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News for Nonprofits

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NONPROFIT AGENDAS

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Lease accounting rules are (finally) here

Implementing the FASB's Accounting Standards Update

The updated accounting standard for leases, released back in 2016, is finally taking effect this year for all organizations, including nonprofits, that haven't already adopted it. You might be surprised at how many "leases" you have under the Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)* — whether for real estate, vehicles, machinery or equipment. The changes are likely to complicate your accounting and financial reporting.

Then and now

Under previous rules, leases were classified as either capital (or finance) or operating, with different accounting treatments for each. Capital leases — for example, the lease on a piece of equipment for most of its useful life — were reported as assets and liabilities on a nonprofit's statement of financial position. Operating leases, such as a lease for office space, were recognized on financial statements as a rent expense and disclosure item.

ASU 2016-02 directs lessees to recognize assets and liabilities for *all* leases for terms of more than 12 months. The classification as capital or operating is relevant only when determining how to recognize, measure and present the expenses and cash flows related to a lease. The standard also requires additional disclosures about leases, including information on variable payments and options to renew or terminate.

Defining leases

A lease is defined as a contract, or *part of a contract,* that conveys the right to control the use of identified "property, plant or equipment" for a period of time in exchange for consideration. You have control over the use if you have both the right to:

- Receive substantially all of the economic benefits from using the leased asset, and
- Direct the use of the asset.

The reference to "part of a contract" is critical. So-called embedded leases might be lurking in agreements that don't appear to be leases on their face, such as technology, advertising or transportation contracts.

In such cases, the updated standard requires organizations to separate lease components from nonlease components. The part of the payment attributable to nonlease components is excluded from the measurement of lease assets and liabilities.

Compliance matters

Nonprofits that adhere to Generally Accepted Accounting Principles (GAAP) likely will need to adopt some new processes and procedures to satisfy the requirements in ASU 2016-02. For example, you'll need to ensure you collect the requisite data on new leases. While smaller organizations with few leases may be able to track the information via spreadsheet, nonprofits with multiple leases may consider purchasing leasing software to assist with the accounting.

Also consider how the changes will affect your stakeholders, starting with your board and audit committee. The rule may significantly increase your assets and liabilities, potentially creating alarm. Think about preparing additional financial statements that allow stakeholders to see how this year and previous years compare with each other under the old standard — in other words, help them see that things haven't changed as much as it might initially appear.

The financial statement changes also could affect financial ratios tied to debt covenants. Your lenders might benefit from seeing the comparison of results under the old and updated standard.

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Landlord issues

The updated standard could have ramifications for nonprofits that rent out space or other assets. For example, it includes provisions designed to align lessors' accounting with the lease accounting model and current revenue recognition rules. Nonprofit lessors may need to recognize certain lease payments as deposit liabilities if the collectability of lease payments is uncertain.

In addition, lessors generally must separate nonlease components that transfer a good or service to the lessor from the lease components. Nonlease components could include utilities or common area maintenance.

Act now

The effective date for ASU 2016-02 was pushed back due to COVID-19, but nonprofits can't afford to drag their feet now. We can help you achieve and maintain compliance.

PICKING THE DISCOUNT RATE

When reporting unpaid lease obligations as a liability, a lessee organization must select a discount rate to reduce payments to their present value. ASU 2016-02 (see main article) requires lessees to use the rate implicit in the lease, if readily determinable. If not, they generally need to use their incremental borrowing rate (IBR), which can be difficult to ascertain.

Your nonprofit, however, can elect to use a risk-free rate instead of the IBR. Moreover, FASB ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities,* allows you to elect the risk-free rate by asset class, rather than applying it to all leases.

The risk-free rate often will be less than the IBR, meaning it may produce higher amounts for the lease asset and liability. So you might, for example, elect the risk-free rate for an asset class with numerous low-dollar leases (such as equipment) and apply the IBR to an asset class with a few high-dollar leases (such as real estate).

Ways to improve your organization's accounting function

Although nonprofits may be exempt from income tax, they still have financial and accounting requirements. This includes projecting budgets and monitoring the results, preparing financial statements and collecting payroll taxes. Accounting processes can become inefficient over time if you don't monitor them. Here are some suggestions of procedures your organization should review regularly.

Invoicing and reconciling accounts

First off, make sure that the individual or group that's responsible for your organization's financial oversight (for example, your CFO, treasurer or finance committee) *promptly* reviews monthly bank statements and financial statements for obvious errors or unexpected amounts. Doing this quickly can help eliminate headaches later.

Another good step toward accounting function improvement is creating policies and procedures for the monthly cutoff of recording vendor invoices and expenses. For instance, require all invoices to be submitted to the accounting department within one week after the end of each month. Too many adjustments — or waiting for employees or departments to weigh in — can waste time and delay the completion of your financial statements.

You also may be able to save *days* at the end of the year by reconciling your balance sheet accounts each month. It's a lot easier to correct errors when you catch them early. Also, reconcile accounts payable and accounts receivable subsidiary ledgers to your statements of financial position.

Boosting efficiency

Designing a coding cover sheet or stamp is another step toward boosting efficiency. How so? An

accounting clerk or bookkeeper needs a variety of information to enter vendor bills and donor gifts into your accounting system. Speed up the process by collecting all of that information on the invoice or donor check copy using a stamp. Route invoices for approval in a folder that lists your nonprofit's general ledger account numbers so that the employee entering data doesn't have to look them up each time.

The cover sheet or stamp also should provide a place for the appropriate person to approve the invoice for payment. Use multiple-choice boxes to indicate to which cost center the amounts should be allocated. Documentation of the invoice's payment should also be recorded for reference. And your development staff will want to provide details about any donor gifts before the gifts are recorded in the accounting system.

Another tip about invoices: Don't enter only one invoice or cut only one check at a time. Set aside a block of time to do the job when you have multiple items to process.

Using software effectively

Many organizations underuse the accounting software package they've purchased because they haven't invested enough time to learn its full functionality. If needed, hire a trainer to review the software's basic functions with staff and teach time-saving tricks and shortcuts. Also standardize the financial reports coming from your accounting software to meet your needs with no modification. This not only will reduce input errors but also will provide helpful financial information at any point, not just at month end.

And consider recording standard journal entries and payroll allocations automatically within your accounting software. Many systems have the ability to automate, for example, payroll allocations to various programs or vacation accrual reports. But review any estimates against actual figures periodically, and always adjust to the actual amount before closing your books at year end.

Staying up-to-date

These are only some of the responsibilities that fall under the accounting umbrella. Handling these tasks efficiently will help your organization run smoothly. Now is the time to eliminate labor-intensive steps that can be automated or that don't add value.

Do you understand the public support test?

Nonprofits that aren't careful can stray over the line that distinguishes between public charities and private foundations. This can expose nonprofits to lower tax-deductible donation limits as well as potential excise taxes and penalties. Certain organizations, including universities and churches, automatically qualify as public charities, but others must pass a public support test.

Role of public support

The tax code recognizes two types of publicly supported organizations. The first, Section 509(a)(1) organizations, rely on donations from the general public, governmental units and other public charities as their primary means of support. The second category, Sec. 509(a)(2) organizations, have significant program revenue.

The IRS has established separate tests for each type. The Sec. 509(a)(1) test can be less stringent, and if your organization doesn't pass it, you may qualify under Sec. 509(a)(2). The tests are included in the IRS Form 990 on Schedule A.

Sec. 509(a)(1) test

This test requires your organization to have 1) at least one third of your total support from the public, governmental agencies or other public charities, or 2) at least 10% of your total support from such sources *and* the "facts and circumstances" indicate you're a publicly supported organization.

Relevant facts and circumstances include whether your organization:

- Can attract public support,
- Has a percentage of public support above the 10% threshold,
- Has sources of support,

- Answers to a representative governing body, and
- Serves the general public on a continuing basis.

The test measures public support over a five-year period, including the current and four prior tax years. If your organization wasn't a Sec. 501(c)(3) organization for the entire period, it should report amounts for the years that it was.

Be careful about misclassifying gross receipts that are subject to the limit; IRS auditors will look for payments that should be deemed gross receipts.

When computing the percentage of public support, exclude from the numerator contributions from each individual, trust or corporation that exceed 2% of your total support. However, you should include these contributions in your "total support" figure, or denominator. The cap doesn't apply to contributions from certain governmental units or some publicly supported organizations.

Note, too, that the Sec. 509(a)(1) test excludes, among other things, program revenue fees from related activities (for example, admission fees), unrelated business income, investment income and "unusual grants" from the public support figure. Net income from unrelated activities and gross investment returns are included in total support, though unusual grants aren't.

The Sec. 509(a)(2) test

Under the second test, an organization must receive at least one-third of its support from contributions from the public and gross receipts from activities related to its tax-exempt purpose. No more than one-third of its support may be from investment income and unrelated business taxable income. Public support is measured over the same five-year period as above. No alternative facts-and-circumstances test is available.

The Sec. 509(a)(2) test is subject to limitations, though. When calculating public support, you can only count the greater of $5,000 or 1% of your total exempt-purpose-related revenue from a single individual, corporation or governmental unit in the numerator. Receipts of any type or amount from disqualified persons, such as board members, aren't considered public support either. All such revenue is included in the total support part of the equation.

Be careful about misclassifying gross receipts that are subject to the limits. IRS auditors will look for payments that should be deemed gross receipts but instead are classified as, for example, contributions, gross investment income or unrelated business taxable activity.

Pass the test

Your organization must comply with the public support test on an ongoing basis — so stay on top of it. Contact us if you have any questions about whether you're at risk of forfeiting your public charity status.

News for Nonprofits

Fundraisers seek protection with "bill of rights"

The Association of Fundraising Professionals (AFP), which previously developed a "Donor Bill of Rights," is now looking inward to protect their members' own "physical, mental and emotional wellbeing" on the job. A recent AFP survey found that nearly a quarter of fundraisers have experienced sexual coercion, meaning pressure from

an employer to make themselves vulnerable to sexual harassment to secure gifts. And 76% have experienced sexual harassment.

The organization has responded by forming a task force to draft a fundraiser bill of rights. The document will address issues such as bullying and harassment, racial and gender equity, accessibility and "donor dominance." The task force plans to hold listening sessions with members to solicit input. It also will conduct a survey after a draft is developed to collect feedback before seeking ratification and endorsement.

What are nonprofit funders' top considerations?

A survey from software company Social Solutions reveals how foundations, charitable trusts and corporate giving programs make funding decisions. Among other things, the survey found that the top three factors when considering whether to fund an organization are mission (cited by 51% of respondents), legal nonprofit status (46%) and impact (46%). In 2017, the top three were impact (98%), mission (49%) and legal nonprofit status (37%).

When it comes to measuring impact, outcomes reign supreme, followed by consistency to mission and detailed data. Outcomes were the preferred metric in 2017, too. The funder respondents also indicated their preferred reporting format when assessing an organization's impact. In 2017, funders preferred impact stories (25%), paper (14%) and spreadsheets (12%). Top scores in 2022 went to dashboards/portals (27%) and spreadsheets (22%), followed by stories (14%). These results demonstrate a significant preference for digital and data-based reporting.

Study finds mixed message on DEI importance

Almost 40% of donors say that learning a charity they support doesn't have fair representation of their personal demographics on its board and staff wouldn't influence their giving. That's according to a survey of more than 3,100 adults in North America by the Better Business Bureau's Wise Giving Alliance.

But it would be a mistake to think donors aren't concerned about diversity, equality and inclusion (DEI) issues. For example, 41% say they wouldn't donate to a charity they previously supported after learning it tolerates discrimination. And 34% wouldn't donate to charities that use culturally insensitive images and language. Younger respondents, people of color and LGBTQ+ respondents were more likely to report hearing about a specific organization having a lack of DEI. They also were more likely to have positive associations toward a charity with a diverse, equitable and inclusive board and staff.

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 Morgan CPAs, PLLC 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
- Outsourced accounting/bookkeeping
- 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 info@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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