MARKS PANETH

ACCOUNTANTS & ADVISORS

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CAUSED-RELATED MARKETING: SET A PLACE AT THE TABLE FOR THE LEGAL AND ACCOUNTING TEAMS, AND DO IT EARLY ON

Cause-related marketing has matured and become all but a must for many companies. The novel approach pioneered by organizations like Marriott and Famous Amos Cookies in the 1970s – the former teamed up with and supported the March of Dimes, and the latter Literacy Volunteers of America – now powers identity and marketing initiatives in industry after industry.

Think about TOMS' effort to help one person in need with every pair of shoes sold, and eyeglass maker Warby Parker's commitment to get eye care and glasses to deserving people in developing countries. Both initiatives involve multiple partnerships with service organizations.

While cause-related marketing programs have become highly sophisticated in terms of marketing, business and public-benefit effectiveness, it's worth pondering whether they are structured with tax implications in mind. From a tax and legal standpoint, are the company and its charitable and social impact partners well served?

That is where legal and accounting departments come in. Stated another way, they should probably take a seat at the marketing and planning table sooner than they usually do.

Too often, the keeper of the brand – the marketing department – forges ahead with a strategic partnership and doesn't consult legal or accounting until later on in the process. That practice and timing can increase the likelihood that potential tax benefits aren't realized and that some potentially unnecessary tax liabilities are incurred – for both the company and the charitable or social impact partner.

Indeed, there are a number of factors that make it advantageous for legal and accounting departments to insert themselves into cause-related marketing planning at an early stage. A key one is Unrelated Business Taxable Income (UBTI).

Take the licensing of a charity's logo. A section of the tax code – 512(b)(2) – allows charitable organizations to license their logo in a royalty arrangement. If structured correctly, the royalty is treated as "passive income" by the charity and would not be taxable. But, if the charity is directly involved in the promotion and marketing of the cause-related marketing venture, then the organization might not be eligible for the favorable royalty treatment offered by the code.

Product promotions combined with a donation element are another common cause-related marketing tactic. For example, if a hearing aid company advertises that $500 from each sale will be given to a charity that serves populations with hearing impairments, there are several ways to structure the arrangement – some more beneficial from a tax perspective than others. If the hearing aid costs $6,000 and the hearing aid company gives $500 to the charity each time it sells one, then the company is making the contribution, not the customer. In this case, the company is entitled to count the $500 as a charitable contribution. The customer is not entitled to a tax benefit; he or she simply bought a $6,000 hearing aid.

On the other hand, if the hearing aid was $5,500 and the customer was told that if he or she paid $6,000, then $500 would be passed on to a charity, the charity would record the amount as a contribution from the customer, and he or she would be able to take the $500 contribution for tax purposes if properly receipted. In this case, the company would not receive a direct tax benefit.

There are a range of other situations in which charitable organizations and companies embarking on cause-related marketing partnerships need to be sensitive to UBIT. They often revolve around the level of involvement and type of marketing effort. Making the optimal call on how to proceed is probably outside the realm of the marketing department; the timing and degree of involvement of legal and accounting teams are key and should be established prior to starting the campaign.

Other variables that make it useful for legal and accounting to be in the picture early include whether the products that are part of the cause-related marketing effort are sold directly or through a procurement house; issues with various states when it comes to collecting sales tax; and other filings with states related to the charity's pursuit of a line of business separate from the tax exempt one.

The bottom line is that cause-related marketing should be approached as a collaborative effort among legal teams, accounting teams, marketing teams and even the general management of the charity and the company. The time spent up front to fine tune arrangements can make all the difference when it comes to the financial success of the effort.

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HOW COULD FRAUD HAVE BEEN PREVENTED?

Joe Doe, a beloved associate program director, worked at a nonprofit social service agency for 15 years. When the executive director retired and he was passed over, Joe stayed on with the organization. During the transition between executive directors (EDs), he took on interim ED duties. His responsibilities included signing privileges for the agency's accounts.

When a new ED was hired, she couldn't figure out why the not-for-profit didn't have a positive bottom line. The organization's revenue streams included rent from tenants in its building and it had been financially healthy in previous years. While Joe was initially helpful in responding to her inquiries, as time went on he became evasive in his answers, stopped attending staff meetings, and took on an extremely low profile.

One day, the new director came across some paperwork that included bank wire transfer instructions for a small checking account and a line-of-credit statement from an area bank. An investigation into these documents revealed that, while acting as interim director, Joe had deposited advance rental payments into the checking account and made withdrawals on a regular basis. During that time, he also opened the line of credit, deposited the proceeds in the checking account and withdrew those amounts as well.

After a two-week investigation, the nonprofit determined that Joe had embezzled approximately $1 million. By that time, Joe had fled the country unnoticed.

Implementing controls

This scenario, which caused severe reputational and financial damage to the nonprofit, could likely have been prevented if the following policies and practices had been in place:

- All bank statements should be delivered unopened to a member of management or the board who has no signing authority.
- The finance committee — with members knowledgeable in finance and accounting — should review monthly bank reconciliations and financial statements and question any transactions that are new or unusual. New bank accounts, both depository and loan accounts, should be approved by the board prior to opening.
- Additionally, employees should be trained to be alert to changes in employee behaviors and possible motivations for fraud. In this case, the fraudster felt entitled to become the next executive director. His fraudulent acts — at first involving small sums — began shortly after he realized he wouldn't be appointed to the position.

Getting expert advice

Do you ever wonder if your operation may be too lax in terms of presenting opportunities for inside fraud? If so, ask your CPA to review your controls and offer suggestions for improvement.

NEWS FOR NONPROFITS

Most Nonprofits Rely on Multiple Income Sources

More than one-third of U.S. charities (39%) receive over half of their income from contributions or grants from individuals, foundations or corporations. So concludes information revealed during a National Index of Nonprofit Board Practices survey, which also found that 72% of charities now have earned income streams. And 21% of charities depend on earned income for more than 50% of their revenue. The survey also found that 65% of charities receive government funding. And 22% of charities rely on government funding for more than half of their revenue. How diverse are your income sources? If one of them dried up, would your organization remain financially stable?

IT ALL ADDS UP

Director Profile: Robert Lyons, CPA, MST

Rob Lyons, CPA, MST, is a tax director specializing in exempt organizations with the firm's Nonprofit and Government Group. To his role, Rob brings more than 30 years of experience providing tax and consulting services to organizations in the nonprofit, higher education and public sector industries. He is based in Marks Paneth's midtown Manhattan headquarters.

A highly regarded thought leader in his field, Rob frequently leads training seminars for the American Institute of Certified Public Accountants (AICPA) and is often published concerning issues related to exempt organizations.

A noted triathlete, Rob has participated in countless races involving running, swimming and cycling in and around New York City over the years.

FASB ROUNDTABLE ON PROPOSED NONPROFIT ACCOUNTING STANDARDS

You are most likely aware that the Financial Accounting Standards Board (FASB) issued a Proposed Accounting Standard update (exposure draft) suggesting major revisions to the way nonprofit financials will look in the future. The proposed changes are considered to be the most sweeping since 1993. The public comment period ended on August 20, during which time Marks Paneth and approximately 260 other entities (accounting firms, state societies of CPA's, individuals, universities and other nonprofits) issued comment letters relative to the exposure draft.

In response to this feedback, the FASB established a series of roundtable meetings on both the East and West coasts to enhance their understanding of the views expressed in the comment letters and to hear possible alternatives suggested by participants.

Marks Paneth was invited to attend one of two roundtable meetings held on September 21 at the FASB's offices in Norwalk, Connecticut, to discuss our views with the FASB Board and their technical managers. On behalf of Marks Paneth, I participated together with my colleague, John D'Amico, Director of our firm's Professional Standards Group.

Other roundtable participants included representatives from EY, The Museum of Modern Art, the National Association of College and University Business Officers (NACUBO), the New York State Society of CPAs, the Pennsylvania Institute of CPAs, the American Diabetes Association, Grant Thornton, KPMG, the Massachusetts Society of CPAs, the North Carolina Association of CPAs, New York University, PwC, the Nonprofit Finance Fund and the University of Pennsylvania.

The discussion focused on the following topics:

Intermediate Measure of Operations

The FASB is proposing two intermediate measures of operations on the statement of activities, namely by mission and by availability. There were lengthy conversations on this topic and general acceptance of having a required intermediate measure of operations. Participants stated that this might increase financial statement complexity, and not all not-for-profits (NFP) can measure their operations in the consistent manner that appears to be the suggestion of the FASB.

Marks Paneth does not fully agree with requiring a standardized measure of operations for all nonprofits. Defining "operations" in such a manner is not practical with so many different types of NFP organizations. We suggested creating a number of sub-industry groups within the NFP sector to which some standardization by sub-group might be achievable.

Presentation of Cash Flows

Generally, there was agreement that the direct method (showing sources and uses of cash in the operating section) is more useful than the indirect method (showing non-cash items like depreciation and changes in balance sheet accounts year-over-year) within the operating section. The indirect method is widely used at present. If the direct method were to be required, the feedback was mixed on allowing the reconciliation of operations to be an addendum to the indirect method. The FASB representatives also advised that they will not pursue alignment of the meaning of operating activities on the statement of cash flows with the proposed operating classification for the statement of activities.

Marks Paneth agrees that the direct method is more understandable and useful. We also believe that the FASB should allow nonprofits to present the reconciliation of operations to the indirect method.

Information Useful for Assessing Liquidity

There was general consensus on having more information on liquidity. There were mixed views on requiring a footnote that has qualitative information about liquidity as it might be too subjective. There were also discussions that a "classified" balance sheet for nonprofits might be a partial solution to the perceived lack of communication about liquidity. A classified balance sheet arrays assets convertible to cash, in the 12 months after the year-end, as current assets with all other assets relegated to long-term. Similarly, the liabilities that would come due in the same 12 months would be shown as current and all others as long-term. This at least provides the financial user with a measure of working capital.

Marks Paneth believes that improving the ability to assess liquidity is an important concept that should be easily communicated and understood in financial statements. We agree that a note to the financial statements would be helpful, and that a classified balance sheet can improve how a nonprofit can show its liquidity position. We also believe information in the notes should be relevant and reliable. Accordingly, we do not agree with the FASB's suggestion that such a disclosure might speak to cash flow needs of the NFP in increments of 30, 60 and 90 days after year-end. This is obvious because often the financials are not issued with the audit report until at least 90 days after year-end. Our view is that a modified classified balance sheet showing assets convertible to cash over the six months after year-end should be classified as current in the notes and all else be considered non-current. For liabilities payable during the same six months, they, too, would be shown as current in the notes.

Expenses by Function

There was overall support for all nonprofits to report their expenses by both function (program[s] and supporting services) together with the natural classification of expenses such as personnel costs, occupancy, etc. Such a "matrix" could be reflected either on the face of the financials or in a separate disclosure in the notes.

Marks Paneth agrees that all nonprofits (not just <u>most</u> voluntary health and welfare organizations) should report their expenses by both function and natural classification.

Investment Return

There was overall support for reporting investment return, net of investment expenses including internal direct costs, if applicable, such as personnel and measurable external costs such as broker fees.

Marks Paneth agrees that investment expense should be shown in this manner.

Changes in Classes of Net Assets

There was general consensus around combining the temporarily and permanently restricted net asset classes into one category called "net assets with donor restrictions", thus leaving only two net asset classes titled, "those without donor restrictions" and "those with donor restrictions".

Marks Paneth agrees with combining these two net asset classes into one donor restricted category. This will help avoid confusion over the existing permanently restricted net asset class, especially as it relates to each state's legal interpretation of the corpus of those funds under their enacted rules of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). We also agree that requiring an enhanced financial statement note, describing what resources can be made available over time or by meeting the donor's intent, would be appropriate. This note would display the temporary nature of those restrictions and further describe those net assets that have a more permanent aspect to them. At the meeting, we also suggested that consideration should be given to requiring a further breakdown of the net asset class without donor restriction to include the net investment in property and equipment and other non-liquid items.

If you would like to hear the audio recordings of each of the three-hour Norwalk roundtable sessions, please click here. Once you are at the link, you can click on the "9/21/15 P.M. Session" to hear Marks Paneth's comments. To read our comment letter, click here.

In conclusion, we recognize the changes proposed by the FASB have potentially far reaching implications for your organization. We expect the draft standard will undergo revisions as a result of the comments and roundtable input that the FASB received from Marks Paneth and the other roundtable participants. One more roundtable is being held in Los Angles in October. As changes and further clarity emerge from the FASB, we will keep you informed. In the meantime, if you have any questions, please feel free to reach out to us.

LEVERAGE OUR EXPERTISE

Marks Paneth LLP is the 35th largest accounting firm in the US and 9th largest in the mid-Atlantic region. We have a long history of serving the not-for-profit community. Today, we work with more than 150 tax-exempt clients and proudly serve 25% of New York's 25 largest charitable organizations, as ranked by Crain's New York Business. Our firm is ranked in the top 1% nationally in pension plan audits and is the 8th largest preparer of Form 990 PFs in the US. Our Nonprofit and Government Group consists of approximately 45 people in New York and Washington DC, including our five Partners and three Directors listed below. If you have questions, please contact one of us. More information can also be found at markspaneth.com.

Nonprofit and Government Leadership Team

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