CliftonLarsonAllen LLP
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Finance Committee and Management
The Arc of East Central Iowa
Cedar Rapids, Iowa

In planning and performing our audit of the financial statements of The Arc of East Central Iowa, herein the Organization, as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered the Organization's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control.

However, during our audit, we became aware of a matter that is an opportunity for strengthening internal control and operating efficiency. Our comment and suggestion regarding this matter is summarized below. We previously provided a written communication dated December 4, 2018 on the Organization's internal control. This letter does not affect our communication dated December 4, 2018.

GENERAL CONTROLS

Bank reconciliations

During our review of bank reconciliations, we noted the July and September 2017 through January 2018 reconciliations had no indication of documented review. We recommend that review and approval processes be evidenced by signing or initialing and dating applicable items. This will protect the Organization and all parties involved should any issues arrive in the future.

EMERGING ISSUES

FASB ASC 606 Revenue Recognition

In May 2014, the FASB issued new accounting standards (Topic 606) that overhauled accounting for revenue recognition. The objective of these new rules is to develop a single principle-based revenue standard. Topic 606 aims to improve accounting for contracts with customers by providing a robust framework for addressing revenue issues as they arise, increasing comparability across industries, and requiring better disclosure. The scope of the new standards includes all contracts with customers except lease contracts, insurance contracts, financial instruments, guarantees, and nonmonetary exchanges in the same line of business to facilitate sales to customers.

The core principle of the new standards is to recognize revenue to depict the transfer of promised goods and services in amounts that reflect the consideration to which your entity expected to be entitled in exchange for those goods or services. FASB included five steps to achieve this core principle. These steps will help your Organization determine how to recognize revenue from contracts with customers:

- Step 1: Identify the contract(s) with the customer.
- Step 2: Identify the performance obligations.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price.
- Step 5: Recognize revenue when (or as) a performance obligation is satisfied.

The following are practical steps for implementing Topic 606:

- Read the standard and all relevant commentary from audit firms and attend related CPE.
- Assign individual staff to become subject matter experts on specific revenue categories or by section to lead a group of staff to understand and implement the new standard. Include relevant staff outside of accounting: internal audit, legal, etc.
- Compile a list of all organizational revenues.
- Develop and document a position paper on each revenue stream:
    - Read the standard.
    - Document your current process (if applicable).
    - Identify the relevant sections, being as specific as possible when options are presented.
    - Support your position with facts, including facts as to why a specific section may not be applicable.
    - Document your conclusion on how to recognize revenue.
    - Review with your external auditor.
    - Finalize and approve new recognition policy.
- Consider discussing issues with similar organizations within your industry.
- If a change is required, is it material?
    - If no, document, discuss impact with auditors (annual passed adjustment?) and continue with prior recognition methodology.

- If a change in recognition is required, consider impact on the following:
    - Are changes in verbiage needed for new related contracts?
    - Recognition processes within the accounting system
    - Technical changes within the accounting or supporting systems
    - Monthly/annual financial close process
    - Internal financial reporting
    - Audited financial statements
    - Forecast and budget processes
    - Dashboard goals
- Communicate changes to CFO, Board, audit/finance committee, senior staff, key programmatic stakeholders, auditors, internal auditors, contract signers, banks, bondholders, etc.
- Determine requirements to retrospectively adopt the new standard or prepare comparative financial statements (prior year restatement?).
- Develop a plan for staff training.

If your organization historically recorded a receivable and deferred revenue as bills were rendered or mailed, that practice is not acceptable under Topic 606, as an unconditional right to consideration does not exist.

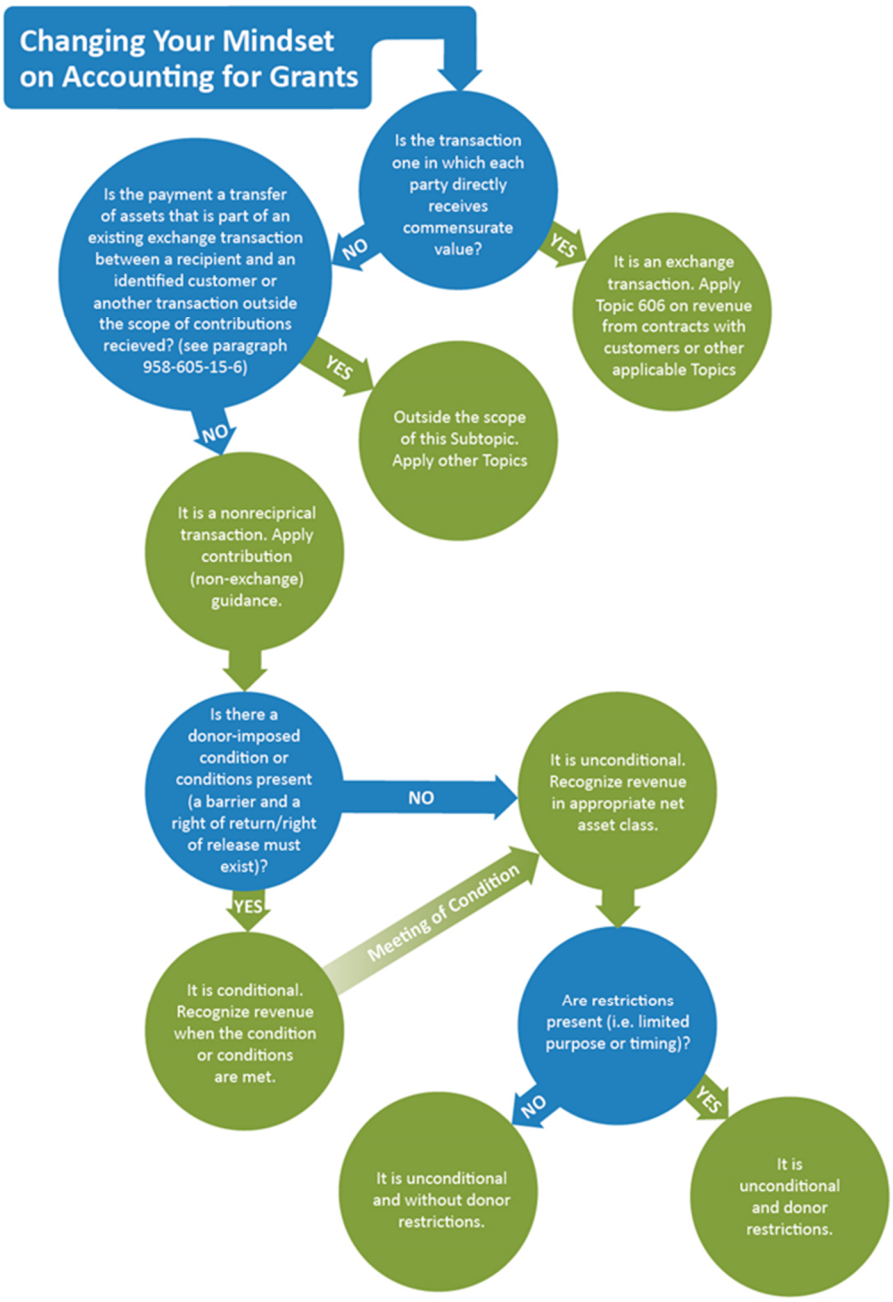
This standard is effective for 2019 calendar year-end or 2020 fiscal year-end as applicable.

FASB ASU 2018-08 Clarifies Revenue Accounting for Nonprofit Grants and Contracts

On June 21, 2018, the FASB released ASU 2018-08, *Clarifying the Scope of the Accounting Guidance for Contributions Received and Contributions Made.*

The update provides clarifying guidance on accounting for the grants and contracts of nonprofit organizations as they relate to the new revenue standard (ASU 2014-09 *Revenue from Contracts with Customers),* and aims to minimize diversity in the classification of grants and contracts that exists under current guidance.

To help organizations better understand the impact of the standard, the guidance includes illustrative examples and a flowchart to provide a framework to evaluate and properly classify revenue streams.



Reciprocal versus nonreciprocal transactions

Step one in the ASU flowchart asks organizations to distinguish between reciprocal (exchange) and nonreciprocal (contribution) transactions. Under current practice, many nonprofits treat governmental entity grants and contracts as exchange transactions, regardless of the substance of the grant or contract.

But for many, the current mindset is that the government does not give contributions — that way of thinking equates the benefits received by the general public to the government receiving commensurate value in return for the assets transferred.

ASU 2018-08 makes it clear that the benefit received by the general public is not the same as the resource provider receiving that benefit (i.e., the government receiving commensurate value in return for the transfer). In addition, execution of the resource provider's mission does not equate to commensurate value. Therefore, under the new guidance, these transactions are considered nonreciprocal.

Determining conditional contributions

Grants and contracts that were previously accounted for as exchange transactions are not necessarily contributions. Step two in the flowchart requires organizations to determine whether a contribution is conditional. Answering this question includes consideration of the following:

- Is there a barrier that must be overcome?
- Does the agreement contain either a right of return of assets transferred or a right of release of the donor or grantor from its obligation to transfer assets?

The updated guidance includes examples of barriers, such as:

- Measurable performance-related requirements (i.e., matching funds, helping a specific number of individuals, etc.)
- Primary purpose agreements (include a specific spending purpose)
- Limited spending discretion

If the contribution is considered unconditional, the final step is to determine if any restrictions exist and to recognize the revenue in the appropriate net asset class.

Implementation of the new standard

Three scenarios are provided to illustrate the possible differences that may affect how the standard impacts your organization include:

- In the past, if you receive funding up front, you may have accounted for the entire grant as a temporarily restricted contribution; the portion that is still subject to the right of return (if a barrier is not met) would now be shown as deferred revenue.
- If you previously accounted for agreements as exchanges, and your policy is to not show restrictions met during the same year as being received as unrestricted support, the revenue would be shown initially as restricted and then as a release from restrictions.
- If you were accounting for grants and contracts using a cost-based reimbursement model, the revenue recognition is likely the same. In the past, you recognized revenue as you met the barrier (i.e., performed the required service). This approach would remain the same in the future, as the condition and the restriction are likely met simultaneously.
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This standard is effective for 2019 calendar year-end or 2020 fiscal year-end as applicable.

Tax Reform Implications for Exempt Organization Employers and Employees

On December 22, 2017, President Donald Trump signed the most significant tax reform legislation in more than 30 years. While the overhaul has wide-ranging implications throughout American business and society, numerous provisions will affect tax-exempt organizations, including public charities, social welfare organizations, colleges and universities, nonprofit health care organizations, associations, and private foundations.

Key provisions for tax-exempt organizations

- **Potential impact on contributions:** Perhaps the greatest uncertainty for many charitable organizations is the potential impact on contribution revenue as a result of the increase in the standard deduction and the lowering of tax rates. The Urban-Brookings Tax Policy Center estimates that, while only 26% of taxpayers itemized their deductions in 2017, those taxpayers were responsible for 82% of charitable giving.

  Under the 2017 Tax Act, charitable donations may decrease to the extent that donors are motivated by tax incentives. For example, the standard deduction for married taxpayers filing a joint return increases from $12,700 in 2017 to $24,000 in 2018. The Tax Policy Center estimates that the number of taxpayers who file itemized deductions could drop by almost 40 million by 2019.

- **Estate tax exclusion:** After December 31, 2017, the estate tax exclusion doubles from $5.6 million to $11.2 million, adjusted for inflation. Combined with reductions in individual tax rates, charitable giving may be of decreased importance for estate planning purposes.

- **Limits on deduction for contributions:** For tax years after December 31, 2017, the deduction for contributions of cash to public charities and certain other organizations is limited to 60% of the individual donor's adjusted gross income (AGI). Such contributions were previously limited to 50% of AGI. The 20, 30, and 50% limitations applicable to other donations are unaffected by the new law.

- **Change in corporate tax rate:** Changes in the corporate tax rate will apply to unrelated business income (UBI). Previously, the rate was only 15% on the first $50,000 of taxable income, and it gradually increased to 35%. Under the new law, UBI is subject to a flat rate of 21%. Nonprofit organizations with net taxable income below approximately $91,000 will experience a tax increase rather than a decrease. For example, a nonprofit reporting $50,000 of net taxable income will see its tax liability increase from $7,500 to $10,500, while an organization reporting $91,000 of net taxable income will see its tax liability decrease from $19,190 to $19,110. The change in tax rates does not apply to tax-exempt organizations established as a trust.

- **Separate reporting of taxable income:** For tax years beginning after December 31, 2017, nonprofit organizations that report income from more than one unrelated trade or business must compute the net taxable income from each activity separately. Losses from one activity cannot be used to reduce taxable income from another activity. However, the $1,000 specific deduction applies to the combined net income of the organization's activities, not to each activity separately. Organizations should exercise care when calculating quarterly estimated payments and extension payments.

- **Changes in rules for net operating losses:** Net operating losses (NOL) generated in tax years beginning before January 1, 2018, may continue to be applied against any UBI, subject to the 20-year carryforward limitation. However, NOLs generated in tax years beginning after December 31, 2017:
    - May not be carried back to prior years;
    - May be carried forward indefinitely;
    - May only be applied against the same unrelated activity that generated them; and
    - May only be used to offset 80% of taxable income.

    For example, an organization has a net loss on its periodical advertising of $10,000 (Form 990-T Schedule J) and net income of $5,000 from rental income from debt-financed property (Form 990-T, Schedule E). Previously, the organization would report an NOL of $5,000 that could be carried forward 20 years and applied against any type of UBI activity. Under the new law, the organization will report $5,000 of taxable UBI and an NOL of $10,000 that can be carried forward indefinitely, but that can only be applied against net income from periodical advertising.
- **An end to certain employer deductions:** Certain fringe benefits are no longer deductible by employers, including commuter transportation, mass transit passes, parking facilities, and onsite athletic facilities (gym, pool, tennis court, golf course, etc.). Tax-exempt organizations that provide such benefits must report the expenditure as UBI unless the benefit is directly connected with a taxable activity already included on Form 990-T. The Treasury Department is expected to issue regulations regarding the appropriate calculation. Note that such benefits are still excludible from the employee's income.
- **New rules for bike-riding employees:** Bicycle commuting benefits are still deductible by the employer, but they are now included in the taxable income of the employee. Therefore, such an expenditure is not reported as UBI.
- **Contemporaneous written acknowledgement of contributions:** A donor wishing to deduct a charitable contribution of $250 or more must obtain a contemporaneous written acknowledgement from the organization receiving the donation. Previously, if the donor failed to retain a copy of the acknowledgement, the donor could attempt to substantiate the donation using the donee's Form 990 Schedule B. For tax years beginning after December 31, 2016, no such exception is acceptable.
- **Interest on current refunding bonds:** Tax-exempt bonds, including qualified 501(c)(3) bonds, are appealing to investors because the interest is excludible from taxable income. A refunding bond is issued to pay principal or interest, or redemption price on a prior bond. A current refunding bond redeems the prior bond within 90 days, whereas an advance refunding bond is issued more than 90 days prior to the redemption of the prior bond. Advance refunding bonds effectively allowed two sets of federally subsidized debt in connection with a single activity. Under the new tax law, interest on current refunding bonds remains excludible from taxable income, but interest on advance refunding bonds issued after December 31, 2017, is not.

- **Repeal of authority to issue tax credit bonds:** The holder of a tax credit bond receives federal tax credits instead of interest. Certain tax credit bonds are direct-pay bonds, which allow the issuer to receive a payment directly from the IRS instead of providing the bondholder with a tax credit. After December 31, 2017, the authority to issue tax-credit bonds and the provision for direct-pay bonds is repealed (e.g., forestry conservation, clean renewable energy, energy conservation, zone academy, and school construction). Bonds issued prior to January 1, 2018, are still subject to the previous rules.
- **Excise tax on large endowments:** In an effort to address private educational institutions where the size of the endowment is out of proportion with the educational mission, the new tax law imposes a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students, of which more than 50% are in the United States, and with noncharitable use assets equal to at least $500,000 per full-time equivalent student. The assets and income of related organizations that are available for the use or benefit of the educational institution, including supporting organizations described in Internal Revenue Code (IRC) Section 509(a)(3), are combined for purposes of this excise tax.
- **No deduction for athletic tickets:** Prior to January 1, 2018, a donor who made a contribution that included the right to buy athletic tickets was entitled to a charitable contribution deduction equal to 80% of the payment. After December 31, 2017, no charitable deduction is allowed for such a payment. The disallowance is based on the right to purchase the tickets, regardless of whether the tickets would have been readily available anyway, or whether the individual actually purchased the tickets.
- **New executive compensation rules:** Tax-exempt employers will be subject to a 21% excise tax on compensation in excess of $1 million, including commissions and bonuses, to any covered employee for tax years beginning after December 31, 2017. Compensation does not include Roth elective deferrals but does include 457(f) deferred compensation, including amounts vested even if not received yet. Compensation also includes nonqualified deferred compensation when there is no substantial risk of forfeiture. The excise tax does not cover compensation paid to licensed medical professionals (including veterinarians) in exchange for medical services performed.

  Covered employees are the CEO, CFO, and the next three highest-paid employees. Compensation paid to a person who meets the definition of covered employee for a tax year beginning after December 31, 2016, will continue to be subject to the excise tax, even if the employee no longer meets the definition of a covered employee otherwise, for as long as they are their beneficiaries receive compensation. The excise tax is in addition to and independent of the rebuttable presumption of reasonableness standard, and the prohibition on private inurement imposed on certain tax-exempt organizations. If an individual receives compensation from more than one employer, then the excise tax on excessive compensation is calculated proportionately among them.

- **Excise tax on parachute payments:** A 21% excise tax is imposed on excess parachute payments, defined as a severance payment, including transfer of property, to any highly compensated employee, that is greater than three times the individual's average salary for the previous five years. Highly compensated employees include 5% owners at any time during the previous year, and employees who received compensation exceeding $120,000 in 2018 (adjusted for inflation). Parachute payments do not include amounts paid to annuity contracts under 403(b) or 457(b), or amounts paid to licensed medical professionals (including veterinarians) in exchange for medical services performed. Compensation is treated as paid when there is not a substantial risk of forfeiture. Deferred compensation and increases in its value under a 457(f) plan are subject to this excise tax when vested, even if not received.

Key provisions for employers

- **Temporary family and medical leave:** The tax overhaul creates a paid family and medical leave credit for tax years beginning after December 31, 2017, and before January 1, 2020. The employer must provide at least two weeks (but not more than 12 weeks) of paid leave providing at least 50% of normal wages. Leave mandated or paid for by a state or local government does not count for purposes of the credit. The employee must have been employed for at least one year, and the employee's prior year compensation cannot exceed $72,000 (adjusted for inflation). The credit ranges from 12.5% if the employer pays the employee 50% of wages, up to 25% for 100% of wages.
- **Treatment of employee loans from retirement plans:** Employee loans from a qualified retirement plan are generally not treated as taxable distributions. However, if the individual's employment is terminated, the unpaid loan balance is treated as a taxable distribution unless it is repaid or rolled over to another plan. Previously, a tax-free rollover had to occur within 60 days , but for tax years beginning after December 31, 2017, the rollover must occur before the extended due date of the individual's tax return for the year employment was terminated.
- **Exclusion of awards from taxable income:** Employee achievement awards for such things as length of service or safety records that are awarded as part of a meaningful presentation, can be excluded from the employee's taxable income as long as they are not disguised compensation. The excludible amount is limited to $400 per person ($1,600 if there is a written plan that doesn't discriminate in favor of highly compensated employees). For amounts paid after December 31, 2017, the excludible award cannot be made in cash, cash equivalents, gift cards, gift coupons, gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, or other securities. Such awards can be included in compensation as taxable fringe benefits and are subject to payroll tax.

- **End to employer entertainment deduction:** Expenditures for entertainment, amusement, or recreation, including club dues paid on behalf of employees, are no longer deductible by the employer even if used for business purposes. Previously, the employer could deduct club dues as salary expense as long as the employee included the amount in taxable compensation. Since nonprofit organizations do not generally receive a tax deduction for salary expense, they would generally treat the mission-related portion of club dues as a working condition fringe and exclude them from the employee's compensation. With the complete elimination of the deduction for social club dues, nonprofit organizations should begin to include such benefits in the employee's taxable compensation.
- **Onsite eating facilities:** Expenses incurred after December 31, 2017, for providing food and beverages to employees at on onsite eating facility that qualifies as a *de minimis* fringe benefit, will be limited to 50%, although employees may continue to exclude the entire amount from taxable income.
- **Repeal of ACA individual mandate:** For months beginning after December 31, 2018, the individual mandate of the Affordable Care Act is repealed, resulting in no penalty on individuals who elect not to obtain health insurance coverage. However, the employer mandate remains in effect, requiring that employers with 50 or more full-time employee equivalents must offer ACA-compliant insurance. Employees may still be subject to individual mandates imposed by certain states, such as California.
- **Substantiation of business use of cars, computers, and entertainment:** Certain employer-provided items, such as cars, entertainment and recreational property, and computers and peripherals used outside of the office, have the potential for personal use. Employers must substantiate the amount of business usage of such listed property. For property placed in service after December 31, 2017, computers and peripherals are no longer subject to the substantiation requirements.
- **End of alimony payment deduction:** Alimony payments were formerly deductible by the payor and included in the taxable income of the recipient. For alimony agreements executed after December 31, 2018, the payments are nondeductible by the payor and excluded from the taxable income of the recipient.
- **Increase in Section 179 expensing:** IRC Section 179 allows organizations to expense the cost of certain property rather than capitalizing and depreciating it. The maximum amount is increased from $510,000 for tax years beginning before January 1, 2018, (with dollar-for-dollar reductions if property placed in service exceeds $2.03 million) to $1 million for tax years beginning after December 31, 2017 (with dollar-for-dollar reductions if property placed in service exceeds $2.5 million).
- **No deduction for moving expenses:** Unreimbursed moving expenses are no longer deductible by the employee. Reimbursed moving expenses will now be taxable to the employee. There is an exception for active-duty members of the Armed Forces who must move pursuant to military orders.

- **Elementary and secondary schools now eligible for 529 plans:** Nondeductible cash contributions can be made to a qualified tuition program, known as a 529 plan, and accumulate tax-free earnings to be used for qualified higher education expenses. Distributions are not taxable to the beneficiary. Starting with distributions made after December 31, 2017, eligible educational institutions include elementary and secondary schools.

Proposed changes that were not implemented

- The flat 1.4% excise tax rate on investment income of private foundations was removed from the final bill. The current tiered system, with brackets of 1% and 2%, remains in effect.
- The so-called Johnson Amendment remains in place, prohibiting 501(c)(3) organizations from engaging in political intervention.
- The provision to tax royalty income from the licensing of trademarks was eliminated.
- Most provisions for employee tuition benefits remain unchanged, including:
    - Employers may deduct $5,250 of tuition assistance per year per employee in pursuit of a degree. The employee may exclude the benefit from taxable compensation (IRC Section 127).
    - Education that maintains or improves existing job skills to allow employee to remain in current position are a tax-free working condition fringe (IRC Section 132(d).
    - Scholarship programs remain unchanged (IRC Section 117).

How we can help

Contact our nonprofit tax professionals for timely information, analysis, and guidance on all matters related to new financial landscape created by tax reform.

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We will review the status of these comments during our next audit engagement. We have already discussed many of these comments and suggestions with various Organization personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

This communication is intended solely for the information and use of board of directors, finance committee, management, and others within the Organization, and is not intended to be, and should not be, used by anyone other than these specified parties.

CliftonLarsonAllen LLP

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Cedar Rapids, Iowa
December 4, 2018