nonprofit agendas

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News for Nonprofits

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How to take the stress out of an independent audit

When you think of your next audit by an outside CPA firm, do you fear hearing words such as "unexplained differences," "unsatisfactory explanation," "noncompliant" and "we'll need more time"? If you have an audit phobia, you're not alone: Some nonprofit leaders equate an independent audit with criticism, demands and time taken from their workweek.

But such anxiety may be unwarranted. An audit provides you with a genuine assessment of your organization's financial condition and the controls surrounding its financial reporting — and it can provide your constituents with peace of mind. If you understand what to expect during an independent audit, the event should proceed smoothly.

LINE UP THE AUDIT

Start by scheduling the audit engagement far enough in advance to give you time to fully prepare. Make sure that key personnel will be in the office and available to answer questions during the auditors' visit.

Set an agreed-upon timeline with the audit firm that outlines key responsibilities in the audit process and establishes due dates. This will clarify expectations for both you and the audit firm.

GET YOUR RECORDS IN ORDER

In an external audit, a CPA verifies certain information on the nonprofit's financial statements and issues an opinion on whether those statements offer a fair picture of the organization's finances and whether they adhere to Generally Accepted Accounting Principles. To provide the audit firm with the information to make those judgments, you'll need to supply an analysis of each major balance sheet, revenue and expense account. You also should provide detailed documentation about your not-for-profit's operation in areas that include:

- Bank correspondence, including monthly statements, reconciliations, records of deposits and issued checks,
- Annual statements from all investment and endowment accounts,
- An inventory of salable items, including sales records,
- Invoices and payments to support transactions in accounts receivable and payable,
- Payroll records, including Forms 941, W-2 and W-3,
- Loans and mortgages, leases and other contracts,

* Grants and contributions, including restrictions in their use — plus donated services and materials,
* Special events and benefits,
* Any formal financial or accounting policies and procedures, and
* Information for your Form 990.

The documentation also should include board meeting minutes, the current year's budget and interim financial statements. Be prepared to explain variations between budgeted and actual results.

It's helpful to have the list of items your auditors will need during the close of your financial year — many records can easily be gathered or prepared during the close process. Make sure that everything requested by your auditors is ready on the first day of audit fieldwork.

Your auditors may request your trial balance, to be used in audit planning, before the first day of their fieldwork. It's also helpful to review your prior year financial statements and update the footnote disclosures once all accounts have been reconciled.

PREPARE FOR A FOCUS ON INTERNAL CONTROLS

Auditors once performed year end "cleanups" during annual audits, rebalancing and completing book entries. But current rules requiring external auditor independence may prohibit them from performing accounting duties during the audit engagement. This gives auditors more time to focus on risk assessment and internal accounting control policies and procedures.

You'll have a less stressful audit if you review your organization's internal controls before the audit and make any necessary improvements. If there are significant adjustments to your financial statements needed as a result of the audit, the auditors may conclude that your internal controls over financial reporting are deficient.

Your auditors will be able to answer questions about proper internal controls at your preaudit meeting. And remember, the more time *you* spend resolving issues before the audit, the less time *they'll* need to spend addressing such problems during their visit and the less likely your auditors will issue a report on control deficiencies.

PUT YOUR AUDITORS ON SPEED-DIAL

Contact your auditors with any questions in the weeks leading to the audit, but don't let that be the only time you give the CPA firm a call. Stay in touch all year as issues arise about your organization's accounting and financial reporting processes and about your internal controls. ❋

What about the audit committee?

Your nonprofit's audit committee has special responsibilities during an independent audit. This team, usually made up of board members and possibly others who are independent of the organization, typically:

* Selects the auditors and communicates with them during the initial discussion, reviews the engagement letter and negotiates fees, and
* Has separate discussions with the audit firm if there are specific concerns: for example, suspected wrongdoing involving management. Or the committee might ask the audit firm to focus on certain areas during the audit, such as an annual event or the handling of grant money.

The audit firm generally will contact the audit committee:

* During the audit if areas of concern arise about management conduct,
* At the end of the audit engagement, to report the results of its audit of the nonprofit's financial statements, and
* To report any areas of significant deficiencies or "material weaknesses" in internal controls.

Setting the salaries and benefits of your executives

Rules known as "intermediate sanctions" allow the IRS to assess penalties against nonprofit executives who receive excess compensation — and the board members who approve it. Do you and your board of directors know what's considered excess compensation and what's viewed as a conflict of interest during the compensation-setting process?

AVOIDING EXCESS BENEFITS

Internal Revenue Code Section 4958 prohibits most 501(c)(3) and 501(c)(4) organizations from engaging in an "excess benefit transaction" with a "disqualified person." Disqualified persons generally include anyone in a position to exercise substantial influence over the organization's affairs at any time in the five-year period preceding the transaction, such as officers, directors and members of their families.

An excess benefit transaction takes place when a disqualified person receives a benefit that exceeds the value of the service, property or payment the organization receives in exchange. An example: an executive director being paid a salary that far exceeds the salaries of executive directors at similar organizations. Violations of Sec. 4958 can lead the IRS to impose excise taxes on the disqualified person who benefited from the transaction as well as the nonprofit's leaders (for example, the board members) who approved it.

PASSING THE IRS TEST

Federal tax regulations provide a "rebuttable presumption of reasonableness" for compensation arrangements that satisfy three requirements. If all of the following are met, it's up to the IRS to show that compensation was nonetheless unreasonable.

Compensation generally must be set in advance by the board of directors or a subcommittee composed of board members. It's critical that none of the participants have a conflict of interest regarding the arrangement. For example, neither the executive nor a subordinate of the executive can participate in the compensation decision.

The authorized body also must rely on appropriate comparability data prior to making its compensation determination. The data can be derived from industry surveys, documented compensation of individuals in similar positions in similar organizations, expert compensation studies or other comparable data about reasonable compensation for the position. If the organization's average gross annual receipts are less than $1 million, it only needs compensation data for three similar positions in similar communities. The regulations don't specify the requisite number of comparables for larger organizations.

Keep in mind that similar job titles don't necessarily mean similar jobs. When evaluating comparability data, the positions must have comparable *duties,* not just titles.

What's more, the authorized body must adequately document the basis for its compensation decision while making that determination. This requirement is often overlooked. Documentation must include terms of the arrangement and the date it was approved, members of the body who were present during debate on the arrangement and those who voted on it, comparability data that was relied on and how it was obtained, and any actions by a member with a conflict of interest.

You must prepare the documentation before the later of the next meeting of the authorized body or 60 days after the body's final actions. The group also must approve the documentation within a reasonable time after preparation.

AVOIDING CONFLICTS OF INTEREST

Conflicts of interest must be avoided during the compensation-setting process. A member of the authorized body charged with approving a compensation arrangement has a conflict of interest if he or she fits *any* of the following five criteria:

1. Is a disqualified person participating in or economically benefiting from the compensation arrangement or is a family member of any such disqualified person,
2. Is in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement,
3. Receives compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement,
4. Has a material financial interest affected by the compensation arrangement, or
5. Approves a transaction providing economic benefits to any disqualified person participating in the compensation arrangement, who in turn has approved — or will approve — a transaction giving economic benefits to the member.

CONSIDERING *TOTAL* COMPENSATION

In setting compensation for key employees, the IRS requires nonprofits to consider *total* compensation. This generally includes regular salary and bonuses, retirement plan contributions, insurance, housing allowances and payment of nonbusiness expenses. Contact your CPA if you have questions about reasonable vs. excess compensation. ❋

Litigation protection

Be safe, not sorry

The Presbytery of Chicago recently entered into a $10 million agreement to sell its beloved Michigan summer camps, which it has owned for nearly a century. Proceeds from the sale are expected to help pay off an $11 million loan that was used in 2008 to settle a 2002 lawsuit brought by four men who said they were molested as minors by one of the church's ministers. Many church members consider the sale an enormous loss.

Lawsuits involving nonprofits aren't unusual in today's litigious society, and organizations sometimes take a huge financial and public relations hit as a result. But your nonprofit can employ safeguards to protect itself from

litigation and potential financial devastation. Here's a quick review of those safeguards.

POLICIES AND PROCEDURES

Lawsuits can come from anyone, including those receiving services (such as the alleged victims in the example above), donors, grantors, volunteers and board members. But current and terminated employees remain the most common source of lawsuits against nonprofits, according to insurance specialists.

To guard your organization against legal actions, your organization should develop, with the assistance of an attorney, comprehensive policies in the areas of:

- Sexual harassment,
- Age, race and gender discrimination, and
- Wrongful termination.

Also consider designing policies and procedures to guard against wrongdoing and potential litigation relating to noncompliance with the Americans with Disabilities Act, mismanagement of restricted funds and failure to provide services.

D&O INSURANCE COVERAGE

Directors and officers (D&O) liability insurance protects an organization's directors and officers from liability in case a lawsuit is brought against them relating to the nonprofit's operation. Qualified candidates usually are more comfortable accepting a board appointment if they know they're guarded from potential lawsuits.

Although D&O insurance can be expensive, it generally takes over where your general liability policy coverage leaves off. For example, although the Volunteer Protection Act of 1997 provides some protection for board members while performing their fiduciary duties, D&O insurance can be used to cover attorneys' fees when a lawsuit is first filed. So, it usually will cover these fees even if the lawsuit is eventually dismissed.

Current and terminated employees remain the most common source of lawsuits against nonprofits.

Employment practices liability (EPL) insurance also is available to provide further coverage in the event of an employee-generated suit and often is available as part of a D&O policy at a small additional cost. Pricing of D&O policies typically is based on the size of the organization's workforce, its claims history and the coverage requested.

AN ONGOING PROCESS

To lessen the chances of your nonprofit being sued, be proactive in developing policies and procedures in any particularly litigious areas of your operation. Be sure to involve your attorney throughout the development process and periodically afterwards to ensure they remain up to date.

Your CPA also can help provide templates for common policies and can advise on financial and general business content. Once you've finalized the policies and have board approval, training your nonprofit's employees to follow the procedures as designed is key to enforcing their compliance. ❋

NEWS FOR NONPROFITS

STUDY: MAJOR FLAWS IMPAIR FUNDRAISING

Many nonprofits are caught in a vicious cycle that threatens their ability to raise funds, according to *UnderDeveloped: A National Study of Challenges Facing Nonprofit Fundraising.*

The recent study, a joint project of service provider CompassPoint and the Evelyn and Walter Haas, Jr. Fund, surveyed 2,700 executive directors and development directors. It found that fundraising weaknesses include a lack of qualified candidates for the development director position as well as high levels of turnover and lengthy vacancies in that job. The study also reveals deeper problems at many nonprofits, including the lack of basic fundraising systems and inadequate attention paid to fund development by key board and staff leaders.

Suggested "calls to action" that might break the cycle include embracing fund development across the nonprofit sector and elevating the field of fundraising — that is, turning it into a "respected and rewarding career." For more information on the study, see CompassPoint.org. ❋

UBI TAX REPORTING VIOLATIONS

The Exempt Organization (EO) arm of the IRS is examining a "statistically valid sample" of nonprofits this year to see if those reporting substantial gross unrelated business income (UBI) for the last three years also are reporting income tax due for those years.

Last year the EO completed compliance checks of 400 organizations that had reported taxable UBI activities on their Forms 990 but hadn't filed Form 990-T, "Exempt Organization Business Income Tax Return." The investigation resulted in the EO securing about 140 delinquent returns and more than $260,000 in tax payments. The agency says it's concerned again this year about whether nonprofits are accurately reporting their sources of UBI and correctly allocating and deducting the expenses associated with it. ❋

GIVING LIBRARY EXPANDS VIDEO COLLECTION

The Laura and John Arnold Foundation's (LJAF's) Giving Library plans to increase its collection of online videos to as many as 850 charities this year. The Giving Library, a research tool for matching foundation grantmakers and individual donors with organizations, hopes to add up to 600 nonprofits by year end.

Each organization's profile includes two videos: a short overview that provides an understanding of its mission and programs, and a Q&A video interview designed to model an in-depth, face-to-face meeting between a donor and the nonprofit. The LJAF covers all participant expenses, including transportation to a Houston production studio and, if necessary, overnight lodging. For further information, visit givinglibrary.org or contact info@givinglibrary.org. ❋

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ABOUT SASSETTI LLC

Our firm was originally founded by Frank L. Sassetti in 1921. For more than 90 years, the firm has provided creative and proactive tax, accounting and audit services to its diverse client base.

Today, Sassetti LLC's clients consist of a broad range of family-owned businesses, SEC regulated companies, employee benefit plans and not-for-profit organizations. Our goal is to maximize business effectiveness and cost-efficiency, and to help clients understand the ever-changing complex accounting and tax rules.

Our staff of 25 experienced professionals strive to understand your needs, propose solutions and deliver timely and cost effective products.

EXPERIENCE COUNTS

For more information on how we can help your organization, contact Jeff Schroeder at **(708) 386-1433** or email **Schroeder@sassetti.com**. We look forward to speaking with you!!