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NEWSLETTER



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PITFALLS OF NOT-FOR-PROFIT ORGANIZATIONS

by Peter Hall, Supervisor

As the number of not-for-profit organizations (NPOs) in the United States has greatly increased over the last 10 years (from about 1 million in 1996 to over 1.4 million in 2005) so has the need for more meaningful and useful financial information about these entities. With ever growing levels of economic resources being provided to and consumed by NPOs in increasingly complex and diverse types of transactions and activities, not-for-profits need to be able to manage and account for these resources in a more efficient and transparent fashion than ever before. The financial reporting scandals of the last five years, and the resulting push for more accountability in the commercial sector, have placed growing pressure on NPOs to avoid the mistakes of their for-profit peers. To their credit, most of the NPOs have responded proactively, with many organizations voluntarily adopting the principles imposed on the publicly-traded commercial sector by the Sarbanes-Oxley Act. NPOs have also striven to augment the transparency of their financial reporting and improve their internal control structure, lest they too fall victim to the problems which have plagued the for-profit world.

While many larger organizations have the resources at their disposal to institute accounting systems and internal controls which would rival those of many an SEC company, the reality of many smaller NPOs is that fiscal management resources are all too scarce, staff are too few in number, and the demands on finance personnel are too great to effectively implement systems and controls which their larger counterparts enjoy. Nowhere does this fact become more apparent than during the annual financial audit of such an agency. However, by being mindful of a handful of common pitfalls and taking necessary steps to avoid them, the smaller NPO can not only render its annual audit (or other year-end accounting process) less painful and more efficient, but can also greatly enhance the usefulness of its own financial reporting.

Taking the Pledge - Revenue Recognition in the Post-FASB 116 Era

Prior to the issuance of FASB (Federal Accounting Standards Board) 116 in 1993, there existed great inconsistency in the accounting treatment of contributions received by NPOs, largely because the authoritative guidance on this topic was itself inconsistent. In some cases, contributions were recognized as direct additions to net assets not affecting current operations. In other cases, contributions to be used for future period's activities were initially recorded as deferred support, and not recognized on the operating statement until the future period's use.

IRS MILEAGE RATE CHANGES

The Internal Revenue Service has issued the 2006 optional standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical or moving purposes.



For the calendar year 2006, the standard mileage rates for the use of a car (including vans, pickup trucks and panel trucks) are:

- 44.5 cents per mile for business miles driven;
- 18 cents per mile driven for medical or moving purposes; and
- 14 cents per mile driven for service for a charitable organization (other than activities related to Hurricane Katrina relief).

Special rates for Katrina-Related Charitable Miles - There will be separate rates for miles driven in relation to Katrina relief efforts.

- 32 cents per mile for deduction purposes; and
- 44.5 cents per mile for reimbursement purposes.

2005 MAINE RESIDENTS PROPERTY TAX AND RENT REFUND PROGRAM

APPLICATIONS MUST BE FILED BY MAY 31, 2006

Over 200,000 Maine households now qualify for property tax and rent refunds.

You may qualify if:

- You do not have a spouse or dependent(s) and your 2004 household income was \$74,500 or less; or
- You have a spouse or dependent(s) and your 2004 household income was \$99,500 or less

AND

- Your 2004 property tax was more than 4% of your 2004 household income; or
- The rent you paid in 2004 was more than 20% of your 2004 household income

NOTE: Low-income Seniors do not need to meet these requirements

Pitfalls of Not-For-Profit Organizations, continued from page 1

FASB 116 sought to eliminate much of this lack of comparability by requiring the recognition, as current period revenue, of all contributions received, including unconditional promises to give (i.e., pledges). And while this accounting standard has been in effect for more than a decade, there are many, usually smaller, NPOs that still maintain their internal accounting records on a pre-FASB 116 basis. For some, this means recognizing as revenue contributions when received in cash, but not promises to give. Other agencies may still be carrying as deferred revenue contributions received but not expended. Still others may record certain contributions (either when received in cash or other form, or when promised by the donor) as direct increases to fund balance or net assets. While all of these methods had appropriate uses in the past, none is consistent with current GAAP (generally accepted accounting standards). Legitimate internal accounting and management purposes may well be served by these methods, but it is important for such agencies to be able to readily adjust their records at year-end (or any other time at which GAAP-based financials are required) to reflect such contribution activity in a manner consistent with FASB 116.

To Fund or Not to Fund – Fund Accounting and FASB 117

At the same time that the FASB issued Statement 116, it also released Statement 117, in which the financial reporting standards for NPOs were substantially revised. Prior to this pronouncement, there was great incomparability among various agencies in the overall format and content of their respective financial statements, as most NPOs presented their financial position and results of operations in the form of fund financial statements (with the attendant variety in the numbers and types of funds thus employed).

With the issuance of FASB 117, however, NPOs are required to present an entity-wide statement of financial position and statement of cash flows, along with an entity-wide statement of activities which segregates all operating results into three distinct net asset classes, which are distinguished from one another by the presence and nature of donor-imposed restrictions attaching to the non-exchange revenue flowing through each such class. This presentation is markedly different from the fund financial reporting many organizations employed previously, and continues to cause some confusion among those

in the NPO community. While a detailed discussion of this accounting standard is beyond the scope of this article, it is important for NPOs to understand the requirements of FASB 117 and be prepared to adjust internal accounting information to a format which supports such a presentation at year-end or any other time GAAP-based financial reporting is needed. NPOs should also be aware that while FASB 117 governs external reporting purporting to be in accordance with GAAP, there is no prohibition against maintaining internal accounting information on a fund basis. Indeed, the case can be made that while this standard may have improved comparability among agencies when it comes to external reporting, that the incorporation of this standard in an agency's internal accounting framework may actually result in less useful information being available to internal decision makers. Many agencies may find themselves, with good reason, resorting to fund accounting for management purposes, and recasting this data in the format required by FASB 117 for external reporting.

What's Not Fun About Functional Expenses?

FASB 117 requires the financial statements noted above for all not-for-profit organizations. In addition, voluntary health-and-welfare organizations are required (and other NPOs are encouraged) to also provide within their basic financial statements a statement of functional expenses. This statement essentially presents, in matrix form, all agency expenses both by natural category and by functional classification. Thus, from this statement, the reader can learn not only how much the agency spent on personnel costs in total (for example) but the extent to which such costs benefited the various functional activities undertaken by the agency. Typically, such functional classifications include program activities and supporting services, such as management, administration and fundraising.

Since even agencies not meeting the definition of a voluntary health and welfare organization are required to disclose, in aggregate form only, the portion of total expenses serving the agency's respective functional areas, it is critical that the agency employ a well-documented system for tracking expenses not only by natural classification (e.g., "what did you buy"), but by functionality as well ("how was this resource used?") The methods for making and recording such distinctions can be as simple or as complex as warranted given the agency's own circumstances, but should include consideration not only of direct costs which are readily traceable to a certain func-

tional purpose, but also of the allocation of indirect costs, to the extent these can be associated with specific functional areas. NPOs should also note that with greater public and regulatory attention being paid to IRS Form 990 filings, even those agencies not including a statement of functional expenses within their basic financial statements should still employ a rational and well-supported system of tracking costs by functional designation to support the functional expense statement required in Form 990.

Special Events

As demand for government funded grant dollars continues to outstrip supply, many agencies are realizing that, now more than ever before, it behooves them to actively solicit donations from the public to not only make ends meet, but hopefully to provide a reasonable level of net assets to act as a safety net in the event of unforeseen circumstances. As special fundraising events, capital and endowment campaigns, and other fundraising efforts become more widespread, agencies are well advised to insist on accurate accounting of both the revenues generated, and the costs incurred. This cost information should be aggregated on an event-by-event basis with detail as to the nature of the costs incurred, so as to be readily incorporated in the statement of functional expenses in the agencies' basic financial statements, and to just as readily be eliminated from such functional expense information when preparing the Form 990.



Tying it All Together – Every Month

As auditors, we most often see the presence or absence of proper treatment of the items above only at the agency's year-end, when conducting audits or otherwise assisting with the year-end process. NPOs will find, however, that the accounting requirements discussed here are best addressed on a day to day basis, rather than only at year-end. Preparation of GAAP-based interim internal financial statements on a monthly basis by agency staff, predicated on an ongoing incorporation of these practices, will serve to not only provide for more useful and timely financial information to insiders as well as outsiders during the course of the year, but should also allow for a less difficult and time-consuming year-end closing, audit and tax preparation process.

RECENT TAX LAW CHANGES RELATING TO NON-PROFIT ORGANIZATIONS AND CHARITABLE CONTRIBUTIONS

by *AJ Brown*,
Senior Accountant

Changing tax laws and regulations are often confusing, so tackling the Internal Revenue Code isn't a task for the faint of heart. The information provided here will hopefully improve your understanding. If either of these changes apply to your specific organization, we urge you to consult us.

Two of the most recent tax law changes deal with the mandatory E-filing of income tax and annual information, and the donation of vehicles to charities.

Electronic Filing for Tax-Exempt Organizations



Recently, the Internal Revenue Service released regulations that require certain large corporations and tax-exempt organizations to electronically file their income tax or annual information returns beginning in 2006. Electronic filing (or e-file) is easier and faster than filing a paper return. It reduces the normal processing time and makes compliance with reporting and disclosure requirements easier.

For 2005 returns due on or after December 31, 2005, regulations require that tax-exempt organizations with total assets of \$100 million or more file their 2005 Form 990 electronically. This regulation only applies to the entities that file at least 250 total returns (including: 990, quarterly 941, and individual W-2's) during a calendar year.

For tax years ending on or after December 31, 2006, the requirement will be expanded to include any tax-exempt organizations with \$10 million or more in total assets (if they file 250 or more returns a year). Additionally, private foundations and charitable trusts will be required to file their Form 990-PF electronically regardless of their total assets. Large tax-exempt organizations that prepare their own returns must be authorized by the Internal Revenue Service as a Large Taxpayer or use a tax professional who is an IRS Authorized E-file Provider. The IRS provides important information which includes

step by step instructions on how to complete the necessary registration and IRS E-file applications.

Tax-exempt organizations can E-file the following forms:

- Form 990, Return of Organization Exempt from Income Tax;
- Form 990-EZ, Short Return of Organization Exempt from Income Tax;
- Form 990-PF, Return of Private Foundation;
- Form 1120-POL, U.S. Income Tax Return of Political Organizations; and
- Form 8868, Application for Extension of Time To File an Exempt Organization Return.

Tax-exempt organizations can request waivers from the electronic filing requirement:

- If the tax-exempt organization can not meet e-file requirements due to technological constraints; or
- If compliance with the requirements would result in undue financial burden on the filer.

Organizations should contact the IRS for more information if they feel either of these two conditions apply to them. For E-file related questions only, you can email questions to tege-ee-file@irs.gov.

Donation of Vehicles to Charity



As a reminder for charitable donations of vehicles, the IRS issued new guidance in 2005 for these donations, as a way to reduce overvalued auto donations. The following is just a brief summary of those changes as a refresher for those donating to charities.

If the value of a donated vehicle is \$500 or more, the deduction the taxpayer can claim depends on how the charity is planning to use the vehicle. If it is sold by the organization, then the taxpayer can deduct only the amount of gross proceeds the charitable organization got from the sale. And the donor (taxpayer) will have to rely on the charitable organization to let them know the donation amount by the individual tax filing deadline.

If however, the charitable organization actually uses the vehicle for what the tax law

deems as "significant" tax-approved charity work, the donor (taxpayer) can then claim the fair market value of the vehicle donated. In addition, this law now provides penalties for fraudulent acknowledgments provided to taxpayers of amounts they can claim.

In relation to the values of the vehicles donated, taxpayers and organizations must substantiate the donation by contemporaneous written acknowledgment by the charitable organization. The acknowledgment must include the following information:

- Amount of cash;
- Description of property other than cash (but need not include the value of property);
- Whether the donee organization provided any goods or services in consideration for any property; and
- Description and good-faith estimate of the value of any goods or services donated.

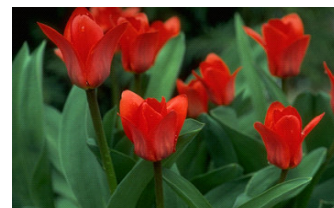
This written acknowledgment is considered contemporaneous if the donor (taxpayer) obtains the acknowledgment on or before the earlier of the date on which he files a return for the taxable year of the contribution or the due date (which includes extensions for filing the return).

The acknowledgment (which includes the gross sales price) must be attached to the taxpayers income tax return. The required content for the acknowledgment is:

- Name of donor;
- Taxpayer identification number of the donor; and
- The vehicle identification number.

When the donee sells the vehicle, the acknowledgment must also include a certification that it was sold between related parties in an arm's length transaction, the gross proceeds of the sale, and that the deductible amount cannot exceed the amount of gross proceeds.

There are other requirements and regulations that donors and donees should be aware of for charitable donations, and they can contact their local IRS office for more on this information.





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Peter Hall has recently joined the firm as a supervisor in the municipal and non profit departments. Peter is a graduate of Amherst College with a degree in Economics (Magna cum Laude, Phi Beta Kappa) and has also studied at the University of Southern Maine as well as the Harvard Graduate School of Business Administration Executive Education Program. He has served several local not-for-profit organizations in various capacities, including as director and treasurer, and is presently serving in a volunteer capacity in municipal government. He is a Certified Public Accountant, and holds membership in the Maine Society of Certified Public Accountants and the American Institute of Certified Public Accountants. He has 14 years experience in private and public accounting, most recently focusing on not-for-profit and municipal auditing. He and his wife reside in Standish with their four-year old son. Peter is an avid competitive sailor, and has completed numerous offshore and ocean yacht races, including the Newport to Bermuda Race.

Diane D. Bourque, CPA joined RKO's Waterville office in January as a senior auditor. She's a Thomas College graduate with more than 20 years of accounting, auditing, and financial experience working in Central Maine. Diane will focus on personal and corporate tax work through April, then auditing for the remainder of the year. For recreation, Diane enjoys family travel and activities with her husband and son, including golf, boating and watersports, dancing, puzzles, and movie and popcorn nights at home.

Notice on Your Personal Data: Regardless of the outcome of pending legislation, RKO has not, and will not sell personal data to anyone. Likewise, RKO prepares all of its clients' tax returns in house; none are shipped to other firms or foreign countries.

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