Nonprofit accounting principles and practices

- We have a fiduciary responsibility to our donors, to the IRS and to the state of Hawaii
- Because nonprofit organizations are so privileged, we are subject to stringent regulations emphasizing complete disclosure
- Currently, Hawaii nonprofit organizations are governed by the IRS, the Department of Commerce and Consumer Affairs and the Hawaii Nonprofit Corporations Act. Two provisions of Sarbanes-Oxley apply to nonprofit corporations, a whistleblower protection policy and a document retention policy.
- The federal tax return, Form 990, is very comprehensive and requires full disclosure of all activities
- The Form 990 is open for public inspection
- Due to all of the above and more, nonprofit accounting principles and practices emphasize accountability and transparency
- We must ensure contributions received are spent for the purposes designated

Taxation of nonprofit organizations

- Exempt from federal income tax under Section 501c(3) of the Internal Revenue Code
- All states conform therefore 501c(3) organizations are also exempt from state income tax
- Unrelated business income is subject to income tax. An unrelated trade or business is not substantially related to the organization's exempt purpose and is regularly carried on for the production of income. There are lots of exemptions in this area.
- In Hawaii, donations, grants and program service revenue are exempt from general excise tax, however GROSS fundraising revenues are subject to general excise tax. Exemption from GET is not automatic; it must be applied for via Form G-6.
- Don't confuse income tax rules with general excise tax rules

Documentation requirements for contributions: Quid Pro Quo Rules

- Quid pro quo means "something for something".
- In order for a donation to be deductible, it must be a "true" donation. A gift was given and nothing was received in return.
- For donations of $75 or more, the organization must provide a written statement: no goods or services were received in exchange for this donation. This statement can be incorporated in the thank you letter.
- If goods or services were given, then your organization must estimate in good faith the goods or services given and inform the donor that the deductible charitable contribution is limited. For example, a donor gives $100 in consideration for a gala dinner ticket valued at $40. In

this example, $60 would be deductible and you must furnish a disclosure statement. Many organizations comply with this by printing this information on the tickets themselves.

- An organization need not make a good faith estimate of a quid pro quo contribution if the goods or services given to a donor are insubstantial in value, such as a poster or a mug, etc.

Tax rules relating to individuals

- Donations of money or tangible property to 501c(3) nonprofit organizations are tax deductible as charitable donations
- Donations of services rendered are never tax deductible
- Amounts paid for drawings are not donations and they are not deductible! FYI, raffles are illegal in Hawaii. Most organizations call them donation drawings but you must let everyone enter regardless of whether or not a donation is made.
- Beginning in 2007, in order to be deducted on an individual's income tax return, all cash gifts, regardless of the amount, must be substantiated by a bank record or a written communication stating the charity's name and the amount and date of the contribution.

Bookkeeping / Accounting Tips

General:

- Always hire a reputable, trustworthy, competent professional.
- Have a clear job description with specific duties.
- Develop internal controls and segregate duties whenever possible.
- Assign someone to oversee the bookkeeper/accountant. Develop a process to ensure the outlined duties are being completed correctly and timely.
- Review & analyze reports & financial statements consistently.

Specific:

- Cash is king. Make daily bank deposits. Prepare deposit slips in duplicate. Prepare receipts for all monies received.
- If possible, someone other than the accountant/bookkeeper should get the mail, open the mail and review the donations received. An admin person can make copies of all the donations received and give one copy to the accountant/bookkeeper and one copy to the data base administrator.
- If possible, someone other than the bookkeeper/accountant should keep the donor database. If deemed necessary, the donor database could be reconciled to the general ledger deposits.
- Prepare bank reconciliations timely. Review cancelled checks for signs of impropriety.
- Invoices should only be processed for payment if supporting documents are attached and approved by the appropriate person.

- Utilize due date reminders, particularly for payroll items.

Types of Financial Statements issued by CPA's

- 1st level of service: Compiled Financial Statements (CFS). CPA takes the organization's data, makes adjusting entries and presents the data in the form of financial statements. Compiled financial statements can be prepared on most any type of accounting basis i.e. cash, modified cash, income tax basis, etc. CFS may or may not include disclosures (footnotes). CPA does not express an opinion or any other form of assurance on the financial statements.
- 2nd level of service: Reviewed Financial Statements (RFS). CPA performs inquiries & analytical procedures. Reviewed financial statements can also be prepared on most any type of accounting basis. RFS require full disclosures i.e. footnotes. Reviews express limited assurance that there are no material modifications that should be made to the financial statements.
- 3rd level of service: Audited Financial Statements (AFS). CPA evaluates the organization's internal controls, conducts compliance tests on random samples of transactions, performs substantive procedures, including confirmation of certain balances, and assesses the accounting principles and significant estimates made by management. Audited financial statements must be prepared on the GAAP basis of accounting, generally accepted accounting principles. GAAP financial statements include: statement of financial position, statement of activities, statement of functional expenses, statement of cash flows and footnotes to the financial statements. The footnotes summarize significant accounting policies, report details of investments, pledges receivable, inventories, fixed assets, notes payable, retirement plans, temporarily restricted net assets, leases and special events. CPA expresses an opinion on the financial statements. An "unqualified opinion" means the financial statements are fairly presented.
- The organization is responsible for its financial statements in all cases.

When should an organization be audited?

- The board of directors should continually assess the need for audited financial statements. Factors to consider include the dollar amount of the charity's assets and annual revenue along with the types of funds received, contracts executed by the organization and the general climate of the organization.
- If any organization receives $500,000 or more annually from the federal government, it must obtain an independent audit.

- Right now, other than the above bullet point, there are no federal rules relating to mandatory audits for nonprofit organizations however Congress will most likely pass some rules very soon.
- Hawaii also does not have any legislation relating to required audits
- California passed the California Nonprofit Integrity Act several years ago and requires nonprofits conducting business in California to obtain audited financial statements if their annual revenue exceeds $2 million

Federal Legislative Update

- Pension Protection Act of 2006 (PPA of 2006)
    - Revised the Form 990 – details to follow
    - Small nonprofits previously exempt from filing the Form 990 because they had annual gross receipts of $25,000 or less are now required to file a new Form 990-N, Electronic Notice, E-Postcard.
    - **Under the PPA of 2006, any organization that fails to file the required annual returns for three consecutive years will automatically lose its tax-exempt status.** The IRS is in the process of designing a voluntary compliance program, an amnesty program. Organizations will be able to avoid automatic revocation of their tax exempt status by filing missing returns and paying all taxes and applicable interest without facing any penalties.
    - Federal/State information sharing legislation
- Current proposals before Congress
    - review of exempt status by the IRS every 5 years
    - limit charitable deductions of appreciated property (other than publicly traded stock) to basis as opposed to fair market value
    - CEO certification of financial statements
    - Required audited or reviewed financial statements for organizations meeting certain criteria
    - Board composition standards and limits
    - Grant IRS express power to remove directors and officers
    - IRS accreditation of charities that meet “best practices”
    - The reforms will affect governance, transparency and accountability. Increasing board education and financial literacy is highly recommended as is adherence to “best practices”.
- In May 2007, The American National Red Cross Governance Modernization Act was drafted to provide for major changes to the ARC board of governors based on the fact that the ARC is a federally chartered entity. Congress may seek to replicate similar reforms to all nonprofits.

- Last year, the IRS increased the number of nonprofit audits and reviewed thousands of Form 990s looking for excessive compensation and self-dealing transactions with nonprofit board members and officers. As a result of this review, the IRS assessed more than $21 million in excise taxes (penalties) against disqualified persons or managers.
- This year, the IRS is sending letters and questionnaires regarding endowment management.

Hawaii Legislative Update

Several bills relating to charitable organizations are in front of the Hawaii legislature. The gist of these bills requires registration of nonprofits with the state attorney general. Additionally, nonprofits would be required to submit organizational, administrative and financial data to the state attorney general, including a copy of the Form 990. Of course, filing fees would be involved. The bills would also allow the attorney general investigative powers. One bill establishes a "Hawaii charitable trust and nonprofit organizations special fund". All fees and penalties would be deposited into this fund for the use of the attorney general enforcement duties.

Redesigned Form 990

- Revisions focus on governance practices, executive compensation, conflicts of interest, transactions with insiders, related party explanations, lobbying activities.
- The new Form 990 will be phased in as follows:
    - Required for the 2008 tax year for organizations with gross receipts over $1 million or assets over $2.5 million
    - Required for the 2009 tax year for organizations with gross receipts over $500,000 or total assets over $1.25 million
    - Beginning with the 2010 tax year the thresholds are permanent: $200,000 in gross receipts or $500,000 in total assets
- The following are new reporting requirements:
    - Number of independent voting members of the governing body. What's an independent voting member? One who isn't compensated. Also applies to family members and relations.
    - Total number of volunteers
    - Expanded reporting for organizations that maintain collections of works of art, historical treasures or other similar assets
    - Expanded reporting for endowments
    - Detail reporting of fees paid for services: management, legal, accounting, lobbying, professional fundraising, investment management fees
    - Reporting of business relationships with family members

- Detail schedule of non-cash contributions if more than $25,000
- Information regarding 1099s filed
- Information regarding W2s
- Information regarding payroll tax forms
- Questions regarding documentation of board meetings and committee meetings and documentation of the actions taken at such meetings
- Questions regarding written policies and procedures governing activities of chapters, branches or affiliates
- Describe the process the organization uses to review the 990
- Questions regarding reaching officers, directors or trustees at addresses other than the principal address of the organization
- Questions regarding policies: conflict of interest, whistleblower protection, document retention, compensation, public disclosure, expense reimbursement
- Questions regarding compensation: travel, housing allowances or residences for personal use, payments for business use of personal residence, health or social club dues or initiation fees, expenses allowances, personal services (maids, chauffeur, chef, etc.)
- Transactions with interested persons: excess benefit, loans, grants or assistance, business transactions

Election year reminder

- A charity may not endorse or oppose any candidate for public office or participate in any political campaign. Tax exempt status will be revoked.
- Political expenditures are strictly prohibited: remuneration to a candidate or prospective candidate for speeches or other services, travel expenses, advertising, fundraising or other expenses that promote public recognition
- Lobbying expenditures are OK if not a "substantial part of activities", less than 10% of expenditures.

Valuable Resources

- Guidestar.org
- IRS Exempt Organization website
- The NonProfit Times
- The Independent Sector website
- National Council of Nonprofit Associations
- HANO (Hawaii Alliance of Nonprofit Organizations)
- HCF (Hawaii Community Foundation)