# nonprofit agendas

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News for Nonprofits



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# Alternative investments: A good choice or not?

**So-called "alternative investments" started out as a way for nonprofits with significant investment portfolios to either improve their overall investment return or diversify their portfolios — or both. But such investments have thrown a new wrinkle into the annual financial statement audits of most organizations, moving the American Institute of Certified Public Accountants (AICPA) to issue an auditing interpretation along with a practice aid for auditors.**

## WHAT ARE THEY?

Alternative investments aren't like other publicly traded stocks, bonds and mutual funds where market prices are readily available. They're often investments in:

- Oil and gas or real estate limited partnerships,
- Private equity funds that invest in publicly or privately held businesses,
- Venture capital funds, and
- Hedge funds.

By their very nature, these investments are generally not as liquid as those that are publicly traded and may require investors to make additional phased-in investments. Information on performance and current value also isn't as readily available for alternative investments as it is for publicly traded investments. Yet for auditing purposes, there must still be appropriate evidence to support the investment's valuation.

*Determining the fair value of a nonprofit's holdings in an alternative investment may be more difficult.*

## WHAT INVESTMENT INFORMATION IS NEEDED?

Under the AICPA auditing interpretation, auditors are advised, when verifying the existence of alternative investments, to confirm the holdings on a security-by-security basis, rather than simply confirming investments in the aggregate. This process isn't an easy one: Private investment fund managers generally don't want to reveal the details of specific positions within their portfolio. So, the transparency that is sought in today's environment is often missing.

If a fund won't provide details on its underlying investments, the AICPA practice aid suggests alternative or additional procedures to obtain the needed information. This includes reviewing:

- The investee organizing documents,
- Correspondence between the investee organization and the fund regarding transactions, and
- Periodic statements from the investee.

Any fund activity should also be compared with the amounts recorded by the investor.

## WHAT'S THE INVESTMENT'S VALUE?

Determining the fair value of a nonprofit's holdings in an alternative investment may be more difficult. According to the AICPA practice aid, management is responsible for making the fair value measurements and disclosures included in the financial statements. But, this may be a tall order for most not-for-profits to fulfill.

Valuation responsibility is a complex process when dealing with investments without readily available current market values. A not-for-profit's management will rely on the fund manager to provide valuation information details for each underlying investment. But your management is ultimately responsible for deciding whether the valuation methodology and conclusions are appropriate.

The management team can make the right decision by studying the fund's annual audited financial statements and any interim internal financial information. Other suggestions mentioned in the AICPA's practice aid include interviewing fund management to understand the fund's strategy, positions and valuation methods, and comparing other sector or industry information, indexes and cash distributions.

## ARE THEY RIGHT FOR YOU?

Many nonprofit organizations have shied away from alternative investments because of the management complications and concerns about increased audit costs, which would likely offset the expected investment return. And less than an unqualified audit opinion might result if you are unable to obtain satisfactory support for investment valuations.

The significance, or relative size, of a nonprofit's use of alternative investments compared to its publicly traded investments and annual operating budget and net worth will determine how onerous these valuation issues will be on management. Relatively insignificant holdings in nonpublicly traded investments may require little or no change in your valuation process and monitoring of investments.

## WHAT CAN YOU DO?

It's important to anticipate what auditors will be looking for. When evaluating alternative investments, complete your regular due diligence, monitor the fund's financial reporting, and identify what controls you need to put into place if and when you do invest. ❋

### Endowment fund and tax implications

If you're thinking about investing endowment funds in alternative investments, check the individual donor documents to make sure they permit these types of investments and that they're within the spirit of the donor's wishes. Also, check your state law to be sure it allows investing endowed funds in alternative investments.

There are also tax considerations. Alternative investments can often generate unrelated business taxable income (UBTI). UBTI can result from operations in flow-through entities (such as limited partnerships) that are unrelated to your nonprofit's exempt purpose. Another common trigger is debt financing within the flow-through entity, such as mortgage debt within real estate partnerships. Nonprofits generally rely on the fund manager to identify income that's normally not considered UBTI. This includes interest and dividends, real estate rentals, capital gains and royalties.

Keep your eye on filing requirements for reportable transactions and for foreign-sourced income. And finally, don't forget to consider state tax requirements.

# Your organization isn't getting older, it's getting better

**Not-for-profits go through many stages. Although the initial startup and growth stages present challenges, many opportunities and obstacles can arise even as a nonprofit matures. What areas should you focus on when your organization is more established? Let's take a closer look.**

## MIDDLE AGE HAS ITS BENEFITS …

Generally, when a nonprofit organization has been operating for five to ten years, it has reached maturity in its life cycle. It's probably well known in the community, not only by the consumers of the services it provides, but also by local and industry funders, community leaders, and other agencies.

Moreover, the early passion and cheerleading mentality of the founder, initial board and volunteers may give way to a more stable — though often less creative — environment. A mature organization has developed processes and systems, is fairly set in its program activities, and has a leadership that may have been involved in developing the current culture.

Opportunities abound for organizations in this stage to continue to provide superior levels of service in an efficient manner for many years and to greatly benefit the community being served.

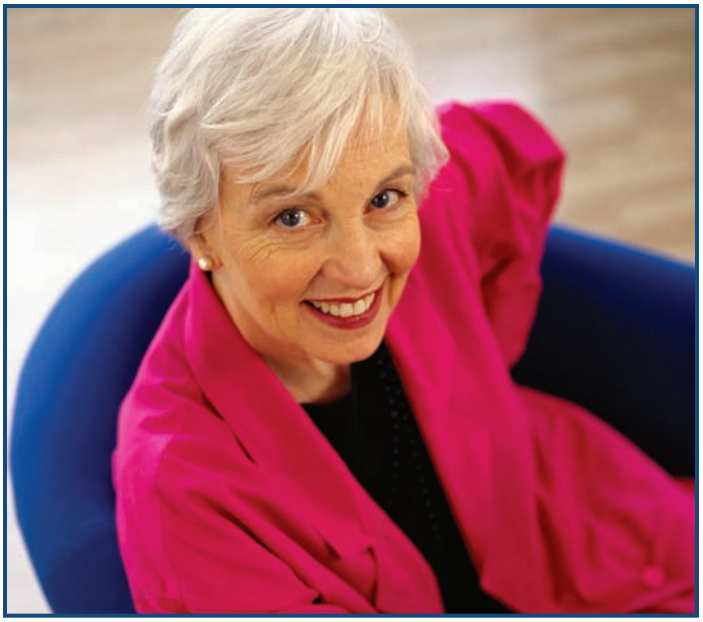
## … BUT ALSO SOME DRAWBACKS

Some of the same mature traits that lead to new opportunities may create their own set of challenges. These challenges can be grouped into five areas:

**1. Decision making.** While always an important part of the daily operations, decision making may become solely the executive director's responsibility. This may lead to little involvement from the board — even in strategic areas.

**2. Fundraising.** Although identifying potential donors is a necessity in the early years, it may reach a plateau as the organization matures.

**3. Infrastructure.** Although the infrastructure may do a good job of supporting current operations,



there may be no process in place to review and revise systems as they become outdated.

**4. Leadership.** The leadership — both management and board members — who had the skills to start up the organization may not have what it takes to move it to the next stage in its development.

**5. Making changes.** Where a startup is willing to take risks, a mature organization may be more comfortable and cautious in making changes.

If your not-for-profit is encountering these issues, don't throw in the towel! Instead, it may be time to redesign your core elements, including your mission and vision, the products or services you provide, and the structure that governs your organization.

## CHANGES AHEAD

To overcome the challenges in each of these areas, take a fresh look at them:

**Decision making.** Explore the levels of decision making appropriate at both management and board levels. In the startup phase your board may have been much more involved in daily operational issues, where, as a mature nonprofit, the board should focus on developing strategy and representing your organization in the community.

**Fundraising.** Explore new funding sources to fit with any new program direction. For example, if you decide to implement a job-training program for the homeless, certain foundation grants and government funds may be available for this purpose that wouldn't have supported an effort to provide housing. Add a development officer who can help you restructure and grow your development office to support your new efforts. Make sure that your leadership is skilled in community and donor relations.

**Infrastructure.** Evaluate centralizing activities, such as bringing your volunteer management or fundraising event coordination under one person's control to standardize your processes. Look at technology that will meet the nonprofit's needs into the future. Review your organization chart and restructure if needed. Develop a succession plan for all key positions. Update written policies and procedures, and establish a process for regular review.

**Leadership.** Clarify the roles and responsibilities of both board members and your internal management team and make sure your leadership team embraces change. Evaluate the skills needed to take your organization to the next level. Encourage diversity in experience and profession on the board.

**Making changes.** Take another look at unmet community needs. Develop or update a long-range strategic plan that may result in changes to existing programs. Where years ago you may have provided the only homeless shelter in your area, for example, your assessment may indicate that job training or mental health services should top your priority list for serving the homeless population today. Also work with other community organizations and leaders to evaluate your services. This may mean eliminating some of your long-standing programs and changing your culture. But, be open to their feedback. Measure your success by comparing your progress to your nonprofit's strategic plan.

## EMBRACE THE CHANGE

Can you make change happen? This may be the determining factor as to whether you continue as a successful, mature nonprofit organization. The choice — although difficult — is yours to make. ❋

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### Decision time

## Outsourcing your accounting function

If your nonprofit is small, your employees are already stretched thin or you need specialized skills, outsourcing the accounting function may make sense. Your organization can outsource accounting for as little — or as much — assistance as you need. Doing so means you won't have to hire additional employees.

But outsourcing the accounting function can be especially challenging for a nonprofit. Why? Whoever you choose must not only maintain efficient recording of funding and expenses, but also adhere to a plethora of accounting and reporting requirements.

Accounting services can range from basic bookkeeping functions, such as bill paying and bank reconciliations, to more complex tasks of board presentations, grant administration and compliance. Other accounting duties may include human resources functions, such as benefits administration and payroll processing, technology and computer support or projects, and general office and facilities management.

But not all of these tasks can be easily outsourced, and those that can may vary from organization to organization. Once you compile your list of likely outsourced tasks, you can begin the process of selecting a service provider.

The first step is to find a provider with not-for-profit or fund accounting experience. Then, check the firm's accounting services and make sure they line up with your needs. Finally, ask for references and check them out. This simple step can save you multiple headaches down the road.

# Develop a well-designed record retention policy

**Record retention problems have diminished somewhat as organizations have gone paperless. But paperless doesn't always mean paperless, and you still need to maintain a number of documents, such as tax, accounting, bank, corporate, personnel and property records.**

## CREATING YOUR POLICY

If you haven't done so already, create a record retention policy that describes how long critical documents should be maintained and ultimately disposed of.

Your organization's legal counsel should review the record retention policy and advise you on areas where state or federal regulations mandate the time period for record retention and which records you should maintain permanently. While no laws offer a specific policy for all types of record retention, state and federal regulations do govern personnel records to protect against unfair labor practices and workplace discrimination.

## KNOWING HOW LONG TO KEEP RECORDS

Here are some minimum, best practice guidelines you can follow for retention periods:

**Accounting records.** Generally, seven years is an adequate time to maintain most accounting records, including accounts receivable, accounts payable, expenditures and purchase orders, and donation records. You should permanently maintain certain items, such as audit reports, depreciation schedules, financial statements, general ledgers, fixed asset purchase records and tax returns.

**Bank records.** Maintain these records for seven years.

**Corporate records.** Nonprofits should permanently retain all corporate records, including board minutes, bylaws, licenses, and patents and trademarks. Keep contracts, insurance policies and leases for seven years after expiration.

**Personnel records.** Maintain employee personnel records, employment tax records, payroll records and timesheets for seven years. You can dispose of employment application records after three years. But you should retain pension and profit sharing records permanently.

**Other records.** Ideally, you should permanently retain construction records, leasehold improvement records and real estate purchase records. You can dispose of lease payment records four years after the end of the lease. Keep expired grant contracts for seven years after the grant's closure.

## DISPOSAL GUIDELINES

Your policy won't be effective unless you train your staff and volunteers on the correct procedures. Place shredding boxes around the workplace as a constant reminder that, if it's proprietary information, it should go in the box and not in a trashcan. Always shred records containing sensitive information about personnel and clients.

Consider enlisting the services of an outside record destruction firm to ensure you don't accidentally leak sensitive information to the public. Also establish a system for monitoring dates as records expire and set a chain of authority for proper authorization for the record disposal.

## PAPER MANAGEMENT

Many not-for-profits can be overwhelmed with paperwork, even in a paperless society. Creating and following a record retention policy is the best way to keep the paper at bay while saving only what you need. *

# NEWS FOR NONPROFITS

## IRS SCRUTINIZES COMPENSATION

In recent months, the IRS has turned its attention to compensation compliance by nonprofits. Its Compensation Compliance Initiative project reveals that significant reporting issues exist: Of 1,223 organizations initially contacted, over 30% amended their returns for compensation reporting. 15% of those contacted were later selected for examination.

Significant reporting deficiencies were found relative to excess benefit transactions, transactions with disqualified persons and issues related to loans made to officers. None of the 50 charities reporting total compensation over $250,000 attached schedules with details of compensation paid to officers or employees, even though this is required.

To avoid problems with executive compensation, make sure you perform due diligence in determining salaries. Always use comparability data. (There are a number of salary studies for nonprofits, including one published by GuideStar.) And compensation should be established in advance of the employment period. No individual involved in setting salaries should have a conflict of interest, and salary decisions should be documented.

*To avoid problems with executive compensation, make sure you perform due diligence in determining salaries.*

You can avoid penalties by reporting all economic benefits available to your officers, directors and key employees on your Form 990, and properly reporting taxable benefits to your employees on their W-2s. ❋

## RECEIVING CONTRIBUTIONS FROM POLITICIANS

With election campaigns in full swing, be mindful of the rules prohibiting nonprofits from engaging in political activity. This includes making contributions to political candidates.

But, is the reverse true — can charities accept contributions *from* politicians? The answer is yes. In fact, sometimes political action committees are terminated by giving the remaining funds to a charity. As long as the funds aren't used for the private benefit of the donating politician, the contribution is treated as any other.

One word of caution, however — make sure that, by accepting the gift, the public's perception of your organization isn't tarnished. You need to ensure that the charity will control the use of the funds and everything is clearly above-board. ❋

## SUN SETTING ON IRA ROLLOVER PROVISION

As part of the Pension Protection Act of 2006, the tax law was temporarily modified to allow individuals 70½ or older to make an IRA distribution of up to $100,000 directly to a charity, avoiding including the amount in their adjusted gross income (with no charitable deduction allowed).

According to the Pennsylvania Association of Nonprofit Organizations, between August 2006 and December 2006, a relatively paltry $50 million in direct donations from IRAs was reported by charities — which could mean that many potential donors either are unaware of this provision or don't understand the benefits. Unless Congress extends it, this special provision expires after December 2007. So you may want to make another push to try to capture some of these untapped funds. ❋

# Experience + Expertise = Service that Builds Success

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Our skilled professionals can help you navigate complex financial and tax statements, comply with fast changing federal and state regulations, and meet the challenges of generating program revenues.

Our not-for-profit specialists understand that your organization is unique and will work with you to uncover hidden problems, anticipate future needs and spot new opportunities to increase your success.

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We truly care about our clients' mission and success—perhaps that's why many of them have been partnering with us 10, 20 and even 30 years. We believe we can make a positive difference in your organization's financial life, and we hope you will give us an opportunity to serve you.

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