



# MUSE

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A monthly publication dedicated to providing ideas and education to tax exempt organizations

## The Changing Nature of Compliance Audits for Not-for-Profit Organizations

We are certainly living in a period of change. But, one area of change that you might not be as aware of involves the performance of compliance audits. Not-for-profit organizations who participate in programs funded by federal, state and local units of government are frequently subject to compliance audit requirements. Even before the passing of the \$800 billion plus Recovery Act in February of 2009, the federal government had expressed concern about accountability and transparency related to the expenditure of federal awards, including those that are passed-through other units of government, to not-for-profit organizations.

In response to the results of a federal study on the quality of audits performed under Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* (also referred to as single audits), which showed that improvements were needed in many areas, the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards (SAS) No. 117, *Compliance Audits*.

SAS No. 117 establishes standards and provides auditors with guidance on performing and reporting on an audit of an entity's compliance with applicable funding source requirements. Examples of such engagements include single audits and audits performed under the U.S. Department of Housing and Urban Development (HUD) Consolidated Audit Guide for Audits of HUD Programs. SAS No. 117 was also issued to address changes in the compliance audit environment and incorporates the risk assessment standards that are currently applied in the financial audit environment.

To further address concerns raised in the federal study, the AICPA updated the Audit Guide, *Government Auditing Standards and Circular A-133 Audits*. The more significant changes to the guide include:

- Tools for improved communication between the auditor and the auditee
- Guidance for auditing the accuracy of the auditee's schedule of expenditures of federal awards (SEFA)

- Sampling guidance and guidelines, which will generally result in a large increase in the number of transactions tested for each major federal program
- Additional guidance for auditing Recovery Act awards
- Reporting on control deficiencies

Future changes to the guide will likely address documentation of internal controls, communication of audit findings and other changes proposed by the federal audit community which follow.

The federal audit community has also been very busy. The Government Accountability Office (GAO) is in the process of drafting changes to the Government Auditing Standards (GAS) for a 2011 release and the Office of Management and Budget (OMB) has been diligently working on changes to the Circular A-133 Compliance Supplement since last summer.

Proposed major changes from the GAO currently address more consistency and a closer alignment of GAS with standard promulgated by the AICPA, a new framework for evaluating auditor independence, clarification of competency requirements and more clarity.

Major changes proposed by the OMB in the single audit environment include:

- Identification of Recovery Act awards as higher risk in determining the scope of the single audit
- Guidance for the audit of specific Recovery Act provisions
- Safe harbor provisions for addressing the treatment of large loan and loan guarantee programs in determining the scope of a single audit
- Prohibitions against federal agencies granting extensions for the filing of single audits
- Additional criteria for low risk auditee determinations

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## Financial Reporting of Alternative Investments and Derivatives Activities Continue to Evolve; Be Cognizant of Continued Changes

If your not-for-profit organization has alternative investments and/or derivative financial instruments, there are recent clarifications and newly effective standards that should be considered. While on the surface they appear to be intended more for financial and commercial enterprises, they may change the financial reporting of your activities.

Although the fair value measurement standards have now been fully implemented, it was clearly a first step in a journey towards more comparability and transparency. The Financial Accounting Standards Board (FASB) has continued to issue new guidance and standards updates regarding alternative investments and derivatives activities to address perceptions that previous reporting was inadequate and that this information is useful for users of financial statements, particularly in light of the current volatile economic environment and the increased complexity of these instruments. These updates have been issued to also continue the convergence of GAAP with the International Financial Reporting Standards (IFRS), which will generally result in significantly more disclosures.

While the framework for GAAP has been structured to allow for industry specific reporting, IFRS has a more general applicability to reporting entities. As a result of the convergence efforts, updates to GAAP are now more widely applicable rather than industry specific, resulting in standards that, in this case, apply equally to banks, hedge funds, and other entities, including not-for-profit organizations.

Not-for-profit organizations may feel a particular challenge in applying these updates as they may not believe them to be at all useful to the intended users of the financial statements. Nonetheless, financial statements prepared in accordance with GAAP must comply with the minimum requirements.

Don't think that the changes in these standards have stopped, as the journey is likely to continue. Not-for-profit organizations should pay specific attention to the following recently issued standards and updates:

### **FASB Staff Position (FSP) 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That are Not Orderly***

FSP 157-4 was released in April 2009 and affirms the objective of fair value measurements, but allows for more management judgment in determining fair value in distressed or inactive markets. This FSP was in

response to market aberrations during the recent economic downturn where the last transaction or last quoted price was increasingly becoming a distorting factor in fair value measurements due to distressed sales in inactive markets. This staff position helps management to determine when markets become inactive and the steps that management should then take to estimate an accurate valuation. This often requires the use of a different valuation technique or multiple techniques between the market, income and cost approaches introduced in SFAS No. 157.

Regardless of whether an entity transacts in instruments with these market conditions, FSP 157-4 highlights the importance of disclosing certain details and information regarding assets and liabilities measured at fair value, including the major types based on the nature and risks of the instruments.

### **Statement of Financial Accounting Standards (SFAS) No. 161, *Disclosures About Derivative Instruments and Hedging Activities***

In March 2008, the FASB released SFAS No. 161, which requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. Such disclosures include a description of: a) how and why an entity uses derivative instruments; b) how derivative instruments are accounted for; and c) how derivative instruments affect an entity's financial position, financial performance and cash flows. The statement requires qualitative disclosures about objectives and strategies for using derivatives and quantitative disclosures about fair value amounts of, volume of activity in, and gains and losses on, derivative instruments.

### **Accounting Standards Update (ASU) No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820) – Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)***

In September 2009, the FASB issued this update to permit, as a practical expedient, a reporting entity to measure the fair value of an investment in certain entities that calculate net asset value per share on the basis of the net asset value per share as reported by the general partner or investment manager if the net asset value of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 [Financial Services—Investment Companies](#) as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with Topic 820. This update also provides criteria under which

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## Patient Protection and Affordable Care Act - Hospital Tax Exemption Reform is Here Now

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (PPACA). This new law has significant new compliance burdens for tax exempt hospitals to maintain their tax-exempt status.

In order to maintain their status, hospitals are required to:

- Conduct a community health needs assessment at least every three years
- Adopt and publicize a written financial assistance policy that includes the provision of emergency medical care
- Bill patients who qualify for financial assistance and receive emergency medical care no more than the lowest amounts charged to insured patients
- Make reasonable efforts to inform individuals of the hospital's financial assistance program before initiating extraordinary collection action against them

If a hospital has more than one facility, each facility has to meet these requirements. These mandates are backed up with new reporting and disclosure requirements; the failure to conduct and implement a community health needs assessment also results in a

**\$50,000 excise tax under new Code Section 4959. In addition, the IRS, every three years, is required to review the hospital's community benefit programs as reported on Schedule H of Form 990.** The requirement to conduct a community health needs assessment applies to taxable years beginning after the date which is two years after March 23, 2010 — the date of enactment. The excise tax is effective for failures occurring after March 23, 2010.

Hospital organization will want to develop a SWAT team to address these requirements. This group may include individuals from finance, legal counsel, community benefit department, public relations, Medicare cost reporting as well as your outside audit and tax advisors. These individuals working collectively through these new requirements will ensure the best possible outcomes.

For more information on the new Patient Protection and Affordable Care Act and Schedule H reporting requirements, contact RSM McGladrey Director Ginny Striegel at 515.218.9272 or at [ginny.striegel@rsmi.com](mailto:ginny.striegel@rsmi.com).

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All of these recently issued and proposed changes will have a significant impact on future compliance audits performed in accordance with GAS, OMB Circular A-133 and/or federal audit guides. While you can't stop change, you should plan to discuss these changes with your compliance auditor and be prepared for these

changes to have a material impact in the scope and cost of upcoming compliance audits.

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these investments may be classified as Level 2 in the fair value hierarchy, and requires enhanced disclosures regarding the activities of the investees. It is important to note that the investment must meet specific criteria within this update to qualify for the practical expedient and for classification as Level 2.

**Accounting Standards Update (ASU) No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures About Fair Value Measurements** Accounting Standards Update (ASU) No. 2010-06 provides more and improved disclosures about fair value measurements. This ASU affects all entities that are

required to make disclosures about recurring and nonrecurring fair value measurements under FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures. The ASU requires the new disclosures in regard to transfers in and out of levels 1 and 2 and activity in level 3 fair value measurements. The ASU also clarifies existing disclosures regarding the level of disaggregation and disclosures about inputs and valuation techniques.

For more information, contact McGladrey & Pullen Partner Paul Nockels at 312.634.4623 or [paul.nockels@rsmi.com](mailto:paul.nockels@rsmi.com).

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