nonprofit agendas

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News for Nonprofits

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Your new financial audit

Hoist your sails and get ready to navigate unfamiliar waters

A new wave of auditing standards from the American Institute of Certified Public Accountants (AICPA) is likely to affect your financial statement audit for fiscal year 2007 and beyond. To ensure smooth sailing through your next audit, familiarize yourself with the changes you'll encounter.

REMEMBER SAS 99 — THE FIRST RIPPLE?

If you had a financial statement audit for your fiscal year 2003, the term "SAS 99" may be familiar seas. You probably talked at length about the then-new standard with your auditors. You also may have noticed some new procedures your auditors performed that year, such as specific fraud inquiries of you and your staff and a detailed review of your journal entries.

Briefly speaking, the AICPA's Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to perform additional fraud-related procedures. The statement was issued in direct response to high-profile fraudulent accounting scandals of that time, such as Enron and WorldCom. Now SAS 99 has been expanded into a new round of audit standards for fiscal years beginning on or after Dec. 15, 2006, making the sea an ocean.

WHAT ARE THE NEW STANDARDS?

The eight new audit standards change the way your auditors will approach your next audit — they're now required to gain a detailed understanding of your internal controls, pinpoint where the greatest risks lie and shape their audit procedures accordingly. Here's a quick look at each new standard:

SAS No. 104, *Amendment to SAS No. 1, Codification of Auditing Standards and Procedures (Due Professional Care in the Performance of Work).* Auditors always have been required to perform an audit to gain "reasonable assurance" of no significant financial statement errors. This standard clarifies that directive: Though reasonable assurance is certainly high, it isn't absolute. However obvious, this statement asserts that your auditors may have failed to detect a misstatement in your financial statements.

SAS No. 105, *Amendment to SAS No. 95, Generally Accepted Auditing Standards.* Auditors always have been required to determine an audit game plan before ever stepping foot in your organization. This statement clarifies that they need to understand "the entity and its environment, including its internal controls" during the planning process, and they must document this understanding in specific ways.

SAS No. 106, *Audit Evidence.* Audit evidence is all of the information the auditors use to support your account balances and the audit opinion. This includes reports printed from your accounting system and the documents supporting those reports, such as canceled checks, invoices and

journal entries. Auditors also use other information, such as board minutes, bank confirmations and internal control manuals. This standard, among other goals, addresses what is sufficient audit evidence, and notes proof is more reliable when the auditors obtain it directly from outside sources.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit.* Audit risk is the risk that an auditor may issue an incorrect opinion on the financial statements. You are (hopefully) familiar with an unqualified, or "clean," opinion on the financial statements. If there was a significant error in the financial statements, the auditor could not rightfully issue this clean opinion.

Materiality is the concept that some matters are important for the fair presentation of financial statements. While auditors always have assessed audit risk and taken into account materiality when conducting your audit, they now must use these concepts to assess the risk of misstatement of each financial statement account. For instance, if your organization has little or no activity in property and equipment for the year, the auditors may assess this account's risk as "low," based on this and other factors. They then may be required to perform only scaled-back procedures as compared to what was done in the prior year.

SAS No. 108, *Planning and Supervision.* This statement provides guidance on communications between your auditor and other firm personnel. The audit firm you use may perform other services for you beyond the audit, such as preparing your tax returns. Your auditors may have asked you to sign a written engagement letter each year that spells out the services they will perform, their responsibilities, your responsibilities and, perhaps, a fees estimate. You may be surprised to know that, though a formal engagement letter is most firms' practice, it was not required before this standard.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.* This standard requires auditors to understand your industry, the regulations that govern it and other external factors. They also must consider the significance and likelihood of specific risks they identify such as the following, as noted by the AICPA's *Audit Risk Alert for Not-for-Profit Organizations Industry Developments for 2006/2007*:

1. Internet-based donations, which may subject the organization to more risk when using such online services as PayPal,
2. Baby boomer retirement — 50% to 70% of executive directors plan to leave within five years, according to surveys analyzed by the AICPA, and
3. The changing face of donors, which takes into account that younger donors recently have shown an increase in their desire to stay in control of their donated dollars.

While auditors were performing this assessment all along, this standard spells out the requirements for documenting the process.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.* This standard requires that, after all risks are assessed (see SAS No. 109 above), there must be a clear link from the risk

Preparation is paramount

You may want to start thinking about the things you can do now to prepare for your upcoming audit. Preparing early will not only help the auditors' process go smoothly, but also will help to minimize work disruption.

First, schedule a meeting with your auditors to discuss how these new standards will change your audit. Let them explain the changes they'll need to make to their audit approach and which processes will vary from last year's engagement. This may be an opportune time to discuss any anticipated fee increases and what you can do to help minimize costs, such as preparing additional schedules, pulling documents together early or completing questionnaires for use as audit documentation.

Second, take a close look at your organization's internal controls. If you're a small, "bare bones" operation, you may not have a sophisticated system of checks and balances. Discuss with your auditors what kinds of controls make sense for your organization. You may not get any new controls up and running for the upcoming fiscal-year audit, but it would be a great start!

Finally, document in detail the internal controls you do have, including all accounting policies and procedures. Creating flowcharts is an easy way to accomplish this. This is documentation your auditors will surely require, and getting a jump on it now will save you much time later.

assessment to the audit procedures performed. In other words, the auditor must tailor each audit to address the specific organization's assessed risk.

SAS No. 111, *Amendment to SAS No. 39, Audit Sampling.* As part of the audit evidence they obtain, auditors may use sampling to test an account balance, such as accounts or pledges receivable or inventory. To determine your organization's appropriate sample size, an auditor assesses the "tolerable misstatement" for the account — the maximum amount of monetary error the auditor is willing to accept. It should be zero, correct? Yes; however, the auditor must set a floor for the dollar amount of error he or she will follow up on. Otherwise, the audit would be more time-consuming and, thus, more costly.

WHAT CAN YOU EXPECT IN THIS YEAR'S AUDIT?

An earlier start, additional work and more communication from your auditors may accompany your audit this year.

For starters, your auditors may contact you a few months earlier than in the past to be engaged to plan the audit in accordance with the new standards. They also may perform more of your audit work upfront, before audit fieldwork is conducted. Additionally, they may perform some interim fieldwork several months before your usual scheduled fieldwork date, and maybe even before your fiscal year-end.

Documenting internal controls will take up most of the auditors' extra hours. As part of the process, they may ask more probing questions about your organization, its internal controls, and any perceived industry- or organization-specific risks you have identified. They'll also want to document how your organization responds to these risks.

Finally, because the auditors will concentrate more on understanding your organization's internal controls, you may see closing comments and recommendations about them. Don't be offended; use this communication to your advantage, asking for help on how to implement any recommendations they may have.

READY TO SAIL FULL SPEED AHEAD?

Although you may not like more requirements and paperwork, you can expect the new audit standards to give you a more complete and in-depth audit on your maiden voyage than you had in the past. And the revamped audit should give your governing board comfort that the auditors will take a closer look at your organization's internal operations — and design an audit plan specific to your, and only your, organization. ❋

Is it sponsorship or advertising?

Know the difference between tax-free and taxable income

As a nonprofit you're generally not taxed on your income, unless that money comes from a trade or business — operating a restaurant or managing a gift shop, for example — that is unrelated to your exempt purpose.

An important exception to the unrelated business income tax (UBIT) rule is sponsorship income. If income is derived from a qualified sponsorship, it's tax-exempt. However, if the income comes from advertising, it's taxable. Thus, knowing the difference between sponsorship and advertising income can help you better evaluate when to accept a

sponsorship and ensure that you comply with tax law, protecting your exempt status.

WHAT QUALIFIES AS SPONSORSHIP

If a nonprofit receives income from a sponsor and there's no arrangement, or expectation, for the sponsor to get any substantial benefit in return, it's a qualified sponsorship payment (QSP). The simple acknowledgment of a sponsor isn't considered a substantial benefit. Some examples include:

- Listing the sponsor's name, brand names, logos or product line,
- Listing the sponsor's locations, phone numbers and Internet address, and
- Describing the sponsor's products or services, as long as the description is value-neutral.

Mere display or distribution of the sponsor's products to the general public at a sponsored activity also isn't considered a substantial benefit. So, for example, you could pass out free toothbrushes from a dental company sponsor at one of your events.

To be a QSP, a sponsorship cannot be an agreement for a contingent payment, such as one that relies on an attendance level or another factor indicating a degree of public exposure. For example, the sponsorship payment could not be contingent on how many people attend a hospital's health fair. Also, the QSP designation wouldn't apply to a name's or logo's use in a periodical published by or for the nonprofit.

WHAT COUNTS AS ADVERTISING

If a nonprofit *promotes* the sponsor's products or services, the sponsor is receiving a substantial benefit, and thus the payment may be considered advertising income, subject to UBIT. Advertising contains qualitative or comparative language and is an inducement to purchase or use a product or service. Thus, going beyond just listing a product to also listing the prices or providing indications of savings or value would be advertising. For example, a nonprofit theater group that acknowledges its sponsors in its program, but also includes product and price information for those sponsors, would have advertising income subject to UBIT.

Actions that produce substantial benefit include not just advertising but also designating a sponsor as an exclusive provider; providing facilities, services or other privileges to the sponsor that are not insubstantial; or granting rights (such as licensing) to an intangible asset of the nonprofit organization.

If a nonprofit promotes the sponsor's products or services, the sponsor is receiving a substantial benefit, and thus the payment may be considered advertising income.

PAYMENT SIZE VS. SPONSOR BENEFIT

If a sponsor receives a benefit but its fair market value is less than 2% of the payment, it doesn't count as substantial. For example, if a company pays $5,000 to sponsor an event and receives $75 worth of advertising, the advertising isn't a substantial benefit because it's less than 2% of $5,000 ($100).

Alternatively, if a sponsor receives a substantial benefit (2% or greater) but the payment to the exempt organization exceeds the benefit's fair market value, the payment in excess of the benefit is treated as

a QSP. In the example above, if the sponsoring company received advertising with a $200 value, $200 would be considered advertising and be subject to UBIT, but $4,800 (the amount beyond the advertising benefit's fair market value) would be treated as a QSP and not taxable to the nonprofit.

EXCLUSIVE PROVIDER AGREEMENTS

A common, lucrative arrangement for the nonprofit organization is an exclusive provider agreement. For example, a college may enter into a multiyear contract with a soft drink company to be the exclusive provider of soft drinks on campus and at all campus events. These arrangements are not QSPs.

However, that does not automatically make the income derived from the arrangements taxable. You need to run through the other UBIT tests — "trade or business," "regularly carried on" and "not substantially related" — to determine whether such an activity constitutes a taxable trade or business.

TAX IMPLICATIONS

Common QSPs, such as naming rights (for example, a $1-million sponsorship payment for the right to put the sponsor's name on a building) or event sponsorships, can be a good source of tax-exempt revenue. But you also may benefit from advertising income, even if it will be subject to UBIT. The important thing is to properly assess the potential tax implications before entering into a relationship with a sponsor. ❋

Small organizations

Implementing internal controls is as easy as 1, 2, 3

Does your organization have only a few employees? In such a small world, you may think it's impossible to put an adequate system of checks and balances in place. But think again.

Take safeguarding cash and checks. In a small nonprofit, one employee may open the mail (that includes the cash and checks), deposit the receipts in the bank, enter the deposit into the accounting system and reconcile the bank account at the end of the month. While you may believe this person is as careful as a trapeze artist and as honest as Abe, the fact that no one else is involved in this process invites error and makes fraud easy.

To segregate the duties in the cycle without hiring more personnel, try this: Have one staffer open the mail and log the checks into a check register and another make the actual bank deposits and enter them into the accounting system. And then the executive director or a board member should reconcile the bank account at the end of the month, or at least perform a detailed review of the bank's reconciliation.

To get on track with internal controls, you should follow these three simple steps:

1. List each employee on staff and his or her accounting and administrative duties.

2. Scrutinize the list, possibly with your accountant or auditor, and determine if any one employee is handling too many duties in a cycle, as in the example above.

3. If you find a lack of segregation of duties, reassign responsibility. If that's not feasible, create a supervisory review of these functions, such as the executive director or board member review of the bank reconciliation in the example.

While nonprofits live in a world where everyone often does everything, your organization can set up some internal controls, almost as fast as saying one, two, three.

NEWS FOR NONPROFITS

EMPLOYEE GADGETS AS FRINGE BENEFITS

Newer technologies — like cell phones, personal digital assistants (PDAs) and laptop computers — allow new ways to provide employees tax-free benefits. *Working condition fringe benefits* are property or services that allow the employee to perform his or her job away from home.

As in the past, if the employee could deduct the cost of the property or services as a business expense if she or he had her/his own business, it isn't considered compensation to the employee and isn't taxable. The employee must keep documentation to support the business purpose. Assuming there's no "personal use" of the equipment or services, little reporting is required.

But if there is personal use, it must be accounted for. On a regular basis — monthly is suggested — the employee must report any personal use, or allocate a percentage of time the equipment is used on nonbusiness activities. The reporting should be detailed by the total number of minutes or other quantifiable measure. At tax time, the fair value of this personal benefit — what it's worth in the marketplace — is added to the employee's annual W-2 as compensation. ❋

EMPLOYEE VS. INDEPENDENT CONTRACTOR

The IRS is looking more closely at the people you treat as contractors rather than employees — cases where you don't withhold payroll taxes from payment for work done. In Uncle Sam's eyes, the key issue is your relationship. Do you direct and control the individual's work through instruction or training? Does this individual work only for you, and is the relationship permanent? Is he or she paid for services based on a measure of time? Do you provide the worker with the type of benefits you extend to employees, such as vacation or insurance?

The more "yes" answers you have to these questions, the more likely the IRS will consider this person your employee. ❋

PROTECTING YOUR DOMAIN

If an illegitimate Web site is set up with your domain name or a similar one, you could face substantial damage to your organization's reputation. You need to be aware of your .ORG domain name's value and make sure your registration is current.

Steps you can take to avoid a public relations nightmare start with knowing when your registration expires. There are more than 200 registrars available, and time limits vary. Put your expiration date on a checklist. Also make sure your contact information is current. ❋

FIN 48 DELAYED AS REQUESTED

The effective date of a new accounting rule, Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), has been extended.

Nonpublic companies, including nonprofit organizations, will now need to apply FIN 48 for fiscal years starting after Dec. 15, 2007. Dec. 15, 2006, originally had been proposed as the transition date.

Entities that already have adopted the provisions of FIN 48 are ineligible for the deferral.

The reason for the delay, FASB said, is to supply organizations with the extra time needed to understand and apply the provisions of the new accounting interpretation. FIN 48 had been criticized for failing to provide examples of how it would apply to not-for-profit organizations and other nonpublic entities.

FIN 48 would require nonprofits to record a liability for any uncertain tax position that arises when calculating unrelated business income tax, and require private foundations to record a liability for the excise taxes on their investment income.

An influential advisory group, the Private Company Financial Reporting Committee (PCFRC), had recommended the postponement. ❋

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The support you need. The service you're looking for.

Succeeding in the not-for-profit sector today requires more than a strong commitment to your mission. It takes shrewd fiscal management, careful regulatory compliance, skillful use of technology and the assistance of advisors who know the issues nonprofit organizations face and how to address them.

This is where Sechler CPA comes in. Our team of experienced professionals cherishes the opportunity to support nonprofit organizations, meet their management challenges and fulfill their missions. We offer a variety of specialized accounting, tax and consulting services including:

- Audit intermediary services
- Budget and policy design
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- Tax form preparation (990, etc.)
- Strategic and management consulting
- Speaking on financial literacy and other topics
- Technology and virtual system design

RESPONSIVE QUALITY

We are committed to providing responsive, personalized service to the highest quality. We take time to truly understand your Organization so that we can customize our recommendations to your specific situation. Our goal is to make your processes easier, streamline your operations and ensure your success in reaching *your* goals.

We welcome the opportunity to discuss your mission and vision so that we may assist you with our expertise. Please call us at 602-230-2700 or e-mail carolyn@azcpa.com and let us know how we may support you. Be sure to visit our website at www.azcpa.com for additional tools and information, as well as our archive of this newsletter.

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