

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

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Ease on down the road

5 tips for making your audit less stressful

The ins and outs of obtaining financing

When is income taxable?

Newsbits



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Ease on down the road

5 tips for making your audit less stressful

Do you bite your nails before your not-for-profit's external audit each year? Does your staff start showing signs of anxiety in anticipation of the auditors walking in the door?

If this sounds like your situation, take a deep breath. Here are five tips for making the audit experience run more smoothly for you and your auditors.

1. BE READY

Ask your auditor for a list of items they'll need during the audit, with deadlines for each item, if such a list isn't provided automatically. Talk to your auditor *before* the fieldwork if you have questions about any of the items, and let your auditor know right away if you won't be ready by the agreed-upon dates.

Because surprise is a required element in the audit, you'll also need to produce some information on the spot, such as specific expense reports, journal entry support, or grantor or program reports. But you can still prepare by establishing files during the year to collect the information you may need.

2. HAVE REALISTIC EXPECTATIONS

Your expectations of the audit should mirror your contract with the auditing firm. It will spell out what the audit will accomplish and your responsibilities.

Auditors once did accounting "clean-up" work for their clients during the audit, such as preparing year end journal entries, fixed asset schedules, and various prepaid expense and accrued liability analyses. But today's professional standards draw a clear line between accounting and auditing services, and your auditor must stay independent of your accounting processes.

If there are accounting tasks you can't do internally due to a lack of expertise, consider hiring a different firm to handle them. But if you're fully capable and

"own" the process, you can engage your audit firm to assist with certain analysis and adjustment information *outside* of the audit.

3. MINIMIZE YOUR RISKS YEAR-ROUND

Draft and review your accounting and procedures manual. Self-assess inherent internal control weaknesses and determine the necessary internal controls to mitigate such weaknesses. Periodically ascertain whether your organization's policies and procedures are being followed.

Don't let the annual audit be the only time you talk to your auditor. If you save up all your questions, it's likely to extend the length of the audit.

If your operations have changed or evolved, discuss these developments with your auditor during the year and update your policies and procedures accordingly. Waiting until fieldwork begins can delay the audit process.

4. BE PREPARED TO DEAL WITH ANY CONTROL DEFICIENCIES

Your auditor will apply risk standards during the audit. AICPA Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (SAS 115), defines deficiencies in internal control and other "material weaknesses" and "significant deficiencies."



The auditor, for example, will look to see if there's:

- ★ More than one person handling cash receipts and reviewing and approving cash disbursements and payroll,
- ★ A second person authorizing contracts and their payment, and
- ★ Adequate oversight of your checks and balances system.

After reviewing the risk and internal control information you've assembled, your auditor could determine there is a "significant deficiency" or the more serious "material weakness."

For any matter identified in the auditor's SAS 115 letter, prepare a written response including whether you have taken or intend to take any action in response to the finding. This is important to the audit committee and board as they oversee the audit and the overall system of checks and balances.

5. STAY IN TOUCH

Don't let the annual audit be the only time you talk to your auditor. If you save up all your questions, it's likely to extend the length of the audit.

Also ask if there are new accounting pronouncements or changes for the year so you and the board aren't surprised after year end. Be proactive in understanding



the new guidance and its impact on your next audit and future financial reporting.

IT'S ALL GOOD

Although the audit — and the preparation that precedes it — requires some work, the benefits are plentiful. The audit not only assesses your overall financial condition, but also can pinpoint problems with financial management and financial reporting, identify ways to reduce risk and strengthen internal controls. *

The ins and outs of obtaining financing

If your nonprofit needs to finance a project or program, you may be discouraged by reports that credit is still tight. But if you understand the choices available to you, your chances of securing financing will grow.

LINES OF CREDIT AND TERM LOANS DIFFER

Bank financing generally comes in two basic forms: line of credit or term loan. Your nonprofit's underlying cash needs will determine which one you should pursue.



A *line of credit* is a negotiated amount of financing you can draw against as needed. When the goal is to smooth out cash flows over the year, it's usually the best option. The maximum amount is available to you, but you use only what you need.

If you obtain a \$200,000 credit line, for example, you may use up to the \$200,000 limit. Once the line has been paid down to \$180,000, you again have \$20,000 available to borrow. You can continue this draw-down and repayment cycle until the credit line's term expires. (But check with your lending officer, because some banks are terminating unused lines of credit.)

Required monthly payments may be limited to interest expense, while principal payments can be made any time cash flow permits. So you have flexibility in how much you repay each month.

When you obtain a *term loan*, you receive a lump sum, usually for a specific purchase. The term loan application process is usually more complicated, and approval typically takes more time. Repayment is in installments, which means you'll make equal monthly payments consisting of interest and principal throughout the entire loan term.

BOND RATES ARE OFTEN ATTRACTIVE

An alternative to a traditional bank line of credit or loan is a *tax-exempt bond* issued by a municipal, county or state government. The interest payments to investors aren't subject

to federal income tax and may be exempt from state and local income tax.

Tax-exempt bond financing may benefit your nonprofit because tax-exempt interest rates are generally two to three percentage points lower than on money raised from other sources. The Internal Revenue Code allows a nonprofit to use the proceeds, which are borrowed from the issuer, to further the organization's stated charitable purpose.

The first step in planning a bond issue is to identify which local government unit has the ability to issue bonds on a nonprofit's behalf. This unit (the issuer) then lends the bond proceeds to you.

The next step is selecting a team of specialists to work out the mechanics of the bond issue, including a bond counsel who'll draft the documents and deliver an opinion. An underwriter advises on the bond issue's structure and then buys the bonds from the issuer and offers them to investors.

Tax-exempt bonds make the most sense for larger capital investments. Although interest payments over the bond's term can be significantly lower than on a term loan, the up-front legal and other fees can be substantial.

Also consider that the process may take longer due to more stringent financial disclosure requirements and tighter scrutiny overall. While a line of credit or term loan can be approved in a matter of weeks, bond financing can take six months to a year before the funds are received.

DO THE ADVANCE WORK

In any economy — whether credit is tight or plentiful — a smart nonprofit will research and weigh its options carefully before seeking financing. Your CPA can assist you in preparing the financial documentation, such as a multiyear cash flow projection and a project budget, which you likely will need to secure financing. *



When is income taxable?

Your 501(c)(3) organization generally is required to pay tax on income that isn't related to its main purpose — even if that income keeps the not-for-profit afloat. This unrelated business income (UBI) is something to watch closely, because if your nonprofit is ever audited, the IRS will likely scrutinize your records to see whether you've accurately reported UBI.

If you haven't reported UBI correctly, your organization may be responsible for back taxes, interest and penalties that can easily go into the thousands. And worse, if the IRS determines that your not-for-profit has significantly strayed from its mission because of UBI-generating activities, your tax-exempt status could be jeopardized. Fortunately, if you understand and follow the rules, you can avoid such scenarios.



HOW THE IRS SEES IT

According to the IRS, an activity generally is an unrelated business and its income subject to UBI tax if the activity:

1. Is a *trade or business*,
2. Is *regularly* carried on, and
3. Isn't *substantially related* to furthering the organization's exempt purpose.

Typically, all three situations must exist for the income to be considered UBI.

ACTIVITIES THAT COUNT

The *types* of activities that can generate UBI sometimes fall under the fundraising umbrella and include the following:

Sale of products unrelated to your purpose. Examples might include sales from a hospital gift shop or a zoo restaurant. To determine if the revenue is UBI, ask:

- ★ Are you regularly — that is, frequently and continuously — selling the goods to make a profit?
- ★ Would a *for-profit* organization want to carry on this kind of activity?

If you answer “yes” to these questions, you'll likely need to report the income from the activity as UBI.

Sale of advertising space. Do you sell ad space in your organization's journal, magazine or newsletter or on its website? Language that induces the reader to buy or use a product or service typically is considered advertising — for instance, a description of the product's or service's quality or a favorable comparison to a similar product or service. And the income from that activity is considered UBI. Conversely, a brief acknowledgment — listing, for instance, the supporter's name and logo in a program — probably isn't advertising, but rather is sponsorship and considered a donation.

Sale of unrelated services.

In an online tutorial, the IRS uses the example of parking lots to explain this type of UBI. If an organization owns a parking lot and opens it regularly to the general public, the parking fee income *is* taxable. That's because the activity — charging a fee for public parking — isn't substantially related to the not-for-profit's exempt purpose.

But, if only members and visitors use the parking lot while participating in the organization's activities, the parking fee income *isn't* taxable. The excellent tutorial can be found under the "Virtual workshop" tab at stayexempt.org.

These are only some of the activities that can generate UBI. Income from certain investments, from selling membership lists and from gaming activities (see "It's all in the game" below) also can produce UBI.

EXCEPTIONS TO THE RULES

Keep in mind that there are many exceptions to the rules — for example, when your volunteers run the activity. According to the IRS, income from any trade or business where uncompensated volunteers perform 85% of the work is exempt from UBI tax.

IT'S ALL IN THE GAME

Charitable gaming is gaining momentum because it's often a successful way to raise money. But the revenue you generate from gaming activities is usually considered unrelated business income (UBI) and is subject to tax — with the exception of traditional bingo.

Newer forms of bingo generally don't qualify for the tax exception, including scratch-off and pull-tab games. And to be eligible for the exception, the wagers must be placed, winners must be determined and prizes must be awarded while all players are present.



A transaction's structure also can exclude the resulting income from taxation. While being paid to directly promote products compatible with your mission probably will result in UBI, receiving royalties for licensing others to use your name or logo to promote such products may avoid it.

Other situations in which your nonprofit's income may be exempt from tax include when the merchandise you sell is largely donated, such as in a book sale, or when gross income from the activity is less than \$1,000. See IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, for more exemptions.

GETTING ADVICE

These examples of activities that produce UBI are straightforward. But your not-for-profit may sponsor activities that seem to fall into a gray area, making them more difficult to evaluate. For instance, an exception that often applies to museum restaurants is when the nonprofit effectively documents that the operation is held for the "convenience of the members or attendees." Additionally, fundraising activities often are exempt because they aren't held regularly.

Your CPA can help you to analyze and quantify potential unrelated business activities and allocate expenses against this income. With proper planning, UBI often can be avoided and taxes reduced. *

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CAN A DONOR DEDUCT CHARITABLE EXPENSES INCURRED AT HOME?

A recent U.S. Tax Court case addressed this question. The case involved a woman who took care of about 70 feral cats in her home to help support the mission of a qualified charity. The IRS had denied her tax deduction for cat-care-related expenses because it said the expenses were nondeductible personal expenses.

The Tax Court, however, ruled that expenses incurred in the home that help a qualified charity to pursue its main mission *are* deductible as unreimbursed charitable expenses if the taxpayer documents the expenses and meets any other applicable substantiation requirements. So the court allowed the cat caregiver to deduct a variety of expenses for which she had appropriate substantiation. But it denied her deductions for expenses of \$250 or more because she didn't have letters from the charity acknowledging the donations.

If your volunteers incur unreimbursed charitable expenses that support your mission, be sure they know that they may be able to deduct those expenses. In addition, advise them to document the expenses and, if \$250 or more, submit them to your organization, so you can issue an acknowledgment letter. For unreimbursed expenses under \$250, a receipt from your organization, the taxpayer's canceled check or certain other reliable written records generally should be adequate to claim a deduction. *



EXECUTIVE DIRECTORS IN TRANSIT

About two-thirds (67%) of the not-for-profit executive directors who participated in the *Daring to Lead 2011*



study, sponsored by the Meyer Foundation and CompassPoint Nonprofit Services, said they plan to leave their current jobs within five years. The percentage was somewhat lower than in the prerecession 2006 study, in which 75% of participating executive

directors said they'd leave their position within that five-year period. *

GETTING TAX-EXEMPT STATUS — AGAIN

The IRS in June released a list of 275,000 nonprofits that automatically had their tax-exempt status "self-revoked" because they'd failed to file an annual return or notice for three years in a row. The agency has since issued a number of rules and notices for those organizations interested in regaining their 501(c)(3) status.

Notice 2011-44 explains the reinstatement process and how to request reinstatement *retroactive* to the date of the automatic revocation — desirable if the organization accepts donations. Typically, nonprofits seeking reinstatement must file Form 1023 (or Form 1024), the application for obtaining tax-exempt status with the IRS, even if they haven't done so in the past.

Related IRS Revenue Procedure 2011-36 provides for a reduced user fee for applications for reinstatement of tax-exempt status filed by certain small organizations following the automatic revocation. *

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