

THE NEWSLETTER OF THE BDO NONPROFIT & EDUCATION PRACTICE

NONPROFIT STANDARD



TAX PROPOSALS FOR EXEMPT ORGANIZATIONS TO WATCH IN 2015

By Laura Kalick, JD, LL.M. in Tax

At this point, we are just about through the first quarter, and 2015 has already seen a slew of legislative proposals that could considerably impact exempt organizations. From the [President's FY 2016 budget proposal](#), to last year's [Tax Reform Act of 2014 \(TRA 2014\)](#), to a new proposal requiring that the Internal Revenue Service (IRS) give exempt organizations notice before their exempt status is revoked for non-filing, nonprofits are in the midst of a legislative landscape potentially poised for reform. As we look to the weeks and months ahead, here are a few major pieces of legislation that nonprofits should be monitoring:

Reduction of the excise tax on the investment income of private foundations:

A private foundation is generally subject to a two percent excise tax on its net investment income, and this rate is reduced to one percent in any year in which a foundation exceeds the average historical level of its charitable distributions. TRA 2014 had a provision to reduce the excise tax on the investment income of private foundations from two percent to one percent. This provision found its way into the America Gives More Act of 2014, as well as other tax provisions that were [passed by the House of Representatives](#), but ultimately did not become law last year.

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TAX PROPOSALS FOR EXEMPT ORGANIZATIONS

Meanwhile, the President's budget contains a proposal to reduce the two percent tax to 1.35 percent across the board. Many in the nonprofit community are opposed to the President's proposal because it could actually result in a tax increase for organizations that are able to reduce the tax to one percent under the current tax law formula.

Make the IRA rollover to charity and enhanced deductions for conservation and food inventory permanent:

These provisions aren't permanent, but they keep getting renewed every year. Legislation in 2014 would have made permanent the tax-free distributions from individual retirement accounts (IRAs) for charitable purposes, an enhanced deduction for contributions of food inventory and also the tax deduction for charitable contributions by individuals and corporations of real property interests for conservation purposes. The America Gives More Act of 2015 that makes these provisions permanent was passed by the U.S. House of Representatives on February 12, 2015. In order to become law, the Senate will also have to pass the provisions and the legislation will require final signoff by the President.

Charitable contribution extensions and simplified rules:

TRA 2014 had a number of provisions that would have impacted charitable giving, including one that would allow taxpayers to treat charitable contributions made up until April 15 as deductible in the previous year's taxes. Although this provision surfaced again in 2014, we have not seen it yet this year.

Meanwhile, the President's proposals aim to simplify the rules regarding limitations on the maximum amount of charitable contribution deductions for a single year, regardless of whether contributions are made to public charities or private foundations, whether they are cash or property, and whether they are for the use of the organization. The proposal would also increase the carryforward period for an unused charitable deduction that is in excess of the limits from five years to fifteen years.

College and professional sports under scrutiny:

Both TRA 2014 and the President's FY 2016 budget proposals have placed sports on the radar in a number of capacities. Under present law, those who donate to colleges and universities and receive in exchange the right to purchase tickets for seating at an athletic event may deduct 80 percent of their contribution. This is in contrast to the usual rule that only the contribution in excess of the fair market value received in return can be deducted. Both TRA 2014 and the President's budget proposals aim to eliminate this deduction.

There are also two other tax proposals aimed at sporting events. TRA 2014 would have eliminated the ability of professional sports organizations such as the NFL, NHL and others to be exempt under Internal Revenue Code (IRC) 501(c)(6). Additionally, although the President's proposals would expand the use of tax-exempt financing for infrastructure and research, they would repeal exempt financing of professional sports facilities on the basis that it transfers the benefits of exempt financing to private professional sports teams, rather than the general public.

New tax bills introduced in the Senate:

Three new tax bills were also recently introduced in the Senate, were vetted in a hearing of the Senate Finance Committee and were approved by voice vote in Executive Session. They include a bill to require the IRS to give an exempt organization 65 days' notice before it has its exempt status revoked for failing to file information returns (Form 990 series); a bill to make certain agricultural research organizations public charities; and a bill to provide an exception to the private foundation excess business holding rules for certain philanthropic business holdings.

TRA 2014:

The Tax Reform Act of 2014 contained many legislative proposals for tax exempt organizations including: disallowing losses from one unrelated business income (UBI) activity to offset the income from another UBI

activity; changes to the corporate sponsorship and royalty rules; expansion of the reach of intermediate sanctions to 501(c)(5) and (6) organizations; and the imposition of a 25 percent excise tax on compensation paid to a nonprofit organization's top five executives in excess of \$1 million. It is possible that some of these proposals could resurface again in the year ahead.

Gifts to 501(c)(4), (5) and (6) organizations:

Finally, we know that gifts to organizations other than 501(c)(3) organizations do not qualify for charitable deductions. However, whether gifts over \$14,000 are subject to the gift tax if made to other nonprofit organizations has never been clear, and there have been times when the IRS has threatened to apply the tax when a gift was made to a 501(c)(4), (5) or (6) organization. To remedy the situation, Ways and Means Oversight Subcommittee Chairman Peter Roskam just introduced H.R. 1104, the Fair Treatment for All Donations Act, which would permanently ensure that donations to 501(c)(4), (5) and (6) organizations are not subject to the gift tax.

Stay tuned to the Nonprofit Standard blog and future newsletters in the weeks and months ahead, as we'll be keeping a close eye on these proposals as they progress through the legislative process, and will keep you updated.

Article adapted from the Nonprofit Standard blog.

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WITH CHARITABLE GIVING TACTICS OLD AND NEW, NIMBLE NONPROFITS WIN

By Laurie De Armond, CPA

THE NUMBERS ARE OUT.

Charitable giving grew by 2.1 percent in 2014, according to the newly-released [2014 Charitable Giving Report](#) from Blackbaud, and this modest growth will no doubt prompt nonprofit fundraisers and executives to take a step back and evaluate their own fundraising results from the past year. But behind this solitary, lackluster statistic, there's a more complex and profound transformation taking place in the U.S. charitable giving environment.

Above all, nonprofits currently face a challenging combination of longstanding norms and evolving trends. Nonprofit trade journals are full of articles about online giving trends, social media tactics and crowdfunding triumphs that provide resounding success stories and helpful tips around improving fundraising effectiveness. These newer fundraising models are critical, and will only become more important over time, but they are just one piece of the puzzle. Online donations accounted for only 6.7 percent of all U.S. giving in 2014, according to Blackbaud, and nonprofits are still largely working to secure donations via traditional channels, attract and retain new donors, and encourage affluent donors to extend their generosity through large gifts. To be sure, these perennial challenges are not going anywhere, but in the face of evolving donor behavior, nonprofits must evolve, as well.

Consider, for example, what's occurring among the largest charities in the United States. According to [The Chronicle's Philanthropy 400 index](#), these top organizations saw an 11 percent boost in donations during 2013, driven largely by affluent donors. Despite this growth, donor preferences shifted notably, and the affluent donors that contributed the lion's share of revenue to the 25 largest nonprofits increasingly gave to donor-advised funds (DAFs). In fact, four of the top 10 nonprofits by revenue were DAFs last year, and a growing number of these funds continue to move up the ranks. For traditional large

charities (which saw [1.3 percent growth](#) in donations during 2014), as DAFs receive a greater share of contributions from America's philanthropists, the ongoing challenge of attracting and retaining donors is only further intensified.

This is just one of many major shifts in donor behavior, but its impact and ramifications are clear: Even the sector's behemoths face competitive threats and the draining

effects of donor abandonment. Charities of all sizes and across all segments rely on large bases of generous givers. But as new generations of donors gain financial means, and as the interests and giving preferences of existing donors transform, so must charities' fundraising strategies.

What remains constant is the need for engagement. However, shifts in technology mean that connecting with donors requires

Does Your Organization's Development Plan Need Refreshing?

In an era where nonprofits can be sharply criticized by donors and watchdog organizations for spending too much on fundraising, some nonprofits shy away from making critical investments in their development efforts—investments which, in the long run, could substantially impact their financial stability.

We've created a checklist below with questions that organizations should consider when determining whether their overall development plan needs refreshing. While not all of the questions can be weighed equally, if you answer "No" to more than five, it may be a sign that your organization needs to strategically reassess its plan.

Y	N	
		Is fundraising seen as the lifeblood of your organization?
		Is your development department stable and able to achieve key fundraising objectives?
		Does your organization regularly review its development plan?
		Does your organization annually consider how effectively it's achieving its mission?
		When reviewing your plan, are you considering the changing demographics of your organization's donor base and proactively addressing these changes?
		Have you discussed new ways to reach potential donors and advocates in the last two years?
		Are your fundraising materials current?
		Have you recently introduced a new fundraising campaign?
		Do you have an online giving program?
		Do you have a mobile giving platform?
		Have you planned or conducted a social media fundraising campaign?
		Do you offer opportunities for potential donors and advocates to get involved in activities that directly fulfill your mission?
		Is your organization flexible and responsive to new fundraising trends and tactics?
		If your organization is experiencing declining donations, does it have a strategic plan in place for increasing contributions?

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CHARITABLE GIVING TACTICS

new mediums of engagement that are accessible, relevant and appealing. For most organizations, antiquated tactics like telethons, telephone solicitation and direct mail campaigns no longer suffice. Effectively competing for funds now demands an adaptive and strategic approach—one that clearly and creatively communicates outcomes; one that creates an impassioned community of advocates; and one that, ultimately, transforms these advocates into a strong base of donors for sustained fundraising growth.

Moving forward, savvy and successful organizations will be those that not only adapt strategically, but also tactically. Digital platforms—online donation portals, mobile-friendly sites, text and email campaigns, social media campaigns—offer the ability to constantly and creatively engage existing and potential donors, as well as build online communities of advocates and financial supporters. Just as importantly, they provide donors with ease and accessibility for actually *making* donations. With [8.9 percent growth](#) in overall online donations during 2014, a strong online presence is now essential for nonprofits.

Still, staying relevant in today's highly competitive environment requires constant tactical innovation. From fun and engaging social media campaigns like the [ALS Ice Bucket Challenge](#), to the rise of community-building giving days like [#GivingTuesday](#), organizations are starting to realize that aside from large gifts, big results can come from outside-the-box fundraising initiatives that encourage peer-to-peer giving. Expect to see more nonprofits pushing the creative bounds and achieving new levels of success in the year ahead.

Article reprinted from the Nonprofit Standard blog.

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COMMUNITY COLLEGE FOR ALL – The Road to Universal Access?

By Tom Gorman, CPA

In his State of the Union Address in January, President Obama outlined the framework for universal access to free education at community colleges. That announcement followed several previews in the days before the speech and has ignited intense debate since. Loosely modeled after a similar plan being implemented in Tennessee, the call for nation-wide access to free education has drawn praise and re-ignited concerns over further government regulation of what many claim to be an over-regulated industry.

THE PROPOSAL

In his address, the President laid out a broad framework for the proposal that would cost an estimated \$60 billion over 10 years. The stated goal of the proposal is to increase the number of students attending community college, and hopefully increase the number of graduates with job skills to enter the workforce. The proposal would be funded through a variety of higher education tax reforms. The most controversial of those was taxing distributions from Section 529 college savings plans. This option was soundly opposed by both Democrats and Republicans, and was subsequently withdrawn from consideration.

Under the proposal, students would need to attend school at least half-time, maintain a 2.5 GPA and show progress towards completing their degree program. In exchange, the federal government would provide 75 percent of the cost of tuition, and states would be required to provide the remainder. In addition, community colleges would need to ensure their credits would be fully transferrable to four-year institutions for those that choose to continue their studies. For their part, four-year institutions may very well develop and expand articulation agreements with community colleges to enhance the pipeline of students with a demonstrated interest in completing their degrees.

TODAY'S REALITY

Many critics of the proposal point out that the average annual price of tuition and fees at community college was recently estimated at \$3,347 by the College Board. This is well below the maximum award limit for the Federal Pell Grant of \$5,730 for the 2014-2015 award year. Others argue that relieving community college students of the financial burden of attending will enhance their completion and graduation rates, and ultimately result in the workforce improvements hoped for by the Obama administration.

The other sticking point of the proposal is the reliance on states to fund one-quarter of the cost of the program. During the economic downturn, state support of higher education—at all levels—fell to some of its lowest levels in recent times. Only recently has state support of higher education increased, and it has just barely returned to pre-recession levels. Many worry that placing additional burdens on states to fund the community college program will simply shift funding from other priorities.

ACCESS, OUTCOMES AND WHERE WE GO FROM HERE

It is hard to look at this free community college proposal in isolation, given the backdrop that exists with the proposed higher education rating system that is being rolled out. The focus on greater access to a college education is laudable; however, funding tied to outcomes and completion rates may prove more challenging. The community college proposal is still at the conceptual stage, with legislative action still to come. We will keep you updated as this proposal takes shape in the coming months.

For more information, contact Tom Gorman, director, at tgorman@bdo.com.

COMPENSATION COMMITTEE – DO WE REALLY NEED ONE?

By Michael Conover



In the Fall 2013 issue of the *Nonprofit Standard*, I contributed a similarly titled article, “*Compensation Consultant... Do We Really Need One? Really?*”. Nearly a year and a half later, it is important to note that for many organizations, the need still exists. But along with compensation consultants, organizations looking to maintain compliance—and their tax-exempt status—are well-advised to also establish compensation committees.

Adoption of final regulations for the Internal Revenue Service (IRS) Intermediate Sanctions (Internal Revenue Code (IRC) 4958) in 2002 prompted many 501 (c)(3) and (c)(4) organizations to formally designate a board-level committee with specific responsibility for oversight of the compensation of their most senior-level executive position(s). This governance structure was a practice adopted long ago by most for-profit and publicly-held organizations. This structure also satisfied one of three criteria stipulated by the IRS for affording a nonprofit organization the ‘Presumption of Reasonableness’ for its pay practices. The Form 990 and requested information in Schedule J provides still more evidence of an expectation of formal governance and oversight of executive pay.

While not every organization has a need for a compensation committee specifically dedicated to this subject, the need for independent board members and the proper process to govern pay is nearly universal for any tax-exempt organization that pays its

senior-most executive(s). It is not unusual to find an executive committee of the board or some similar subset of the board fulfilling this role. This arrangement may have been in place for many years prior to the Intermediate Sanctions, revised Form 990 and the increased scrutiny toward executive pay practices of nonprofit and for-profit organizations alike.

In some of these organizations without a committee dedicated to compensation, longstanding methods of ‘handling’ executive pay may have failed to keep pace with the growth in size and complexity of the organization and/or IRS requirements. Generally, these organizations are categorized as having no compensation committee. The symptoms are often fairly obvious: There is little or no evidence of any policy or process for executive compensation decision-making; there are no external sources of compensation practices for comparable organizations; and there are no meaningful minutes of board discussions and decisions about pay. The oversight of executive compensation is simply a part of the annual chorus of required board votes: “Do I hear a motion? A second? All those in favor.”

Almost as troubling is another scenario in which a board compensation committee has been created, but the commitment of the organization or individual members to the committee’s role is inadequate. Admittedly, many board members assigned to the committee are often volunteers and they are

frequently selected for their interest in the organization’s mission—not for their expertise in executive compensation. Nonetheless, two different causes create what can be considered as, “a compensation committee in name only.”

The first cause is a committee with members having little to no understanding of executive compensation in the nonprofit sector and little or no interest in learning any more about it. These individuals often fail to engage in the discussions and decisions that directly impact the leadership of the organization. Careful consideration of competitive pay practices, thoughtful discussions about the organization’s beliefs about pay, effective evaluation of executive performance and related pay actions are not present. Compensation decision-making is often reduced to predictable, annual upticks in executive salary with sporadic attention to other components of pay (e.g., retirement benefits, life insurance, etc.), often without regard to the executive’s total compensation program.

The second cause is membership turnover. Significant changes in the makeup of the committee on a year-to-year basis can severely reduce its ability to be effective. Without the benefit of any compensation subject matter previously given to former committee members or continuity with past discussions or decisions, new members are a compensation committee in name only. This new group of committee members is

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COMPENSATION COMMITTEE

essentially starting all over again. If past committees have left no policies or processes in place, the new members will potentially need to create a compensation strategy for their tenure.

Organizations without compensation committees, or where the committee is not properly performing the role—or performing it in name only—are at risk. Inattentive or even well-intentioned decision-making without the benefit of effective policies and processes for managing executive pay may have negative consequences. At a minimum, an opportunity for an objective assessment of the executive's performance and the reasonableness of compensation in light of competitive practices by comparable organizations may be lost. In more serious cases, an organization may be startled by the realization that executive pay has become the focal point of embarrassment and adversity.

Above all, organizations that pay their senior executive(s) would be well-advised to consider the following recommendations:

- Formally assign responsibility for oversight of executive pay to a committee of independent board members. It may be a committee already in existence, or a new compensation committee may need to be established.
- Draft a charter describing the role and accountability of the committee. In addition to monitoring competitive pay practices for comparable organizations, consider the role the committee could play in managing the performance/evaluating the effectiveness of the executive(s) for which it is responsible.
- Establish membership guidelines for the committee. Ideally, a member should serve through two or more annual cycles of the process. In addition, committee membership and committee chair terms should be staggered to ensure adequate continuity on a year-to-year basis, but also allow the introduction of new members in the process.

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GOING CONCERN: WHAT NONPROFIT MANAGEMENT TEAMS NEED TO KNOW

By Lee Klumpp, CPA, CGMA

Financial reporting issues remain hot topics for those in the nonprofit industry, but one of these issues in particular has historically lacked direction and guidance for for-profit and nonprofit organizations alike: going concern.

To help provide clarity around the issue, the Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements - Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*.

For the sake of background, the principle of going concern is embedded in our conceptual accounting framework. It's based on the assumption that an organization will remain in operation for the foreseeable (a reasonable time period) future. Conversely, this also means the organization will *not* be forced to cease its operating and programmatic activities and liquidate its assets in the near term. By making this assumption, management is justified in deferring the recognition of certain expenses until a later period, when the organization will presumably still be operating to achieve its mission and using its assets in the most effective manner possible.

The going concern principle is presumed as the basis for preparing financial statements—unless and until the organization's liquidation becomes imminent. If and when a nonprofit's liquidation *does* become imminent, financial statements should be prepared using the liquidation basis of accounting in accordance with Subtopic 205-30. For years, U.S. auditing standards assisted auditors in evaluating whether there was substantial doubt about an organization's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. However,



in practice, this created difficulties between auditors and management.

To clarify, an organization is assumed to be a going concern in the absence of significant information to the contrary (e.g., an organization's inability to meet its obligations as they come due without substantial asset sales or debt restructurings). Even if an organization's liquidation is not imminent, there may be conditions or events that raise substantial doubt about the organization's ability to continue as a going concern. In those situations, financial statements should continue to be prepared under the going concern basis of accounting. However, the user of the financial statements should be informed that these conditions exist. With the issuance of ASU 2014-15, there is now guidance in generally accepted accounting principles (GAAP) about management's responsibility to evaluate whether there is

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GOING CONCERN

substantial doubt about an organization's ability to continue as a going concern, and if so, provide related footnote disclosures.

Auditors have always been required to consider the possible financial statement effects, including footnote disclosures, on uncertainties about an organization's ability to continue as a going concern for a reasonable period of time (the American Institute of Certified Public Accountant's Codification of Statements on Auditing Standards Section AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*). With the implementation of ASU 2014-15, management must now perform this analysis and determine the impact on the financial statements.

ASU 2014-15 now requires that management evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the organization's ability to continue as a going concern within one year after the date that the financial statements are issued (or, when applicable, within one year after the date that the financial statements are available to be issued for entities with conduit debt). Management should consider, among other issues, the following items in deciding if there is a substantial doubt about an organization's ability to continue as a going concern (See the related article entitled "Assessing Financial Stability" for a checklist of items to consider):

- Negative trends in operating results, such as a series of losses;
- Loan defaults by the organization;
- Denial of trade credit to the organization by its suppliers;
- Uneconomical long-term commitments to which the organization is subjected; and
- Legal proceedings against the organization.

This evaluation should be based on relevant conditions and events that are known and reasonably foreseeable at the date that the financial statements are issued—or at the date that the financial statements are available to be issued. Substantial doubt about an organization's ability to continue as a going concern exists when relevant conditions and events indicate that it's probable the organization will be unable to meet its obligations as they become due within

one year after the date that the financial statements are issued (or available to be issued). The term *probable* as defined in the Accounting Standards Codification (ASC) Topic 450 means that the future event or events are likely to occur.

The mitigating effect of management's plans should be considered only to the extent that (1) it is probable that the plans will be effectively implemented and, if so, (2) it is probable that the plans will mitigate the conditions or events that raise substantial doubt about the organization's ability to continue as a going concern. If conditions or events raise substantial doubt about an organization's ability to continue as a going concern, but the substantial doubt is alleviated as a result of consideration of management's plans, the organization should disclose information that enables the users of the financial statements to understand all of the following:

- a. Principal conditions or events that raised substantial doubt about the organization's ability to continue as a going concern (before consideration of management's plans);
- b. Management's evaluation of the significance of those conditions or events in relation to the organization's ability to meet its obligations; and
- c. Management's plans that alleviated substantial doubt about the organization's ability to continue as a going concern.

It is also possible for nonprofits to mitigate their going concern status by having a third party guarantee their debts or agree to provide additional funds as needed. By doing so, a nonprofit's management can be reasonably assured that they will remain functional for a reasonable period of time as stipulated by GAAP.

If conditions or events raise substantial doubt about an organization's ability to continue as a going concern, and substantial doubt is not alleviated after consideration of management's plans, an organization should include a statement in the footnotes indicating that there is substantial doubt about the organization's ability to continue as a going concern within one year after the date that the financial statements are issued

(or available to be issued). Additionally, the organization should disclose information that enables users of the financial statements to understand all of the following:

- a. Principal conditions or events that raise substantial doubt about the organization's ability to continue as a going concern;
- b. Management's evaluation of the significance of those conditions or events in relation to the organization's ability to meet its obligations; and
- c. Management's plans that are intended to mitigate the conditions or events that raise substantial doubt about the organization's ability to continue as a going concern.

In a situation where management believes that their organization may no longer be a going concern, the issue of whether the organization's assets are impaired needs to be addressed, as it may call for the write-down of their carrying amount to their liquidation value. The underlying concept is that the value of an organization that is assumed to be a going concern is higher than its break-up value, since an organization that is a going concern can potentially continue to fulfill its mission and serve the public good through providing programmatic activities to its beneficiaries.

ASU 2014-15 is effective for fiscal years ending after December 15, 2016 and can be adopted early.

In the meantime, we encourage you to familiarize yourself with the FASB's ASU 2014-15, which provides helpful guidance in GAAP about management's responsibilities surrounding these issues.

Article adapted from a post on the Nonprofit Standard blog.

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ASSESSING FINANCIAL STABILITY

By Dick Larkin, CPA, and Elizabeth Pilacik, CPA

As part of sound financial management practices, management has a responsibility to evaluate its nonprofit organization's ability to continue as a going concern (i.e., the organization's ability to continue operating both financially and programmatically for a reasonable period of time). This review by management should occur every time the financial statements are prepared and made available to the users of those financial statements (no less than annually). The checklist included below identifies key items, as well as other indicators, that management should consider in documenting their assessment. Use of this checklist provides both management and the organization's external auditors with a basis for evaluating certain financial stability factors. For more background information, see Lee Klumpp's article, "Going Concern: What Nonprofit Management Teams Need to Know" on page 6.

Going Concern Checklist for Nonprofit Organizations

Purpose – To assist a nonprofit's management team in evaluating and documenting its assessment of their organization's ability to continue as a going concern. Of course, there may be other indicators not listed here that should also be considered in management's analysis.

For each indicator that applies, describe what mitigating factors, if any, may lessen the impact on the organization's financial stability. Conclude as to whether the evaluation of these key items, indicators and mitigating factors raise substantial doubt about the organization's ability to continue as a going concern, and whether that substantial doubt can be alleviated. Ensure that management's plans are documented and determine appropriate financial reporting and disclosure requirements.

Use the following key items, where appropriate, in evaluating the indicators:

- the latest available interim financial statements and other key financial and operating data;
- events after the statement of financial position (balance sheet) date;
- minutes of meetings of the governing board and key committees of the board, including at least the executive, finance, audit and investment committees; and
- correspondence with lawyers.

COMMUNITY SUPPORT

- Decline in utilization of the organization's services by the local community (fewer students, patients, visitors, members, concertgoers or other users)
- Decline in real dollar support through gifts (cash and in-kind), grants, bequests and member dues
- Decline in hours of time made available by volunteers
- Increasing incidence of turndown of grant requests
- Increasing reliance on very few different sources of support

- Criticism of the organization or its programs by public figures or media, sanctions imposed by programmatic or charity regulators, or being found out of compliance with charity watchdogs' standards
- Concerns about the intent or ability of affiliated organizations to provide continuing support

FINANCIAL STABILITY

- A growing percentage of expenditures for basic operations funded by restricted grants
- A growing percentage of own-source unrestricted revenues committed to meet matching-fund requirements or needed to supplement restricted revenues for special projects
- Operating reserves appear inadequate to support the size of the operations
- Continuing decline or substantial deficit in operating income or unrestricted net assets
- Continuing decline or overdraft in cash and cash equivalents
- A net liability (unrestricted net asset deficit, exclusive of net equity in fixed assets) or net current liability (working capital deficiency) position
- Significant deterioration in key ratios (e.g., debt to equity, gross profit from business-type activities and, if applicable, days' sales in accounts receivable and inventory turnover)
- Long overdue accounts, loans, pledges receivable or excessive inventory
- Difficulty in obtaining trade credit or in paying bills in a timely manner (e.g., due to negative cash flows)
- Organization is financing activities out of overdue suppliers and other creditors

OBLIGATIONS

- A growing debt burden
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment

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GOING CONCERN CHECKLIST

- Violations of loan or grant covenants where appropriate waivers are not likely
- A lender has refused to provide financing for operations or new activities, a line of credit or a guarantee has not been renewed or there have been loan defaults (principal or interest) or other deterioration of lender relationships
- Obligations to fulfill uneconomic long-term contracts
- Significant unfunded pension or other employee future benefit obligations
- Legal proceedings against the entity that may, if successful, result in judgments that could not be met

CURRENT REVENUES AND COSTS

- Cost per unit of service rising rapidly
- Rapid increases in fixed cash costs (salaries and fringes, rent, debt service or others)
- Number of employees per unit of service rising rapidly
- User fee rates rising rapidly (unless resulting from a deliberate management decision to reduce the amount by which such fees are subsidized from other revenue sources)
- Increasing incidence of revenue shortfalls
- Recent declines in profit margins from business-type activities
- A pattern of budget cost overruns, either overall or in specific programs/departments
- Proceeds of long-term debt or sales of long-term investments being used for current operating purposes
- Deferring needed maintenance of capital assets
- Low or declining funding of replacement of capital assets near the end of their useful life
- Failure to pay payroll or other taxes when due (Note: Also represents a possible personal liability)
- Inability to pay salaries or other expenses when due, or borrowing to cover such amounts shortly before payment
- Borrowing of cash or other assets from restricted funds, or other diversions of restricted resources to inappropriate purposes

MANAGEMENT PRACTICES

- Earnings on investments declining disproportionately to general trends of investment yields
- Interest rates charged by lenders increasing disproportionately to general trends of interest rates, unwillingness of lenders to lend to organization or insistence by lenders on burdensome debt covenants
- Levels of receivables, inventory or prepaid expenses increasing faster than related activity would dictate
- Heavy reliance on the success of a significant project or new product
- Increasing incidence of funding source challenge or disallowance of expenses
- Loss of key employees or volunteers
- Violation of laws, regulations or other statutory requirements
- Financial and operating data provided to board members and management is delayed, unclear, or incomplete; explanations of key items and variances are unavailable or of doubtful validity
- Failure on the part of board members and/or management to understand and accept the seriousness of the financial situation**

INDUSTRY AND ENVIRONMENTAL FACTORS

- Recent financial failures of similar organizations
- Recent technological developments that threaten a key program
- Recent changes in legislation or government policy that could have a significant adverse impact on the entity
- Key customers or suppliers have been lost or experienced financial difficulty
- Shortages of important supplies
- Labor disputes, strikes or work stoppages involving the organization or its key suppliers
- Uninsured or underinsured catastrophe, such as fire, drought, earthquake or flood
- Significant negative consequences from environmental remediation problems
- Threats of receivership or forced bankruptcy

Are there any other indications that the organization may not be able to continue as a going concern? If so, describe:

Conclusion – Based on management's evaluation of the noted key items, indicators and mitigating factors, management should determine whether substantial doubt about the organization's ability to continue as a going concern does / does not exist. Where substantial doubt does exist, consideration of management's plans needs to be performed to determine whether these plans have / have not alleviated the substantial doubt. Management's plans should be clearly documented and supported by appropriate and verifiable information.

Checklist completed by _____ Date _____

For more information, contact Dick Larkin, director, at dlarkin@bdo.com, or Elizabeth Pilacik, director, at epilacik@bdo.com.

2014 CHANGES TO FORM 990 AND SCHEDULES

By R. Michael Sorrells, CPA

As in the past few years, most of the 2014 changes to the Form 990 and its many schedules are fairly minor. There is, however, one exception— Schedule A: the schedule required for all Section 501(c)(3) public charities, which has gone from four to eight pages and now includes eighteen pages of instructions.

SCHEDULE A CHANGES

All public charities must check a box on Schedule A indicating why they are a public charity, and based upon that, may have to complete one of two possible numerical support tests to prove public support over a five-year period including the current year. Certain organizations, such as schools and colleges, hospitals and Section 509(a)(3) supporting organizations do not have to complete either of the support schedules. Supporting organizations are exactly what has caused the Schedule A to expand this year. The Internal Revenue Service (IRS) and Congress see significant opportunity for abuse with these organizations and have decided to utilize the Schedule A to gather a large amount of information from them to determine if they are in compliance. Other (non-supporting) organizations will see no change to the information required on Schedule A.

As the name implies, supporting organizations are organized to provide financial or programmatic support for one or more publically supported organizations. There are four types of supporting organizations: Type I, Type II, Type III Functionally Integrated and Type III Non-Functionally Integrated. Type I and Type II organizations are both controlled by the supported organization(s) while both Type III organizations are not. The Type III organizations (especially Non-Functionally Integrated Type III's) pose the most risk in the eyes of the IRS and Congress. Thus, Type III Non-Functionally Integrated organizations are subject to a set of rules very similar to private foundations in terms of making minimum distributions to their supported organization(s). All supporting organizations



are subject to a variety of rules concerning transactions with, and control by, disqualified persons. Some supporting organizations are subject to the private foundation excess business holding rules of Sec. 4943.

The 2014 Schedule A has a battery of questions for all supporting organizations regardless of type that go to the heart of the various rules governing them. However, for Type III Non-Functionally Integrated organizations, there are two pages of fairly complex financial data required in order to prove that distributions have been made at the proper level.

All supporting organizations should take a careful look at the new Schedule A so they are not caught by surprise by the disclosures required. Supporting organizations may wish to discuss their status (type) with outside advisors before completing the various parts of Schedule A.

OTHER 2014 FORM 990 AND SCHEDULE CHANGES

Part VII and Schedule J Compensation: The Form 990 and Schedule J instructions now clearly state that any deferred income actually paid within 2½ months of the end of the calendar year included in the fiscal year being reported, and which are included in reportable income (W-2) on Form 990, does not get reported as deferred income on Form 990 Part VII or on Schedule J.

Group Returns: In Form 990 Appendix E, Group Returns, new instructions are provided

for group returns with Section 509(a)(3) supporting organizations.

Schedule L Transactions with Interested Persons:

This four part schedule discloses various transactions between nonprofit organizations and various interested persons ("insiders"). Previously, each section had slightly different definitions for interested persons. The 2014 Schedule L instructions now say that the definition for insiders is "harmonized" for Parts II, III, and IV with some special definitions still being applicable to Part III, Grants or Assistance Benefiting Interested Persons. Additionally, for Part IV, Business Transactions with Interested Persons, transactions with publicly traded companies in the ordinary course of business, on the same (or better for the organization) terms as it offers to the general public, are excluded from being reported here.

The IRS expects organizations to make a reasonable effort to obtain information about such transactions with interested persons. For 2014, the reasonable effort definition has been harmonized for all four types of transactions, so that the same efforts will pass muster for each. An example of a reasonable effort is for the organization to distribute a questionnaire annually to each person it believes to be an interested person requesting information relevant to determining if the transaction is reportable. See Schedule L instructions for more information.

For more information, contact R. Michael Sorrells, national director, Nonprofit Tax Services, at msorrells@bdo.com.

EFFECTIVELY COMMUNICATING YOUR MISSION AND ACCOMPLISHMENTS: FORM 990 AND BEYOND

By Joyce Underwood, CPA

The Form 990 plays an important part in communicating your nonprofit organization's mission and accomplishments to the world, and is also a key means for promoting your organization.

Filing the Form 990 satisfies your tax compliance requirements, but it is also a public document distributed widely and manipulated by third parties on an ever-increasing basis. Ensuring information in your Form 990 is accurate and conforms to your other communications about your organization is important.

You want to ensure the messaging agrees to your website and social media communications, and conforms to your intended public image. You can describe your organization in a way to attract a certain type of supporter, or speak to an intended generation of donor. You will also want to describe your accomplishments showing effective outcomes, and consider if you want to focus your message on the giver or on the receiver of your resources. These days, more and more donors seek to support organizations with which they find a personal connection, and demonstrating outcomes is one of the most effective ways of showing the progress and impact your organization is making, which helps to create those connections.

The first page of the Form 990 (Part I, line 1) is intended to highlight the organization's mission or most significant activities in condensed form. You should be direct but brief here, providing succinct wording to describe the organization. Page two, the Statement of Program Service Accomplishments (Part III), is where you can shine. Part III requires more detailed information about the mission and activities, and provides an opportunity to further promote the organization and capture interest. The mission described here should reflect the language in the approved mission

adopted by the governing body, either initially or through amendment.

It is important to communicate to the Internal Revenue Service (IRS) any discontinued, changed or new activities, as your tax exemption is dependent upon your approved mission and activities. Should your mission or activities evolve over time from their original intent and not be communicated—or remain appropriate for your status—you could have tax exemption issues.

Organizations are also required to describe the top three program activities, as measured by expenses, and list any other programs carried on. You can describe all program activities, if you prefer. Even if you're not a public charity or public welfare organization, which are required to include the revenue and expenses attributable to the programs, you are required to describe your activities. The IRS requests that you describe program service accomplishments through specific measurements such as clients served, days of care provided, number of sessions or events held, and/or publications issued; describe the activity's objective, both for this time period and the longer-term goal, if the output is intangible, such as in a research activity; and give reasonable estimates for any statistical information if exact figures are not readily available. Indicate that this information is estimated. As long as you satisfy these requirements, you are free to word your descriptions to describe your organization in its best light or to satisfy another audience.

GENERATIONAL ISSUES

An organization should consider its target audiences in addition to the IRS. Have you considered whether you are you targeting Baby Boomers, Gen-Xers or Millennials? There has been a lot of discussion in recent years regarding the different behaviors and preferences of individuals based upon their age and experience. Focusing on these characteristics in your communication style can have an impact on attracting donors

and program participants. In designing your communication, be sure to ask yourself the following questions:

- Do the people you want to attract respond better to certain types of communications?
- Does your mission seem meaningful and engaging? Does it address issues that a specific generation is attracted to or has concerns about?
- Do your descriptions help a donor feel like they can be an active participant in your mission?
- Do you provide validation to donors in your description of accomplishments that helps them see the outcomes of their support?
- Will referencing support of a “member” or “partner” help a donor feel they can become involved?
- Are you using the right language to attract donors that may have an interest in giving through a will or living trust?
- Would it be effective to describe and provide links to more far-reaching digital tools, such as social media campaigns, to attract a large number of small donations?
- Do you effectively utilize a blog, Twitter or other social networking sites?
- Do you know how to speak to and attract a long-term donor?
- Do you know how to send a message that will get noticed, catch on and spread the word?

Giving your readers information about what you do with their generational needs and concerns in mind can be helpful in connecting with them as you describe your mission and activities in your Form 990.

MEASURING IMPACT

Many donors and charity evaluators have been very focused on outcomes in recent years. Since the information from Form 990

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FORM 990 AND BEYOND

is more readily available and increasingly in a readable format, many industry partners are jumping on the bandwagon, either for philanthropic or commercial purposes. Data about organizations is now gathered, analyzed and compared to describe and compare your nonprofit to other organizations. At the same time, others are compiling and analyzing data and demanding more concrete information about performance. It is often now expected that an organization devote resources to measuring and communicating how they have used funding to effectively produce outcomes, as well as justify that the outcomes are appropriate. It can be a balancing act between serving your mission and satisfying the new performance-oriented donor or member. An organization that does not focus on and effectively communicate its results may be at a disadvantage when seeking grants, contributions, dues and other resources.

SHARE YOUR STORY

Storytelling can be an effective communication tool. Stories influence a reader and help people remember facts and circumstances. As such, they provide nonprofits an opportunity to better connect with donors, which can prompt them to be more generous. Stories can also instill a sense of urgency or need, as they have the power to paint a picture. Be sure to state what you stand for and connect them with an image or activity readers will remember. To accomplish this, you may want to include other members' perspectives of your organization in the Form 990 preparation process. Many organizations now have a final review by their development department or the social media team to help provide this collaborative overview.

Above all, whatever you use to describe your organization for Form 990 purposes, you should always consider your larger audience. Although you may want to be brief and quickly scratch off the Form 990 preparation from your to-do list, targeting your readers and telling your story can provide a significant advantage to nonprofits. But remember, you're also talking to the IRS.

BDO'S REBEKUH ELEY APPOINTED TO AICPA'S EXEMPT ORGANIZATION TAXATION TECHNICAL RESOURCE PANEL



BDO is pleased to announce that **Rebekuh Eley, tax senior director in Chicago and a member of the Nonprofit & Education practice**, has been appointed to serve as associate member on the [American Institute of Certified Public Accountants \(AICPA\) Exempt Organization \(EO\) Taxation Technical Resource Panel \(TRP\)](#). In this role, she will contribute to important panel projects, including legislative and regulatory activities, as well as provide tools, information and counsel to other members in the practice regarding improvements to tax practices and procedures.

Eley becomes one of just 30 associate members in this influential group, where she joins BDO tax partner Jeff Schragg. Also an associate member, Schragg has served on the EO TRP for several years, and is active among a number of the AICPA's nonprofit initiatives. He serves as an advisory council member for the [AICPA's new Not-For-Profit Member Section](#), and is a member of the Steering Committee for the AICPA Not-For-Profit Industry Conference.

Eley, Schragg and the rest of the panel are currently tackling various advocacy and member service projects, including the Corporate Governance task force, EO Accounting Method Change task force, EO E-Filings task force and Form 990 and Instructions task force. The panel also maintains a direct dialogue with the EO Commissioner of the IRS

to inquire about IRS initiatives and focus for the year, as well as additional information and guidance from the agency.

"It's an honor to be a part of such a great group of thought leaders and learn from their experience, as well as discuss the trends and changes within the industry," said Eley. "I look forward to working both within the AICPA and in conjunction with the IRS to further advance their important EO initiatives."

"We are very pleased to have Rebekuh join Jeff on this important industry panel," said Bill Eisig, National Nonprofit & Education Practice Leader and National Director of the BDO Institute for Nonprofit ExcellenceSM. "This is an invaluable opportunity for these BDO professionals to not only grow their industry knowledge and better serve our clients, but also to make a meaningful difference in the nonprofit sector overall."

BDO's **Neena Masih, assurance partner**, was also recently appointed to the [AICPA's Not-For-Profit Task Force on Revenue Recognition](#), where she liaises with other members of the task force and coordinates with the AICPA to help nonprofit organizations apply the provisions of the Financial Accounting Standard Board's (FASB) [ASU 2014-09, Revenue from Contracts with Customers](#) that addresses revenue recognition.

For more information, contact Joyce Underwood, director, Nonprofit Tax Services, at junderwood@bdo.com.

NONPROFIT ORGANIZATIONS AND THE TANGIBLE PROPERTY REGULATIONS

By Nathan Clark, CPA

WHAT ARE THE TANGIBLE PROPERTY REGULATIONS?

These regulations were issued by the Internal Revenue Service (IRS) to provide guidance for the acquisition, production or improvement of tangible property—buildings, furniture, fixtures and equipment assets, typically—which must be capitalized and depreciated, deducted in the future or deducted immediately. On a more granular level, these rules dictate how to establish a basic capitalization policy (“de minimis expenses”), identify repair and maintenance costs, account for materials and supplies, determine which costs must be capitalized for the improvement or acquisition of buildings and equipment, and when disposed property may be written off.

These regulations apply equally to all businesses subject to U.S. tax law, regardless of for-profit or exempt status, organization size, legal entity, or industry. They apply to taxable years beginning on or after January 1, 2014. However, in certain situations, the regulations could affect capitalization of costs incurred in years prior to 2014, regardless of a tax return’s normal statute period.

Prior to this new guidance, the previous regulations governing tangible property were a subject of constant disagreement between taxpayers and the IRS, which led to a patchwork of court cases, rulings and other guidance that was not always consistent, nor easily applicable across industries. The IRS, with much feedback and input from taxpayers, rewrote these regulations, which included proposed and temporary regulations, before finalizing the regulations. The prior guidance applied to nonprofits just as the new regulations do. Many for-profit and nonprofit organizations are addressing these regulations now because of the broad application and complexity over the old guidance.

BUT MY ORGANIZATION IS TAX-EXEMPT!

The primary impact of the tangible property regulations is the capitalization of tangible property on the statement of financial position (balance sheet) and the computation of taxable income. Expenditures could be capitalized as improvements to existing buildings, leasehold improvements or equipment assets and deducted over time through depreciation, or conversely, deducted as a repair and maintenance expense, de minimis property, or as materials and supplies.

Nonprofits that pay unrelated business income tax, have taxable subsidiaries, or lose their tax exempt status will need to consider the impact of these regulations and determine if there is a change to current methods of calculating taxable income. Amounts may be re-characterized as capital improvements that were historically deducted, or vice versa.

For example, consider a nonprofit university that operates a convention center and hotel, resulting in unrelated business income tax for the nonprofit university. In 2012, the hotel underwent a renovation to repaint guest rooms, replace broken lighting and plumbing fixtures, and replace the roof, among other miscellaneous expenditures. The university in this example must compare the facts and circumstances of the expenditures to the regulations to determine if the expenditures were improvements that must be capitalized and depreciated, or repair costs that were deductible when incurred. Depending on the scope of the work performed, these amounts could have been capital improvements or deductible repairs. The regulations introduce the concept of “Unit(s) of Property”, which is how the regulations identify the asset that is being repaired or improved. Historically, an entire building was the unit of property. However, now the regulations subdivide building property into nine different “building systems”. When evaluating an expenditure to determine if it is a repair or an improvement, the expenditure must be compared to the relevant “building system” as opposed to the

entire building. This change in how we define the asset that is being repaired or improved can result in characterization of expenditures as capital or deductible that is different from the historical characterization.

OPTIONAL ELECTIONS

Elections are a formalized manner of adopting tax return positions provided by the Internal Revenue Code and regulations. There are three new elections in the regulations that each nonprofit should consider making. All of the elections described below require a statement to be attached to the organization’s timely filed federal income tax return, including extensions. Further, these are annual elections that will need to be considered for 2014 and every subsequent tax year.

De Minimis Expensing Safe Harbor

Most organizations have historically had a capitalization policy or practice where amounts beneath a specified amount were not capitalized as fixed assets. Prior to these regulations, there was no guidance on establishing such a practice. The regulations introduce the De Minimis Safe Harbor to establish a basic capitalization policy. The key requirements are as follows:

1. The organization must have a capitalization policy in place at the beginning of the year specifying that amounts incurred for the purchase of tangible property beneath a fixed dollar amount will not be capitalized for financial accounting or tax purposes;
2. The capitalization threshold cannot exceed \$5,000 if the organization’s financial statements are audited by external auditors, or \$500 if the organization’s financial statements are not audited; and
3. The policy must be in writing if the organization has an audited financial statement.

If an organization follows the above practices—and most importantly follows the practice equally for financial accounting and tax purposes—then the IRS will not

CONTINUED FROM PAGE 13**TANGIBLE PROPERTY REGULATIONS**

question the expensing of amounts beneath the threshold. The capitalization threshold may change (but not exceed the safe harbor limits above) as necessary to meet the changing business practices and needs of the organization.

Small Taxpayer Safe Harbor

The regulations provide an election for a simplified repair versus improvement analysis for small taxpayers. A small taxpayer, for purposes of this safe harbor, is an organization with average annual revenue for the prior three years of not more than \$10 million. Small taxpayers meeting the revenue threshold may expense costs to repair, improve or maintain building property(s) if those expenditures in aggregate, per building, do not exceed the lesser of \$10,000 or two-percent of the original building cost. This simplified analysis may be applied to each building a small taxpayer owns that has an original cost (or total amount of rent payments expected to be paid by the lessee under the term of the lease, including renewal periods) of not more than \$1 million.

Conformity to Book Capitalization of Repair and Maintenance

It is a common occurrence that an amount may be capitalized for financial accounting purposes but deductible under the regulations for taxable income purposes, or vice versa. Another means of simplifying the adoption of the regulations is an election that allows a taxpayer to capitalize amounts that are deductible for taxable income purposes, if those amounts are capitalized for financial accounting purposes. This election allows a taxpayer to capitalize for taxable income purposes amounts already capitalized for financial accounting purposes.

In addition to the formal elections discussed above, the regulations contain numerous other elections, not discussed herein, that are made simply by taking a position on the organization's tax return.

MANNER OF ADOPTION

The regulations, as stated above, are adopted through elections where indicated and by filing Form(s) 3115, *Application for Change in Accounting Method*, as indicated by the IRS

in separate guidance. Consideration should be given to the taxable situation and nature of each nonprofit's activities to determine whether filing of Form 3115 is necessary. A Form 3115 is generally, but not always, filed with a retroactive catch up adjustment that is the difference between the deductions claimed to date under the old method and the deductions that should have been claimed to date under the new method. This adjustment will factor in all amounts from prior years unless otherwise specified by IRS guidance. However, adjustments for certain accounting method changes are required to be calculated on a prospective basis. Filing a Form 3115 provides protection against IRS audit penalties where the old method of accounting could have resulted in unfavorable IRS audit adjustments.

The IRS recently provided relief to simplify the procedures for small businesses making accounting method changes. A small business, for this purpose, is defined as a trade or business with average total revenues for the prior three years of not more than \$10 million or total assets not more than \$10 million. If either test is met, then a nonprofit may adopt the regulations through these simplified procedures. The new procedures allow small businesses to change a method of accounting on a prospective basis without filing Form 3115 or calculating retroactive adjustments. No formal election or statement is required to be filed to request a change in accounting method under these simplified procedures. Eligible small businesses following the simplified adoption procedures will compute taxable income starting with the 2014 tax returns according to the regulations without having to file a Form 3115. However, taxpayers will still be subject to additional taxes, penalties and interest if, upon IRS exam, amounts were deducted in pre-2014 years that should have been capitalized and deducted in a later year or depreciated over time.

PLAN FOR THE FUTURE

Organizations should consider how they are affected by these regulations currently, as well as potential future implications. An organization that currently does not have unrelated business taxable income may feel little impact from the regulations from an

income tax perspective. There will be little incentive for the IRS to enforce the regulations for many nonprofits where income tax is not paid. However, where a nonprofit pays unrelated business income tax, has taxable subsidiaries, or loses its tax exempt status, it should absolutely address these regulations currently. A nonprofit should anticipate filing Form 3115 in future years subject to unrelated business income tax, even if not currently subject to income tax. It is generally recommended that an organization make the de minimis safe harbor election regardless of whether it currently pays unrelated business income tax.

Consideration should also be given to determine whether these regulations could change the way overhead percentages are calculated for benchmarking purposes, statement of financial position (balance sheet) implications to assets or activities potentially eligible for a future sale, spin-off or other separation resulting in tax concerns upon separation, or taxable income implications for activities that cycle in and out of taxable activities. The tangible property regulations may also result in changes to the capitalization practices for financial accounting purposes.

The regulations provide broad ranging guidance on what must be capitalized as tangible property. However, they do not change any depreciation rules. For amounts required to be capitalized under these regulations, nonprofits will need to continue to apply the appropriate tax depreciation rules to elect appropriate tax depreciation methods.

Although these regulations affect many issues related to tangible property, they offer flexibility and options for determining the best course of action. Nonprofits, although not affected in the same manner as for-profit entities, are nevertheless subject to these regulations, and should discuss with their tax adviser the potential implications in order to plan for and mitigate unexpected and potentially adverse consequences.

For more information, contact Nathan Clark, senior tax director, at nclark@bdo.com.

2015 OUTLOOK: NONPROFIT HEALTHCARE ORGANIZATIONS

By Adam Cole, CPA, Cortney Marcin, and Patrick Pilch, CPA, MBA

Pressures to perform and transform, merge, acquire or consolidate, and protect are building and converging on nonprofit healthcare organizations. As such, 2015 promises to be a seminal year for these organizations and the communities they serve.

According to the American Hospital Association's 2013 Hospital Statistics, there are about 5,686 hospitals in the U.S., 2,904 of which are nongovernment nonprofit community hospitals and 1,010 are tax-exempt state and local government community hospitals.

The pressure to perform and transform is informed by numerous data points that are combining to make the current operating model structure unsustainable:

- The Medicare Payment Advisory Commission's 2014 Data Book shows a demonstrable decline in Medicare inpatient and outpatient margins from 2002 to 2012. For that period, the overall hospital Medicare margin decreased from 2.2 percent to a negative 5.4 percent.
- Modern Healthcare analyzed earnings for approximately 200 hospitals and health systems and included a mix of nonprofit and investor-owned through 2013. The study revealed a shrinking of margins for all hospitals to 3.1 percent in 2013.
- A Moody's report on operating margins of nonprofit hospitals and health systems for 2013 showed overall operating margin deterioration to 2.2 percent.
- Moreover, the typical hospital's payer mix is 40 percent Medicare. This year, 8 percent of Medicare payments to hospitals will be value- or risk-based. Moreover, in February, Health and Human Services (HHS) announced a goal of tying 30 percent of existing fee-for-service Medicare payments to value-based payment models such as Accountable Care Organizations (ACOs) or bundled payment models by the end

of 2016, and ultimately 90 percent of all traditional Medicare payments by 2018.

The trend is accelerating, and makes the current operating model structure unsustainable. The credit rating agencies know this. For the third consecutive year, the three major credit rating agencies all forecast a negative outlook for the nonprofit healthcare and hospital sector. They pointed to declining cash flows from operations because of lower revenues associated with the shift to risk-based reimbursement from volume-driven fee-for-service reimbursement, coupled with the rising costs of operations. The agencies also anticipate further rating downgrades due to the continuing challenges associated with the implementation of the Affordable Care Act (ACA).

The shift away from traditional fee-for-service to value-based payments has been underway for some time through various

innovation models, and has accelerated under the ACA. The acceleration has been the result of a greater emphasis being placed on overall population health, preventative care, reductions in hospital admissions and readmissions, and providing services in lower cost of care settings to reduce overall costs.

Adding to the uncertainty is the upcoming U.S. Supreme Court decision in the *King vs. Burwell* case, which may overturn the ACA's provision for insurance coverage purchased through federally operated state exchanges.

One might ask, "have similar dynamics occurred in other industries?" The resultant tipping point faced by the healthcare industry is similar to that faced by another capital-intensive industry in the late 20th century: U.S. steel. In that emblematic case study, new, more nimble competitors eroded the country's global market advantage by introducing more modern methods and technologies. A flurry of

INTRODUCING THE BDO KNOWS HEALTHCARE BLOG

The BDO Center for Healthcare Excellence & Innovation is pleased to launch the BDO Knows Healthcare Blog, a new resource and discussion platform focused on critical issues impacting the industry and redefining the future of care. Posts come from prominent industry thought leaders with a wealth of knowledge and experience in both business advisory and clinical practice. They explore how reimbursement and regulatory changes are reshaping provider and payor business models, covering both the financial and clinical implications and drawing on their depth of experience in healthcare finance, operations and clinical practice. They also touch on the myriad compliance and risk management challenges healthcare organizations face, as well as M&A and capital strategies.

In today's increasingly complex healthcare environment, BDO understands that collaboration is crucial to creating robust organizational change.

We invite you to join us on this journey at <http://healthcareblog.bdo.com>.



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2015 OUTLOOK

capital restructuring and operational redesign followed, and the industry ultimately shifted to more efficient mini-mills structures. By the 1980s, the rush of competition not only forced the shutdown of aging mills, but also began to threaten some of the more thinly capitalized new entrants.

We posit that 2015's outlook for nonprofit healthcare organizations will reflect a similar dynamic; nonprofit hospitals will need to access the right capital aligned with the new—and different—operating and delivery models, and they must monitor and adapt to outside factors that will impact access to this capital, as well as their operations and reimbursements. New regulations and stressed government budgets threaten access to grants and tax-exempt bonds, and even tax-exempt status itself. Compliance will be critical in the face of these evolving requirements and new scrutiny.

Typically, for nonprofit healthcare organizations, capital is provided through tax-exempt bond financing, charitable contributions through foundation development and, occasionally, government or private grants. Tax-exempt bond financing represents the primary source of capital. Rates for these borrowings are lower than their taxable comparables, but easy access to such financing is challenging given both a negative outlook for reimbursement and the sector, as well as the need for more efficient capital and scale to redesign nonprofit healthcare organizations. The need for capital has accelerated mergers and acquisitions and consolidation activity. For the last several years, this activity has been robust among nonprofit hospitals and within the social service sector. In addition to traditional M&A activity, nonprofit healthcare organizations have been pursuing risk sharing arrangements through ACOs, bundled payment arrangements and managed care contracts. Other capital arrangements through joint ventures with Real Estate Investment Trusts (REITs) also create access to new sources of capital. We expect these activities to continue, and even accelerate.

Potential regulatory changes may place nonprofit healthcare organizations' tax exempt status at risk in two important ways.

First, in return for tax-exempt status, federal law requires nonprofit health systems to provide services to the poor and uninsured/underinsured, as well as to provide community benefits to the general public. The ACA contains a provision that requires hospitals to make "reasonable efforts" to assess whether patients qualify for financial assistance before taking an aggressive step like filing a lawsuit. This provision has bipartisan support in Congress. Recent news reports suggest that the government intends to enforce this provision in the form of significant penalties to those organizations that appear to cross the line. While a loss of tax exempt status has not yet happened under this provision, it remains highly possible this provision will impact the tax exempt status of organizations that do not comply.

Secondly, billions of dollars in tax exemptions granted to nonprofit hospitals are being challenged by regulators and politicians as federal, state and municipal budgets have been strained significantly since the recession. Nonprofit healthcare organizations need to ensure that they are in compliance with the new provisions of the ACA, as well as state and local regulations, in order to protect their nonprofit status.

There are myriad additional regulatory and compliance requirements taking effect in 2015, including notable changes impacting federal funding as affected by the Office of Management and Budget's (OMB) new Uniform Guidance. The guidance is the most comprehensive set of changes to occur to the OMB regulations in decades, and will impose more consistent guidelines on both grant recipients and organizations issuing grants to sub-recipients, which is more common with certain healthcare funding arrangements. Compliance will be critical in the face of these evolving requirements and new scrutiny.

So, what should nonprofit healthcare organizations consider for 2015 and beyond?

1. Understand your cost of care and cost of operations.

This is often easier said than done. Care delivery is complex, and fragmented outcomes are disassociated from financial and market

analytics. There is much market opportunity to reposition nonprofit healthcare organizations for the future sustainability.

2. Understand your investment thesis.

Nonprofit healthcare CFOs can take a page from global corporations whose CFOs must evaluate their enterprises from a portfolio perspective. In the same way that steel industry CFOs redeployed capital into new mini-mill models, so too can healthcare providers examine their assets in terms of ROI. Reduce or moderate investment in lower ROI assets in favor of aligning investments with higher-ROI businesses in emerging or growing markets or assets. Think care design and new risk-based models.

3. Understand your market and your "customer."

Nonprofit healthcare leaders need to understand the implications of the risk shifts from payer to provider to consumer, as well as the opportunities for investing in a customer-focused relationship. Understanding the market need through visual analytics will serve nonprofit healthcare organizations well in redesigning their models around the population they serve. Tapping into best practices from consumer focused industries will be helpful.

4. Understand who you are and what your organization means.

Do you have the vision, leadership, appropriate resources, ideas, capital and partners to mitigate the risks and take advantage of the opportunity for your organization? Each CFO must ask himself or herself: "Where are the gaps? Can we execute the change?"

5. Understand what your future state could look like—the art of the possible.

Look to the future and assess what will be the successful models in five or 10 years, taking into account the first four recommendations.

The next step is to get started!

For more information, contact Adam Cole, partner, at acole@bdo.com, Cortney Marcin, manager, at cmarcin@bdo.com, or Patrick Pilch, managing director, The BDO Center for Healthcare Excellence & Innovation, at ppilch@bdo.com.

NONPROFITS BEWARE: THE HIDDEN COSTS IN AN OFFICE LEASE

By Patrick Gioffre, The EZRA Company

HAVE YOU EVER HEARD OF A "GROSS UP" CLAUSE? DO YOU KNOW WHY OPERATING EXPENSE PROVISIONS COULD COST YOU THOUSANDS?

There can be inconsistencies and dangers lurking in an office lease, and nonprofits should be privy to the ways some building owners aim to pass on additional expenses to tenants. Here's what to look for and how to prepare.

The financial components of most leases for office space include a base rent, an annual escalator, a tenant improvement allowance, perhaps some free rent and a pass-through of increases in operating expenses over a base year.

For example, a 10-year office lease could have a base rent of \$41 per square foot (which is increased by 2 percent per year), 10 months of free rent, an improvement allowance of \$60 per square foot to be used by the tenant to build out its space and a pass-through to the tenant of increases in operating expenses over a base year of 2015.

All of the financial components of this sample deal are easy to estimate, except the increase in operating expenses over the 2015 base year. If not properly negotiated, increases in operating expenses can be significant. Let's consider the operating expense component of the lease a little closer.

OPERATING EXPENSE PROVISIONS

Most leases have a provision that allows the landlord to pass its pro rata increase in operating expenses to the tenant. If the tenant occupies 10 percent of the building, the landlord can pass to the tenant 10 percent of



all increases in operating expenses over a base year (i.e., usually the initial rental year).

It is the landlord's objective to define operating expenses as broadly as possible to provide the landlord with maximum flexibility to pass through any and all building costs. Operating expenses include real estate taxes, insurance, and common-area maintenance expenses that the landlord incurs to maintain the building, including:

- janitorial services
- gas, water and electricity utilities
- repairs and maintenance to the building systems such as elevators, heating, ventilating and air conditioning (HVAC) systems, electrical systems and plumbing
- property management fees
- labor

If properly negotiated by the tenant's real estate agent, the operating expense provisions should have numerous exclusions and adjustments, which are often lengthy and

include complex mathematical formulas and highly detailed definitions that can run for pages. Unfortunately, some real estate agents don't have a comprehensive understanding of operating expense provisions, so the documents are often not negotiated very well, if at all. The result is that the tenant pays a significant amount more than is fair or necessary over the term of the lease.

For example, if the base year is understated by \$1 per square foot in favor of the landlord on a 10,000-square-foot lease for a 10-year term, this item alone would cost the tenant more than \$100,000 over the term of the lease. It is typically the landlord's goal to keep the base-year expenses as low as possible, in order to pass more operating expenses to tenants.

In a new building, equipment like elevators and HVAC systems are under warranty for the first year. If the first year is also the base year in the lease, then the base-year operating expenses could be understated because of the warranties. If the operating expense provision

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HIDDEN COSTS

does not specifically state that the base-year expenses should be increased for the value of the warranties, then the tenant will likely pay for the impact of these warranties for the entire term of the lease.

This may seem unfair, but if the lease does not specifically address adjusting the base-year operating expenses for items such as warranties, then the landlord will most likely not make those adjustments.

Another example that could have a significant economic impact for nonprofits concerns repairs and maintenance associated with a parking garage. When a landlord charges a parking fee in addition to rent, any cost attributable to the operation of the parking garage should not be included in operating expenses. Again, if this is not specifically addressed in the lease, then most likely the landlord will pass these expenses to the tenant. These are just two examples, and there are numerous others.

THE “GROSS UP” CLAUSE

Another area that could have a significant economic impact if not properly addressed in the lease negotiation is the “gross up” clause. Grossing up expenses is a method of extrapolating certain expenses that vary based on occupancy. If the building is not fully leased, the operating expenses should be adjusted to accurately reflect the expectation of the parties. For example, if the building is only 50 percent occupied during the base year, then operating expenses for items such as janitorial services will be significantly less than if the building was fully occupied.

For the purpose of calculating the operating expenses for the base year, the expenses for janitorial services should be increased as if the building was fully occupied. If this is not done correctly, resulting in the operating expenses for the base year to be understated, then expenses passed to the tenant for the entire term of the lease will be overstated.

THE AUDIT CLAUSE

This provision of the lease allows the tenant to audit the operating expenses for the base year and each year thereafter. It is important that this clause require the landlord to give the

NONPROFIT FACTS: Did you know...

Data from a survey of 261 leading U.S. companies, including 62 Fortune 100 companies, reveals they contributed more than \$25 billion in total giving in 2013, equivalent to around 1 percent of pre-tax profits, or more than \$600 per employee, according to an article in *The Conversation*.

According to the *2014 Fundraising Effectiveness Survey*, 43 percent of donors who made a gift in 2012 did so again in 2013.

Twenty percent of adults under 30 volunteered in 2013, up from 14 percent in 1989, according to census data analyzed by the *Corporation for National and Community Service*.

According to the *Chronicle of Philanthropy*, the viral Ice Bucket Challenge campaign drove an estimated \$220-million in donations globally in 2014, with \$115-million to the ALS Association.

Based on the latest numbers from the *Blackbaud Index*, overall charitable giving increased just 0.1 percent for the three months ending November 2014, compared to the same period of 2013, with online giving increasing 4.4 percent.

Donations on the latest #GivingTuesday surged to an estimated \$45.7 million, more than double the amount raised in 2012 when the event began, according to a new report by *Giving USA Foundation* and *Indiana University's Lilly Family School of Philanthropy*.

According to a survey of eighty nonprofit executives released by *GiveCentral*, only 23 percent of respondents work for nonprofits that measure mobile payment processing, and only six percent have donors who pay via their mobile devices.

Eighty-seven percent of volunteers say there is overlap between the organizations they support financially and where they volunteer, with 43 percent describing significant or total overlap with the organizations they support financially and as a volunteer, according to a recent *Fidelity Charitable* report.

A new Journal of Consumer Research study found that giving donors fewer options spurs more gifts at the end of a campaign.

Nineteen nonprofits, including the American Red Cross, Livestrong Foundation, and Unicef, now have the ability to receive donations through their Facebook page with a donation feature that Facebook recently incorporated.

tenant a detailed accounting of the operating expenses on an annual basis. It should require that requested documents be provided to the tenant to determine that all items included in operating expenses are allowable as well as provide for an adequate amount of time to conduct an audit. Tenants should exercise this option in the lease to ensure operating costs are appropriate.

ASK FOR HELP

Be sure you hire and/or consult with real estate and financial professionals who are capable of negotiating the complicated provisions throughout your office space lease. By taking steps to assure you are getting the

most for your organization's dollars, you are helping to support your important mission.

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For more information, contact Patrick Gioffre, senior vice president at The EZRA Company, an independent firm focusing on tenant and buyer representation, at 571-214-8532 or pgioffre@ezracompany.com.

OTHER ITEMS TO NOTE

Issuance of Uniform Guidance

On December 19, 2014, the [joint interim final rule](#) was issued by the Office of Management and Budget (OMB) implementing the [Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards at 2 CFR 200](#) (Uniform Guidance) in the *Federal Register*. This joint interim final rule incorporates the implementing regulations of all the federal awarding agencies and was necessary to bring into effect the new Uniform Guidance for Federal Awards under 2 CFR 200. It was effective on December 26, 2014.

Included in this are certain technical corrections to language included in the original Uniform Guidance (previously referred to as the Supercircular) which are highlighted below:

- The effective applicability date has been revised to allow a grace period of one fiscal year for non-federal entities to implement changes to their procurement policies and procedures in accordance with the revised procurement standards.
- CFR Section 200.320 was revised to clarify that the requirement for sealed bids to be advertised and opened “publicly” is applicable to state, local and tribal entities only.
- There were several places in the guidance where “should” has been revised to “must”.

Management of nonprofit organizations should review the Uniform Guidance to ensure that all requirements of the guidance have been addressed by their organization.

2015 OMB Compliance Supplement

The OMB has provided the AICPA Governmental Audit Quality Center (GAQC) with a draft version of the 2015 OMB Compliance Supplement (Supplement) for their review. The major change in the Supplement this year is the incorporation of the requirements and guidance from [OMB's Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards](#) (Uniform Guidance).

During the period covered by the 2015 Supplement, organizations will have federal awards expended that are subject to requirements from different sources.



Nonprofit & Education Webinar Series

The BDO Institute for Nonprofit ExcellenceSM provides a complimentary educational series that is designed specifically for busy professionals in nonprofit and educational institutions.

The BDO Institute for Nonprofit ExcellenceSM is proud to announce our **2015 BDO KNOWLEDGE Nonprofit and Education Webinar Series** to keep you abreast of trends, issues and challenges that are impacting the nonprofit environment. We invite you to take part in this program with members of your organization, including board members. All webinars are conveniently scheduled from 1:00 to 2:45 p.m. Eastern Time and offer two hours of CPE credit.

Stay tuned to the *Nonprofit Standard* blog or refer to www.bdo.com for further details and registration information.

The 2015 calendar of events currently scheduled is below.

4/16/2015	Social Media – The Changing Landscape of Fundraising	REGISTER NOW
5/7/2015	Measuring and Monitoring Program Impact and Outcomes – What You Need to Know!	REGISTER NOW
6/11/2015	Rethinking Risk to Build a Better Investment Portfolio – Investment, Accounting and Tax Considerations	[Registration link coming soon]
9/10/2015	Annual Nonprofit Tax Update	[Registration link coming soon]
10/8/2015	Annual Nonprofit Audit and Accounting Update	[Registration link coming soon]
11/4/2015	Nonprofit Entity Risk Management – How to Manage Risk to Ensure Success	[Registration link coming soon]

For example, federal awards made before December 26, 2014, are subject to the “old” OMB cost principles and administrative requirements. However, new federal awards are subject to the cost principles and administrative requirements contained in the Uniform Guidance. To address this transitional situation, a new section will be included in Part 3 of the 2015 Supplement. The new Part 3.2 will apply to compliance testing of new federal awards and incremental funding made on or after December 26, 2014. Part 3.1, which is the previous Part 3 from the 2014 Supplement updated for normal annual changes, will apply to federal awards subject to the “old” rules.

It is important for management to review these guidelines when the Supplement is issued to ensure they are in compliance. The new Section 3.2 will be effective for March 31, June 30, and September 30 year-end single audits if federal funds have been expended under federal awards subject to the new Uniform Guidance.

There is no stated date for the release of the 2015 Supplement, however, OMB's goal is to try and issue it earlier than in the past due to the significant changes being made as a result of the Uniform Guidance.

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OTHER ITEMS TO NOTE

FASB Prepares to Release Not-for-Profit Financial Reporting Proposal Draft

For the last 18 months, we've been closely monitoring updates from the Financial Accounting Standards Board (FASB or the Board) regarding the organization's *Not-for-Profit Financial Statement Reporting Project*. To date, we've highlighted the Board's tentative decisions surrounding [not-for-profit financial reporting](#), [expense report requirements](#) and [cash flow statements](#) in both our blog and newsletter.

On March 4, the Board announced long-awaited news: It voted 5-2 to release a

proposal for updates to the existing net classification scheme, as well as requirements concerning liquidity, financial performance and cash flow information that nonprofits must present and/or disclose. The proposal's exposure draft will likely be issued to the public for review and comment in early to mid-April.

Stay tuned to our Nonprofit Standard blog in the weeks ahead, as we'll provide a detailed overview of the FASB's proposal draft once it's released. In the meantime, you can review all of our past posts on the Board's deliberations up to this point:

- [FASB Announces Tentative New Decisions on Not-for-Profit Financial Reporting](#)
- [FASB Continues Deliberations on Nonprofit Financial Reporting](#)
- [FASB Outlook – How Recent Decisions by the FASB Board to Reset its Agenda Might Impact Nonprofits](#)
- [FASB Board Discusses Potential Updates to NFP Expense Report Requirements](#)
- [FASB Board Proposes Changes to Nonprofit Cash Flow Statement](#)

BDO PROFESSIONALS IN THE NEWS

BDO professionals are regularly asked to speak at various conferences due to their recognized experience in the industry. You can hear BDO professionals speak at these upcoming events:

APRIL

Michael Sorrells will be presenting a session entitled "Current Hot Items: IRS Issues, Form 990 and Legislation" at the Maryland Association of CPAs Nonprofit Conference on April 17 in College Park, Md.

MAY

Lee Klumpp will be presenting a session entitled "Surveying the Scene: An Overview of Recent FASB Projects" at the Virginia Society of CPAs Business & Industry Conference on May 13 in Williamsburg, Va.

Sorrells will also be presenting the session entitled "Current Hot Items: IRS Issues, Form 990 and Legislation" at the BDO Nonprofit Conference on May 14 in San Antonio, Tex.

Klumpp will present a session entitled "NFP Audit and Accounting Update and Accounting Update" on May 14 at the BDO Nonprofit Conference in San Antonio, Tex.

Sandra Feinsmith and **Laura Kalick** will be conducting a session entitled "Annual Nonprofit Tax Update" at the Georgia Society

of CPAs Annual Nonprofit Conference on May 15 in Atlanta, Ga.

Klumpp will be conducting a session entitled "Accounting and Auditing Standards Update" at the Florida Institute of CPAs at their 2015 Not-for-Profit Organizations Conference on May 28 in Ft. Lauderdale, Fl. and on May 29 at the same conference being offered in Tampa, Fla.

JUNE

Klumpp will be conducting an all-day session on June 8 entitled "COSO's Updated Internal Control Framework: Critical Concepts in Design, Evaluation, Implementation and Monitoring" for the New Hampshire Society of CPAs in Manchester, NH.

Klumpp will also be conducting an all-day course on June 9 entitled "Performing Single Audits in 2015 and Beyond" for the New Hampshire Society of CPAs in Manchester, NH.

Several professionals are scheduled to speak at the 2015 AICPA Not-for-Profit Industry Conference being held June 15-17 in National Harbor, Maryland. Here is a summary of the BDO speakers:

Patty Brickett and **Jeffrey Schragg** will be presenting a session entitled "Onboarding to Termination: Tax Reporting for Employees" on June 16.

Laurie De Armond and **Schragg** will be presenting a session entitled "Protecting

Your Brand: Challenges Associated with Chapter/Affiliate Relationships: Interactive Unplugged" on June 16.

De Armond and **Sorrells** will be presenting a session entitled "Tax Red Flags for Auditors and Financial Managers" on June 17.

Rebekuh Eley and **Schragg** will be presenting a session entitled "Mythbusters! EO Tax Edition (or Mythperceptions)" on June 17.

Several BDO professionals, including **Terri Albertson**, **Tom Gorman**, **Kalick** and **Klumpp**, will be presenting various nonprofit topics at the BDO Annual Florida Government and Nonprofit Conference on June 18 in Fort Lauderdale, Fla. and on June 19 in Miami, Fla.

Klumpp will be conducting a half-day session entitled "Frequent Frauds Found in Government and Yellow Book Audits" on June 22 for the Arkansas Society of CPAs in Little Rock, Ar.

Klumpp will be conducting an all-day session entitled "Applying OMB Circular A-133 to Nonprofit & Governmental Organizations" on June 24 for the Virginia Society of CPAs in Fairfax, Va.

Klumpp will also be presenting an all-day session entitled "FASB Review: Common GAAP Issues Impacting all CPAs" on June 25 for the Greater Washington Society of CPAs in Washington, D.C.

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BDO NONPROFIT & EDUCATION PRACTICE

For 100 years, BDO has provided services to the nonprofit community. Through decades of working in this sector, we have developed a significant capability and fluency in the general and specific business issues that may face these organizations.

With more than 2,000 clients in the nonprofit sector, BDO's team of professionals offers the hands-on experience and technical skill to serve the distinctive needs of our nonprofit clients – and help them fulfill their missions. We supplement our technical approach by analyzing and advising our clients on the many elements of running a successful nonprofit organization.

In addition, BDO's Institute for Nonprofit ExcellenceSM (the Institute) has the skills and knowledge to provide high quality services and address the needs of the nation's nonprofit sector. Based in our Greater Washington, DC Metro office, the Institute supports and collaborates with BDO offices around the country and the BDO International network to develop innovative and practical accounting and operational strategies for the tax-exempt organizations they serve. The Institute also serves as a resource, studying and disseminating information pertaining to nonprofit accounting and business management.

The Institute offers both live and local seminars, as well as webinars, on a variety of topics of interest to nonprofit organizations and educational institutions. Please check BDO's web site at www.bdo.com for upcoming local events and webinars.

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