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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.

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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.

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.

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

Upcoming Events

Please visit our website for more information and to register today!
www.capincrouse.com

August

Thursday, August 25
1:00 pm EDT

Online Webcast
Foreign Tax Reporting Update

September

Wednesday, September 7
Financial Seminar for Churches
Southlake, TX

Tuesday, September 20
2011 Annual Nonprofit Seminar
Indianapolis, IN

October

Tuesday, October 11
2011 Annual Nonprofit Seminar
Atlanta, GA

Tuesday, October 18
Financial Seminar for Churches
Ft. Lauderdale, FL

Friday, October 21
Half-Day UBIT Workshop
Colorado Springs, CO

November

Tuesday, November 8
2011 Financial Forum for Ministries
Presented by CapinCrouse & ECCU
Brea, CA

Wednesday, November 9
2011 Financial Forum for Ministries
Presented by CapinCrouse & ECCU
San Diego, CA

Wednesday, November 9
2011 Annual Nonprofit Seminar
Lombard, IL

Thursday, November 10
2011 Financial Forum for Ministries
Presented by CapinCrouse & ECCU
Livermore, CA

December

Tuesday, December 6
2011 Financial Forum for Ministries
Presented by CapinCrouse & ECCU
Colorado Springs, CO

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 at <http://www.stayexempt.org/VirtualWorkshop.aspx>.

These are only some of the activities that can generate UBI. Income from certain investments, from selling membership lists and from gaming activities (see the sidebar “It's All in the Game”) 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.

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.

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.

We Can Help!

The staff at CapinCrouse LLP works with hundreds of churches and not-for-profit organizations. This experience base allows us to quickly identify areas for improvement in many organizations. If your organization desires to improve its efficiency, please contact your Capin Crouse representative or one of our offices to discuss how we may help you.

About CapinCrouse LLP

With more than 700 not-for-profit organizations and 1,500 tax clients, CapinCrouse is the country's leading accounting and advisory firm primarily serving the Christian not-for-profit community.

Since 1972, CapinCrouse has been serving not-for-profit entities including megachurches, institutions of higher education and secondary schools, and international missions agencies by providing a full range of audit, review, tax, and advisory services.

CapinCrouse is dedicated to helping our clients operate with financial integrity so that they can dedicate themselves to fulfilling their mission.

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.

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.

Atlanta
678.518.5301

Chicago
630.682.9797

Colorado Springs
719.528.6225

Dallas
817.328.6510

Denver
720.283.7326

Indianapolis
317.885.2620

Los Angeles
714.671.9300

New York City
212.653.0681

Orlando
407.883.4671

San Diego
858.638.7220

Tax Department
317.885.2620

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.

In the Spotlight: Protect Your Organization from a Breach of Trust

by Carol Winters

By their nature, faith-based organizations and their boards, personnel, donors, beneficiaries, and other stakeholders embrace trust and forgiveness. While these are very important and laudable core values, be aware that they can also leave an organization at risk for fraud.

Unfortunately, your organization's mission alone is not sufficient to protect it from violations of trust. The reality is that the faith of religious organizations and their stakeholders can create a culture of unquestioned trust in leaders and personnel, without the necessary levels of oversight, inquiry, risk assessment, and internal control. **This puts the organization at risk for breaches of trust that can result in fraud.¹**

Fraud risk is elevated when a triangle composed of incentive, opportunity, and rationalization exists. The convergence of these elements can set the stage for fraud to occur. Fortunately, organizational leaders can have influence over one of these elements: opportunity.



¹Herbert Snyder and James Clifton, "Stealing from the Collection Plate: Fraud in Churches and Religious Groups," *Fraud Magazine*, Nov./Dec. 2005, pg. 20 - 23

Trust violators fall into three categories: **perpetrators, enablers, and abettors**. Perpetrators of fraud may purposefully target smaller, trust-based organizations with the intention of skimming donations or making fraudulent payments to themselves. More commonly, though, perpetrators are trusted employees who explain away their actions (rationalization) because they are faced with a financial problem (incentive). A lack of internal control (opportunity) allows them to solve their problem by embezzling or misappropriating assets from the organization.

Without appropriate controls, an organization can unwittingly become an enabler by providing the opportunity for a vulnerable employee to stumble and commit fraud.

Further, faith-based organizations with a culture of trust and forgiveness may be reluctant to prosecute an employee who has misappropriated assets. Although Leviticus 6:1-7 supports restitution for fraud, the board may decide to extend grace and dismiss the employee rather than seek repayment or prosecution. Leaders may also fear damage to the organization's reputation and the trust of its stakeholders if an embezzlement becomes public knowledge.

But the discrete dismissal of an employee perpetrator may result in the organization unknowingly becoming an abettor to the perpetrator's future victimization of another trust-based organization. The leadership team of the first organization has then become a trust violator themselves by causing harm — no matter how inadvertent — to another organization and its stakeholders.

Protecting Your Organization

The board and leaders of a faith-based organization have a fiduciary responsibility to protect the organization's reputation, stakeholders, and assets, as well as the larger community it serves. So what can your leaders do to protect against the harm caused by breaches of trust resulting in fraud?

Fraud risk oversight is the responsibility of those charged with the governance of an organization, commonly the audit committee or the board of directors. According to the American Institute of Certified Public Accountants (AICPA), the audit committee should take an active role in the prevention, detection, and deterrence of fraud.²

We strongly recommend that your organization establish a fraud risk assessment and management program.

This should include:

- Assembling a team of internal and external experts
- Developing a program to identify risks
- Evaluating the likelihood of occurrence and the impact of each risk on the organization
- Identifying mitigating controls and determining whether existing controls are functioning properly or additional controls are needed

CapinCrouse can help your organization establish a fraud risk assessment and management program. We'll discuss this in more detail later in this article.

Responding to Fraud

What should leaders of organizations do when fraud is suspected or detected? We recommend that those charged with governance, typically the audit committee, first assemble a fraud team that includes the insurance carrier, legal counsel, and a CPA/forensic specialist. These professionals will help ensure that your organization complies with the law, understands the requirements of the insurance policy and fidelity bond, and is aware of alternative actions that can be taken. They can also provide services for investigation, the gathering and safeguarding of evidence, dispute resolution, expert testimony, and prosecution.

The next step is for the audit committee or board to decide what course of action your organization will take. If the organization will be making a claim on the insurance policy, the insurance carrier will expect you to accumulate evidence, file a police report, and take steps to prevent further loss. The audit committee or board may decide to seek restitution

²Fraud and the Responsibilities of the Audit Committee: An Overview," American Institute of Certified Public Accountants, 2010

from the perpetrator through mediation or a civil lawsuit, or to involve law enforcement for a criminal prosecution. Either of these actions will require investigation and the collection of evidence to be used during dispute resolution hearings or trials before a court of law. The insurance carrier, law enforcement officials, and other involved parties will likely seek the advice and services of CPA forensic accountants.

We Can Help

CapinCrouse's experience in the not-for-profit sector, combined with our forensic accounting services team, can provide the expertise you need to implement effective fraud prevention and detection measures.

We can help your organization establish a **fraud risk assessment and management program**. This typically includes developing, implementing, and monitoring:

- A code of ethics
- A system of internal control
- A whistle-blower policy and hotline
- Strict employment hiring policies
- A conflict of interest policy
- Computer and Internet security policies
- Detection and monitoring procedures

To help smaller organizations, we also provide a **consulting review** service that evaluates four areas of board and management oversight: corporate and administrative matters, internal control, financial accounting and reporting, and tax compliance.

Both of these preventative services have been created to help our clients and their boards fulfill the fiduciary responsibilities entrusted to them by the organization's stakeholders.

CapinCrouse also provides forensic services to organizations, their insurance carriers, and their legal counsel in response to suspected or detected fraud occurrences. Our team includes CPAs certified as fraud examiners, and we offer forensic services in the categories of fraud investigation and evidence preservation, dispute resolution, and litigation support. In addition, our consultants are available to provide expert advice and testimony for dispute resolution and litigation support.

Our focus on the not-for-profit sector provides the perspective faith-based organizations need in pursuing and resolving breaches of trust that result in fraud.

Trusting and Protecting

A breach of trust harms a faith-based organization, its stakeholders, and the larger community of believers. But with the right oversight and accountability, this harm can be prevented without damaging and organization's trusting culture. Please contact us if you have any questions about or need assistance in preventing, detecting, and deterring fraud at your organization.

Newsbits

[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.