

Introducing: The Holtz Rubenstein *Not-For-Profit Adviser*

After 15 years as a successful practice area of Holtz Rubenstein, we are pleased to unveil the firm's first quarterly newsletter aimed directly at the not-for-profit community.

This quarterly newsletter will provide both general information relating to the Not-for-Profit industry, as well as industry-specific developments that will be of importance to special education providers, mental health providers, organizations that help the developmentally disabled, and other New York State and Federally funded organizations.

This inaugural issue of the HR *Not-For-Profit Adviser*:

- o Looks at the perks and pitfalls of not-for-profit alliances,
- o Reviews the potential impact of the Sarbanes-Oxley Act on not-for-profits, and
- o Details the latest news and legislation impacting the not-for-profit sector.

“This quarterly newsletter will provide both general information relating to the Not-for-Profit industry, as well as industry specific developments.”

The ideas we discuss in the HR *Not-For-Profit Adviser* are relevant to your business success, and we would welcome your questions or comments.

Holtz Rubenstein specializes in serving the not-for-profit sector, and we would be glad to assist you in any way we can. Contact Not-for-Profit Partners Beatrix G. McKane and Gordon M. Siess at 631-752-7400 at any time.

Interested in receiving future issues via **e-mail**? Do you have ideas or suggestions for future issues? Let us know your name, organization, and specific e-mail address at nfpadviser@hrcpa.com. ■

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What You Need To Know About Financial Statements

Most volunteers, senior managers and not-for-profit organization employees are not accountants. Regardless, recent scandals and calls for greater accountability mean that you need to know more than ever before about your not-for-profit's financial operations. A good place to start is its financial statement, which is composed of a balance sheet that includes net assets, an activities statement, a cash flows statement and footnotes. Here are more details on each component.

Balance Sheet Components

Your "statement of financial position," or balance sheet is a snapshot of your financial standing. It shows what you own, what you owe (either loans or accounts due to others as well as sometimes grant or contract money that has been received but not yet fully earned) and your equity (known as net assets).

Balance sheets list assets and liabilities in order of liquidity, meaning how quickly they can be turned into cash. These include net assets, which are the mathematical difference between what you own and what you owe. You should break them down into unrestricted amounts as well as those restricted by donors, including temporary restrictions and permanent restrictions (such as endowment funds), which stay in perpetuity.

Activities statement

This shows support (grants and contributions), revenue (income earned for services) and expenses for a period of time. It will report all of the income the organization received during the year and identify amounts that donors have temporarily or permanently restricted. It also reflects expenses by function and shows specifically how last year's net assets plus this year's surplus or deficit produce the current year's net assets. You can design the activities statement to break out your regular operating activities separately from nonoperating activities such as investment results.

Cash flows statement

This reconciles the surplus or deficit to the change in cash balance. For instance, depreciation is an expense in your activities statement but it doesn't require cash. Revenue you earned, but which is unpaid at the balance sheet date, is included in income but doesn't increase cash. This statement identifies cash flows from operating activities (such as your normal operations) vs. investing activities (such as purchase or sale of investments or of fixed assets).

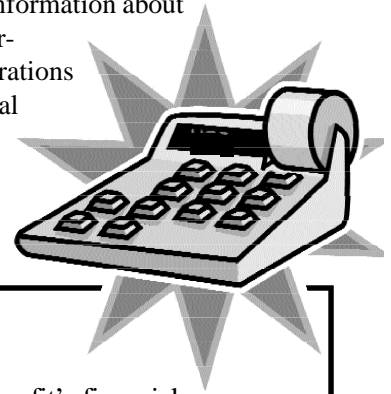
Financing activities, including borrowings and repayment on loans, are also shown.

Footnotes

These are invaluable explanations about your financial statement's preparation. Footnotes explain whether the organization follows the cash or accrual basis of accounting. (The accrual

basis means that revenue and expenses are recorded when earned, not when they're received or paid.) The notes also provide additional information about equipment depreciation, loan terms, lease commitments and certain other potential liabilities. They may also include supplemental information about volunteer services and other contributions.

These items are critical to providing accurate information. Together they should give you a fair picture of where your not-for-profit stands. A properly prepared financial statement provides a wealth of information about your not-for-profit's operations and financial health.



Three Accounting Report Types

If an independent accountant drafts your not-for-profit's financial statement, the CPA must include a letter explaining his or her responsibility based on the work. It will almost always fall into one of three categories:

Audit report

Here a CPA performs the most thorough level of analysis, typically confirming accounts with outsiders and verifying computations.

Review

This less intensive examination usually includes analytic procedures such as checking financial relationships — for example, the relationship of loan interest to amounts owed and payroll taxes to payroll. It also generally compares account balances or activity with prior years and with budgeted amounts.

Compilation

This involves the least oversight. The independent accountant need only organize information into a proper financial statement format. No further investigation or analytic procedures are required.

Funders or regulatory agencies may specify the level of service you need. But in many cases, we can help you develop an accounting report. For more information, contact Holtz Rubenstein Not-for-Profit Partners Beatrix G. McKane, 631-752-7400 x-350, BMcKane@hrcpa.com or Gordon M. Siess, 631-752-7400 x-315, GSiess@hrcpa.com. ■

Financial Statement Breakdown

Beyond your balance sheet, activities statement, cash flows statement and footnotes, you must understand other issues related to your not-for-profit's well-being. Annual financial reports for virtually all not-for-profit organizations include the following:

Donor restrictions.

Net asset classes should reflect donor restrictions, including temporary ones that circumstance or time will later remove, and permanent restrictions, such as donor-established permanent endowment funds.

Board designations and donor conditions.

Only donors can impose restrictions, but the board may designate unrestricted assets for a specific purpose. Unlike donor restrictions, board designations can be changed at the governing board's discretion and are unrestricted net assets.

Donor-imposed contribution conditions.

These are usually beyond your organization's control and include matching requirements (contributions will not be recorded). But absent those conditions, contributions are recorded even if they are due another year.

Information timeliness.

The date interim financial information is available for internal use will depend on your not-for-profit's complexity and the need for outside information, such as invoices from suppliers and reports from investment managers. But as a general rule, interim financial information the organization prepares should be available no more than three to five weeks after the balance sheet date.

Investment policy.

If you have money available for investment, you need a sound, prudent investment policy that (among other things) accounts for how long money can be invested.

Involve board members and outside financial experts to develop this policy; most important, make sure your investment manager follows it.

Functional expenses.

These should be reported according to the function they accomplish. Service-delivery expenses are called "program expenses," and each major program can be reported separately. Costs of operating the organization should be classified as "management and general," whereas costs to bring in contributions and donations should be classified as "fund-raising."

Some organizations also have a "membership development expenses" category. Management and general, fund-raising, and membership development expenses are together referred to as "supporting services."

Fund-raising costs and fund-raising revenue.

These factors give insight into the cost of raising money. You can examine them for a specific event and also for your entire fund-raising activity. If more than half of your revenue is spent fund raising, questions may arise about your primary purpose.

Remember, your financial information ends up in your annual Form 990 — a public inspection document. Anyone who wishes can see it, so you need to learn its contents.

Averting Disaster

Financial statements are complex beasts. But only by having a clear understanding and working knowledge of their role and how they work will you be able to tame them.

The team of not-for-profit experts at Holtz Rubenstein can help with your financial statements. Contact us at nfpadviser@hrcpa.com. ■

JGTRRA Has Minor Effects on Not-for-Profits

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) was recently signed into law. It contains virtually no provisions directly affecting not-for-profit organizations; however, both your not-for-profit and its supporters may still feel the legislation's effects. Why?

Lower marginal tax rates. The rates scheduled to be effective for 2003 were 10%, 15%, 27%, 30%, 35%, and 38.6%. But JGTRRA accelerates these to 10%, 15%, 25%, 28%, 33% and 35%, retroactive. These new amounts weren't previously scheduled to take effect until 2006.

Increased depreciation amounts. Previously, taxpayers could take an additional 30% depreciation for certain tangible property acquired after Sept. 10, 2001, and before Sept. 11, 2004. The law increases the additional first-year depreciation to 50% for any property purchased and placed into service after May 5, 2003, and before 2005.

Section 179 changes. Not-for-profits with related taxable entities will now have the ability to expense a greater amount of capital expenditures. Section 179 allows an election to expense, rather than depreciate, a certain amount of personal property — from \$25,000 to \$100,000 for tax years beginning after 2002 and before 2006. (The limit reverts to \$25,000 after 2005.) Also, you can include off-the-shelf computer software in the Section 179 expenses, which you could previously only amortize.

Before the new law, once you elected to expense assets under Section 179, the election couldn't be revoked without prior IRS consent. Congress chose to make the election and revocation of Section 179 elections simpler and more efficient for taxpayers. Thus, an election to expense property under Section 179 can be revoked without prior IRS consent, with respect to any election made for a tax year beginning after Dec. 31, 2002, and before Jan. 1, 2006.

Alternative minimum tax (AMT) relief. JGTRRA increases the AMT exemption for married couples filing jointly and surviving spouses to \$58,000, and for single filers to \$40,250. ■



Not-for-Profit Alliances: Treacherous Waters or Smooth Sailing?

Using another not-for-profit or a for-profit entity to boost your not-for-profit's profile and further spread your message can be effective and beneficial. But beware: There are various tax, legal and accounting procedures to follow when dealing with not-for-profit joint ventures, partnerships, mergers, alliances and spin-offs. So before you even dip your toe into this pond, you must ask yourself: Would such a move make sense for our not-for-profit?

What To Expect

If these ventures are so perilous, why even engage in them? Well, you have about as much to gain as you have to lose. But *if* you proceed with proper due diligence and know what to expect, these ventures can:

Boost funding. A merger or other alliance could assure continuity of services that would otherwise stop because of lack of funding.

Reduce administrative expenses. Every not-for-profit has certain administrative responsibilities (such as payroll, record keeping and annual filings). A larger combined organization can meet all of those needs with proportionally lower costs because everything is combined.

Provide an opportunity for a true synergy of services. For instance, a drug-awareness organization could merge with one that provides counseling and therapy. This would result in complementary services benefiting a greater number of clients.

How To Proceed

Assuming that one of these opportunities presents itself, what procedures should you follow to examine the benefits and pitfalls of a strategic alliance? Well, your intuition

will probably tell you whether the merger or other alliance makes economic sense. Nevertheless, you should prepare a formal projection of the combined entity. This would include activity statements that display your financial activity and its efficiency — that is, the proportion of program services vs. supporting services.

A combined projected balance sheet would display the new organization's consolidated assets and liabilities and show the relationship of its current assets to liabilities. This is the best indicator of the combined entity's ability to pay its bills on time. And finally, a combined projected cash flow report provides additional useful information on the availability of cash after the merger occurs.

With Whom To Merge

Personal compatibility and similar values are extremely important to a successful merger or alliance. Parties to the alliance probably all have goals of quality client service and teamwork, but their ideas about how to achieve those goals can vary dramatically. Some questions that you must ask in evaluating an alliance include:

- o How do the work ethics and the compensation systems compare?
- o How does use of technology compare?

Share With Care

Sharing resources such as facilities and employees in a partnership venture may be a good idea, but it may also complicate matters. In arrangements like these, a not-for-profit likely enjoys an unemployment tax exemption that the taxable subsidiary doesn't share. In addition, 403(b) retirement plans are available only to organizations exempt under Section 501(c)(3). There may also be sales tax exemptions and even real property tax exemptions the parent, not the subsidiary, can use. In fact, shared facilities could jeopardize a not-for-profit parent's real property tax exemption.

Restrictions also exist on payments of rent, royalties or similar amounts the subsidiary owes to the parent. The IRS wants your taxable subsidiary to pay tax on its profits before sending a dividend to the not-for-profit parent. As a result, the agency eliminates or limits deductions for rents and royalties paid to a not-for-profit parent.

Despite these concerns and caveats, a taxable subsidiary may be a good solution to avoid problems with your exempt and public charity status — not to mention the fact that it may help increase your income and your privacy. Careful, informed planning will help make sure the move is in your favor and not to your detriment. ■



- o How does the leadership and the staff demonstrate their commitment to quality client service?
- o What is the staff turnover rate?
- o Do they have meaningful procedures for measuring outcomes and continuous process improvement?
- o What is the fund-raising culture?
- o How is billing and collection handled?
- o What are the biggest problems experienced in your organization and your potential merger partner, and would an alliance exacerbate or reduce those difficulties?

(continued on page 5)

Not all mergers or affiliations happen between two not-for-profits. In many instances, your best merger partner might be a for-profit organization. But such a strategy would lead to tax and legal complexities.

The main one is that an arrangement with a for-profit partner can't involve the not-for-profit improperly transferring assets to its for-profit partner. The IRS has stiff penalties (called intermediate sanctions) for transactions that improperly reduce a not-for-profit's assets.

What Form To Take

If you decide to establish a taxable subsidiary, you have a few more issues to consider. For instance: What structure will you use? What assets will be transferred to the subsidiary? Will you have the same board, a related board or an unrelated board of directors? Would you need to consolidate those financial statements with the parent company's financial statements? Will you be sharing facilities, employees and other services? (See the sidebar "Share With Care" on page 4.)

Your taxable subsidiary can be set up as a traditional C corporation, S corporation, partnership or limited liability company (LLC).

Assets you transfer to the taxable subsidiary should be those that support the subsidiary's activities. You will retain control of those assets because you own the company that will hold them, and you can require their return to the parent organization. You may also mandate that the taxable subsidiary be liquidated, with all of its assets returned to the parent organization.

How To Move Forward

A number of financial, tax, legal

Sarbanes-Oxley and Not-for-Profit Organizations

As a Not-for-Profit organization based in New York State, it is important for you to be aware of certain regulations proposed by the Attorney General of New York State that will significantly increase organizational roles and responsibilities. The proposed regulations parallel the reform and additional requirements enacted by the Sarbanes-Oxley Act. Some of the more significant aspects of the proposed regulations are as follows:

- The Executive Director and Chief Financial Officer of certain Not-for-Profit organizations will be required to certify to the accuracy of the financial statements and other financial information included in the annual report.
- The Executive Director and Chief Financial Officer of certain Not-for-Profit organizations will be required to certify as to the sufficiency of the organization's internal controls.
- The Attorney General of New York State will be authorized to bring action for the removal of directors and officers for

persistent failure to file complete and accurate reports.

- Certain Not-for-Profit organizations will be required to designate an Executive Committee of the Board of Directors.
- Certain Not-for-Profit organizations will be required to designate an Audit Committee of the Board of Directors.
- Each Audit Committee, or Board of Directors, will be required to establish procedures for handling complaints or concerns received regarding accounting, internal accounting control, or auditing and other financial matters.

If you are interested in obtaining more information regarding the proposed new regulations, or in ways we may be able to help facilitate your compliance with them, please call Holtz Rubenstein Partners Beatrix G. McKane, 631-752-7400 x-350, BMcKane@hrcpa.com or Gordon M. Siess, 631-752-7400 x-315, GSiess@hrcpa.com. ■



and strategic considerations come with every potential alliance. Holtz Rubenstein can help with your planning — especially with the financial projections and tax impact.

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BMcKane@hrcpa.com or Gordon M. Siess, 631-752-7400 x-315, GSiess@hrcpa.com, or contact Tax Partner Tim

Mulcahy at 631-752-7400 x-325, TMulcahy@hrcpa.com. ■

Valuing a Volunteer's Time

Independent Sector (www.independentsector.org) recently announced the updated value of volunteer time. The new level has increased from \$16.05 an hour in 2001 to \$16.54 an hour in 2002. This value is based on the average hourly earnings for private nonagricultural workers as determined by the U.S. Bureau of Labor Statistics, and then increased by 12% to estimate fringe benefits. Independent Sector noted that this estimate provides a uniform way for volunteer managers, not-for-profit executives, government agencies and others to account for the value of volunteer time.

IRS Stops Targeting Not-for-Profit Lobbyists

In April 2003, several charitable organizations led by the Alliance for Justice (a national association of environmental, civil and consumer advocacy organizations) met with IRS officials to confront the agency about its targeting of charities engaged in lobbying. The IRS didn't initially respond when asked whether it was looking to audit those charities. Ultimately, it did admit to doing just that, but said its findings of noncompliance were not widespread. Based on this discovery, the IRS said it would no longer zero in on charities that lobby.

Not-for-Profit Program Classification System Emerges

The National Center for Charitable Statistics (NCCS) reports on the activities of charities. It has undertaken several projects, including development of the Nonprofit Program Classification (NPC) system to capture and classify the program activities reported on Form 990. It has made that information available in a searchable format in a digitized database.

NCCS acknowledges that many organizations have multiple and diverse programs, services and activities. Using the NPC system to classify those activities allows the descriptive information to be organized for use by researchers, the public and policymakers. The system, according to NCCS, helps to answer "What do not-for-profits do?" It also includes codes for recipients of the services and their geographic locations. Familiarize yourself with this classification system so you can answer questions about your not-for-profit.

The Perfect Time for a CRT?

Many donors make contributions through a charitable remainder trust (CRT). This arrangement allows donors to receive earnings from donated assets during their lifetimes. Donors also get a substantial tax deduction when making gifts. Even though the stock market may not have peaked, and therefore gifts of stock through a CRT are smaller, now might be the perfect time for a CRT. This is because of another important planned-giving dynamic. That is, tax incentives for donors of assets to not-for-profits through a CRT are based on the present value of the donation, which is determined by the value of the investments that will ultimately go to the charity, donors' life expectancy, and interest rate.

The last factor has a big impact. Rates are still low but likely to go higher, and when rates are low, the present value of the gift is higher. For example, a 60-year-old puts \$200,000 worth of stock into a CRT. She receives the income for life and a charitable deduction for the gift's present value. The charity receives the assets when she dies.

Let's assume she has a life expectancy of 25 years. The present value of that \$200,000 future gift at a 4% interest rate is about \$75,000 (which probably means a \$30,000 tax reduction for the donor). However, when rates go up to 8%, the present value of that gift falls to approximately \$29,000 (or an approximate \$11,600 tax reduction). The interest rate allowed for CRTs is 120% of the applicable federal midterm rate, referred to as the Section 7520 interest rate. This rate is published monthly by the IRS.

Upcoming Events:

FEATURED EVENT -

November 12:

Annual Holtz Rubenstein Not-For-Profit Fiscal Workshop.

Speakers: Holtz Rubenstein Partners Beatrix McKane and Gordon Siess; Senior Managers Patrick Yu and Ellen Labita; and Sentry Software Solutions President George Gerstein. Topics: the effect of Sarbanes-Oxley on your organization; outcome and performance measurement; federal compliance and 990 update; maximizing benefits of not-for-profit accounting software. 1:30 – 5 p.m. at the Huntington Hilton. Free.

To register, call 631-752-7400 x-212, fax 631-752-1742, or e-mail ffederman@hrcpa.com.

December 2:

Keeping Current & Making Your Life Easier.

Topics: The effect of Sarbanes-Oxley on your organization; outcome and performance measurement; Top 10 ways to know your banker doesn't understand you; why leasing shouldn't be overlooked as a financing option. 2-5 p.m. at the Marriott LaGuardia Hotel, Elmhurst, NY. Free.

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To change contact information for the HR Not-For-Profit Adviser, or to sign up for an e-mail version please contact us at nfpadviser@hrcpa.com.