collect in advance the kind of information your auditor needs to see.

Ratio revelations

What expense data says about your spending habits

Today, citizens have the tools needed to be more knowledgeable than ever about how a not-for-profit spends its money — and sometimes they don't like what they see. Most everyone has witnessed some form of outrage when a nonprofit spends more of its funding on administering itself than on the programs it offers.

> *Your financial statements can provide valuable information for functional expense reporting — mainly, the allocation of costs between the categories of program, management and fundraising expenses.*

But how do funders, government agencies and watchdog groups get this information? And what financial information will present your organization accurately and in the best light?

POPULAR RATIOS

Most often, third parties use Form 990, "Return of Organization Exempt from Income Tax," to obtain cost information because it's a readily available document. Your financial statements also can provide valuable information for functional expense reporting — mainly, the allocation of costs between the categories of program, management and fundraising expenses.

Readers of the 990 can calculate ratios that indicate your nonprofit's efficiency based upon the functional expense allocation. There are two common ratios obtained by financial information users. The *program-spending ratio* captures total program expenses divided by total expenses. The *fundraising-efficiency ratio* represents fundraising expenses divided by total contributions.

EXPENSE CATEGORIES

There are two broad categories of expenses: program service and supporting service expenses. Generally Accepted Accounting Principles (GAAP) define *program services* as "the activities that result in goods and services being distributed to beneficiaries, customers, or members who fulfill the purposes or mission for which the organization exists." *Supporting services* are all activities other than program services, including management/general, fundraising and membership development.

According to IRS instructions for Form 990, the management/general category includes expenses for overall function and management rather than the direct expenses incurred in fundraising or program services. Fundraising expenses are the total expenses incurred

in soliciting contributions, gifts, grants and so on. (See "Keeping your expenses accurate" at right.)

Not only must you identify the direct costs of each category, but you also must classify the less obvious indirect costs. As defined in Form 990 instructions for 2009, direct costs are expenses that can be identified specifically with an organization's activity or project and assigned to an activity or project with a high degree of accuracy. Indirect costs are expenses that can't be identified specifically with an activity or project.

For example, a computer bought by a university specifically for a research project is a direct cost. In contrast, the costs of software licensing for programs that run on all of the university's computers are indirect costs.

TIME AND EXPENSE ALLOCATIONS

The first step in accurately allocating expenses is to identify the direct costs. Some of these expenses could be common to more than one function. For example, you could have the cost of producing a brochure that provides educational material (program service) as well as a solicitation for donations (fundraising). GAAP provides specific guidance on *when* allocations must be made, but little direction on *how* to make such allocations. Form 990 instructions tell the organization to use a "reasonable method" of allocation.

Typically, personnel costs are a nonprofit's largest expense, so properly allocating those expenses can have a significant impact on cost allocation accuracy. The primary method is to track staff time and make the allocation based on each employee.

Time should be tracked through a time-tracking system (TimeClick, Timeslips or GetMyTime, for example). Another option would be to perform a periodic time study of all employees to assess the proper percentage allocation of their time, and thus their compensation.

For example, if the executive director likely spends most of his or her time managing the organization, the salary will be allocated to management/general. However, if he or she spends 10% of the time fundraising, 10% of his or her salary will be allocated to fundraising expense. When allocating personnel costs, all related costs — such as benefits and payroll taxes — should be allocated in a similar manner.

Other costs must be analyzed to determine the most effective way to allocate them. For example, occupancy costs (rent, utilities and insurance) often are most accurately allocated by square footage. That is, the percentage of the area used in program services is applied to occupancy costs (rent, utilities, insurance) to determine the program services portion of total occupancy costs. If 25% of the space occupied by the

KEEPING YOUR EXPENSES ACCURATE

When you tally your management/general costs and fundraising expenses, make sure you include the following categories:

Management/general expenses (not all-inclusive):

- Salaries/expenses of the chief officer and staff,
- Board of directors meetings,
- Committee/staff meetings,
- General legal services,
- Accounting,
- General liability insurance,
- Distribution of the annual report,
- Office management and personnel administration, and
- Investment expenses.

Fundraising expenses (not all-inclusive):

- Conducting fundraising campaigns,
- Soliciting bequests/grants,
- Soliciting government grants,
- Participating in federated campaigns,
- Distributing fundraising manuals and materials,
- Fees paid to professionals, and
- Kickoff events.

organization is used for program services, 25% of rent, utilities and other occupancy expenses would be allocated to the program services cost category.

ALLOCATION METHOD

The physical-units method can be an accurate allocation method in some cases. For example, if a direct mailing includes program content (100 lines) as well as fundraising content (50 lines), the cost could be allocated based on the proportion of lines for each purpose — for example, two-thirds of the cost for program services and one-third for fundraising. GAAP only allows this type of fundraising activity to be allocated jointly if certain criteria related to purpose, audience and content are met in the communication.

These criteria prevent nonprofits from allocating a portion of fundraising costs to program, management or general expenses when the underlying reason for the communication is really to solicit contributions. For instance, if a mailing, containing legitimate program-related information and soliciting contributions, were sent only to previous or potential donors, the audience criteria wouldn't be met. All mailing costs would be considered a fundraising expense.

RESOURCES

For further information on cost allocation, see Form 990 instructions. It's also a good idea to review your allocation method with your financial advisor for reasonableness. He or she can help you calculate your program-spending and fundraising-efficiency ratios. ❋

CODIFICATION — ONE YEAR LATER

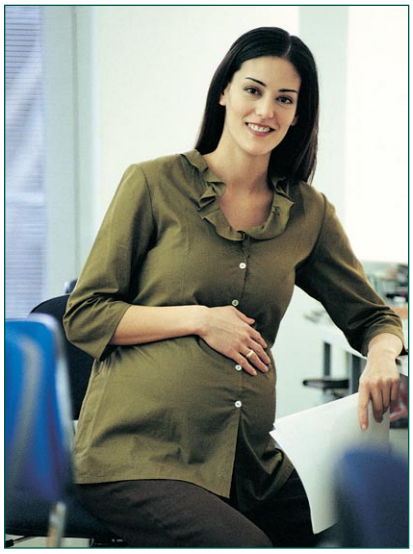
Nearly a year ago, the Financial Accounting Standards Board (FASB) launched its new system of organizing accounting standards. The change affects the way Generally Accepted Accounting Principles (GAAP) are organized, researched and referenced. As you prepare financial statements and other documents with accounting citations this year, remember:

- FASB Accounting Standards Codification™ (codification) is effective for financial statements (both interim and annual) issued for periods ending after Sept. 15, 2009.
- GAAP is now a single body of standards organized in a topical manner. GAAP is continually updated by FASB via Accounting Standards Updates (ASUs), which are available free of charge through the online "FASB Store" at fasb.org/store.
- Footnotes in interim and annual financial statements should no longer refer to FASB pronouncements, such as SFAS 116, but refer to GAAP or ASUs.
- A "basic view" of codification is available at no charge by registering at http://asc.fasb.org.
- A "professional view" of codification costs $850 a year per single use, and offers sophisticated text searching and "go to" features.
- A four-volume bound edition of codification can be purchased for $195 at the FASB Store.

In addition to updating accounting positions and records that support accounting policies and financial reporting, remind your board and its audit committee about the changeover to codification. These changes may affect references in board policies that hinge on specific FASB pronouncements. Your accountant can assist you or your audit committee in making the necessary changes.

Newsbits

SMALL CHARITIES GET HEALTH CARE INSURANCE TAX CREDIT



If your charity has 25 or fewer full-time employees with average wages below $50,000 and pays at least 50% of the premiums for the health insurance plan it offers them, it will qualify for a tax break under the new health care reform law.

For tax years 2010 through 2013, nonprofits will qualify for a tax credit for up to 25% of their paid contribution toward their employees' health insurance premiums. And starting in tax year 2014, they'll be eligible for up to 35% of their contributions if they buy insurance from the new exchanges or insurance marketplaces that states must set up for small businesses.

The tax break for nonprofits is expected to have a wide reach. According to the Independent Sector, a coalition of charities and foundations, more than half of the country's 1.5 million nonprofit employers have fewer than 10 employees and 65% have fewer than 25. ❋

AUDIT COMMITTEE TRENDS

Audit committees are getting more financial brainpower, and are meeting with their auditors far more often than their boards do. These are among the findings of the *2009 National Board Governance Survey for Not-for-Profit Organizations* conducted by Grant Thornton. According to the survey, there's been an increase in the percentage of responding organizations' audit committees that include CPAs. It's now at 74% — up from 66% in 2008.

Also, 38% of the respondents reported that their full boards met with an independent auditor. This percentage has been decreasing steadily since 2005, when it stood at 53%, and may reflect a growing tendency for audit committees to take the lead in working with the auditor. ❋

SPOTLIGHT ON EMPLOYEE MISCLASSIFICATION?

The Department of Labor is allocating $25 million in next year's budget for hiring 100 investigators to target employers who misclassify their workers as independent contractors when their job duties are actually those of an employee.

And proposed legislation also signals tougher handling of misclassification. The Senate is considering a bill that would amend the tax code to strengthen rules about independent contractors and increase penalties against companies that fail to comply. The House is weighing a similar measure.

Many states have their own initiatives in this area. Good tools for classification assessment are available through the federal IRS and state Web sites. ❋

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Katz, Sapper & Miller has committed top talent and substantial resources to providing the best, most extensive services to the not-for-profit sectors. With over 60 years experience, we understand the unique issues you face and have the resources and expertise to address those issues. For more information , call one of our Not-For-Profit Service Group professionals at 317.580.2000 or visit our website at www.ksmcpa.com.

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