

NONPROFIT STANDARD



THE EVER CHANGING REGULATORY ENVIRONMENT OF THE FEDERAL GOVERNMENT

The regulatory environment for those who receive federal funds is constantly changing these days. Some might say that the changes are related to current political and regulatory agendas being pursued. However, if you really take a look at the changes, a significant number of them have been in the name of accountability and transparency, which is a good thing. We seem to have forgotten about the days prior to the Single Audit Act of 1984 when each federal agency had the authority to require an audit of each federally funded program or activity; there was no coordination among the federal agencies or sometimes even departments of the same agency, causing audit overlaps and organizational inefficiencies. For example, a nonprofit organization receiving funds from three different federal agencies could have been subjected to three different audits, performed by three different auditors consecutively or worse yet you could have had all three auditors simultaneously.

At least, from this perspective, we can say we are better off today. This article discusses some of the current projects and agendas of the Office of Management and Budget and the U.S. Government Accountability Office.

THE OFFICE OF MANAGEMENT AND BUDGET

The Office of Management and Budget (OMB) has introduced two initiatives that they hope will help reduce fraud and improper payments made to nonprofit organizations, for-profit entities and individuals. The purpose of these initiatives is to cut government waste and create a more transparent government that is responsive to the American public, according to OMB Director Peter R. Orszag.

In June, President Barack Obama issued an executive memorandum for the first initiative

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directing the creation of a Do Not Pay List, which would be a single source to help all federal agencies check the status of a potential receiver of federal funds in order to prevent improper payments. Oftentimes, a federal agency does not check all the databases that the government has or finds it hard to do so. This prevents agencies from verifying information that they need to use in determining if the payment is allowed under federal regulations, for example, whether an individual is alive or dead, or if a contractor had been suspended or debarred.

The Do Not Pay List will allow federal agencies to access this information in a more timely and cost effective manner and will help reduce improper payments made by the government and help save taxpayer dollars. Every year the federal government pays out tens of millions of dollars in benefits to nonprofit organizations, for-profit entities and individuals that have been suspended or disbarred, who are dead, fugitive felons or those in jail and who are not eligible for benefits or payments.

The second initiative deals with technology that was developed by the Recovery Accountability and Transparency Board (RATB) to ensure that American Recovery and Reinvestment Act (ARRA) funds were spent and not wasted through fraud, error or abuse. This technology consists of fraud-mapping tools that leverage the latest technologies in data capture and analytics to identify potential fraud and error. These tools collect significant quantities of real-time information that then gets analyzed to identify indicators of possible fraud or error.

In a recent Bloomberg News article regarding the RATB's Recovery Operations Center, the article stated that the "RATB's aim is to catch fraud before it happens." The RATB's Operations Center uses digitized maps to analyze data that show what areas of the country are receiving federal spending. The tools look like Doppler radar systems for detecting fraud, waste and abuse. One map aggregates contract spending and crime levels, while the other maps focus on foreclosure rates and reported fraud. The data helps guide the RATB's team of analysts to which projects might deserve additional scrutiny and consideration. I had the distinct pleasure of co-presenting with Glen Walker, Executive Director of the RATB, at the Maryland Association of CPAs 2010

Government and Not-for-Profit Conference this past May and started wondering after his presentation when such a broad-reaching fraud-detection system would start finding its way into other government agencies and why it took a terrible recession and the American Recovery and Reinvestment Act to develop it to begin with. It looks like that time may have finally come.

At this year's National Grants Management Association's Annual Training Conference, Ken Dieffenbach, Senior Special Agent with the U.S. Department of Justice, Office of the Inspector General, Fraud Detection, presented a session on Preventing Fraud in Grant Funded Programs. During his presentation Special Agent Dieffenbach discussed that the federal government will likely consider adding language to Office of Management and Budget circulars covering grants and cooperative agreements that will require grantees to inform inspector generals about potential fraud. This language is already contained in the American Recovery and Reinvestment Act that currently affects all programs receiving funds under the stimulus program.

This is important to the federal government at so many levels. Prior to ARRA, if a nonprofit organization became aware that an employee had committed fraud or was stealing funds from the nonprofit organization or lying on their timesheets, it did not have to step forward and report the instance to the federal government. There are a couple of exceptions to this statement where specific federal agencies such as the Department of Labor have written the requirement to report fraud into the code of federal regulations for their agency. Language may be added to the various OMB circulars that will require all fraudulent acts committed with federal money to be reported. ARRA currently requires that all grantees and sub grantees promptly refer to the appropriate inspector general "any credible evidence that a principal, employee, agent, contractor, sub grantee, subcontractor or other person has submitted a false claim under the False Claims Act or has committed a criminal or civil violation of laws pertaining to fraud, conflict of interest, bribery, gratuity or similar misconduct involving those funds." As part of his comments Special Agent Dieffenbach stated that "by expanding this requirement to all grants it may spur more grantees to look at their internal controls and other processes on a regular basis to avoid potential areas of fraud."



U.S. GOVERNMENT ACCOUNTABILITY OFFICE

At the Association of Government Accountants 59th Professional Development Conference and Exposition in Orlando, Florida in July, Gene L. Dodaro, Acting Comptroller General of the U.S. Government Accountability Office (GAO) was a featured speaker and spoke on Anticipating and Meeting Accountability Challenges in a Dynamic Environment. Mr. Dodaro stated that the GAO has several Single Audit Recommendations that it is currently making in order to leverage the Single Audit as an effective oversight tool for monitoring the federal funds that are disbursed to grantees and sub grantees such as the following:

- Move to earlier reporting on internal controls;
- Focus on ARRA programs;
- Give relief for low-risk programs;
- Fund timelier, effective Single Audits; and
- Provide timelier Single Audit guidance and federal agency decisions on corrective action plans.

We have noted that the GAO has recommended for congressional consideration that the Single Audit Act be amended or that Congress enact new legislation to address many of the items noted above. How these recommendations will play out with Congress, Office of Management and Budget and other federal agencies at this

time we cannot predict but we will keep you informed.

In addition, as stated in the June 2010 issue of the Nonprofit Standard, the GAO has released an exposure draft of the revisions to the Government Auditing Standards (Yellow Book). The proposed revised Yellow Book would include a principle-based approach to the independence standards and clarify continuing education requirements for those involved in Yellow Book engagements to ensure that those participating in such engagements be qualified and maintain professional competence. The GAO has also proposed expansion of its quality control and assurance requirements in the Yellow Book. The GAO has released the following timeline for the revision as follows:

- Exposure Draft of 2011 Revision of GAGAS: August 2010
- Comments due on the exposure draft: October and November 2010
- Issue 2011 Revision of GAGAS: February – March 2011
- The effective date is still to be determined.

You may access the exposure draft at <http://www.gao.gov/new.items/d10853g.pdf>.

We will keep you informed on the progress of the revised Yellow Book as it moves forward through the exposure process. ■

SHOULD YOUR ORGANIZATION MAKE THE 501(h) LOBBYING ELECTION?

If you are an executive of an Internal Revenue Code (IRC) 501(c)(3) public charity that engages in any legislative activity, you should consider whether the organization should make the IRC section 501(h) election. If an IRC 501(c)(3) public charity engages in “substantial” lobbying activities its exempt status could be revoked.¹ As to what is “substantial,” there is no clear definition. The 501(h) election allows a 501(c)(3) public charity to use a bright line expenditure safe harbor instead of the facts and circumstances test in determining whether an organization is engaged in substantial lobbying.

In the absence of making the 501(h) election, the test for permissible levels of lobbying is a facts and circumstances test and includes factors such as volunteer labor and does not even have a clear definition of lobbying. For example, if an organization has two out of two hundred employees that are lobbying on its behalf, lobbying might not sound like a substantial activity. However, if each year the organization spends substantial time organizing thousands of volunteer members to conduct Congressional visits lobbying for the organization’s causes, the facts and circumstances may point toward substantial lobbying activities. Likewise, a small new organization with no employees could be considered to be engaged in substantial lobbying activities when the board of directors lobbies for appropriations to fund the organization’s programs.

If an organization makes the 501(h) election, only the lobbying expenditures are counted toward the limit, not activities by volunteers. There are also clear definitions in the Internal Revenue Code Regulations as to which activities are actually lobbying. Furthermore, based on a sliding scale formula that takes into account how much an organization spends on its exempt purpose activities, an organization may be able to spend up to \$1 million on lobbying. Therefore, unless an organization is very large and spending over a million dollars would not be considered substantial, the election may make sense.

Lobbying can be either direct or grassroots. Direct lobbying is contacting

legislators or their staffs about specific legislation and reflecting a view on the legislation. Legislation is defined broadly as Federal or state or local laws including budgets and appropriations, Constitutional amendments, confirmation of nominees for office and treaties that must be ratified by Congress. Legislation includes both legislation that has already been introduced in a legislative body and specific legislative proposals that the organization either supports or opposes.

Lobbying also includes grassroots lobbying which is defined as an attempt to influence legislation through a communication with the general public that urges the public to contact legislators in support of or in opposition to legislation. There is a separate sub-limit on grassroots lobbying for organizations that have made the section 501(h) election.

Under the 501(h) election, IRC 4911 provides that the allowable amount of all lobbying expenditures (direct and grassroots combined) is limited to the sum of (1) 20 percent of the first \$500,000 of the organization’s exempt purpose expenditures for the year, (2) 15 percent of the next \$500,000 of such expenditures, (3) 10 percent of the third \$500,000 of such expenditures, and (4) 5 percent of any additional such expenditures with total expenditures not to exceed \$1 million no matter how large the budget.

Grassroots lobbying is subject to a separate limitation, equal to 25 percent of the overall permissible lobbying amount.

In order to prevent organizations from avoiding the dollar limitations of section 501(h) by forming related entities, certain affiliated 501(c)(3) organizations under common control are treated as one organization for the purpose of applying the section 501(h) tests. However, if there is an affiliated organization that can engage in unlimited lobbying, such as a 501(c)(4) or 501(c)(6) organization, these organizations are not grouped together for the limit. Forming a related 501(c)(4) or (c)(6) is very common for exactly this reason.

If lobbying expenditures in any one year exceed the allowable amounts under

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section 4911, then a penalty excise tax is imposed on the organization equal to 25 percent of the excess lobbying expenditures. If the organization's lobbying expenditures over a four-year period are more than 150 percent of the allowable amounts, then not only will the organization be subject to the excise tax penalties under section 4911, but the organization may lose its tax-exempt status.

CONCLUSION

The rules on lobbying are very complicated and an organization could easily cross the blurred lines of what constitutes substantial lobbying activities. Organizations should consider the bright line tests of IRC 501(h) and also forming affiliates that can engage

in unlimited lobbying if the limits of 501(h) are too low. Regardless of whether the organization has made the section 501(h) election, Congress and the states have rules regarding the registration of lobbyists and organizations must be mindful of these rules as well. ■

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CHALLENGES AHEAD FOR U.S. EMPLOYERS



[BY 2011]

- It will require individuals and small group insurance plans to spend at least 80 percent of premium dollars on medical services. Large group plans would have to spend at least 85 percent.

[BY 2014]

- It will provide subsidies for families earning up to 400 percent of the poverty level to purchase health insurance.
- States would be required to set up new “exchanges,” or insurance marketplaces, that would offer a variety of healthcare plans for small businesses and individuals who do not get coverage from their employers
- The Act will require most employers to provide coverage or face penalties.
- The Act will require most people to provide coverage or face penalties.

[BY 2019]

The Act will have expanded insurance to an estimated 32 million people. ■

NEW HEALTH CARE TAX CREDIT

Under a provision of the recently passed Patient Protection and Affordable Care Act, certain small tax exempt organizations will be eligible for a tax credit for health care insurance expenses beginning in 2010. The credit is not insignificant: for tax years 2010 to 2013, the maximum credit is 25% of premiums; in 2014 the maximum increases to 35%. The maximum credit goes to smaller employers—those with 10 or fewer fulltime equivalent employees (FTEs) and paying annual average wages of \$25,000 or less. The credit is completely phased out for employers that have 25 FTEs or average wages of \$50,000 or more.

The IRS has just issued a draft of Form 8941 which will be used to calculate the credit. A revised 990-T will be used to claim the credit (even for organizations that do not otherwise have to file Form 990-T). The draft Form 8941 can be viewed at <http://www.irs.gov/pub/irs-dft/f8941--dft.pdf> (although draft instructions are not yet available).

THE ENACTMENT OF THE RECENT HEALTHCARE REFORM LEGISLATION WILL AFFECT AND PRESENT CHALLENGES FOR EVERYONE FROM HEALTHCARE PROVIDERS, INSURANCE COMPANIES, AND EMPLOYERS TO INDIVIDUALS.

Employers will need to prepare in order to manage through the new mandates, changing tax implications and potential shifts in cost. One major cost shift is the expansion of the State Children’s Health Insurance Program (SCHIP) providing coverage to more children. The Patient Protection and Affordable Care Act’s (The Act) primary goals are to expand coverage to Americans without health insurance, lower the costs of providing healthcare, and put in place reforms to improve the overall quality of the delivery of healthcare. The following is a summary of what the Act will do and when.

[WITHIN ONE YEAR]

- It will provide a \$250 rebate to Medicare prescription drug plan beneficiaries whose initial benefits run out.

[AFTER 90 DAYS]

- It will provide immediate access to high-risk insurance pools for people who have no insurance because of preexisting conditions.

[AFTER SIX MONTHS]

- It will bar insurers from denying people coverage when they get sick.
- It will prevent insurers from denying coverage to children who have preexisting conditions.
- It will bar insurers from imposing lifetime caps on coverage.
- It will require insurers to allow young people to stay on their parents’ policies until age 26.

RECENT ACCOUNTING STANDARDS UPDATES AND EXPOSURE DRAFTS ISSUED



The following is a summary of several recently issued accounting standards updates (AS U) and exposure drafts.

[ASU]

SFAS 157 and its various amendments require extensive disclosures, including new disclosures required by ASU 2010-06. These include:

- A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value (FV) measurements and describe the reasons for the transfers; and
- In the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present information about purchases, sales, issuances, and settlements separately (gross rather than net).

In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures:

- For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and

- A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early application is permitted.

[PROPOSAL]

All Financial Instruments at Fair Value

In July 2009, the Board agreed to propose a model to improve financial reporting for financial instruments. The Board reached the following decision:

... to propose that all financial instruments will be presented on the balance sheet at fair value with changes in value recognized in net income or other comprehensive income with an optional exception for own debt in certain circumstances, which will be measured at amortized cost.

While the main effect of this proposal will be to change SFAS 115, it would also

presumably remove the options that nonprofits now have under the audit guide for non-SFAS 124 investments.

In May 2010, FASB issued a proposed ASU (Exposure Drafts (ED)) that would largely implement this decision. A list of its proposed effects appears on page 15.

[PROPOSAL]

In June 2010, FASB issued another proposed ASU that would amend FAS 157; that would:

- make terminology and clarifying changes to further converge U.S. and International accounting standards;
- clarify that the 'highest and best use' concept would only apply to non-financial assets;
- provide guidance on measuring FV of an instrument classified in equity (not normally applicable to nonprofits);
- provide additional flexibility for measuring FV of assets and liabilities managed in a portfolio on the basis of the entity's net exposure to a particular market risk (interest rate, currency, and price) or credit risk of a counterparty;
- expand the prohibition against applying blockage factors at all input levels; and
- require additional disclosures, including:
 - Measurement uncertainty inherent in Level 3 inputs;

- If an asset that is valued using a highest and best use basis, but is not actually being used that way; and
- Categorization by input level of assets not reported at FV, but who's FVs are disclosed in the notes.

[AICPA ISSUES PAPER]

In January 2010, the AICPA issued a draft issues paper intended to provide additional implementation guidance for applying SFAS 157 in three areas:

- Unconditional promises to give cash (pledges);
- Beneficial interests in perpetual trusts; and
- Split-interest agreements.

As of August, it has not yet been issued final.

[PROPOSED ASU]

In addition, FASB has issued the following ASU related to additional disclosures needed with regard to receivables that is amending Accounting Standards Codification (ASC) Topic 310. This ASU applies to all organizations. This ASU was issued in July 2010, and is effective for nonpublic entities for periods ending on or after December 15, 2011 (essentially calendar 2011 and later); for public entities, certain disclosures are effective one year earlier.

It requires additional disclosures about the allowance for credit losses and the credit quality of financing receivables.

Many of the requirements do not apply to most trade accounts receivable due within one year, and the statement excludes unconditional promises to give (pledges), as well as debt securities.

It includes loans receivable, which is where its main effect on the nonprofit sector is expected to be – particularly loans to students and faculty made by educational institutions, and loans to churches and other religious organizations made by religious denominations and other higher-level religious entities.

The purpose of the statement is to enhance disclosures about the nature of credit risk inherent in a portfolio of financing receivables, how that risk is analyzed and assessed in arriving at the allowance

for credit losses, and the changes and the reasons for those changes in the allowance.

The required disclosures are very complex and detailed; organizations with affected receivables need to study the statement carefully to assess its effects on their financial statement footnotes.

In addition, FASB has issued an exposure draft to amend ASC Topic 450 related to accounting for loss contingencies. This exposure draft will apply to nonprofits.

The exposure draft was issued in July 2010 and comments were due in August. FASB has indicated that a final statement is anticipated in the third quarter of this year, with an effective date for nonpublic entities of fiscal years beginning after December 15, 2010 (essentially calendar 2011 and later). The effective date for public entities is calendar 2010.

It deals only with disclosures (nonpublic entities are permitted to make slightly fewer disclosures). In addition to its obvious applicability to litigation, it will also apply to subjects such as environmental remediation, asset retirement obligations, product warranties, guarantees, and contingencies related to business combinations. It will not apply to uncertain tax positions (already well covered by ASC 740, formerly FIN 48), or employee benefits (covered by various other standards) – except that it will apply to a potential liability that would be incurred upon withdrawal from a multi-employer benefit plan.

The proposal would not eliminate any existing requirements, but it would add new requirements to disclose information about the nature of loss contingencies, their potential magnitude, and the potential timing (if known). Thus it is proving controversial because of the effect it may have on auditors' communications with attorneys, and disclosure of information about litigation that, while it may be publicly available in court records, distribution of which most defendants would probably prefer to keep as limited as possible, such as the contentions of the parties, amounts of claims, and possible insurance recoveries.

Aggregation of information about similar

The required disclosures are very complex and detailed; organizations with affected receivables need to study the statement carefully to assess its effects on their financial statement footnotes.

types of contingencies will be permitted. Information about certain potentially severe, remote loss contingencies will be required. When assessing materiality, possible insurance recoveries would not be considered. ■

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UNCERTAIN TAX POSITIONS: LESSONS LEARNED AND A LOOK FORWARD



[CONVINCING NONPROFITS THAT THEY HAVE TAX POSITIONS]

Many organizations would say something like: “We’re tax exempt nonprofit, so this is a no-brainer — we don’t have tax positions.” In many cases, it was a real task to convey the idea that their very exempt status, as well as each income stream, is, in fact, a tax position that requires analysis before the organization can say that there are no uncertain tax positions.

ASC 740-10, Accounting for Uncertainty in Tax Positions (formerly FIN 48) was required to be implemented by “public” non-profits, such as those with certain tax-exempt bonds for years beginning after December 15, 2006. However, the vast majority of nonprofit organizations were allowed to defer this requirement until years beginning after December 15, 2008 (generally calendar year 2009 and fiscal years beginning in 2009). This is mandatory for all organizations who issue financial statements in accordance with generally accepted accounting principles.

Thus, we now have had a significant amount of experience in implementing this provision (which we will refer to as FIN 48 in this article, as that is how most folks still label it). We have described the basics of FIN 48 in previous Nonprofit Standard articles and an article by Laura Kalick (available on BDO.com in the Nonprofit Industry section) and will not be rehashing those points here. We will be discussing some of the issues that we have seen and how we have addressed them as well as taking a look at subsequent years.

[LACK OF ADEQUATE TOOLS]

Since FIN 48 applies to for-profit entities as well as nonprofits, firms such as BDO had developed checklists and procedures over the past several years. We found that these tools were somewhat inadequate for analyzing the tax positions for nonprofits since the issues were so different. We have had to develop a completely new comprehensive procedural model and checklists which we recently have unveiled internally. These tools provide standardization to the process and ensure that issues are not missed.

[COMPLEXITY OF ANALYSIS REQUIRED]

Even some not-so-large organizations were surprised with how many issues they had to address. If there are a lot of significant revenue streams, it gets complicated. Add on some alternative investments and the level of analysis required really escalates.

[SOME OF THE MORE SIGNIFICANT ISSUES DISCOVERED]

- Pass-through income reported on K-1’s or from foreign investments sometimes contained elements of unrelated business income (UBI) of which the organization was not aware. Some K-1’s did not properly report UBI or did not bother reporting it because the organization was not identified as an exempt organization on the K-1.
- State unrelated business income tax (UBIT) returns were not being filed. Organizations often don’t realize they have state nexus due to multi-state operations or employees; or have pass-through UBI from K-1’s that is generated from operations in one or more states outside of their home states.
- Organizations with foreign operations often have little knowledge of tax filings and payments required by foreign jurisdictions.
- Mission “creep”. Organizations claiming that certain activities are related to their exempt purposes, but these activities bear

little relation to the exempt activities for which they were granted exemption as described on Form 1023 or 1024.

- UBIT calculations prepared the same way for years with no changes. Often, the activities have changed significantly or the method of expense allocation is outdated due to changes in general ledger coding.
- Huge net operating losses that get bigger each year and just keep getting carried forward without considering whether such losses might be disallowed because the activity is not being carried on with an expectation of profit or because the expense allocations are too aggressive.
- Analysis of “royalty” contracts revealing that some contain requirements for significant activity on the part of the nonprofit; possibly making the revenue non-passive and UBI.
- Corporate sponsorship payments with significant return benefits to the sponsor being booked entirely as donations, when in fact they may contain elements of UBI.

[LOOKING FORWARD]

The first year of implementation does require a significant amount of effort that simply cannot be avoided. Subsequent years will be a lot easier. Organizations should review the prior year analysis and update for new activities and activities that were discontinued.

Overall, while we have seen very few materials, uncertain tax positions, this analysis has provided many organizations a much needed UBI and operational review and helped them to become aware of a wide variety of tax issues. This then has enabled many of them to get their tax house in order before the IRS comes knocking on the door with an examination document request. ■

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FASB LEAS E EXPOSURE DRAFT – AUGUST 2010: EFFECTS ON NONPROFIT ORGANIZATIONS

The Financial Accounting Standards Board (FASB) (in conjunction with the International Accounting Standards Board) has issued its long-awaited exposure draft on accounting for leases. While implementation of the proposed standard will likely not have a major impact on the statement of activities of most lessees, its effects on the balance sheet (statement of financial position) will often be significant.

This proposed standard will apply to all organizations – including nonprofits, and to all leases (with minor exceptions – see below).

There is no proposed effective date stated in the draft; that will be determined after the exposure period. Since the exposure period ends December 15, 2010, the effective date is not likely to be earlier than calendar 2012.

The main effect will be to require lessees to account for all leases in much the same way as capital leases are currently treated – i.e., by recording an asset, largely offset by a liability. Thus the effect on net assets will, in most cases, be minimal. However there can be a significant effect on ratios such as debt to equity and others of that type. Organizations should promptly determine at least the approximate effect on any covenants to which they are subject, including covenants in both debt and grant agreements (many grants to nonprofit organizations include covenants of types similar to those usually found in debt agreements).

One aspect of the proposed accounting that is likely to prove challenging for many nonprofits is the requirement for lessees to use their incremental borrowing rate (or the interest rate implicit in the lease, if determinable by the lessee) to discount the long-term obligation to make lease payments. As is often the case, FASB has written this requirement with for-profits in mind – assuming that all lessees know their borrowing rate, which is likely true for most for-profit entities. However many – especially smaller – nonprofits have never borrowed, and some of these probably are in a financial condition that would make it virtually impossible for them to borrow, so they would not know, and often could not determine this rate. They may also not be

able to determine the rate the lessor has used to set the lease payments, or, in some cases, that rate may not be appropriate for the lessee to use.

It is hoped that FASB will provide some guidance to help with this problem.

The following is from the introduction to the exposure draft:

WHAT ARE THE MAIN PROPOSALS?

This exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources and leases of some investment properties. For leases within the scope of the proposed guidance, this means that:

- (a) a lessee would recognize an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.
- (b) a lesser would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:
 - (i) Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or
 - (ii) Derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognizing approach).

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- (a) Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- (b) Uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected

payments under term option penalties and residual value guarantees, specified by the lease.

- (c) Is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components...
[Deleted words applicable only to IFRS.]

For leases of 12 months or less, lessees and lessors would be able to apply simplified requirements.

The exposure draft also proposes disclosures based on stated objectives, including disclosures about the amounts recognized in the financial statements arising from leases and the amount, timing and uncertainty of cash flows arising from those contracts. ■

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ESTABLISHING EFFECTIVE PROCEDURES FOR A NONPROFIT

As part of our ongoing series on Nonprofit Governance, this article discusses best practices in designing and developing an organization's procedures to support its overall policies and the internal control of the organization. Remember like policies, internal controls and procedures vary from organization to organization.

Sometimes organizations get caught up in the different types of policies. There are broad sweeping policies that are entity wide and support the mission and strategic plan of the organization for which the Board is responsible and then there are other policies that are more operational oriented for which management is responsible. Understanding the different types of policies is key to developing well designed and effective procedures to manage a nonprofit organization. The management team is responsible for developing the organization's procedures to carry out the day-to-day operations of an organization. The Board of Directors' key responsibility is to provide vision and strategic thinking and planning for the organization and provide the monitoring and oversight process in order to carry out their fiduciary duty. It is important that this concept of division of responsibilities be understood by all parties.

There is not a one size fits all method for designing, establishing and implementing effective procedures to carry out the policies of the organization and provide the organization with strong internal controls.

THE DIFFERENCE BETWEEN INTERNAL CONTROL AND PROCEDURES

Internal control is a process, which is affected by people. It's not merely policy, manuals, and forms, but people at every level of an organization. Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an organization's management and Board of Directors that an error or misstatement will be caught by an employee during the course of doing their job and be corrected on a timely basis. Internal control is geared to the achievement of objectives in one or

more separate but overlapping categories discussed below.

The Committee of Sponsoring Organizations (COSO) defines internal control as a process, affected by an entity's Board of Directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

It is important to remember that internal controls involve human action, which introduces the possibility of errors in processing or judgment. Additionally, we must keep in mind the human component of internal controls since in almost every major fraud since the beginning of time, collusion among employees or coercion by top management has been a factor.

THE FIVE COMPONENTS OF THE COSO FRAMEWORK

The COSO internal control framework consists of five interrelated components derived from the way management runs an organization. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization. The five components are the following:

Control environment: The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the tone from the top, integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization.

Risk assessment: Every entity faces a variety of risks from external and internal

sources that must be assessed. A precondition to risk assessment is establishment of objectives and thus risk assessment is the identification and analysis of relevant risks to the achievement of assigned objectives. Risk assessment is a prerequisite for determining how the risks should be managed.

Control activities: Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address the risks that may hinder the achievement of the organization's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and most importantly segregation of duties.

Information and communication: Information systems play a key role in internal control systems as they produce reports, including operational, financial and compliance-related information that make it possible to run and control the activities of the organization. In a broader sense, effective communication must ensure information flows down, across and up the organization. For example, formalized procedures exist for people to report suspected fraud. Effective communication should also be ensured with external parties, such as members, customers, suppliers, regulators and other stakeholders about related policies.

Monitoring: Internal control systems need to be monitored, which is the process of assessing the quality of the system's performance over time. This is accomplished through ongoing monitoring activities or separate evaluations. Internal control deficiencies detected through these monitoring activities should be reported upstream and corrective actions should be taken to ensure continuous improvement of the system.

The policies and procedures of an organization are widely recognized as an essential component of internal control. The policies and procedures manual of an

organization should include everything needed to implement accounting policies and procedures for increased internal control over your Finance, Accounting, Computer and IT, and Human Resources processes.

HOW TO DEVELOP PROCEDURES TO SUPPORT INTERNAL CONTROL

The process of developing, documenting and implementing organizational procedures to support the organization's policies and internal control should not be taken lightly. An organization's policies and procedures are the fundamental groundwork of the organization's internal control. It is important that each organization design document and implement a sound internal control process.

Once your organization has developed and documented its policies and procedures to establish its internal control and the organization and the management team has implemented the policies and procedures that form the internal controls then it must also make the commitment to monitor the activities as well.

Failure to fully implement or implement haphazardly sends a message to employees that the controls are not important or even worse that policies and procedures only need to be followed when someone is looking over your shoulder. There needs to be only one message, which is internal control, represents the policies and procedures of the organization and that they need to be followed to the letter of the law no matter what the circumstances. The tone from the top needs to be "do the right things always." However, there is one exception; if the policies and/or procedures are not working effectively then there needs to be a process in which a member of the organization can raise the question in a manner where their concern can be looked upon as a contribution to the organization.

What are the benefits of strong procedures?

- Reduce or eliminate misinterpretation of the organization's critical policies and procedures.
- Feel more confident about covering legal issues like conflict of interest.
- Help an organization manage its fraud risk.



- Assert control over the organization's assets.
- Help identify signals that raise the red flag when a policy or procedure needs to be changed.

There are several keys things to consider in developing and documenting effective procedures and internal control for an organization.

Keep It Simple – Procedures should document the overall process being executed and the key internal control. It is not necessary to document every single step and detail of a transaction process. That level of detail information belongs in accounting work instructions or training materials. By including such low level minutia and details the procedures manual becomes overly long and confusing, which is a sure way to ensure that the procedures will neither be used nor followed.

Use Flow Charts and Graphics Where Possible – Graphics can illustrate the transaction process flow, inputs/outputs, and important relationships or risks that are not easily conveyed in text. We have all heard the saying that a picture is worth a thousand words; using graphics can improve simplicity and usability of an organization's procedures manual, which can lead to better understanding of the transaction process flow and the internal control.

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letter of the law no matter what the circumstances. The tone from the top needs to be "do the right things always."

Be Consistent – Process transaction flows and procedures should be consistent in format and design, and especially the use of language and terms. Specific language and terms that are used in the procedures manual should be highly recognizable and familiar to the organization as a whole. If there are technical terms used, consider defining them in a glossary.

Maintain Them – Manuals need to be kept up-to-date. A change in the process means a change in the procedures manual; make sure that changes are documented in a timely manner.

Communicate – Procedures must be communicated to all affected parties through training, meetings or other types of communication or events. Then, regular internal reviews/audits are needed to ensure that personnel are aware of the accounting procedure and the process requirements. A strong control environment set by the Board of Directors and the key members of the management team clearly sets the tone from the top for which there are several benefits, one of which is to clearly communicate the expectations and core values of the organization to all members of the staff, including volunteers.

Several questions that Board of Directors and members of the management team should be able to ask themselves are as follows:

- If someone outside the organization were or/a member of the management team, what is the risk of fraud within the organization, would he/she be comfortable saying the risk is low? If not, why not?
- Does the Board of Directors and/or the members of the management team regularly consider whether there is anything about the organization and its operations that it would be embarrassed to read about – and know that its donors/members are reading about – on the front page of the local newspaper?
- The Board of Directors and/or members of the management team should identify risks specific to their organization. They should ask themselves the question: What could go wrong? Some of the areas that they should think about are as follows:
 - Fraudulent financial reporting – Understand why/how financial information might be misstated. What motivation would someone have to misstate financial information?
 - Theft of assets – Are there adequate safeguards and internal controls established and enforced to ensure that assets are not misappropriated?
- Procedures to ensure that goods and services are provided only to those who have paid for them, i.e., admission to events (concerts, conferences, meetings, classes, dinners, etc.), sending of member publications, issuance of diplomas and transcripts, treatment in clinics, etc.
- Management should also give appropriate consideration to internal control over activities outside the financial function. Although such weaknesses are not directly related to financial transactions, they can result in severe financial consequences if not addressed (i.e. failures include control of human organ transplants to ensure proper blood type match, and misbehavior of organization staff/volunteers with respect to children).

[INVESTMENT MANAGEMENT]

- Each organization should have a formal documented investment policy that is reviewed by the investment committee on a regular basis, approved by the investment committee and the Board of Directors, and communicated to all advisors and managers.
- All investment managers and advisors should be vetted by the Investment Committee but approved by the Board of Directors.
- The Investment Committee should regularly monitor and review results of the actual investments as reported by the advisors and managers and compare the results to benchmarks established by the committee.

[INFORMATION TECHNOLOGY]

- There should be controls in place to restrict access (authorized and unauthorized) to equipment, programs, and data and define who is permitted access to what equipment and programs.
- There should be procedures in place to establish and monitor user passwords and ensure that they are changed regularly.
- Establish a disaster recovery plan to safeguard the organization's data and test the plan on a regular basis.

The design, implementation and operation of an organization's policies and procedures that make up the internal control system vary from organization to organization and there is not a one size fits all

REGULATION OF TAX EXEMPT BONDS

The regulation and oversight of the municipal debt and bond market is performed by the Municipal Securities Rulemaking Board (MSRB). One of MSRB's top initiatives has been the development of the Electronic Municipal Market Access (EMMA) website. On July 1, 2009, the MSRB began collecting disclosure documents from municipal issuers around the country and posting them for public access. As a result, EMMA is a complete repository of municipal bond disclosure documents. Nonprofit organizations with bonds should be aware that their data may be posted and available on the EMMA website. Nonprofit organizations with bonds should visit the EMMA website, <http://www.emma.msrb.org> to determine if information related to their debt is posted there. Organizations should also consider the impact this may have on determining the date through which subsequent events should be examined as publication of financial statements on the EMMA website are available to the public. The Nonprofit Standard will discuss this issue and the other details of the bond market in more detail in the December issue.

answer for what would work best in your organization. However, with careful planning and consideration of the concepts discussed in this article you will have a basis for designing an effective internal control system for your organization. ■

For more information please contact us at 703.437.8877 or via email at info@millermusmar.com.

It is not possible to take into account every procedure and internal control within the confines of this article, but we have included three areas that seem to come up on a regular basis.

[SEGREGATION OF DUTIES]

- There should be a policy and a process to ensure that all employees take vacation regularly, during which time their duties should be performed by others.
- There should be separate individuals involved in the initiation, review, and approval process of all key transactions and reconciliations such as the following:
 - Contributions
 - Cash receipts
 - Cash disbursements
 - Compliance with donor restrictions
- Government grants, especially: time records, procurement procedures, and allowable costs, sub recipient monitoring, and reporting
 - Purchasing (competitive bid requirements, conflict of interest consideration, etc.)

OTHER NOT-FOR-PROFIT TAX ITEMS IN THE NEWS

By Kim A. Barrow, CFE

Cell Phone Change to Become Law September 23, 2010

The House passed, and the President is expected to sign, H.R. 5297, the Small Business Jobs Act of 2010. This bill includes the provisions discussed in our June Nonprofit Standard, removing cell phones from the definition of listed property which eliminates the onerous recordkeeping to substantiate business use of a cell phone. Lack of substantiation and not including personal use as income to an employee under prior rules could result in an automatic excess benefit transaction and possible application of intermediate sanctions on exemptions. When signed into law, the de-listing will be retroactive to January 1, 2010.

IRS Offers Relief to Small Charities at Risk of Losing Exempt Status

The IRS announced it will provide one-time relief for small organizations to help them comply with the new rules that revoke an organization's exempt status for failing to file a return for three years. There is an extension to Oct. 15th for the 990-N e-postcard filing, and a voluntary compliance program (VCP) for 990-EZ filers. VCP provides for reduction of penalties with payment of a compliance fee.

Updated IRS Publications on Charitable Contributions and Gaming

A revised version of Publication 1771, Charitable Contributions Substantiation and Disclosure Requirements has been released and explains the federal tax law, including recordkeeping and substantiation rules, for organizations such as charities and churches that receive tax-deductible charitable contributions and for taxpayers who make contributions. Sample language is provided for each type of acknowledgement. The IRS also released a revised version of Publication 3079, Tax-Exempt Organizations and Gaming, describing the impact on an organization's exempt status and requirements for special recordkeeping and reporting for the unique activities

that surround gaming events including income, employment and excise taxes. The publication also includes a calendar with due dates for all the possible filings that may be required by gaming operations. Both publications are available on the IRS website, www.irs.gov.

IRS Finalizes Guidance on Excise Tax on Prohibited Transactions

The IRS has issued final regulations on entity-level and manager-level excise taxes, and disclosure and return obligations for organizations participating in prohibited tax shelter transactions.

Medical Community Expresses Concerns and Submits Comments to IRS on Additional Requirements for Tax-Exempt Hospitals

Many organizations have provided public comments on the new requirements under IRC section 501(r), (Notice 2010-39), regarding community health needs assessments and strategic plans submitted to IRS under the July 22 deadline, expressing concern on timing and practical considerations.

IRS' Taxpayer Advocacy Service (TAS) Submits Mid-Year Report to Congress

In July, IRS' organization that protects taxpayers submitted a report to Congress that identified priority issues IRS will address during this coming fiscal year. There is concern about the adequacy of IRS resources, especially when health care reform is implemented, and the report indicates particular emphasis on 1) taxpayer services – outreach and education, 2) new business and tax-exempt reporting requirements, and 3) IRS collection practices.

Lawmakers Question Offshore Investment of Funds

In July, Senate Finance Committee members questioned the Boys & Girls Clubs on why the national organization

has invested in offshore investments while local clubs struggle without adequate funding. Committee members questioned why the government should provide funding when investments are made offshore.

NYS BA Report to Congress

In August, the New York State Bar Association submitted a report on the imposition of income tax under IRC Section 514 on debt-financed income of tax exempts, recommending a revision of the rules to simplify them and eliminate the need for exempts to structure investments using offshore investment fund vehicles as feeders or blockers.

IRS to Eliminate Paper Coupon Method for Tax Deposits

IRS plans to require income, excise, payroll and other taxes to be paid electronically beginning January 1, 2011. The IRS issued proposed regulations in August to eliminate the use of the paper coupons and force the use of the Electronic Federal Tax Payment System (EFTPS) because the Treasury Department will no longer maintain the paper coupon system after December 31, 2010. Although taxpayers who have a de minimus tax liability would be able to pay the amount with their return, all other taxpayers would be required to pay electronically. After a brief comment period the rules are expected to be finalized before the end of 2010.

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FINAL 2010 OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT ISSUED

The Office of Management and Budget (OMB) issued the final 2010 Circular A-133 Compliance Supplement (the Supplement) dated June 2010. The Supplement is available on OMB's website at http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2010 in both a pdf and word format. The full version of the Supplement is over 1,400 pages in length. You can download the entire Supplement or sections of the Supplement from the website. The Supplement is applicable to audits of fiscal years that begin after June 30, 2009.

As in past years, Appendix V lists the changes from the 2009 Supplement dated March 2009 and Addendum #1, dated June 30, 2009. Appendix V also includes changes from the draft 2010 Supplement dated March 2010 that was issued to help organizations and auditors plan for the upcoming audits. The final version includes more details on Recovery Act reporting requirements and updated program clusters. Throughout the Supplement items that have changed from the draft 2010 Supplement are identified in boldface print. The following is a summary of some of the changes from the draft Supplement.

[REPORTING]

As noted in our June 2010 issue of the Nonprofit Standard, Part III – Compliance Requirements related to Reporting for funds received under the American Recovery and Reinvestment Act (ARRA) was not completed in the draft Supplement issued. The Supplement includes a new Section, III.L.4 Section 1512 ARRA Reporting, that helps organizations and auditors determine whether ARRA Section 1512 reporting requirements apply to a specific program or cluster.

This section in the Supplement is only applicable to awards received by direct federal funding (prime) recipients. The Supplement includes excerpts from the OMB document M-09-21, Implementing Guidance for the Reports on Use of Funds Pursuant to the American Recovery and Reinvestment Act of 2009 related to the reporting requirements under ARRA.

(OMB has issued other documents that provide guidance on the reporting requirements under ARRA and these can be found on their website at http://www.whitehouse.gov/omb/recovery_default/.) Under Section 1512 of ARRA, recipients must report on the use of ARRA funds no later than the 10th day after the end of each calendar quarter. The recipient reports must include the following detailed information: total amount of funds received; and of that the amount spent on projects and activities and details on sub-awards and other payments. The list of projects and activities funded should be by name and include a description of activity/ project, the completion status and estimates of the jobs created or retained.

All Section 1512 reports are required to be submitted through www.FederalReporting.gov. All Section 1512 reports that are submitted will be made available to the public through www.Recovery.gov as well as on individual Federal agency recovery websites.

The final reports will be subjected to testing by auditors in accordance with guidance in the Supplement. The auditor will be responsible for testing the underlying data in these reports and verifying that the key data elements were presented in accordance with the required or stated criteria and methodology and ensure the accuracy and completeness of the 1512 reporting. Auditors will also be responsible for determining whether a recipient who passed through funds has a process to monitor the accuracy of sub recipient reporting. This is required even in cases where the recipient may have delegated the 1512 reporting to a sub recipient.

The final version of the Supplement answers the question about the auditor's responsibility with regard to the job creation and retention information required to be included in the 1512 reporting. The final resolution is that the "number of jobs" is a required data element on the 1512 reports but auditors will not be required to test this as part of their compliance work performed on the 1512 reporting.

[PROCUREMENT AND SUSPENSION AND DEBARMENT]

The revisions to the Supplement include provisions that ARRA funds are prohibited from being used to fund a project for the construction, alteration, maintenance, or repair of a public building or work unless all the iron, steel and manufactured goods used in the projects are produced in the United States. ARRA provides for a waiver of these terms only in certain specified circumstances. Recipients of ARRA funding that is being used in these types of projects should maintain documentation that all the goods used were produced in the United States unless they have documentation of specific waivers.

[SUB RECIPIENT MONITORING]

The Supplement contains specific new procedures to be followed by all organizations with sub recipients. All recipients should inform their first-tier sub recipients about the requirement to register with the Central Contractor Registration (CCR), obtain a Dun and Bradstreet Data Universal Numbering System (DUNS) number and to keep that information up to date as part of a Recovery Act award. Recipients that pass-through funds should ensure that sub recipients have current CCR registrations prior to making sub awards and perform periodic checks to make sure sub recipients have updated their information. Auditors are required to test that recipients have performed these procedures.

[SPECIAL TESTS AND PROVISIONS]

In Part III of the Supplement in the special tests and provisions section the following requirements are included in the Supplement related to ARRA funds.

- An organization who has received funds under ARRA must track these funds separately from other grant awards.
- Recipients who make sub awards must inform the sub recipient of the federal award number, CFDA number, amount of ARRA funds received, the requirement to track these funds separately in the

accounting system and require that sub recipients provide appropriate identification in their Schedule of Federal Expenditures and Data Collection form of these ARRA amounts.

Auditor must verify that the recipient has complied with these requirements. Organizations should be aware that the Supplement reinforces the fact that OMB has advised all federal agencies that they

should not grant any single audit extension requests for fiscal years 2009 through 2011. This becomes critical because OMB has urged that in order for an organization to be considered a low-risk auditee for the current year, the prior two years audits must have met the requirements of OMB Circular A-133, including timely report submission to the Federal Audit Clearinghouse by the due date. It is recommended that organizations review the Supplement for a full list of

changes that may affect them and ensure that they have complied with all the applicable compliance requirements.

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Effects of Proposed ASU (May 2010) on Nonprofit Organizations' Use of Fair Value (FV) for Financial Instruments

Item	Present method of valuation (unless FAS 159 has been adopted for the item)	Effect of this ED	Change?
Cash & equivalents	Face value, which is assumed to be FV	No change	No
Investment securities covered by FAS 124	Quoted market price (excluding purchase commission and fees)	Already at FV, per SFAS 124	No
Non FAS 124 investments that are:			
Financial instruments, (except investment in affiliates)*	Various, see paragraph 18 of SFAS 157, and permitted alternatives per Appendix A to Chapter 8 of the AICPA Audit Guide	Required to use FV	Yes
Not financial instruments **	Same as above	None; only applies to financial instruments	No
Assets and liabilities of an acquiree under SFAS 164	Fair value – see other items		
Investment in affiliates not meeting criteria for consolidation (SOP 94-3):			
Carried at equity	Various, see paragraph 18 of SFAS 157; also adjust for liquidity constraints, if any	Excluded from scope of ED (paragraph 4e), but see ***	Maybe
Not carried at equity	Same as above	Required to use FV	Yes
Derivatives	Amount required to cancel the contract	No change; already at fair value, per SFAS 133	No
Beneficial interests in 3rd-party irrevocable trusts	Current FV of assets in trust	No change	No
Earned income receivable (sales, investment income), and accounts payable and accrued expenses ****		(See paragraph 33)	
Short-term (<1 year)	Normally, face value (amortized cost)	May report at amortized cost	No
Other	Normally, face value (discounted)	Required to use FV	Yes
Contributions (pledges) receivable/payable	Present value of estimated future cash flows, using the historical interest rate	Excluded from scope of ED by paragraph 4n	No
Assets and obligations under split-interest agreements	Present value of estimated future cash flows, using a current interest rate	For most, no change; already at FV	Mostly, No
Loans receivable and payable (except mortgages payable –see next item)	Amortized cost, adjusted to reflect debtor's risk	Required to use FV	Yes
Mortgages payable	Amortized cost	Permitted to use amortized cost if criteria in paragraphs 21 and 28 are met	Normally, No
Notes and bonds payable	Face value, adjusted for debtor's risk	Required to use FV	Yes

* – non-marketable equity securities, mortgage notes, partnership interests, etc.

** – property, collectibles, etc.

*** – criteria for use of equity method are changed; see paragraph 130

**** – other than: (1) compensation-related items (excluded from ED by paragraph 4c), and (2) most obligations under leases (excluded from ED by paragraph 4i)