

**Financial Management of  
Nonprofit Arts Organizations**

**A Practical Guide for Fiscal Survival**

## **A WORD ABOUT TEXAS ACCOUNTANTS AND LAWYERS FOR THE ARTS**

Texas Accountants and Lawyers for the Arts (TALA) is a nonprofit, tax-exempt organization dedicated to serving the arts community in Texas. From its offices in Houston, a pool of more than 350 volunteers enables TALA to provide statewide services from Beaumont to El Paso and Tyler to McAllen.

TALA directly assists eligible artists and nonprofit arts organizations with art-related legal and accounting issues through referrals to appropriate volunteers. TALA does not help artists with personal matters, such as divorce or individual tax returns; however, TALA does provide tax advice to individual artists and nonprofit cultural organizations, among other services. In addition, TALA frequently sponsors educational programs in various Texas cities on practical topics, such as federal income tax, gallery and commission contracts, or insurance issues for nonprofits.

Currently, in addition to this handbook, TALA publishes a quarterly newsletter *TALA Talk* and the *Art Law and Accounting Reporter*, as well as the handbooks *Taxation of the Visual and Performing Artist*; *Establishing Tax Exempt Arts Organizations in Texas*; *Responsible Management: Duties and Liabilities of Directors, Officers and Trustees of Nonprofit Arts Organizations*; *Pas de Deux: Labor and Employment Issues in the Arts and Nonprofit World*; and *Copyright for Performing, Literary and Visual Artists*.

TALA receives funding from the Texas Commission on the Arts, the Cultural Arts Council of Houston, foundations, corporations, law and accounting firms, and many dedicated individuals.

Additional copies of this handbook at \$5.00 each may be obtained by downloading an order form from our website or calling TALA. Please include \$1.50 for postage and handling.

For further information on TALA or any of its programs contact:

Texas Accountants and Lawyers for the Arts  
1540 Sui Ross  
Houston, Texas 77006  
(713) 526-4876 ext. 201  
[info@talarts.org](mailto:info@talarts.org)  
[www.talarts.org](http://www.talarts.org)

**Copyright 2004 Texas Accountants and Lawyers for the Arts**

## TABLE OF CONTENTS

	<u>Page No.</u>
<u>Introduction</u>	4
<u>Bookkeeping and Financial Statements</u>	5
<u>Budgeting</u>	13
<u>Reporting Requirements for Exempt Organizations</u>	18
<u>Business Income of Exempt Organizations</u>	37
<u>Auditor's Reports</u>	48
<u>Reporting for Grants</u>	51
<u>Investing Excess Cash</u>	55
<u>Acknowledgements and Special Thanks</u>	62

## INTRODUCTION

To be successful, today's nonprofit arts organization must achieve proficiency in two areas. First, it must create a product of high quality, which satisfies a public need. Second, it must operate in an efficient, business-like fashion to satisfy the requirements of governmental and private funding sources.

Too often the effort required to create a quality product takes undue precedence over the requirement that the organization operate as a business. The reason for this is often a lack of knowledge of sound fiscal management and an apparent lack of time.

It may be difficult for the small and often unpaid staff of a community theatre, for example, to remember to make Social Security and Medicare payments or timely Internal Revenue Service filings when the deadline for such filings coincides with a major production. Similarly, the same organization may lack the expertise to maintain its books and records in a professional fashion and to organize its data properly and promptly to complete a grant application effectively.

Unfortunately, governmental agencies and funding sources have become less patient with inadequate fiscal management on the part of nonprofit organizations. As a result, the IRS is unlikely to abate a penalty for a late filing, and funding sources are less likely to award a sloppily prepared grant application with the desired grant. In fact, the failure to operate a nonprofit arts organization as a business could result in a degree of mismanagement, which may subject the organization and its directors to liability under federal and state law.

The purpose of this handbook is to provide nonprofit arts organizations with the requisite tools for effective financial management. This handbook was conceived upon the premise that an arts organization, which can more efficiently fulfill the requirements imposed upon it by governmental and funding entities, will have more time to expend on its creative purpose and more fund-raising capability. To the extent that this premise is valid, sound fiscal practices on the part of arts organizations will enhance creativity and the availability of funds. It is with this hope that the following material is offered.

## **BOOKKEEPING AND FINANCIAL STATEMENTS**

Financial information is used to make managerial decisions and to provide information required by outside parties such as foundations, banks or governmental agencies. Adequate and accurate financial records should always be maintained; however, many organizations' records do not adequately report financial information that may actually be needed. It is important, therefore, that exempt organizations establish sound bookkeeping and financial statement policies and procedures.

## BOOKKEEPING AND FINANCIAL STATEMENTS

### I. Introduction.

A. From its inception, a tax-exempt organization receives money and incurs expenses. Accounting for these, as well as many other types of transactions, is commonly called "bookkeeping."

B. Financial statements are prepared from records produced by "booking" (recording) an organization's transactions. These statements are summaries (prepared annually, semiannually, quarterly or monthly) of the:

1. "Financial Position" of the organization - Assets, liabilities and fund balance (discussed later on),
2. "Results of Operations" - The excess of revenues over expenses and
3. "Changes in Financial Position" - An analysis of the sources and uses of funds and capital assets.

### II. Bookkeeping

A. "**Fund accounting**" is the system of accounting for financial information used by tax-exempt entities and governments. It is different from the systems used by for-profit businesses. "Funds" are resources such as cash or other assets, which are designated to serve general and/or specific operations or projects. A contributor to an exempt organization may designate or "restrict" how funds she contributes must be used by the exempt organization (example: making a contribution to the United Way Foundation for use in aiding senior citizens only). Such restricted funds must be kept track of separately from funds, which are donated to the "general" fund for uses as management considers necessary (such as for daily operations). The board of directors of an exempt organization may also restrict some of the general funds for a specific purpose, such as for future purchases of office equipment. Regardless of how funds are designated, management has the obligation to use these various funds for the purposes which they were intended and not to commingle restricted funds with funds intended for other uses.

B. An exempt organization's "**method of accounting**" is the method the organization chooses to "time" when revenues or expenses will be recorded. For example, although a pledge to contribute money in the future is not actually received by the organization, the current year portion expected to be received may be recorded as revenue. A discussion of the various methods of accounting follows:

1. "**Cash basis**" accounting simply means that revenues are recorded when received, expenses are recorded when paid and noncash transactions are recorded upon their occurrence. While this method is easy to understand and implement, it often results in financial information that is misleading, because it does not reflect all transactions which may have occurred but have not been recorded.

f. Another method of accounting is called the "accrual" method. Transactions that have actually occurred and are associated with the current period are recorded. The theory behind this method of accounting is that financial information should accurately reflect all of the activities of the current period, not just cash transactions. Examples of some transactions which would be recorded under this method include the current portion of contributions from pledges to be received, wages accrued but not paid and interest income earned but not yet credited to the exempt organization's investment account.

g. The "modified cash basis" method is often used by exempt organizations. Under this method, bookkeeping entries are made strictly on the cash basis throughout the period. At the end of the period, entries are made at one time to adjust the financial records to an accrual basis form. This is usually only done in order to present the financial statements in accrual form. Many exempt organizations even have their auditors make these adjusting journal entries for them, so all the organizations need to be concerned with is always maintaining accurate cash basis records. Transactions such as those described under the accrual method are examples of adjustments that will be made.

C. Once a method of accounting has been adopted, a bookkeeping system must be established. The following information briefly identifies and explains the steps that need to be followed in setting up such a system. **HOWEVER, THE SERVICES OF AN EXPERIENCED BOOKKEEPER AND/OR ACCOUNTANT ARE ESSENTIAL WHERE AN ORGANIZATION'S FINANCIAL ACTIVITIES ARE SUBSTANTIAL.**

1. The "**double entry**" system of accounting is used by virtually every organization in the U.S. This system is based on one simple equation called the "balance sheet equation":

$$\text{Total Assets} = \text{Total Liabilities} \textit{ Plus Funds}$$

Any increase or decrease in an asset, liability or fund is offset by an equal increase or decrease in another asset, liability or fund. For example, the receipt of a contribution of \$5,000 will increase assets by \$5,000 and increase funds by \$5,000. All financial transactions will ultimately affect this equation. (Following the discussion on Financial Statements is a flow chart that illustrates how a single transaction eventually winds up in the balance sheet.)

2. An "**account**" (or "**journal**") should be set up for each material type of asset, liability, fund, revenue or expense (ALFRE). Accounts are separate records that reflect the current amounts of these items. Examples of accounts include: cash, office furniture, wages payable, general funds, contributions, utilities expenses and rental payments. Another account called the general journal is created to record unusual or nonrecurring transactions.

Balances in the accounts are transferred to the "general ledger" which is a summary of all accounts.

3. After the appropriate accounts are created, the dollar amounts of each should be recorded. Transactions occurring after this point will affect these accounts.

At the end of the period (monthly, quarterly, semiannually or yearly), the general ledger balances for each of these accounts is adjusted to match the balances in the journals.

4. Periodic "**trial balances**" are then prepared from the general ledger. These are summary reports of account balances, which provide assurance that the double-entry system is functioning properly.

Other tests referred to as "**internal control tests**" will also aid the organization in determining whether the bookkeeping system is operating correctly.

5. Adequate supporting documents should always be maintained. Canceled checks are excellent supporting evidence for expenses, and copies of donor checks provide support for contributions. Minutes of the board of directors are extremely important evidence of resolutions to restrict general funds or plans to acquire costly equipment.

6. Adequate and accurate bookkeeping practices will save time and effort, enable management to make informed decisions and will aid the exempt organization in providing information required by outside parties.

### **III. Financial Statements.**

A. Financial statements have three major components: the balance sheet, the statement of activity and the statement of changes in financial position. Examples of each type of statement and a flow chart of how transactions eventually affect these statements are included at the end of this section. Referring to these Examples periodically while reading the remainder of this section should be helpful.

1. The balance sheet consists of two major sections: the asset section and the liabilities and fund balance section. The categories and dollar balances shown on the balance sheet usually consist of several of the general ledger account balances. These have been consolidated under one general description (example: fixed assets which may consist of furniture, buildings, and land) in order to simplify the user's analysis of the balance sheet. The total assets presented on a balance sheet will equal the total liabilities and fund balance. Hence, the balance sheet formula "Total Assets = Total Liabilities Plus Fund Balance" is satisfied.

2. The statement of activity is a summary of the various revenues received and expenses incurred throughout the period. The excess or deficiency of revenues over expenses increases or decreases the general fund balance. This adjusted fund balance plus restricted fund balance is the amount that appears on the balance sheet. Thus, all revenues and expenses flow to the balance sheet.

3. The statement of changes in financial position is a summary of current resources (working capital) generated throughout the year and how these resources were used. It begins with net activity according to the statement of activity and adds resources that were provided by activities such as the sale of assets or payments received on loans. Use of these resources, such as for the purchase of assets, reduces these resources to yield an increase or decrease to working capital.

B. In order to understand how a single transaction eventually affects the financial statements, refer to the flow chart following this section. If a \$5,000 check contribution is received, the bookkeeper will prepare a deposit slip for the amount and deposit the check in the exempt organization's bank account. The contribution will then be listed in the cash receipts journal for \$5,000, and an equal amount will be listed in the revenue account "Gifts and Grants." At the end of the period, the total of both the cash receipts and gifts and grants journals, as well as all other journals, will be "posted" (transferred) to the general ledger.

At this point, certain account balances in the general ledger will be consolidated under one general description, such as fixed assets. Consolidated balances of revenues (which will include the \$5,000 contribution) and expenses are transferred to the income statement. The excess or deficiency of revenues over expenses is obtained and added or subtracted from the fund balance.

This new fund balance and the consolidated balances of assets (which includes the \$5,000 cash) and liabilities are then brought to the balance sheet. If all transactions were properly recorded, assets will equal liabilities plus the fund balance.

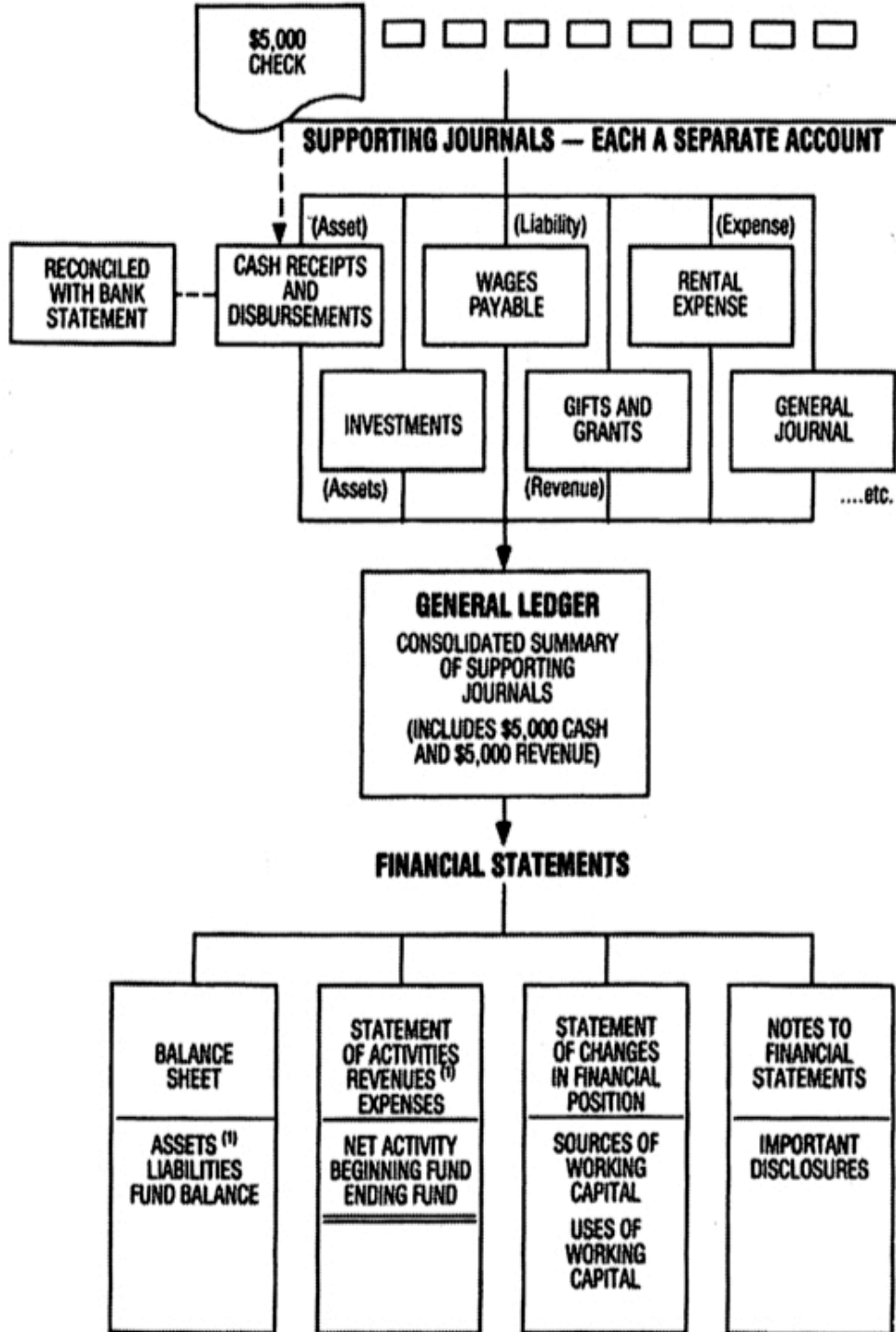
C. In addition to the financial data provided in the financial statements, some supplementary facts called "footnotes" may be necessary in order to make the financial statements complete. Footnotes usually disclose information about existing loans, the use of fund accounting, exemption from taxation and other significant matters. An auditor will provide assistance with these items.

D. If the financial statements are audited, they will also contain the "auditors' opinion." The following section on Auditing will discuss this.

# FLOW CHART OF FINANCIAL ACCOUNTING DATA

## SUPPORTING DOCUMENTS

Checks Received, Invoices, Bank Statements, Etc.



<sup>(1)</sup>includes the \$5,000 contribution.

D. THE COMIC BOOK MUSEUM

BALANCE SHEET-DECEMBER 31, 20X5

ASSETS

CURRENT ASSETS:	
Cash	\$25,000
Pledges receivable, current portion	120,000
Prepaid expenses	5,000
Other current assets	<u>10,000</u>
Total current assets	160,000
PLEDGES RECEIVABLE, noncurrent	500,000
FIXED ASSETS (Less accumulated depreciation of \$50,000)	600,000
NOTES RECEIVABLE	<u>15,000</u>
Total assets	\$1,275,000

LIABILITIES AND FUND BALANCE

CURRENT LIABILITIES:	
Wages payable	\$2,000
Accrued liabilities	5,000
Deferred support, current portion	<u>120,000</u>
Total current liabilities	127,000
NOTES PAYABLE	80,000
DEFERRED SUPPORT, noncurrent	<u>500,000</u>
Total liabilities	707,000
FUND BALANCE, unrestricted	268,000
FUND BALANCE, restricted	<u>300,000</u>
Total liabilities and fund balance	\$1,275,000

**THE COMIC BOOK MUSEUM**  
**STATEMENT OF ACTIVITY**  
**FOR THE YEAR ENDED DECEMBER 31, 20X5**

<b>SUPPORT AND REVENUE:</b>	
Gifts and grants	\$455,000
Membership fees	6,000
Interest income	<u>4,000</u>
Total support and revenue	<u>465,000</u>
 <b>EXPENSES:</b>	
Program-	
Public information	20,000
Additions to book collection	75,000
Supporting services -	
Management and general	195,000
Depreciation expense	50,000
Interest expense	<u>6,000</u>
Total expenses	<u>346,000</u>
 NET ACTIVITY FOR THE YEAR	 119,000
FUND BALANCE (UNRESTRICTED), beginning of year	<u>149,000</u>
FUND BALANCE (UNRESTRICTED), end of year	<u>\$268,000</u>

**THE COMIC BOOK MUSEUM**  
**STATEMENT OF CHANGES**  
**IN FINANCIAL POSITION**  
**FOR THE YEAR ENDED DECEMBER 31, 20X5**

<b>SOURCES OF WORKING CAPITAL:</b>	
Net activity for the year	\$119,000
Add - Depreciation	50,000
Proceeds from note payable	<u>80,000</u>
Total sources of working capital	<u>249,000</u>
 <b>USES OF WORKING CAPITAL:<sup>(1)</sup></b>	
Additions to fixed assets	<u>185,000</u>
 INCREASE IN WORKING CAPITAL	 <u>\$64,000</u>

---

<sup>(1)</sup> The reader should refer to III.A.3. for the explanation of uses of working capital.

## **BUDGETING**

Exempt organizations should use budgets. Use of budgets aids management in evaluating the organization's goals and objectives and planning future activities. Budgets also assist management in monitoring current operations.

Creating a budget does not require a great deal of skill but does require good judgment and an objective approach. This section addresses the basic steps that should be followed to properly prepare a budget.

## **BUDGETING**

### **I. Definition.**

A financial model forecast created from existing current and historical data by which management:

- A. Decides how to use its assets to achieve the tax-exempt organization's goals and objectives and
- B. Evaluates the feasibility of goals and objectives.

### **II. Objectives.**

- A. To illustrate, in terms of monetary reports, the *realistic* expected resources and liabilities available to the nonprofit organization. The expected resources and liabilities are derived by anticipating the amounts of cash received through contributions, borrowing or by other means and expenditures for assets and operating expenses.
- B. To monitor financial activities during the current year. Thus, current activities can also be supervised to assure that revenues and expenses follow the organization's "planned" revenues and expenditures (Le., the budget).

### **III. Preparing a Budget.**

- A. The first step toward proper budgeting is to assess what types of budgets will be most useful to an exempt organization. Generally, these include cash flow, net income from activities, and capital asset expenditure budgets.
  - 1. Cash flow budgets compare cash inflows from all sources to all cash outflows. All exempt organizations should consider the need for this type of budget in order to assure that enough cash is available to cover expenditures as they occur.
  - 2. Net income from activities budgets are similar to cash flow budgets but do have some significant differences. While cash flow budgets involve *actual* cash receipts and expenditures, net income from activities budgets can include revenues not yet received and expenses not yet paid. Additionally, expenses that require no actual cash outlay, such as depreciation expenses, are included. The section on Bookkeeping explains why such noncash items are reported in the current period rather than in subsequent periods. (See Case Example "A" at the end of this section. This case also incorporates a performance comparison to show the usefulness of budgeting.)
  - 3. Capital asset budgets aid organizations in planning for the acquisition of major assets. These budgets allow exempt organizations to plan to have enough resources available either through available funds or through borrowing at the time the assets are to be purchased. (See Case Example "B" at the end of this section.)

B. After deciding which budgets to prepare, the exempt organization should accumulate historical data relevant to each type of budget. From this historical data, a budget using *actual* data should be prepared using the *most recent year's* information. Then, trends in contributions, membership fees, general and administrative expenses, etc., should be identified in terms of rates of growth, decline, or stabilization. Each of these rates can then be compared to management's expectations for further growth, decline, or stabilization in order to project how rates for revenues, expenses, etc., should reasonably change over the period the budget covers. These expected changes are referred to as "assumptions." The assumptions, when applied to the actual data previously accumulated, can give reasonable dollar estimates for each category of revenue or expense. Few organizations should create budgets for more than five years because the degree of uncertainty with regard to any element of revenue or expense increases the further into the future a prediction is made.

#### **IV. Interpreting the Budget.**

A. In order to properly interpret a budget, management should identify areas within the budget that may cause problems. Examples of such problems include cash deficiencies, sharp increases in any expense, or declines in revenues.

B. After problem areas have been identified, management may wish to consider altering its plans. Perhaps, for example, some capital expenditures may be deferred to future periods or more aggressive revenue drives may be considered.

**CASE EXAMPLE "A"**

<b>THE COMIC BOOK MUSEUM NET INCOME FROM ACTIVITIES BUDGET FOR THE YEAR ENDED DECEMBER 31, 20X6</b>		<b>PERFORMANCE COMPARISON TO ACTUAL ACTIVITY FOR THE QUARTER ENDED JUNE 30, 20X6</b>			
		<b>ACTUAL</b>			<b>PROJECTED</b>
		<b>1<sup>st</sup> Quarter</b>	<b>2<sup>nd</sup> Quarter</b>	<b>3<sup>rd</sup> &amp; 4<sup>th</sup> Quarters</b>	<b>YEARLY AMOUNT</b>
<b>SUPPORT AND REVENUE:</b>					
Gifts and Grants — Cash	\$250,000	\$ 63,000	\$ 63,500		\$253,000
Gifts and Grants — Books	40,000	9,500	10,200	NOT	39,400
Gifts and Grants — Other	210,000	54,000	52,000	AVAILABLE	212,000
Membership Fees	8,000	2,100	1,900		8,000
Admission Fees	4,000	1,100	1,000		4,200
Interest Income	5,000	1,200	1,000		4,400
Miscellaneous Income	1,000	300	400		1,400
Total Support and Revenue	<u>518,000</u>	<u>131,200</u>	<u>130,000</u>	<u>—</u>	<u>522,400</u>
<b>EXPENSES:</b>					
<b>Program —</b>					
Films	5,000	1,250	1,300		5,100
Publications	2,000	700	700		2,800
Membership Newsletters	500	150	120		540
Additions to Book Collections	80,000	21,000	22,000		86,000
Total Program Expense	<u>87,500</u>	<u>23,100</u>	<u>24,120</u>	<u>—</u>	<u>94,440</u>
<b>Supporting Services —</b>					
Salaries	90,000	22,500	22,700		90,400
Legal/Accounting Fees	5,000	1,200	1,000		4,400
Telephone & Utilities	2,000	600	400		2,000
Printing	1,000	300	300		1,200
Promo, Travel & Entertainment	10,000	2,600	2,500		10,200
Interest	4,000	900	950		3,700
Insurance	2,000	600	650		2,500
Depreciation	75,000	19,000	19,100		76,200
Miscellaneous	3,000	800	800		3,200
Total Supporting Services Expense	<u>192,000</u>	<u>48,500</u>	<u>48,400</u>	<u>—</u>	<u>193,800</u>
Total Expenses	<u>279,500</u>	<u>71,600</u>	<u>72,520</u>	<u>—</u>	<u>288,240</u>
<b>NET ACTIVITY FOR THE YEAR</b>	<u>\$238,500</u>	<u>\$ 59,600</u>	<u>57,480</u>	<u>—</u>	<u>\$234,160</u>

NOTE: This budget is similar to the "Net income from Activities" financial statement, but is more detailed.

## CASE EXAMPLE "B"

### THE COMC BOOK MUSEUM CAPITAL ASSETS BUDGET FOR YEARS 20X5 – 20X9

	<u>20X5</u>	<u>20X6</u>	<u>20X7</u>	<u>20X8</u>	<u>20X9</u>
<b>SOURCES:</b>					
Restricted fund contributions — fixed assets	\$ 55,000	\$ 25,000	\$ 20,000	\$ 15,000	\$ 25,000
Carryover of prior year's restricted fund — fixed assets	—	—	15,000	20,000	25,000
Restricted fund contributions — book addition	80,000	80,000	50,000	50,000	15,000
Carryover of prior year's restricted fund — book addition	—	5,000	5,000	30,000	40,000
Excess unrestricted funds <sup>(1)</sup>	50,000	52,000	55,000	50,000	40,000
Financing for building <sup>(2)</sup>	620,000	—	—	—	—
<b>Total Sources</b>	<u>805,000</u>	<u>162,000</u>	<u>145,000</u>	<u>165,000</u>	<u>145,000</u>
<b>USES:</b>					
Purchase of building	670,000	—	—	—	—
Purchase of furniture and fixtures	5,000	10,000	15,000	10,000	10,000
Purchase of comic books	75,000	80,000	25,000	40,000	45,000
<b>Total Uses</b>	<u>750,000</u>	<u>90,000</u>	<u>40,000</u>	<u>50,000</u>	<u>55,000</u>
<b>Excess of Sources over Uses</b>	<u>\$ 55,000</u>	<u>\$ 72,000</u>	<u>\$105,000</u>	<u>\$115,000</u>	<u>\$90,000</u>

**NOTES:**

<sup>(1)</sup>Excess unrestricted funds are those funds in excess of funds needed to cover daily operations.

<sup>(2)</sup>The building is financed by paying \$50,000 down and financing the balance.

## **REPORTING REQUIREMENTS FOR EXEMPT ORGANIZATIONS**

Tax-exempt organizations are subject to many of the same type of government filing requirements as for-profit corporations. It is usually the case, however, that while the forms are similar, they are rarely identical. The differences may be subtle, such as in the number of employees required before an organization must file with the TWC; or they may be substantial, as with the concept of unrelated business income. The information on the following pages provides a reference guide to assist tax-exempt organizations in the recognition of applicable reporting requirements, the methods that must be followed to produce this information, and the procedures for remitting this information in a proper and timely fashion.

As is the case with any government filing requirements, policies and rules may change. The instructions and information on the most recently received form should always be read with care and followed if there is conflict with any information included here.

The preparation of forms and timely filing of documents is vital in maintaining a tax-exempt status, and organizations are encouraged to read the following guide carefully. Any questions that linger or issues that remain unclear should be discussed with an appropriate professional.

## **REPORTING REQUIREMENTS FOR EXEMPT ORGANIZATIONS**

" ... every organization exempt from tax under Section 501(a) of the Code shall keep such permanent records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements and other required information." Guide to Record Retention Requirements, FEDERAL REGISTER, December 31, 1980

Tax-exempt organizations are subject to many of the same types of government filing requirements as for-profit corporations. It is usually the case, however, that while the forms are similar, they are rarely identical. The differences may be subtle, such as in the number of employees required before an organization must file with the TWC; or they may be substantial, as with the concept of unrelated business income. The information on the following pages provides a reference guide to assist tax-exempt organizations in the recognition of applicable reporting requirements, the methods that must be followed to produce this information, and the procedures for remitting this information in a proper and timely fashion.

*As is the case with any government filing requirements, policies and rules may change. The instructions and information on the most recently received form should always be read with care and followed if there is a conflict with any information included here.*

The preparation of forms and timely filing of documents is vital in maintaining a tax-exempt status, and organizations are encouraged to read the following guide carefully. Any questions that linger or issues that remain unclear should be discussed with an appropriate professional.

### **I. Introduction to Form 990 and Related Filings.**

A. Generally, every organization exempt from income tax must file Form 990 by the 15th day of the fifth month after the accounting period ends.

1. Included in the exceptions to the filing requirements are organizations whose gross receipts are not normally greater than \$25,000.

Test - Form 990 is not required where the organization:

- a. has been in existence one year and gross receipts are \$37,500 or less; or
- b. has been in existence from one to three years and averaged gross receipts are \$30,000 or less; or
- c. has been in existence for more than three years and averaged gross receipts for the current year and two immediately preceding years are \$25,000 or less.

*Suggestion:* If the above exception applies to your organization, complete the information in the blocked area on page 1 of the form (name, address, federal identification number, code section under which exemption is based, accounting method, etc.). Also, mark the appropriate block to indicate that gross receipts are not normally more than \$25,000 and file the return in a timely fashion.

2. A short form (990EZ) is provided for organizations with gross receipts over \$25,000 but whose total revenue for the accounting period is \$25,000 or less.

B. Your organization may be required to complete the following additional forms:

1. Schedule A, Form 990: if the organization qualifies for exemption under internal Revenue Code Section 501 (c)(3).

2. Form 990-T: if the organization has gross income of \$1,000 or more from the conduct of a trade or business unrelated to its exempt purpose.

C. Complete Form 990 by using the same accounting method you use to keep the organization's books and records.

D. There are substantial penalties for failure to file or for late filing - \$20 a day, up to a maximum of \$10,000, unless you can, show that such late filing was due to reasonable cause.

E. An authorized individual must sign the form.

F. The purpose of filing Form 990 is:

1. To account for the results of operations.

2. To prove the organization is operated substantially for exempt purpose and continues to qualify as a public charity.

3. To prove that a public interest is served such that no private shareholder, director, or other person receives substantial direct or indirect benefit.

4. To segregate activities that are substantially related to the organization's exempt purpose from those that may be subject to tax as unrelated business income.

G. All form 990's are filed with the Internal Revenue Service, Ogden UT 84201-0027.

## **II. Analysis of Revenue, Expenses and Fund Balance.**

A. Separate gross receipts by category.

1. Contributions and their source.

a. Generally, contributions will be received directly from individuals, other foundations, corporations or governmental units. Indirect contributions are those received through solicitation campaigns conducted by fund-raising agencies.

b. Maintain a list of contributions from anyone source that amounts to \$5,000 or more, including the name and address of the donor. In determining whether contributions are equal to \$5,000, total only gifts of \$1,000 or more.

Non cash contributions (stock, furniture, land, buildings, etc.) are reported at their fair market value as of the date of the contribution less any outstanding debt attached.

c. If the organization provides the contributor with merchandise of only nominal value in exchange for the contribution, report the entire amount received as a contribution. Similarly, "membership fees" that are in excess of the monetary value of membership benefits to the payer are contributions.

d. Do not include the value of services donated to the organization, or items such as the free use of materials, equipment or facilities. Also, an amount paid to the organization for which the donor receives more than an incidental benefit is compensation for services rather than a contribution.

2. Investment income (dividends, interest, rents and royalties).

3. Sales of inventory (items held for sale in the ordinary course of a trade or business).

4. Sales of investments and assets used in your trade or business (automobiles, furniture and fixtures, etc.).

5. Program service revenue or amounts received from the conduct of activities upon which your exemption is based. Itemize by each significant program or activity. (Examples: admissions to performing arts events, tuition for educational training sessions, fees charged for tours, lectures, etc.).

6. Membership dues and assessments for which the payer receives a commensurate benefit, such as reduced rate admissions to events, publications, newsletters, discounts on merchandise, etc.

7. Special fundraising activities or events (dinners, dances, raffles and other functions, the primary purpose of which is to raise funds). When a donor pays more for such goods or services than their value, the excess constitutes a contribution.

8. Other revenue including interest on notes receivable not held as investments, coffee and soft drink machine revenue and miscellaneous nonrecurring receipts.

9. Optional information with regards to expendable (unrestricted) versus nonexpendable (restricted) amounts, which is used to indicate externally imposed restrictions on the use of

gross receipts. Generally, such restrictions are imposed by donors.

B. Classify itemized expenses by function (as a reference, see the list on page 2, Form 990, Part II).

1. Direct expenses attributable to fundraising (costs of soliciting contributions), program service (costs associated with activities on which exempt status is based) or management and general (costs of day-to-day operations such as legal, accounting, investment advice, personnel, rent, insurance, etc.).
2. Indirect expenses allocable to one or more of the above-listed functions (for instance, base the allocation on the percent of time or use). *Suggestion:* Advise personnel to keep a log of their time spent directly for fund-raising and program service activities.
3. If the organization makes grants or awards to other nonprofit corporations or to individuals, the following information is required:
  - a. The class of activity.
  - b. The donee's name and address.
  - c. The amount given.
  - d. If the recipient is an individual, the relationship of the donee to any person who has an interest in the organization.
4. Compensation and expense account allowances of officers, directors or trustees of the organization.

C. *Statement of Program Services Rendered* - Expenses allocable to program services should be grouped by the four most significant activities or functions of the organization. Activities should be listed generically and described in detail. For example, if an organization conducts training in theatrical performing, as well as sponsors theatre touring companies, then the educational program should be reported separately from the sponsored events. Similarly, gallery exhibits should be reported separately from dance lecture/demonstrations.

Additionally, show:

1. Pertinent statistical information, such as number of students participating or number of patrons in attendance.
2. The amount of grants that are included in total expenses for each program service rendered.

D. Fund balance at the beginning of the year is added to the excess of revenues over expenses (or the deficit is subtracted there from) to arrive at ending fund balance.

### **III. Balance Sheet.**

Classify assets, liabilities and fund balances according to the descriptions on Form 990, page 3, Part VI.

A. Attach detail schedules where requested (investments, depreciable assets, notes payable, etc.).

B. Fund balances on the balance sheet should correspond with the amounts reported on Analysis of Revenue, Expenses and Fund Balances (Form 990, page 1, Part I).

C. Fund accounting distinguished from other methods: an organization which uses fund accounting segregates its assets, liabilities and net worth into separate funds according to externally imposed restrictions on their use.

### **IV. Other Statements and Representations on Form 990.**

A. Change in the organization's activities:

1. Report any significant changes to the Internal Revenue Service so that the IRS may analyze the effect on the organization's exempt status.

2. Only those changes previously undisclosed or not proposed in the application for exemption need be described.

3. Attempt to show that the changes in activities (whether they are new, discontinued or modified) do not prevent the organization from carrying out its exempt purpose.

B. Changes in the organization's governing documents, including articles of incorporation and bylaws:

1. Changes are reported to the IRS in order that it may analyze the effect on the organization's exempt status.

2. A "conformed" copy is required or one that agrees with the original document, as executed by the appropriate official of the organization. If the document is not signed, it must be accompanied by a declaration certifying that it is a complete and accurate copy.

3. If a number of changes are made, send the IRS a copy of the entire revised document along with the original provisions. Otherwise, only the modified section, with an appropriate explanation, must be sent.

C. Unrelated business gross income.

1. If unrelated business gross income is greater than \$1,000, the organization must file on

Form 990-T, Exempt Organization Business Income Tax Return.

2. With respect to business activities that are regularly carried on but are not considered to be unrelated, attach an explanation as to how the conduct of such activities contributes importantly to the exempt purpose.

D. Dissolution, liquidation or substantial contraction.

1. A complete liquidation requires the organization to file a final return, attach a certified copy of the plan of termination and show how net assets have been (or will be) distributed in accordance with the governing instrument.

2. A substantial contraction is defined as either of the following:

a. A disposition of 25% or more of the fair market value of net assets held at the beginning of the year.

b. A series of dispositions that result in 25% or more of the net assets being distributed (measure percent from first tax year in which the series of distributions began).

3. A substantial contraction does not occur when:

a. Losses are due to market fluctuations,

b. Transfers are for full consideration or

c. Distributions are out of current income.

4. Disclose major distributions in statement form listing the name and address of each recipient along with the nature of the assets transferred.

E. Related organizations.

1. Designate those organizations that have the same governing body, officers, trustees or membership as the reporting entity.

2. Indicate whether such organization is exempt or nonexempt.

3. Disregard affiliation with statewide or national organizations.

F. Political expenditures.

In order to be granted tax-exempt status under Section 501(c)(3), an organization must "not participate in or intervene in any political campaign on behalf of any candidate for public office." Therefore, political expenditures jeopardize tax-exempt status as a charitable

organization.

**V. Additional Financial Information Required for Completing Schedule A, Form 990.**

A. One of the main purposes of Schedule A is to show why the organization qualifies as a public charity. Refer to the advance ruling or determination letter from the IRS for the basis of nonprivate foundation status. If the organization relies primarily on public support or gross receipts from exempt-function activities, then it must prove it is maintaining such status by completing the support test. The test is designed to show whether the organization maintains its responsiveness to public rather than private interests and is administered on the basis of the source of gross receipts. Two types of publicly supported organizations that are common exceptions to private foundation status for cultural arts organizations are:

1. An organization that normally receives at least one-third of its support from the general public or
2. An organization that normally receives at least one-third of its support from the general public and gross receipts from exempt-function activities. The financial information required for completing Schedule A is set out below. An example of the support test calculations follows this outline. Because it is difficult to evaluate an organization's maintenance of public charity status from Schedule A, it is recommended that an organization to which the support test applies prepare an analysis each year.

B. Compensation of five highest paid employees other than officers, directors and trustees if their individual compensation is greater than \$50,000.

C. Compensation of five highest paid persons who rendered professional service, if paid more than \$50,000.

D. Categorized gross receipts for the four previous years of operations (or years of existence if less), if the organization either relies primarily on public support in the form of contributions or relies primarily on gross receipts from activities related to its exempt purpose.

E. A list of donors and amounts they contributed for the four immediately preceding years or years of existence if less. Excess contributions are amounts, contributed by one individual corporation trust, etc., that are greater than 2% of total support.

F. If the organization relies primarily on gross receipts from activities related to its exempt purpose, a list of contributions, membership fees and gross receipts from admissions, merchandise sold or services performed (for the four immediately preceding years or years of existence if less) from any of the following sources:

"Disqualified Persons" (any of the following)

1. A person who has contributed more than \$5,000, if that amount is more than 2% of total contributions for the year.
2. An officer, director or trustee.
3. An owner of more than 20% of a corporation, partnership or trust that contributed greater than \$5,000.
4. The spouse, ancestors, children and their spouses of an individual in the first three categories.
5. A corporation, partnership, trust or estate in which any of the persons described above owns more than 35 %.

G. If the organization relies primarily on gross receipts from activities related to its exempt purpose, a list of the names and amounts for each person other than disqualified persons as listed above from whom the organization received more than \$5,000 (or 1 % of gross receipts, if greater) with respect to gross receipts from admissions, merchandise sold or services performed. This information is also required for the four immediately preceding years or years of existence if less.

H. A list of the amount and source of unusual grants for the four previous years or years of existence if less. Unusual grants are substantial contributions from disinterested parties, which:

1. Are attracted because of the organization's publicly supported nature.
2. Are unexpected and unusual because of the amount.
3. Are large enough to endanger the organization's status as a public charity.

I. If applicable, lobbying expenditures to influence public opinion or legislative bodies.

J. If applicable, a list of donors who made contributions of real property, the value of which is more than \$5,000, to be used for conservation purposes. Include the donor's name, address, identifying number, the date of the contribution, a description of the property, and the legal interest of such property contributed (i.e., life estate versus remainder interest).

## **VI. Other Statements and Representations on Schedule A, Form 990.**

A. Lobbying activities.

1. A public charity may lose its exempt status if "carrying on propaganda or otherwise attempting to influence legislation" is a substantial part of its activities. It is important to note, however, that lobbying is permissible within established limits.

2. Lobbying activities include the following:

a. Contacting, or urging the public to contact, members of a legislative body for the purpose of proposing, supporting or opposing legislation.

b. Advocating the adoption or rejection of legislation.

3. The support of a particular political candidate constitutes political activity and is never permitted of public charities.

4. Prior to engaging in legislative activities, the organization should petition the IRS for approval to make such expenditures. Even so, the amount of lobbying expenses must fall within a permissible dollar limit or the organization will be subject to an excise tax. If over a four-year averaging period, the organization's annual lobbying expenses are more than 150% of certain dollar limits, its exempt status may be jeopardized. This area must be reviewed very carefully before an organization engages in legislative activities.

B. Private inurement (detail of direct and indirect transactions between the organization and its creators, officers, directors, trustees, etc:).

1. The public charity must serve a public rather than private interest. Therefore, in order to obtain and maintain tax-exempt status, no part of the net earnings may inure to the benefit of any private shareholder or individual.

2. Transactions that may amount to instances of private inurement are transactions between an organization and a private individual, as follows:

a. Sale, exchange or leasing of property unless the payment therefore is reasonable, and the arrangement is beneficial and desirable to the organization (i.e., in furtherance of its tax-exempt purpose).

b. Lending of money or other extension of credit unless the terms of the loan are financially advantageous, commensurate with the organization's purposes and the loan is timely repaid.

c. Furnishing of goods, services or facilities unless the value of such is incidental and not provided on a regular basis.

d. Payment of compensation unless such is reasonable in amount given the services provided.

e. Transfer or use of the income or assets of the organization unless it is established that the private benefit is merely incidental and the organization is fulfilling its exempt purpose in the provision of such income or assets.

3. All transactions between a public charity and an "interested party" should be explained

fully, emphasizing that the transaction does not impair the organization's purpose of serving a public benefit.

C. Disbursements to individuals or organizations.

1. Attach a statement explaining how disbursed amounts are used for a qualified charitable purpose and further the basis for exemption of the organization. Review the purpose section in the application for exemption in answering this question.
2. Scholarships, fellowships and student loans should be disclosed, indicating the charitable purpose the organization is fulfilling in granting such payments.

D. Private school questionnaire.

1. The definition of a school considerably restricts the parameters of an educational organization that qualifies as a public charity. It requires the following:
  - a. The maintenance of a regular faculty and curriculum,
  - b. A regularly enrolled body of students and
  - c. Relatively incidental noneducational activities, as compared to educational activities.
2. Schedule A requires a private school to answer several questions regarding its racially nondiscriminatory policies. Review of the questions for the appropriate recordkeeping requirements and statistical information is advised.

## **VII. Analysis of Support Tests for Publicly Supported Organizations.**

A. Under the one-third support test for organizations which normally receive a substantial part of their support from governmental units or the general public, the organization must receive at least one-third of total support from governmental units or the general public. Qualifying support also includes amounts received from other publicly supported organizations ("indirect" public support).

1. The test is applied for the four tax years immediately preceding the current year or years of existence if less.
2. Meeting the aggregate support test qualifies the organization as a public charity for its current and immediately succeeding tax year.
3. Contributions from anyone individual, trust, corporation or private foundation are taken into account in the numerator of the support fraction only to the extent of 2% of total support. Unusual or unexpected contributions, which by reason of their size adversely affect the organization's status as a public charity, are excluded both from the numerator

and denominator of the support fraction. Recall that these contributions must be unsolicited and attracted merely by the organization's publicly supported nature in order to be excluded.

4. Support includes the following:

- a. Gifts, grants, contributions or membership fees,
- b. Net income from unrelated business activities whether or not regularly carried on,
- c. Gross investment income,
- d. Tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization and/or
- e. Value of services or facilities furnished by a governmental unit without charge.

5. Support excludes:

- a. Gain on the sale of capital assets,
- b. Value of exemption from federal, state or local
- c. Amounts received from the exercise or performance of exempt-function activities and/or the instructions on (
- d. Contribution of services for which a deduction is not allowable.

Example 1: IRC 509(0)(1) (Box 12, Schedule A, Form 990, Part IV, Page 2.)

The following example illustrates how one-third support test is applied. Assume X organization received support from the following sources for the last four years preceding the current taxable year.

Indirect contributions from the general public through another publicly supported organization	\$ 40,000
Direct Contributions	180,000
Governmental unit	20,000
Investment income	<u>100,000</u>
Total Support	\$340,000

One-third of total support is \$113,334. Support from governmental units and from contributions from the general public must total at least \$113,334. For these purposes, the following qualify:

Support from governmental unit	\$ 20,000
--------------------------------	-----------

Contributions—	70,000
Various donors (no one having made contributions in excess of \$6,000, 2% of total support)	
10 contributions (each in excess of \$6,000, 2% of total support) 10 X \$6,000	68,000
Indirect contributions	<u>40,000</u>
Total qualifying support	\$198,000

Because the amount of XIS support from governmental units and from the general public one-third of its total support, the organization qualifies as a publicly supported charity under 509(a)(1) for the current taxable year and for its succeeding taxable year.

B. The facts and circumstances test.

1. If the organization fails to meet the one-third support test, this test provides an alternative to retain public charity status.
2. The requirements are as follows:
  - a. At least 10% of total support is normally received from governmental unit or the general public. The organization must consider the same four-year test period, 2% limitation with respect to contributions from anyone source and sources of support.
  - b. The organization must be organized and operated to attract new or additional public support on a continuous basis. In order to prove that this requirement is met, it is suggested that the organization maintain a bona fide solicitation program, as well as carry on other activities designed to attract public support.
3. Other factors that are considered include the following:
  - a. Normal receipt of support in excess of 10% from the general public,
  - b. Sources of support from a representative number of persons,
  - c. Organization's governing body that represents broad public interest and
  - d. Availability of facilities or services to the general public.

Example 2: Assume X organization received, support from the following sources for the four immediately preceding tax years:

Governmental unit	\$ 50,000
Direct contributions (2 contributions)	350,000
Receipts from services rendered	<u>120,000</u>
Total support	520,000

Excluded support (receipts from services rendered)	<u>120,000</u>
Total support	\$400,000

One-third of total qualified support (qualified support being \$400,000 in this example because gross receipts for services rendered are excluded from both the numerator and the denominator of the one-third fraction) would be \$133,333. Assume support from governmental units and the general public (above the 2% limitation) is as follows:

Governmental units	\$ 50,000
2 contributions (each in excess of \$8,000, 2% of total support)	
2 X \$8,000 \$ 50,000	<u>16,000</u>
	\$ 66,000

X's support from the general public and from governmental units does not meet the one-third test. However, because its support from these organizations does exceed 10% of its total support, it may meet the alternative test.

C. The aggregate support test for organizations that normally receive a substantial part of their support from governmental units or the general public and from gross receipts from the conduct of activities on which their exemption is based.

1. The one-third support test is modified somewhat for this type of publicly supported organization.

a. Support includes the items previously discussed and income directly related to the performance of the exempt function (i.e., gross receipts from admissions, sales of merchandise, performance of services, and other related trades or businesses),

b. The following rules also apply:

(1) Gross amounts received from anyone person or entity in performance of exempt-function activities are included in the numerator only to the extent the amount does not exceed the greater of \$5,000 or 1 % of total support.

(2) The organization must normally receive no greater than one-third of its support from gross investment income.

(3) Contributions from disqualified persons are excluded from the numerator of the support fraction.

D. The support test is applied over the four tax years immediately preceding the current year or years of existence if less. Additionally, if the organization meets the aggregate support test, it qualifies as a public charity for its current and immediately succeeding tax year.

E. The same provision for exclusion of unusual or unexpected gifts, grants or contributions applies (see above VII. ,A. ,2.).

F. For this type of organization, the public support test is determined solely on the basis of the cash receipts and disbursements method of accounting.

Example 3: mc 509(a)(2) (Box 13, Schedule A, Form 990, Part IV, Page 2).

City of Houston for exempt-function services rendered by X	\$ 20,000
Harris County for exempt-function services rendered by X	10,000
X, an individual, for exempt-function services rendered by X	10,000
General public (for admissions to events sponsored by X)	400,000
Gross investment income	60,000
Contributions from individual substantial contributors (disqualified persons)	200,000
Total support	\$700,000

Because the \$20,000 received from the City of Houston, the \$10,000 received from Harris County and the \$10,000 received from Y each amount to more than the greater of \$5,000 or 1 % of X's total support (\$700,000 X 1 % @ \$7,000), each amount is limited to \$7,000. In determining if one-third of A's support is from the general public, X received support from sources taken into account in the numerator as follows:

City of Houston	\$7,000
Harris County	7,000
Y, an individual	7,000
General public, receipts from admissions	400,000
Total	\$421,000

\$421,000 becomes the numerator and \$700,000 the denominator of the support fraction. No contributions are considered in the numerator of the support fraction in this example because amounts received from disqualified persons are specifically excluded.

Qualifying receipts account for greater than one-third of total support. Gross investment income accounts for less than one-third of total support. Therefore, the organization qualifies as a public charity under 509(a)(2) for its current and immediately succeeding taxable years.

## **VIII. Payroll Tax Filing Requirements.**

NOTE: Assuming Application for Exempt Status (Form 1023) has been filed.

### **A. Form SS-4, Application for Employer Identification Number.**

1. Who must have an Employer Identification Number? Every person who:
  - a. pays wages to one or more employees or
  - b. is required to have an identification number for use on any return, statement or other document, even though not an employer.
2. When to file for identification number?
  - a. Filing must be in sufficient time for the identification number to be included in returns, statements or other documents required to be filed.
  - b. To receive your identification number immediately, go to the IRS website at [www.irs.gov](http://www.irs.gov) and file online.

### **B. Filing for Employees and Independent Contractors.**

1. *Employee* - When the Employer controls the result and how the result is to be accomplished, the following forms must be filed:
  - a. *W-4*, Employee's Withholding Allowance Certificate is used for determining amount of federal taxes withheld each pay period. Federal tax withholding tables can be obtained from a local Internal Revenue Service Center.
  - b. Social Security and Medicare taxes:
    - (1) Employer withholding required for social security is 6.2% of current gross wages and 1.45% for Medicare taxes for a total of 7.65%.
    - (2) Employer pays 7.65% of gross wages made by employee.
    - (3) *W-2*, Wage and Tax Statement - Summary of wages and withholdings per employee for the calendar year. Copies B, C and 2 are sent to each current or former employee by February 1st. Copy A is sent to the Social Security Administration before March 1st. The remaining copies are held for Employer records.
    - (4) *W-3*, Transmittal of Income and Tax Statements - Summation of all *W*-s sent out. The *W-3* is sent along with Copy A of the *W-2*s to the Social Security Administration before March 1st.

2. *Independent Contractor* - This is the status when services are in the nature of a single transaction, not part of continuing employment, and the manner and performance are not subject to control and supervision of Employer.

a. Employer is not required to withhold federal, social security or medicare taxes for Independent Contractors.

b. *Form 1099 MISC* (Nonemployee Compensation) - Summary of total compensation paid to contractor. Employer must provide a statement for each individual to whom Employer has paid at least \$600 in fees, commissions or any other form of compensation.

C. *Quarterly Employer's Reports and Deposits of Withholdings.*

1. *Form 8109*, Federal Tax Deposit Coupon - These forms may be ordered from any Internal Revenue Service office. When making deposits, include the federal tax deposit coupon and a single payment made payable to the depository where the deposit will be made.

2. EFTPS. The Electronic Federal Tax payment System is an alternative way to pay your federal taxes electronically - on-line or by phone 24 hours a day, 7 days a week. Visit [www.EFTPS.gov](http://www.EFTPS.gov) to enroll. You can use this system to pay both your payroll taxes and any other taxes that may be due on unrelated business income.

3. *Form 941*, Employer's Quarterly Federal Tax Return - This form is used when the Employer withholds federal income tax, social security, and medicare tax. The return reports taxes withheld from wages during the quarter and deposits made, if any.

a. The report is due by the end of the month following the end of the filing quarter. If all taxes were deposited when due for a quarter, Employer has 10 more days after the due date to file.

b. *Deposit Requirements* - In general, Employer must deposit withheld income tax and Employer and employee social security and medicare taxes with an authorized financial institution, or Federal Reserve Bank or branch, using a preinscribed Federal Tax Deposit Coupon (Form 8109) or using the EFTPS system with each deposit. The following rules apply to deposits of taxes:

1. Monthly Schedule. Deposit Form 941 taxes on payments made during a month by the 15th day of the following month.

2. Semiweekly Schedule. Deposit Form 941 taxes on payments made on Wednesday, Thursday, and/or Friday by the following Wednesday. Deposit amount accumulated on payments made on Saturday, Sunday, Monday, and/or Tuesday by the following Friday.

3. Exception. You may make a payment with the Form 941 instead of depositing

if you accumulate less than a \$2,500 tax liability during the quarter.

c. *Note* - Deposit requirements are subject to revisions by the IRS. Refer to the instructions on Circular E and Form 941. You can download these on the ms website at [www.irs.gov](http://www.irs.gov).

4. *Form C-3*, Texas Workforce Commission (TWC) Employer's Quarterly Report, and *Form C-4*, Wages List - Purpose is to report wages paid during the quarter to each employee and to determine the Employer's contribution to the state unemployment fund. This form is used when Employer withholds federal income tax, social security, and medicare tax.

a. Coverage is mandatory for a nonprofit organization that employs four individuals on any day, each day in a different calendar week, in 20 different weeks during the current or preceding calendar year. Nonprofit organizations may finance the payment of benefits by one of these methods:

(1) *Contribution Method* - A specified percent, determined by the TWC, of first \$9,000 of wages paid to each individual is contributed to the unemployment fund. (First year: 2.7%, subsequent years; based on experience.)

(2) *Reimbursement Method* - The organization may elect to reimburse the unemployment fund for the actual cost of benefits paid plus one-half of extended benefits paid to each former employee. This is in lieu of regular contributions. The election must be made within 45 days after notice is mailed to the organization that it is a subject Employer. Further information should be obtained for filing requirements of this method.

b. *Status Report* - This determines whether or not the Employer is subject to unemployment tax:

A report (1) will either be automatically mailed to you after the organization has applied for a federal identification number or (2) may be obtained by contacting the local TWC tax office,

c. *Forms C-3 and C-4* are to be filed quarterly and are due on or before the last day of the month following the close of the period covered by the report,

d. *Note* - Refer to the specific forms for other filing instructions.

e. *Electronic Filing*. You can file your TWC reports online at [www.tlljc.state.tx.us](http://www.tlljc.state.tx.us). The website has a wealth of helpful information from downloading forms to the independent contractor or employee issue,

D. Organizations described in Section 501(c)(3) do not have to file *Form 940*, Employer's Annual Federal Unemployment Tax Return.

Example 1: *Figuring amount of deposited taxes - October:*

*Pay Period 1: Gross wages of \$2400:*

Employee Withholdings -

FIT	\$300	(per tables in the Internal Revenue Code)
Social Security	150	(6.2%)
Medicare	35	(1.45%)
Total undeposited taxes	\$485	

Example 2: *Tax deposits:*

The taxes on wages paid in October are \$485, and the taxes on wages paid in November (for example) are \$2,550. No deposit is required for October, but add the \$485 to the \$2,550 for November and deposit the total (\$3,035) by December 15.

## **BUSINESS INCOME OF EXEMPT ORGANIZATIONS**

An organization must be organized and operated exclusively for an exempt purpose in order to be spared taxation.

For the purpose of the Internal Revenue Service, this means that no more than an insubstantial part of its activities may be for purposes not in furtherance of the organization's stated exempt purpose.

Because an organization has received exempt status does not necessarily mean that all activities it carries on will be exempt from taxation regardless of whether they are related to the tax-exempt purpose. Unrelated activities, which must remain insubstantial if tax-exempt status is to be retained, may still be taxed as unrelated business income.

The primary objective of imposing a tax on unrelated business income of exempt organizations is to eliminate a source of unfair competition for taxpaying entities conducting the same type of business activity. This tax may apply to all organizations exempt from taxation under Section 501(a) of the Internal Revenue Code.

## **BUSINESS INCOME OF EXEMPT ORGANIZATIONS**

### **I. Fundamentals of the Concept of Unrelated Trade or Business.**

#### A. There must be a trade or business

1. which is generally defined as an activity carried on for the production of income from the sale of goods or the performance of services,
2. which includes all activities which are intended to produce income, whether or not they actually result in profit.

#### B. The trade or business must be regularly carried on by the organization.

1. The following factors are considered in determining whether an activity is regularly carried on:

- a. the frequency of the activity,
- b. the continuity of the activity and
- c. whether the activity is pursued in a manner similar to comparable commercial activities of nonexempt organizations.

2. Generally, business activities that are engaged in only periodically will not be considered as regularly carried on if the activities are conducted without competitive and promotional efforts typical of commercial endeavors.

#### C. The business activity is unrelated if it is not substantially related to the exempt purpose of the organization aside from the need of income or funds, or the use it makes of the profits derived there from.

1. Substantially related means there must be a substantial causal relationship between the trade or business activity and the accomplishment of the organization's exempt purpose (or the activity contributes importantly to the exempt purpose).
2. Consideration is given to the size and extent of activities in relation to the nature and extent of the exempt functions they purport to serve.

#### D. Application of the fundamentals:

1. Generally, there is no unrelated business income where the organization sends out 10w-cost articles in connection with the solicitation of contributions. However, in order to establish more clearly that the public charity is not in competition with taxable business entities, the following additional suggestions are submitted:

- a. The contribution necessary to "buy" the gift or premium should be substantially greater than its cost.
  - b. The organization should bear the financial risk rather than an independent promoter.
  - c. The organization may send reminders to those potential donors who have not made a contribution, but should not invoice the balance of receipts below the "suggested contribution."
- 2. An annual gala ball is not considered regularly carried on even if planning the event necessitates months of preparation.
  - 3. Operation of a parking lot on a commercial basis each Saturday would be considered regularly carried on.

## **II. Exceptions to the Definition of Unrelated Trade or Business.**

A. Any work or business in which substantially all of the work is performed for the organization without compensation.

An example of this work is the sale of a cookbook designed and compiled by museum volunteers where recipes are donated and the cookbook contains pictures of the museum's collection.

B. Any trade or business carried on primarily for the convenience of its members, patrons, students, patients, officers or employees.

- 1. Operation of a snack bar, restaurant, theatre/ auditorium or similar facility by an exempt organization for the convenience of staff, employees or patrons is generally not subject to UBTI.
- 2. The facility should be open to the general public only during regular business hours, or during concerts, performances, exhibitions, etc.
- 3. The organization should not engage in promotion or competitive activities with other ventures that carry on the same or similar business for profit. For example, the regular operation of a museum's theatre for after-hours showing of recent commercially available films would produce unrelated business income.

C. Any trade or business that consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of this trade is the sale of clothes and household goods to indigent families where the merchandise has been donated by department stores.

### **III. Administrative Procedures.**

#### A. Tax rates.

1. Corporate tax rates for exempt corporations.
2. Trust tax rates for exempt trusts. B Tax returns.

#### B. Tax returns.

1. In addition to other filing requirements imposed on exempt organizations, if gross income from an unrelated trade or business is in excess of \$1,000, a Form 990- T must be filed.
2. The due date of Fonn 990-T coincides with the filing date of Form 990 - the 15th day of the fifth month after the organization's accounting period ends.
3. Form 990-T is filed at the Internal Revenue Service Center, Ogden, UT 84201-0027.

#### C. Calculation of unrelated business taxable income.

1. Unrelated business taxable income is gross income derived from an unrelated, trade or business less deductions directly connected with the carrying on of such trade or business.
  - a. Deductions attributable solely to the unrelated business activity satisfy the directly connected requirement:
  - b. Dual use deductions (such as the use of facilities or performance of services) that relate both to carrying on exempt purpose and unrelated activities must be allocated between the functions on a reasonable basis.
2. If the organization operates two or more unrelated activities, unrelated business taxable income is the aggregate of the net income or loss from all such activities or the gross income from all unrelated businesses less all applicable deductions.

### **IV. Examples of the Application of the Principles of Unrelated Business Income (UBI) to Income Producing Activities.**

A. Dividends, interest and royalties are generally excluded.

B. Rents from real property are generally excluded. (But see Paragraph IV,]. relating to debt-financed property.)

Exception: If personal services are rendered to the occupant of the space, payments are not rent and are subject to UBI. General cleanup and the provision of utilities are not considered personal services. However, if the organization provides security, food service

and ushers, then it may be considered as providing personal services.

C. Rents from personal property leased with real property (provided the rents attributable to such personal property are incidental) are excluded.

1. Incidental means that rents from personal property do not exceed 10% of the total rents from all property leased.

2. If personal property accounts for greater than 10%, but less than 50%, of rental income, the organization must allocate that portion to unrelated income.

3. If more than 50% of the rental income is attributable to personal property, total rents are subject to UBI.

4. Example - Exempt organization X leases its facility - land and a building that houses a small computer and video equipment. The lease agreement states that the total rent shall be \$6,000, \$600 for the computer and equipment and \$5,400 for the facility. Due to the fact that rent attributable to personal property was stated at 10% of total, no unrelated business income was accounted for.

Upon examination, the ms determined (irrespective of the lease agreement) that \$2,500 of the rent was attributable to personal property and \$3,500 to realty. Therefore, X organization must consider \$2,500 (42% of total rent) as unrelated business income.

D. Gains and losses from the sale, exchange or other dispositions of property other than that held primarily for sale to customers in the ordinary course of the trade or business are excluded from UBI.

E. Income from the presentation of performances, workshops and exhibitions is excluded from UBI, assuming the function contributes importantly to the stated exempt purpose.

F. Income from the sale of a book or record album will generally constitute UBI. Consider a transfer of the publication rights to a commercial publisher such that the organization receives royalty income that is exempt from UBI.

Exception - Where the book or album contains material that is not commercially available, there is no competition with taxable businesses.

G. Income from the use of an organization's donor or membership list is subject to UBI.

H. Income from the sale of products resulting from the performance of the organization's exempt purpose is excluded from UBI if such products are sold in substantially the same state as if they were completed by the person or persons involved in their creation.

1. Example - The sale of handicrafts made by children who are enrolled in the organization's educational classes. The purpose of offering such items for sale emphasizes

the total educational program. This is similar to a play sponsored by a children's theatrical training organization in which all the performers are students of the program.

2. However, care should be taken in applying this general rule. Distinguish the above facts from the following situation:

An exempt museum was formed by art patrons to promote community understanding of modern art trends by selecting for exhibit, exhibiting and selling artwork of unknown local artists. It retains a 10% commission on all sales, far less than commercial galleries charge. Sales of art were occasional and were considered incidental to furthering the exempt purpose. However, the IRS ruled that the organization was benefiting the private interests of the artists whose works were displayed for sale. It states that the sale of original works of art does not contribute importantly to the accomplishment of a museum's exempt purpose, which is to educate the public in art appreciation. The IRS considers the sale of original art to be unrelated business income, because such activity detracts from the organization's purpose since sold works are removed from public display.

I. Income from advertising in periodicals, brochures, newsletters or programs generally will constitute unrelated business income. If gross income is earned by an exempt organization (other than a 501(c)(7), (9), (17) or (20) organization) from sale of advertising in an exempt organization periodical, then organization should complete Schedule I of Form 990-T.

1. Example - Unrelated business income from advertising (exploitation of exempt purpose).

Assumptions:

- a. The organization publishes a monthly periodical or newsletter, the content of which is related to its exempt purpose.
- b. The periodical contains commercial advertising for which the organization received gross advertising income of \$20,000.
- c. Total periodical costs are \$30,000, of which \$5,000 constitutes direct advertising costs and \$25,000 relates to readership content cost.
- d. The periodical is distributed to all members at no additional charge, and it is neither sold nor distributed to nonmembers.
- e. Membership receipts are \$64,000, comprised of annual membership dues of \$64 paid by each of the organization's 1,000 members.
- f. All other activities of the organization are related to its exempt purpose and produced receipts of \$25,000 with related expenses of \$70,000.

Computation of unrelated business income –

Gross advertising income	\$20,000
Less - Direct advertising costs	5,000
Advertising net income	\$15,000

Allocation of membership receipts to circulation income -  
Circulation income = membership dues X

Periodical costs  
Periodical costs + Other  
exempt activity costs

$$\$19,200 = \frac{\$64,000 \times \$30,000}{\$30,000 + \$70,000}$$

Readership/circulation income -	
Allocable membership receipts	\$ 19,200
Direct charge for periodicals	-----
Less - Readership costs	<u>25,000</u>
Readership net loss	<u>\$ (5,800)</u>
Advertising net income	\$15,000
Less - Readership net loss	(5,800)
Unrelated business income attributable to advertising	\$ 9,200

2. Other comments:

- a. If the organization has net advertising income AND net readership income, then only net advertising income is subject to tax.
- b. If the organization has a net advertising loss, there is no taxable income.
- c. If the organization does not have members or does not charge for membership, eliminate the allocation of membership receipts to circulation income.
- d. Special situations not covered in this example are the following:
  - (1) Where 20% or more of total circulation of the periodical is from nonmembers.
  - (2) Where 20% or more of members' dues are reduced because they do not receive the publication.

3. Advertising is not considered to be business income where the organization can show the following:

- a. It is not regularly carried on.

Computation of unrelated business income –

Gross advertising income	\$20,000
Less - Direct advertising costs	5,000
Advertising net income	\$15,000

Allocation of membership receipts to circulation income –

$$\text{Circulation income} = \text{membership dues} \times \frac{\text{Periodical costs}}{\text{Periodical costs} + \text{Other exempt activity costs}}$$

$$\$19,200 = \frac{\$64,000 \times \$30,000}{\$30,000 + \$70,000}$$

Readership/circulation income –

Allocable membership receipts	\$ 19,200
Direct charge for periodicals	-----
Less - Readership costs	<u>25,000</u>
Readership net loss	<u>\$ (5,800)</u>
Advertising net income	\$15,000
Less - Readership net loss	<u>(5,800)</u>
Unrelated business income attributable to advertising	<u>\$ 9,200</u>

2. Other comments:

a. If the organization has net advertising income AND net readership income, then only net advertising income is subject to tax.

b. If the organization has a net advertising loss, there is no taxable income.

c. If the organization does not have members or does not charge for membership, eliminate the allocation of membership receipts to circulation income.

d. Special situations not covered in this example are the following:

(1) Where 20% or more of total circulation of the periodical is from nonmembers.

(2) Where 20% or more of members' dues are reduced because they do not receive the publication.

3. Advertising is not considered to be business income where the organization can show the following:

a. It is not regularly carried on.

b. It is an integral part of an annual fundraising program (i.e., contained in a book or program distributed at the annual charity ball).

c. It contributes importantly to the organization's exempt purpose (i.e., the sale of advertising by journalism students for the university's campus newspaper if conducted as part of on-the-job training).

J. Income from debt-financed property generally produces UBI.

1. Debt-financed property is any property held to produce income if, at any time during the tax year, there was acquisition indebtedness outstanding on the property.

a. Acquisition indebtedness is the amount of outstanding principal indebtedness incurred by the organization to acquire or improve the property.

b. "Held to produce income" relates to dispositions at a gain as well as recurring types of income such as rent.

2. If substantially all (at least 85%) of the use of the property is related to the exempt purpose, income from the property is not subject to UBI.

3. To the extent that the use of a portion of the property is substantially related to the exempt purpose, the income from that portion is not subject to UBI.

K. The fragmentation rule.

1. With respect to retailing activities of exempt organizations, the sale of certain items may be found to produce UBI while others produce exempt-function income. Recall that the regular sale of items that do not contribute importantly to the organization's exempt purpose may be subject to UBI. Without application of the fragmentation rule, an activity might face an all-or-nothing approach to unrelated business income. Of course, the broader an organization's exempt purpose, the more diverse may be the items that can be sold without producing UBI.

2. The IRS focuses on three types of sales, as follows:

a. "Lavish" or "expensive" items (i.e., jewelry).

b. Otherwise unrelated items that bear a logo (i.e., T-shirts).

c. "Adaptations" as opposed to "reproductions."

3. Opposition to the ms' fragmentation rule.

a. Certain authorities believe that particular unrelated sales should not be isolated and

characterized as unrelated where substantially all (equal to or greater than 85%) of the retail operations are related to the organization's exempt purpose.

b. There is an objection to categorically stating that all sales of clothing or luxury items produce UBI without reference to the relationship of such items to the organization's exempt purpose.

4. Opposition to IRS position on sales of items bearing logos. When an item such as clothing bears an exempt organization's logo, it is arguable that it per se contributes importantly to the exempt function since the logo enhances public awareness, stimulates or sustains interest and encourages greater visitation and patronage. Stated simply, a logo publicizes the organization's educational (or other exempt) purpose.

5. Distinguishing reproduction from adaptation, the IRS' position is as follows:

a. According to the ms training manual, faithful reproductions of art and artifacts are considered related items. Reproductions are "copies of pieces originally created by master period craftsmen and are made today in a manner commensurate with the period." An adaptation, however, may differ significantly in form from the original work (Le., aT-shirt with the Mona Lisa, a desk set imprinted with a Chinese flower scene, etc.). The ms examines adaptations closely for their relatedness to the exempt purpose.

b. Authorities that oppose the ms' narrowly defined position argue that an adaptation that has sufficient intrinsic merit or historical significance should be related regardless of whether it differs significantly in form from the original work. Therefore, adaptations are acceptable if it can be shown that the adaptation satisfies the ms as to relationship to exempt purpose.

#### L. Partnership income.

If the organization owns an interest in a partnership that carries on an unrelated trade or business or that is a publicly traded partnership, it must treat income and deductions whether or not distributed as UBI.

#### M. Income from controlled organizations.

1. Control is defined as follows:

a. For a stock corporation, equal to or greater than 80% of combined voting power of all classes of stock entitled to vote and it least 80% of the total number of shares of all other classes of stock.

b. For a nonstock corporation, at least 80% of the directors or trustees are either representatives of or directly/indirectly controlled by the exempt organization.

2. Interest, annuities, royalties and rents received from a controlled organization may be

UBI whether or not the activity conducted by the controlling exempt organization to earn these amounts is a regularly carried on trade or business.

3. Computation of UBI where the controlled organization is exempt from tax-

Interest, rent, etc., received X

Unrelated taxable income of controlled organization

Greater of the following, before distributions to the controlling exempt organization

- Taxable income of controlled organization, computed as though it were not exempt
- Its unrelated business taxable income

4. Computation of UBI where the controlled organization is not exempt from tax -

Interest, rent, etc., received X

Excess taxable income of controlled organization

Greater of the following, before distributions to the controlling exempt organization

- Taxable income of controlled organization
- Excess taxable income

**V. Final Note.**

THERE ARE FEW ABSOLUTES WHEN YOU CONSIDER THE COMPLEX UNRELATED BUSINESS INCOME RULES. THEREFORE, AN ORGANIZATION IS ADVISED TO CONSULT ITS TAX ADVISOR PRIOR TO ENGAGING IN ANY NEW ACTIVITIES IN ORDER TO ISOLATE EXPOSURE AREAS AND ESTABLISH SUPPORT FOR ITS POSITION THAT INCOME FROM REVENUE PRODUCING BUSINESS VENTURES IS RELATED TO THE ORGANIZATION'S EXEMPT PURPOSE.

## **AUDITOR'S REPORTS**

Although an exempt organization may be adept at keeping financial records current and correct, an outside appraisal or other kind of review of the records is usually advantageous. Independent auditors can perform series of tests of financial data, which will improve the credibility of financial statements and assist an exempt organization in tax and reporting requirements. Additionally, an auditor may provide helpful advice on bookkeeping or other procedures.

## AUDITOR'S REPORTS

### **I. Introduction.**

An independent accountant may provide various financial review services concerning an organization's financial statements, each of which may be adequate for purposes of the nonprofit organization under certain circumstances. Most commonly, the accountant/auditor may either compile the financial data for the period and prepare financial statements, review, on a limited scope, the financial statements issued by the organization or attest to the fairness of the presentation of the financial statements based on an examination in accordance with generally accepted auditing standards. Audits are usually performed only when required by funding sources or where dictated by the size and complexity of the organization.

### **II. Definition of a Compilation.**

A compilation is limited to presenting in the form of financial statements information that is the representation of management. The accountant does not audit or review the statements and therefore does not express an opinion or any other form of assurance on them.

### **III. Definition of a Review.**

A review is a series of inquiries and analytical procedures followed by the accountant in order to achieve a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The scope of a review is substantially less than that of an audit examination. Therefore, the accountant disclaims any opinion regarding the financial statements taken as a whole.

### **IV. Definition of an Audit.**

A. An audit is a series of procedures followed by an experienced professional accountant used to test transactions and internal controls used by the organization in order to form an opinion on the fairness of the presentation of the financial statements for the period. An auditor does not examine every transaction that has been recorded. Instead, she conducts a series of tests, the result of which will give her a basis for evaluating the accuracy of accounting records and the degree of reliance she can place on the organization's internal controls. The end result of an audit is the expression of an opinion.

The auditor may render one of four basic opinions:

*1. Unqualified* - The financial statements are considered to be fairly presented in conformity with GAAP (generally accepted accounting principles).

2. *Qualified* - The auditor takes exception to some specific part of the financial statements as presented or is unable to form an unqualified opinion because of some contingency which might affect the financial statements.

3. *Adverse* - In the auditor's opinion, the financial statements do not present fairly the financial position in conformity with GAAP.

4. *Disclaimer* - Auditor is unable to form an opinion due to limitations of scope, uncertainties in the future or poor bookkeeping by the client.

## B. *Benefits and Costs.*

### 1. *Benefits.*

a. *Credibility of Financial Statements* - The purpose of financial statements is to communicate in a direct manner what has happened during the fiscal period. The presence of an auditor's opinion helps in this communication because an independent expert has performed an examination and determined that the financial statements are presented fairly. If an organization can tell its financial story accurately and completely and it is accepted at face value, the potential contributor is more likely to feel that the organization is well managed.

b. *Meaningful Statements* - A CPA has years of experience in helping organizations prepare financial statements in a format that will be clear and understandable to the reader.

c. *Advice on Internal Control and Other Matters* - A CPA is in a position to advise the board on how to strengthen internal control or simplify bookkeeping procedures.

d. *Assistance in Tax Reporting and Compliance Requirements* - A CPA can help submit reports to regulatory agencies and/or the IRS.

### 2. *Costs.*

a. *Hourly Rate* - These rates vary based on the individual assigned to an audit and his/her experience. Most audits involve a team of individuals with various levels of experience. A CPA (or firm) should not be selected solely on the basis of its rates. The selection should be based on reputation and willingness to serve the organization. However, exempt organizations should make a concentrated effort to obtain a CPA willing to perform its work at prices beneficial to the organization on a pro forma basis.

b. *Time* - It is possible that extra time will be required of the treasurer or bookkeeper to prepare for and assist the CPA in the audit. Hopefully, this will not affect his/her regular duties too much. Some inefficiency, however, should be expected and planned for.

### *C. Audit Approach.*

(\*GENERAL NOTE: It is important to point out that the audit approach on any particular engagement is, of course, dependent on the nature of the organization and its level of internal control (an organization's system of procedures designed to provide reasonable assurance that errors or irregularities will be timely discovered). Outlined below are general procedures that may be used in an audit.)

1. The first procedure is usually the evaluation of internal control. When evaluating internal control, the auditor may consider the following:

- a. If the exempt organization has a limited number of staff personnel, appropriate segregation of duties (authorization, execution, recording of transactions) may not be present. Segregation of duties reduces the possibility that errors or irregularities exist.
- b. The manner in which responsibilities and authority are delegated among volunteers and employees may be analyzed to assure proper control over financial transactions.
- c. If the exempt organization has an approved budget, this may serve as authorization for activities carried out by management in attaining program objectives.
- d. The auditor also obtains knowledge and understanding of the flow of transactions through the accounting system.

2. Another procedure the auditor may follow is analyzing the assets of the organization to assure all assets are owned and are properly valued. A few of the assets analyzed may be: cash, receivables, inventory, marketable securities (CD's, etc.), prepaid expenses, fixed assets and art or other unique assets.

3. Liabilities, deferred revenues and support and fund balances may be evaluated by the auditor for proper amounts and classification. These include: accounts payable, accruals, long-term debt, deferrals (membership dues, taxes, grants, etc.) and fund balances (equity).

Unique items may be examined including tax-deferred annuities for employees, interfund borrowings and refunds due to third parties for amounts collected under reimbursement agreements.

4. Revenues are often checked to make sure that amounts are properly and timely recorded. Examples include: service fees or sales of publications, subscriptions, advertising space, souvenirs or reproductions.

5. The classification, timing and amounts of expenses is important when filing many governmental reports. The auditor therefore usually verifies most of the major expenses such as: program services and management, supporting services and capital additions.

6. Some other matters considered by many auditors include: affiliations with other organizations, related-party transactions and anticipated events and/or changes.

## **REPORTING FOR GRANTS**

The purpose of this section is to assist qualified organizations in obtaining grants from various governmental or private organizations. Standard forms must be completed with specific information. This information includes actual budgeted figures. Therefore, good internal accounting records are necessary along with well-planned budgets for future period information. Also required is a precise statement concerning the functions, objectives, needs, etc., of the organization.

## REPORTING FOR GRANTS

### I. Introduction.

A. The past few years have seen large cuts in governmental budgets for the arts. At the same time, the demand for these funds has been increasing steadily. These cuts have affected the direction of governmental and private organizations' funds because these granting organizations are becoming more selective as to which exempt organizations will receive these funds.

B. Timely, accurate records are required of exempt organizations applying for funds. Granting organizations are requiring both historical and forecasted data as well as other supplemental data. Organizations that maintain such records will have a better chance of receiving more of the dwindling available funds.

### II. Historical Data.

A. Income statements, balance sheets and other financial statements are the main source of financial data required by granting organizations. The information that such organizations are concerned with includes past operating revenues, operating expenditures and support from other organizations.

Other historical financial information which exempt organizations must be prepared to provide include breakdowns of expenditures for salaries, professional fees, rent, travel and entertainment, promotional expenses, and most other expenses.

B. Nonfinancial historical information that may be required includes descriptions of past activities, bylaws, long-range objectives adopted and the minutes of meetings of the Board of Directors.

This financial and nonfinancial information is used to assess an exempt organization's past financial position and progress toward its goals.

### III. Current Data.

A. The same financial data required for historical reporting is required for current data. However, this information may be required in greater detail. Whereas, for example, historical operating revenues may be given in total, current operating revenues may need to be broken down into membership fees, contributions and program service revenue.

B. Other information required is similar to that of historical information, but again may be required to be more detailed. Most applications for grants require descriptions of what funds will be used for, the objectives of current projects and the means the exempt organization plans to use to carry out these objectives.

### IV. Forecasted Data.

A. Again, the same financial data required in II and III. probably will be required. Many times, however, an exempt organization will be required to furnish several years of forecasted information. Sound, reasonable estimates should be generated since the exempt organization may later be asked to substantiate its projections. (See the section on computers.)

B. Other projections will probably incorporate goal and objectives adopted in current and historical periods.

## **V. Summary.**

Since competition for available funds is increasing, accurate and current financial and nonfinancial records must be maintained. Organizations taking the time to make such information available will have better chances of obtaining grant funds.

## **INVESTING EXCESS CASH**

Not-for-profit organizations should utilize existing assets to the best extent possible. Excess cash is one asset that should be invested in order to maximize its benefit to an organization.

The following section discusses the reasoning behind investing, factors affecting investments and several investment alternatives.

## INVESTING EXCESS CASH

### I. Introduction.

A. Excess cash is cash that is not needed for day-to-day operations and which may flow either from operating cash or from unrestricted or endowment funds. Investing excess cash generates additional revenue outside of ordinary operating revenues.

B. The reason for investing is to make the best use of available excess cash. Funds not expected to be used to cover current expenses can be used to generate more funds. If left in a checking account, such funds may not be "at work" for the organization. This cash can be invested with minimum risk.

C. Before continuing the discussion on investments, a few terms need to be defined:

1. *Venture* - An investment undertaking.

2. *Term of Investment* - The period during which funds are invested in a particular venture.

3. *Risk* - The probability that the funds invested will either be lost or reduced. Nonprofit corporations have a duty to refrain from investments that involve a high degree of risk.

4. *Return (Yield)* - The dollar or percentage amount of funds earned by an investment.

### II. Factors Affecting Investment Alternatives

A. There are several factors that affect the investment of cash: The amount of excess cash available, the term of the investment, the risk factor of the venture and the desired percentage return on the investment combine to form the main ingredients.

B. The primary goal of investing excess cash is to maximize the return on the investment within acceptable risks and term periods. As risk a rid/or term increases, so does return. Conversely, as risk and/or term decreases, so does return. If risk and term diverge, the effect on return is uncertain. The table below should help illustrate these concepts.

RISK	Increase	Decrease	Increase	Decrease
PLUS: TERM	Increase	Decrease	Decrease	Increase
EQUALS: RETURN	Increase	Decrease	?	?

### III. Types of Investments.

Once acceptable return, risk and term parameters have been established, a variety of investment alternatives are available to satisfy these parameters.

A. Excess cash may be kept in a checking account. Amounts deposited in such an account may be withdrawn at any time upon demand. Checking accounts can be opened at any commercial or full-service bank or savings and loan association in amounts as small as \$100. There is very little risk involved in opening a checking account since the Federal Deposit Insurance Corporation (FDIC) or Federal Savings and Loan Insurance Corporation (FSLIC) insures amounts deposited up to \$100,000. Since regular checking accounts do not pay interest, there is no return on this type of investment.

B. A Money Market Account is an investment account that has a low rate of return. It is FDIC insured up to \$100,000 and has a limited number of withdrawals per month

C. Another option is a Certificate of Deposit. This is an investment account with a higher rate of return, FDIC insured up to \$100,000, and has a penalty for early withdrawal. The CD's are classified as regular, which is less than \$100,000 and jumbo, which is greater than \$100,000.

D. If excess cash will not be needed immediately such cash may be invested in a Certificate of Deposit (CD). CDs are classified in two categories. The first category is money market certificates. Money market certificates are offered by most banks and issued in amounts of \$100 to several thousand dollars for one to six months. The yield offered changes from week to week, but once the investment has been made the rate of return in effect at the time of purchase becomes fixed for the term. These certificates are insured up to \$100,000, thus, minimizing risk while providing a higher return.

The second category of CDs is the large certificate of deposit where a minimum investment of \$100,000 is required before this certificate will be issued. There is some risk involved in this investment because the maximum insurance available is only \$100,000. The yield on large certificates is negotiable. It is usually dependent upon the institution's ability to reinvest your money and earn an acceptable return. Terms of large certificates of deposit vary from 14 days to one year, and sometimes longer.

F. United States Treasury Bills are U.S. obligations that pay the amount shown on their "face" (also called "par") at the end of the bill's term. When issued, these bills are "discounted." This means that the bill is issued at a price less than the face amount. The difference between the face amount and the issue price reflects the inherent interest rate to be earned on the investment. When the bills mature, they are paid off at 100% of the face amount. The bill may (and often is) be acquired from a broker in or in the open market. At this point, the bill may be further discounted or sold at a "premium" (a price higher than the broker paid for the bill yet lower than the face amount). Bills are sold at discounts or premiums in order to provide the investor with an effective rate of return on his investment,

which will equal the current market rate on similar investments.

G. U.S. Treasury Notes, U.S. Treasury Bonds, Government and Private bonds are obligations issued with maturities of 1 to 30 years. They each have face values of usually \$1,000 and pay interest at the rate specified on the bond or note. These obligations may also be sold at a discount or premium depending on the nominal rate paid on the obligation in relation to the market rate of interest at the time of sale. At maturity, the face amount is paid to the holder of the bond or note.

#### **IV. Summary.**

A. Excess cash of an exempt organization can be invested in order to make best use of this cash.

B. Risk, term and return are factors that should be considered when making investment alternatives. However, nonprofit corporations should avoid investments with a high degree of risk.

C. A wide variety of investment alternatives exist. Each alternative has different risk, term and return implications.

#### **IV. Sample Applications.** (See Case example and illustrations in back of booklet.)

A. Mailing List.

B. Five-Year Financial Forecast.

#### **CASE EXAMPLE**

The Comic Book Museum was founded in 1974. During its early years, the Museum struggled for sufficient funds to continue its activities. Initially, these funds came solely from contributions from the general public plus a nominal fee it charged for admission.

In the late '70's, the Museum began receiving recognition in many popular magazines and even from a couple of national television talk show interviews and documentaries. Since that time, several private foundations and affluent individuals have consistently contributed large amounts of money and/or comic books from their personal collections. These and future contributions, as well as funds raised from a membership club which is to be formed in 1985, are expected to be sufficient for the Museum to purchase a larger facility for its expanding collection.

C. Michael (Mick) Book, the Museum's Director, is concerned about having enough money to cover the financing of the new facility as well as the costs of operating the Museum. He believes that a five-year forecast is necessary to approximate what revenues and expenses will be in order to see whether purchasing the new facility is feasible. Recently, Mick purchased a computer for use in the Museum. Mick believed that more work could be performed and more information

stored after having read a recent article published by TALA. He then consulted a local software company as to which software programs best fit the Museum's needs. The software company recommended an Electronic Spreadsheet Program for mailing lists and other general uses (including the aforementioned forecast). Mick asked Ino (Mike) Rose, the Museum's bookkeeper, to prepare a mailing list and the five-year forecast using the computer. Later that week, Mike reported back to Mick with these reports (see examples on the next two pages).

**THE COMIC BOOK MUSEUM**  
**Mailing List**  
**as of June 30, 19X4**

NO.	NAME	STREET ADDRESS	CITY AND STATE	ZIP
1	Costello, Abbott N.	2303 Houzon #1	Tulsa, OK	67606
2	Lone "R" Range	5701 Key Mosob, Suite B	Ruidoso, NM	44356
3	Love D. Funnies Foundation	133 Hill Larius	Chicago, IL	82707
4	Mann, Spide R.	1618 Webb	Houston, TX	77806
5	Manosteel Corporation	1800 Lois Lane	New York, NY	90079
6	Reed, I. Offen	1400 Vizeene	Phoenix, AR	73021
7	Rich, Richard	100 Grand	San Francisco, CA	34484
8	The Archies Foundation	1823 Veronica	Riverdale, NY	90035
9	Tomm and Gerald, CPA's	1247 Chase	Grand Rapids, MI	57631
10				
11	(Etc.)			
12				
13				

**NOTE:** The data base program used to create this mailing list will sort the list alphabetically, by city or by any criteria you choose.

**ASSUMPTIONS (Provided by Mick):**

1) Percentage increase in gifts and grants per year	15%
2) Percentage increase in value of comic book gifts per year	5%
3) Percentage increase in number of memberships per year	15%
4) Cost per membership	\$50
5) Number of members expected in 19X5	300
6) Percentage increase in admission fees per year	10%
7) Interest rate earned on prior year cash excess (if any)	7.5%
8) Expected proceeds from sale of old building and land	\$72,100
9) Interest rate on loans to cover cash shortages	12%
10) Percentage increase in public information costs	10%
11) Percentage increase in management and general expenses per year	10%
12) Percentage of membership publication costs to membership dues	25%
13) Percentage increase in other expenses per year	5%
14) First year revenues are estimated based on 6/30/X4 actual information when applicable	
15) Mortgage amount on new land and building	\$670,000
16) Mortgage is 30 years at 10% interest	

**NOTE: Merely by changing any of the above variables, you can obtain a new forecast within a few seconds! The spreadsheet program will automatically recalculate the entire forecast!**

**THE COMIC BOON MUSEUM**  
Cash Flow Analysis  
For Years 19X5 — 19X9

DESCRIPTION	19X5	19X6	19X7	19X8	19X9	TOTAL
<b>CASH SOURCES FOR OPERATIONS:</b>						
Excess cash from prior year	\$ —	\$ 29,790	\$ 5,326	\$ —	\$ 8,540	\$ 43,656
Gifts and grants (current portion)	225,000	258,750	297,563	342,197	393,527	1,517,037
LESS: Comic Book contributions	30,000	31,500	33,075	34,729	36,465	165,769
Net liquid gifts and grants	195,000	227,040	269,814	307,468	365,602	1,394,924
Membership dues	15,000	17,250	19,838	22,814	26,236	101,138
Admission fees	8,000	8,800	9,680	10,648	11,713	48,841
Interest income	500	2,234	399	—	641	3,774
Funds from short term loans	—	—	7,126	—	—	7,126
Sale of old building and land	72,100	—	—	—	—	72,100
<b>NET CASH AVAILABLE FOR OPERATIONS</b>	<b>290,600</b>	<b>285,325</b>	<b>306,857</b>	<b>340,930</b>	<b>404,192</b>	<b>1,627,903</b>
<b>CASH USES FOR OPERATIONS:</b>						
Public information	21,000	23,100	25,410	27,951	30,746	128,207
Management and general (Total)	165,000	181,500	199,650	219,615	241,577	1,007,342
Membership publications	3,750	4,313	4,960	5,704	6,559	25,286
Payments on mortgage per year	70,560	70,560	70,560	70,560	70,560	352,800
Interest on short term loans	—	—	—	855	—	855
Repayments of short term loans	—	—	5,726	7,126	—	12,852
Other miscellaneous expenses	500	525	551	579	608	2,763
<b>TOTAL EXPENSES</b>	<b>260,810</b>	<b>279,998</b>	<b>306,857</b>	<b>332,390</b>	<b>350,050</b>	<b>1,530,105</b>
<b>NET CASH FLOW FROM OPERATIONS</b>	<b>\$ 29,790</b>	<b>\$ 5,326</b>	<b>\$ —</b>	<b>\$ 8,540</b>	<b>\$ 54,142</b>	<b>\$ 97,798</b>

## ACKNOWLEDGEMENTS AND SPECIAL THANKS

Texas Accountants and Lawyers for the Arts extends its deep appreciation to Kathy Ploch of Zientek & Co., P. C. and Michael Aubuchon of Frost Bank in Houston for the preparation of the third edition of this handbook. This edition was made possible by a grant from the Texas Commission on the Arts.

Texas Accountants and Lawyers for the Arts also thanks Ernst & Young for their generosity in printing this publication and for their continued support of TALA and the arts in Texas. The original edition of *Financial Management of Nonprofit Arts Organizations* was prepared by Charles A. Schneider and Steven V. Stendebach of Arthur Andersen & Co. in San Antonio and was printed by Arthur Andersen & Co. in Houston. Attorney David E. Tripp of Spectradyne in Dallas contributed the artwork for the booklet. The original edition also was made possible by a grant from the Texas Commission on the Arts.