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Nonprofit Observer

Are you ready for change?
FASB proposes accounting overhaul for nonprofits

Investment fraud: It could happen to your nonprofit

When to look a gift horse in the mouth — and report its value

6 tips for building the board of your dreams

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Are you ready for change?

FASB proposes accounting overhaul for nonprofits

In April, the Financial Accounting Standards Board (FASB) proposed new accounting standards that, if finalized, will fundamentally alter the way nonprofits prepare their financial statements. The proposed update, *No. 2015-230, Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for-Profit Entities,* is intended to address what FASB considers unnecessary complexities and inconsistencies in current nonprofit financial reporting.

According to FASB member Lawrence W. Smith, the changes will "make not-for-profit financial statements even more useful to donors, lenders, and other users." Not everyone is expected to agree with his assessment, and FASB has invited nonprofits and concerned individuals to comment on its draft by August 20. Here's an overview of what could end up being the biggest update of nonprofit accounting standards in more than two decades.

KEY PROVISIONS

The update makes several significant proposals relating to:

Asset classes. Currently, nonprofits classify net assets as unrestricted, temporarily restricted or permanently restricted. FASB would reduce these three categories to two — net assets subject to donor restrictions and net assets without donor restrictions. In effect, the change would eliminate the distinction between temporarily and permanently restricted net assets.

All nonprofits would have to summarize expenses by natural classification, such as salaries and rent, as well as by function or program.

Statement of activities presentation. Organizations would be required to segregate revenues and expenses related to their mission (or operating activities) from other activities. Such other activities include investment income and board designations that place or remove organization-imposed limits on resources, making them unavailable for current period operating activities. Nonprofits would have to report such income net of external and direct internal investment expenses. All activity would further be separated into the two classes of net assets described above.

Classification of expenses. All nonprofits would have to summarize expenses by natural classification, such as salaries and rent, as well as by function or program. This grid-style information could be presented in an additional statement, on the face of the statement of activities or in a footnote.

Cash flows. Nonprofits would be required to use the direct (as opposed to the indirect) method of stating cash flows. The direct method involves separate reporting of cash receipts and payments tied to operating activities.

Cash flow classifications. Changes would be made in the classification of some transactions. Purchases and sales of, as well as contributions for, long-lived assets move from investing to operating cash flow items. Interest payments move from operating activities to financing activities. Investment income — other than for loans or investments made for programmatic purposes — generates investing cash flows.

Expirations of certain restrictions. To report the expiration of restrictions on a gift to be used to acquire or construct a long-lived asset, organizations would be required to use the placed-in-service approach. This would replace the method of releasing donor restrictions over the estimated useful life of the gift.

Underwater endowment funds. Donor-restricted endowments for which the fair value is less than either the original gift amount or the amount that is required to be maintained — otherwise known as underwater endowment funds — would have to be fully reported in net assets with donor restrictions. (Currently the underwater amount of an asset is reported in the unrestricted category.) Nonprofits would also need to disclose the original gift amount or level required to be maintained and their board's policy on spending such funds.

Liquidity. Organizations would be required to disclose both quantitative and qualitative information about liquidity and explain how it's being managed.

QUESTION OF TIME

If approved, FASB's accounting standard changes will go into effect on a retrospective basis. The board is still determining whether new standards would apply to all nonprofits at the same time and whether some organizations would be allowed to adopt them early.

Where's the GAAP?

In its Accounting Standards Update (ASU) 2015-230, the Financial Accounting Standards Board (FASB) acknowledges that new proposed standards are reasonably different from current Generally Accepted Accounting Principles (GAAP) — and that initial compliance with the rules could be challenging. Officially, however, FASB believes that the benefits, including greater transparency and clarity of financial statements, outweigh the costs.

Unofficially, there's some dissent, even among FASB board members. In fact, FASB's own chairman Russell Golden has expressed concern that some aspects of the new standard should be studied on a global level because they address issues for nonprofits that also apply outside the nonprofit sector.

Higher education finance officers have also spoken up. In March, a group told FASB that certain proposals — those that reduce net asset classes to two and that require nonprofits to present a uniform measure of operations — would be hard for them to follow.

In the meantime, to review FASB's proposal as well as questions for respondents, visit fasb.org, enter "2015-230" in the search box, and click on "Exposure Documents Open for Comment." The resulting page includes a link to the proposal. And be sure to voice your opinion by August 20. ✱

Investment fraud: It could happen to your nonprofit

Last year, a Cincinnati man was sentenced to over 15 years in prison for perpetrating an elaborate Ponzi scheme that included among its victims several charitable organizations. Professional money manager Glen Galemmo solicited money from investors, but never purchased the securities he claimed would provide them with outsized returns. Instead, he used it to pay off previous investors whose money he had already lost and to fund his family's extravagant lifestyle.

Unfortunately, Galemmo is only one of many con men eager to "invest" your organization's funds. To avoid becoming a victim, your nonprofit needs to screen investment advisors carefully. And to remain in the IRS's and public's good graces, it's important to come clean if investment fraud occurs.

DIRTY LITTLE SECRET NO MORE

Investment fraud can cause significant financial losses, but the harm it does an organization's reputation with donors and the public may be even worse. Since 2008, nonprofits have been required to disclose on their Form 990 whether they've experienced a loss of more than $250,000 (or 5% of the organization's total budget or assets) to embezzlement or any other illegal "diversion." If so, they must provide a description of the incident on Schedule O.

Such data becomes public and is likely to be reported by charity watchdog groups and the media. Indeed, the *Washington Post* analyzed Form 990 data from thousands of nonprofits in 2013 and made a startling discovery. At least 1,000 public charities had experienced heavy fraud losses, totaling hundreds of millions of dollars. A surprising number of these schemes were categorized as investment fraud.

One way investment fraud differs from occupational fraud is that its perpetrators generally are outside advisors — not employees. They may be brokers, bankers, financial planners, investment advisors or even self-styled money experts. In many of the cases reviewed by the *Post*, the thieves were registered or licensed, enjoyed good reputations in their communities and had no previous record of wrongdoing.

AVOIDING CROOKS

How then can your organization avoid hiring a crook? First, beware of unrealistic promises. If an advisor guarantees immediate results or annual returns of 20% — even in years when the general stock market tanks — he or she is either lying or incompetent. Also be wary of investment fund managers who don't submit to outside audits or report their results publicly.

Instead, look for an advisor who encourages you to discuss investment goals and risk concerns. A good advisor should understand your organization's investment policy — or be willing to help you develop one. Accessibility is important, too. For example, your board likely holds meetings after business hours and your investment advisor needs to be able to meet with them from time to time.

HOW TO LIMIT DAMAGE

According to the *Marquet Report on Embezzlement*, nonprofits and government entities are second only to financial services as the most frequently victimized sector. Various conditions — from lax internal controls to a trusting environment — can make charities prime pickings for fraud perpetrators. But while there's ultimately a limit on how much damage a dishonest staff member can do, the sky's the limit for a crooked investment advisor who has, for example, access to your endowment.

Ask other nonprofits or your attorney or CPA for investment advisor referrals. And make sure your board scrutinizes investment recommendations, carefully reviews performance reports and constantly monitors account balances. ✱

When to look a gift horse in the mouth — and report its value

The familiar proverb "Don't look a gift horse in the mouth" is good advice in many circumstances — but not when your nonprofit receives a generous gift of noncash property. In many such cases, your donor must provide an appraisal of the gift and your organization needs to report its value in your financial statements and on your Form 990.

ALL FACTS AND CIRCUMSTANCES

The IRS defines FMV as the price that a knowledgeable buyer is willing to pay a knowledgeable and willing seller for property, assuming neither party is obligated to buy or sell. For example, if a donor contributes used household goods, the FMV would be the price that typical buyers would actually pay for items of the same age, condition and use. Ultimately, FMV must consider all facts and circumstances connected with the property, such as its desirability, use and scarcity.

Several factors help determine a gift's FMV, including its cost or selling price. The cost of the item to the donor or the actual selling price received by your organization may be the best indication of the item's FMV. However, because market conditions can change, the cost or price becomes less important the further in time the purchase or sale was from the date of contribution. This is particularly true with certain goods such as technological devices, which become obsolete quickly.

A documented arm's-length offer to buy donated property — for example, real estate — close to the contribution date may help prove its value to the IRS. But such an offer must have been made by an independent, unrelated party willing and able to complete the transaction.

SIMILAR GOODS

The sale price of a property similar to the donated property, or a comparable sale, also helps determine FMV. The weight that the IRS gives to a comparable sale depends on the:

- Degree of similarity between the property sold and the donated property,
- Time of the sale,
- Circumstances of the sale (for example, was it made at arm's length?), and
- Market conditions.

The two properties must be similar enough that reasonably well-informed buyers or sellers of the donated property would have considered buying it at the comparable property's selling price. It's important that the transactions not be between related parties, and be considered arm's-length sales. The greater the number of similar sales for comparable selling prices, the stronger the evidence of the FMV.

FMV can consider the cost of buying, building or manufacturing property akin to the donated item. But the replacement cost must have a reasonable relationship with the FMV. And if the supply of the donated property is more or less than the demand for it, the replacement cost becomes less important to its value.

The cost of an item to the donor or the actual selling price received by your organization may be the best indication of the gift's value.

DONOR AND RECIPIENT RESPONSIBILITY

Professional appraisals are generally needed for property for which the donor will claim a deduction of more than $5,000 (except for such donations as publicly traded securities, intellectual property and business inventory). However, donors who deduct more than $500 for any single item of clothing or any household item that's not in "good used condition" or better must include a qualified appraisal with their income tax return.

Donors should understand that the IRS will weigh the appraisal based on the report's completeness and the appraiser's qualifications and demonstrated knowledge of the donated property. Written appraisals must provide all facts applicable to giving an "intelligent judgment" of the property's value, such as purchase price and comparable sales.

AVOIDING TROUBLE

To avoid trouble from the IRS, handle noncash property donations carefully. Ensure that larger gifts are accompanied by a qualified appraisal — paid for by the donor. And if you receive more than $25,000 in noncash contributions, or gifts of art, historical items or conservation easements, include Schedule M, "Noncash Contributions," with your 990. For more information, consult IRS Publication 561, *Determining the Value of Donated Property*. ✱

6 tips for building the board of your dreams

In response to a recent survey on nonprofit governance, chief executives and board chairs gave their boards of directors an average overall grade of B-. Average grades for certain functions, including community relations and fundraising, were even lower, according to consulting firm BoardSource's 2015 *Nonprofit Governance Index*. Clearly, nonprofit boards could be doing better.

But if you've ever tried to recruit board members, you know how difficult it is to find people who're qualified, passionate about your mission, and committed to good governance and transparency. Even when you've found what appears to be an excellent candidate, you may learn that the person can't put in the required hours or is otherwise unqualified. There's no magic bullet, but here are six suggestions for finding the best possible board members.

1. Target your search. Don't just look for *anyone* to serve on your board; search for people with the specific talents or experience you need. For example, if your board already has plenty of financial and legal expertise but struggles when it comes to fundraising, you probably want to seek a candidate with an outgoing personality who has successfully raised money in the past and has plenty of community contacts.

2. Find fresh referrals. If you usually recruit new members through current board members, consider trying a different approach. Advertise on social media sites, in your nonprofit's newsletter, in your local newspaper and in other publications whose target audience includes your ideal candidate. Also ask "people in the know," such as community leaders, politicians and business reporters, for suggestions.

3. Don't overlook volunteers. Today's humble volunteer may be tomorrow's director. Volunteers are passionate about your cause and usually have a unique "ground level" perspective from

working with staff and the public. Keep your eye on potential candidates and mentor the ones who show unusual promise.

4. Treat the position like a "real" job. Even if your board seats are unpaid positions, they're important jobs. Ask applicants to provide a resume that highlights experience and skills relevant to your board and a possible committee assignment. Then request that applicants fill out an honest self-assessment that asks, for example, whether the candidate is able to commit 10 hours a month to your nonprofit. Your executive director, board chair and nominating or executive committee chair (if you have one) should interview the candidate one-on-one.

5. Provide a proper orientation. New directors should receive an orientation that includes a tour of operations and introductions to key employees and fellow board members. Make sure the new board member completely understands your mission and programs, knows the rules of good governance — including financial oversight — and is up to date on current challenges and initiatives.

6. Don't keep reinventing the wheel. If you're starting from scratch every time a board seat opens up, you're doing something wrong. Keep all applications and interview notes from previous searches on file, and be sure to record the names of individuals who have either formally or in passing indicated that they might be interested in a board position. ✱

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At Smith & Gesteland, LLP we know that running a successful not-for-profit these days requires more than just dedication and hard work. It takes the assistance of experts who understand the complex needs of these organizations and have the knowledge, experience and service commitment it takes to help them fulfill their missions.

Our Not-for-Profit Service Group consists of professionals focused on increasing the success of organizations like yours. For more than 50 years, our firm has served businesses, organizations and individuals throughout south central Wisconsin. We are delighted to currently work with more than 70 not-for-profits and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

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We would welcome the opportunity to serve you. For more information about our services or the ideas presented in this newsletter, please contact us at (608) 836-7500 or mail@sgcpa.com.