

**Baldwin CPAs Fall 2017 Nonprofit Newsletter**

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## FASB ISSUES EXPOSURE DRAFT ON ACCOUNTING FOR CONTRIBUTIONS RECEIVED AND CONTRIBUTIONS MADE

By Lee Klumpp, CPA, CGMA

The Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update (ASU), *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*, intended to clarify and improve the scope and the accounting guidance for contributions received and made, primarily by not-for-profits.

Accounting for contributions is an issue primarily for not-for-profit organizations because contributions are a significant source of revenue. However, there are some situations where for-profit entities apply this guidance and the proposed ASU would apply to them as well.

According to the press releases issued by the FASB, Chairman Russell G. Golden stated that “Stakeholders indicated that there is difficulty and diversity in practice among not-for-profits with characterizing grants as exchanges or contributions, and in distinguishing between conditional and unconditional contributions.” Additionally Chairman Golden stated that, “The proposed ASU provides not-for-profits with a more robust framework to evaluate and determine if a transaction should be accounted for as a contribution or an exchange.”

The diversity in practice that Mr. Golden referred to has been an issue going back to the issuance of the original guidance issued for accounting contributions. The issue is around how we treat a grant or contract from the federal or state government versus how we treat the same types of agreements from a not-for-profit funding organization or a private donor. Overall, it is believed that once the new guidance is finally issued, not-for-profit organizations will be able to more consistently apply the accounting guidance, and make the accounting for contributions more operable.

The proposed ASU also helps not-for-profit organizations decide if transactions should be accounted for as a contribution or an exchange transaction. Not-for-profit organizations would accomplish this by using clarifying guidance to evaluate whether a resource provider is receiving commensurate value in return for the resources provided. If the answer to this question is yes, then the asset transfer is an exchange transaction. The proposed ASU provides clarification that social benefit, even if it furthers the resource provider’s charitable mission, is not deemed to be commensurate reciprocal value.

Additionally, the proposed ASU would also help not-for-profit organizations evaluate such arrangements by using an improved framework to determine whether a contribution is conditional or unconditional, and better distinguish a donor-imposed condition from a donor-imposed restriction. The ASU states that if the answer to both of the following questions is yes, a contribution would be considered conditional:

- Does the donor/grantor retain a right of return to the resources provided?
- Is there a barrier the not-for-profit organization must overcome to gain rights to the resources provided?

The second question is more difficult to assess. To assist with this, the proposed ASU provides the following indicators that a barrier may exist:

- The not-for-profit is required to achieve a measurable outcome (e.g., incur certain qualified expenses, help a specific number of beneficiaries or produce a certain number of units).
- The not-for-profit is required to overcome a barrier related to the primary purpose of the asset transfer agreement (this excludes trivial administrative requirements).
- The not-for-profit has limited discretion over how the resources are spent.
- The not-for-profit is required to take significant additional actions that it otherwise would not have taken.

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**FASB Issues Exposure Draft on Accounting for Contributions Received and Contributions Made (cont.)**

If a contribution is deemed to meet these criteria, it would be considered a conditional contribution. Conditional contributions are recognized as liabilities or not recognized at all until the barrier(s) are overcome. Once this occurs, the revenue would be recognized as net assets with or without restrictions based on whether the donor imposed any restrictions.

This topic was added to the agenda by the FASB to help address issues that were raised by stakeholders in trying to apply ASU 2015-09, *Revenue from Contracts with Customers*, (Topic 606) to revenue transactions in the not-for-profit environment. Specifically, do not-for-profit grants and contracts fit the definition of a contract with a customer and, thus, does the new revenue standard apply? Or are these transactions more appropriately classified as contributions, which would exclude them from the scope of the new revenue standard?

This proposed standard follows the same effective dates as ASU 2015-09 as follows:

- A public company or a not-for-profit organization that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market would apply the new standard to annual reporting periods beginning after Dec. 15, 2017, including interim periods within that annual period.
- Other organizations would apply the standard to annual reporting periods beginning after Dec. 15, 2018, and interim periods within annual periods beginning after Dec. 15, 2019.

The proposed amendments would not apply to transfers of assets from the government to businesses. The guidance would apply to both a recipient of contributions received and a resource provider of contributions made.

Early adoption of the amendments in this proposed ASU would be permitted irrespective of the early adoption of the amendments in the revenue recognition standard.

The FASB has asked stakeholders to review and provide comments on the proposed ASU. BDO plans to provide a comment letter on this proposed ASU. We encourage you to read the proposed ASU and provide your feedback to the FASB prior to Nov. 1, 2017.

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## IRS REVOKES HOSPITAL'S TAX-EXEMPT STATUS, SHEDDING LIGHT ON SECTION 501(R) COMPLIANCE CONCERNS

By Laura Kalick, JD, LLM

Earlier this month, the IRS released a letter revoking the tax-exempt status of a hospital for noncompliance with section 501(r) of the Internal Revenue Code. Why? The hospital failed to conduct a community health needs assessment. Tax-exempt hospitals: read this as a cautionary tale.

On Aug. 4, the IRS released a letter, dated Feb. 14, 2017, revoking the tax-exempt status of a hospital for noncompliance with section 501(r) of the Internal Revenue Code (IRC or Code) (Revocation 201731014). We do not know the identity of the hospital, and to the best of our knowledge, this is the first IRS revocation of a hospital due to noncompliance with IRC 501(r). The details of this revocation are somewhat unique in that the hospital whose status was revoked is a so-called dual status hospital, i.e., the hospital is a government hospital that had applied for 501(c)(3) status for benefits reasons in addition to exemption from income tax.

We've previously written about the focus of the 2017 IRS Workplan that included, among other items, emerging issues such as IRC 501(r), and this revocation is a clear confirmation that the IRS is implementing the Workplan, and will likely continue to focus in on these issues.

The letter is a caution to tax-exempt hospitals and all exempt organizations that the IRS is going to enforce rules in instances where there is not complete compliance. Also, universities that have academic medical centers must be particularly mindful of their hospital's compliance with section 501(r) because noncompliance could jeopardize the exemption of the university itself.

In the ruling, the hospital's exemption was revoked because it failed to conduct a community health needs assessment (CHNA), adopt an implementation strategy and make it widely available to the public. The IRS found that the failures were not minor, inadvertent or due to reasonable cause. While the hospital can appeal the decision in court, there's a heavy penalty for noncompliance. If an organization fails to meet the CHNA requirements of section 501(r)(3), section 4959 imposes a \$50,000 excise tax for any tax year for which there is such a failure. This particular letter did not mention whether an excise tax was imposed.

### Background on Section 501(r)

Section 501(r) came into law in 2010 as part of the Patient Protection and Affordable Care Act (P.L. 111-148), also known as Obamacare. After several years of hearings and many, many comments, the published final regulations were set to take effect for tax years beginning after Dec. 29, 2015. Seven years later, the IRS now has at least 30 trained agents conducting related examinations. Finding evidence of noncompliance is fairly easy because almost all the information must be made widely available by putting it on a website, meaning the agents only need to surf the web to spot potential issues. The trend toward increased scrutiny from the IRS seems to be growing, and we have seen a significant number of hospitals audited on section 501(r) in the past six months.

As we mentioned, the hospital in question was a "dual status" hospital. A dual status hospital is a government hospital that would be exempt from tax because of its relation to the government. Forty or so years ago, many government hospitals applied for section 501(c)(3) status so they could take advantage of offering certain pension plans to their employees that were only available to the employees of section 501(c)(3) organizations, and to make it easier to solicit charitable contributions with the familiar 501(c)(3) status.

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**IRS Revokes Hospital's Tax-Exempt Status, Shedding Light on Section 501(r) Compliance Concerns (cont.)**

The reality is that contributions to governmental entities are tax deductible, and today there are many more pension options for employees of government entities. The IRS letter said that “During the audit, the organization’s administrators made it clear that \* \* \* had neither the will, the financial resources, nor the staff to follow through with the CHNA process required under § 1.501(r)-3 on a triannual basis. Consequently, \* \* \*’s 20XX failure to meet the requirements of § 1.501(r)-3 is considered willful. Especially since the organization expressed on several occasions that they did not need to be exempt under IRC § 501(c)(3) and that this status at times actually got in the way of their ability to be involved in various Medicare reimbursement programs.” While this hospital might not place much value on their tax-exempt status, many other organizations depend on their 501(c)(3) designation.

Section 501(r) provides that a tax-exempt hospital must:

- Conduct a community health needs assessment at least once every three years and adopt an implementation strategy to meet the needs identified through the CHNA;
- Establish a written financial assistance policy (FAP) and a written policy relating to emergency medical care;
- Not use gross charges and limit the amounts charged for emergency or other medically necessary care provided to individuals eligible under the FAP to not more than the amounts generally billed (AGB) to individuals who have insurance covering such care; and
- Make reasonable efforts to determine whether an individual is FAP-eligible before engaging in extraordinary collection actions.

Before the implementation of section 501(r) the requirements for hospital tax exemption were compliance with the general section 501(c)(3) rules, and compliance with the community benefit standard set forth in 1969 in Revenue Ruling 69-545, which required an open medical staff, an open emergency room, and acceptance of patients who had insurance, including Medicare.

Concerns were raised that tax-exempt hospitals were essentially indistinguishable from for-profit hospitals and that there should be stricter requirements—perhaps even a requirement that they provide a certain level of charity care to be considered charitable. Also, there were no prohibitions on tax-exempt hospitals charging uninsured patients gross charges and then taking extraordinary collection actions (ECAs) against individuals who could not pay their bills. The resulting section 501(r) made changes regarding ECAs, but did not impose a required level of charity care. Many believe that since Obamacare has decreased the level of uninsured patients, the distinction between the tax-exempt hospital and the for-profit is now even more blurred.

What Tax-Exempt Hospitals Need to Know

Hospitals must comply with a myriad of regulations imposed upon them by different agencies and programs, such as Medicare and federal and state government requirements. While many of these requirements are similar in nature, there are usually some important, but subtle, differences. For example, many states have required that a hospital publish a community benefit report. However, the requirements of these community benefit reports differ from those of the CHNAs, and what is adequate for one may not be adequate for the other. Therefore, if a hospital wants to maintain its section 501(c)(3) status, it is imperative that it complies with all the rules it’s subject to, especially IRS rules.

These rules also include the Financial Assistance Policy (FAP) requirements that are quite specific. For example, a hospital must list those physicians and facilities that will provide services with FAP discounts and those that will not. This list must be updated periodically. The FAP must be on the hospital’s website and must be publicized in a manner to give reasonable notice to patients who may qualify, and contain information about billing and collection, charges to FAP patients, etc.

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**IRS Revokes Hospital's Tax-Exempt Status, Shedding Light on Section 501(r) Compliance Concerns (cont.)**

While this revocation was at the national level, the exemption issue has also been raised by local governments throughout the country as to whether hospitals deserve property tax exemptions. Some hospitals do make payments in lieu of taxes (PILOTS) to compensate for the use of local services such as fire, police and other conveniences, but many do not. And as states examine their fiscal solvency, questions around tax exemptions could grow more common and frequent at that level, as well. According to an analysis of National Conference of State Legislatures data by POLITICO Pro, nine states face a revenue shortfall in their current fiscal year, and 27 states project budget shortfalls in the current or next fiscal year or biennium.

Conclusion

Compliance with section 501(r) is mandatory and complicated. The bottom line is that revocation is not an empty threat and the IRS is serious about enforcement of section 501(r). All exempt organizations should take a close look to determine if they're compliant, or they risk potential adverse tax consequences.

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## OBSTACLES TURNED OPPORTUNITIES IN THE NONPROFIT INFRASTRUCTURE

By Paul Jan Zdunek, MBA

The infrastructure of a nonprofit is deceptively complex and vulnerable to conflict or even crisis if not diligently self-monitored by the board and executive leadership. This is a topic we've covered many times before, (see Laurie De Armond's article, "[Building a Resilient Organization – A Toolkit for Nonprofit Boards to Manage Transformational Change](#)") but one that seems to be a constant trial in the nonprofit world. Below are two real-life examples of organizations that found themselves at challenging crossroads. This article explores the choices they made, the results that followed and the best-practice options available to all nonprofits.

### Case Study A: CEO Chaos

An extremely competent and experienced chief executive officer (CEO) manages a nonprofit institution with a difficult board chair who is the foremost business leader in the region. While this board chair is deeply passionate about the organization's mission and has close personal and professional relationships with many of the board members, he also believes he knows how to operate this particular nonprofit and continually bullies his fellow board members with a data-deficient point-of-view. When she arrived on the job, the CEO spent her first two years reversing a long-standing structural deficit, and has since been operating in the black. From the time this challenging board member became chair eighteen months ago, the organization has been faltering and is now facing its first deficit in years due to his lack of fiduciary focus, and derogatory treatment of board and staff. As just one example, he unilaterally increased compensation and renewed the employment contract for the chief creative officer without the knowledge of the board or CEO until after the fact. There have been no real consequences to his actions by the rest of the board, despite the CEO's pleas for help.

### Case Study B: Acquisition Angst

A failing 85-year-old nonprofit thought it could boost its financial strength by acquiring another failing nonprofit. The acquisition happened to occur just prior to the economic crash of 2008, which proved to be incredibly challenging. The CEO came up through the ranks of the organization as a staff practitioner and was completely overwhelmed by scenarios that required conflict-resolution techniques and data-driven business acumen. He simply ignored those tough situations or totally gave into the unreasonable requests of his employees and vendors. His failed leadership and mismanagement of the acquisition caused this almost century-old nonprofit to temporarily shutter its operations while it searched for a sustainable solution.

### Obstacles

Both of these stories are based on real-life situations and are good examples of issues commonly faced by nonprofits, including:

- A volunteer board of directors without the expertise required to effectively operate the nonprofit, yet feel obligated to manage vs. govern
- Board members who are influential leaders in their own respective companies, industries, and/or communities, who also have personal and/or professional relationships with one another, resulting in just a few degrees of separation between them as well as their collective networks
- An organization solely driven by passionate, mission-based decision-making processes

Additionally, in Case Study B, the nonprofit was led by an executive who was a former practitioner within the nonprofit with no formal training or experience in managing the business of a nonprofit.

It is no surprise that if these obstacles are not addressed thoughtfully and strategically, a nonprofit can find itself at a crossroads, in conflict or even in the midst of a full-blown crisis. Often when an organization is experiencing a complete crisis or just simply stuck, the root causes stem from at least one, if not a mixture, of the above obstacles.

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**Obstacles Turned Opportunities in the Nonprofit Infrastructure (cont.)**

**Opportunities**

Despite these common challenges, every issue nonprofits face provides an opportunity for the organization to look inwards, and to change its practices to better support its mission and grow sustainably. Below we outline some best practices nonprofits should consider when at an organizational crossroads.

View Board Members and Executive Leadership as Partners

The success of any nonprofit starts with the quality and engagement of each board member, who primarily brings his or her fiduciary responsibilities and philanthropic gifts to the table. Additional qualities, such as an expertise in an area where the organization could use advice, are welcomed, but not necessarily required. These governance oversight and fundraising responsibilities become complementary to the executive leadership's primary responsibilities of exceptional financial and programmatic management of the nonprofit. While the board is technically "in charge", the executive leadership team members are the front-line experts and should be given the full responsibility and authority their positions deserve. Unless they consistently fall short of goals, prompting prescribed correction by the board, executive leadership team members should not be micro-managed.

While there is a legal employer-employee structure, board members and executive leadership should work as partners, marrying their relevant skills and experiences. Unfortunately, many board members across the vast nonprofit landscape tend to micromanage the executive leadership. Board members should channel their passion for the organization into ensuring that the executive leadership has all the resources available to fully operate an exemplary organization.

Board members, when it comes to your relationship with the CEO, hire carefully, support thoroughly and terminate swiftly, if necessary.

Strive for Cross-pollination Instead of Cannibalization

In addition to bringing their fiduciary and philanthropic responsibilities to a nonprofit, it is vital that board members bring their networks as well. Ideally, each board member should have a unique network to add to the collective. Often, boards are made up of friends and colleagues who tend to have overlapping relationships, thus producing just one or two networks for a 20-member board. The ideal is to strive for a board where each member brings a unique network upon which to draw. The execution of this simple concept can transform a nonprofit in crisis.

Recruiting committees should be sure to search for and add only *new* networks that will enhance the current board networks in place, no matter how wonderful, wealthy or influential a potential board member might be. This not only produces more and diverse resources for the nonprofit, but also results in board members who are not personally or professionally connected to one another, allowing for tough decisions to be addressed efficiently and effectively.

Mission vs. Business

Nonprofits often ask themselves if they should be driven by mission-based or business-based reasoning. The answer is both. Decisions should be made with a full mixture of passion and data. One without the other is a recipe for disaster.

Mission must be a part of every decision—that is why the nonprofit exists. However, business acumen must also play a role. Without data, consequences of decisions could be catastrophic. At a large, nationally-recognized nonprofit, a single mission-based, data-deficient decision almost resulted in bankruptcy. It took more than five years to finally overcome the enormous deficit that this decision had created for the nonprofit.

It is vital to the success of any nonprofit that its executive leadership be fully trained and equipped to direct the various aspects of finance, human resources, marketing, sales, fundraising, operations and stakeholder relationships, especially given a nonprofit's board-staff organizational structure and its potential obstacles outlined above.

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**Obstacles Turned Opportunities in the Nonprofit Infrastructure (cont.)**

**Case Study Updates: Two Approaches to Turmoil**

Case Study A: CEO Chaos

The CEO has a new board chair, but the previous chair remains on the board and continues to be disruptive. The governance committee has been extremely sympathetic to the CEO's plight and has even privately grumbled about the challenging board member to her. However, in the end, they suggest it is her job to address the difficult board member because they are too close personally and professionally to him, and any interference on their part might mar their own relationships with him. The CEO has quietly begun her job search.

Micromanagement of this skilled CEO, as well as the board's unwillingness to address their close colleague's behavior, will unfortunately continue to plague this otherwise healthy organization until it finds itself in crisis, which is looming closer each day.

Case Study B: Acquisition Angst

Faced with crisis, the organization hired a consultant to step into the role of chief restructuring officer, who then carefully and deftly designed a strategic roadmap that allowed the nonprofit to reverse its course and head in a direction of stabilization. Today the nonprofit is flourishing with an engaged board that has virtually no overlapping networks, and executive leadership that makes every decision with a full mixture of passionate mission-based and data-rich processes.

This organization fortunately had a board chair that terminated the ineffective CEO after a swift, but thorough, corrective process. She was also aware of her own limitations and made the decision to hire an experienced crisis consultant with a proven track record. Additionally, the cornerstone of this organization's success was diversifying the board's collective networks, resulting in a cross-pollination of resources that continues to drive this nonprofit's success.

Conclusion

Every obstacle presents an opportunity. The challenge is to identify the root cause of the problem and take appropriate corrective actions to focus on solutions that allow the nonprofit to survive and thrive.

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## CRITICAL CONVERSATIONS BETWEEN MANAGERS AND EMPLOYEES – DO WE HAVE TO?

By Donna Bernardi Paul, SPHR, SHRM-SCP

Do I have to tell my employees when they're not performing to my expectations? Shouldn't they already know what they're supposed to be doing? After all, I hired them based upon what they told me during our interview.

When was the last time you sat down with one of your employees and provided feedback on a performance issue? Was it received positively? Did you receive the behavior change that you were hoping to receive?

Many managers are reluctant to enter into these types of conversations for some of the following reasons:

1. They don't want to "bite the hand that feeds" – If I upset this employee, he/she may give me the silent treatment or become passive-aggressive for a period of time, and I need all of my employees to be productive, even if not at 100 percent.
2. They don't want to run the risk of engaging the employee in an argument if the employee disagrees with the message.
3. They are reluctant to inadvertently step on a legal landmine if the employee can link the message to a discriminatory action.
4. It's difficult for them to engage in critical conversations that are confrontational, and they want to be liked.

So, if it is too difficult to enter into this type of conversation and run the risk of having it backfire on you, why do it in the first place? Because the risk of not doing it is greater for the following reasons:

1. Employees will believe that they are performing well if they don't receive information to the contrary; so they will continue performing at that level (including showing up to work late, taking off too much time or behaving inappropriately in the workplace).
2. Managers have a tendency to reach a breaking point when less than adequate performance continues. Managers may reach a point where they become irate and want to fire the employee without having had any prior conversations – surprise!
3. Co-workers will have to pick up the slack and become disgruntled; plus the manager will look weak in the eyes of the other employees.

The good news is that there is a process or road map to follow when having to engage in these types of conversations. In fact, there are actually three coaching opportunities:

1. When employees are doing great work: Tell them what they did and why it was great.
2. When employees make an error: Tell them PRIVATELY and help them to determine how they might have done the task differently for a better outcome. Remember, we all make mistakes. Mistakes are how we learn. They are a breakdown on the path to success; not a failure.
3. When employees are on a dead-end path: If an employee continues to make the same mistake or continues the same unacceptable behavior repeatedly, follow these steps in this order:
  - a. State what you've observed (e.g., you are 30 minutes late)
  - b. Wait for a response (e.g., traffic was bad, etc.)
  - c. Remind them of the goal (e.g., we've spoken about this before. You need to be here on time because customers are calling, your co-workers have to step in when you're absent, etc.)

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**Critical Conversations Between Managers And Employees – *Do We Have To?* (cont.)**

- d. Ask them for a solution (e.g., what are you going to do differently so that we don't have to have this conversation again?)
- e. Agree and document – if the proposed solution makes sense to you, then agree to it and hold the employee accountable for the future. Send the employee a memo detailing the conversation with the stipulation that if the employee wants to remain in the position, then the behavior needs to change immediately and remain sustained, if that's what you want.

Being a manager can be challenging. Employees want managers they can trust to be honest and open with them. Using a process, such as the one outlined above for engaging in critical conversations, can help managers earn the trust and respect of their teams and, most importantly, receive the performance they expect.

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## A BEGINNER'S GUIDE TO STATE NONPROFIT REGISTRATION AND AUDIT REQUIREMENT RULES

By Lewis Sharpstone, CPA

### Why you might be noncompliant, and two ways to act now

Every nonprofit knows that they are subject to federal and state regulations for the state(s) in which they operate, but some state requirements are easy to overlook.

Say your organization operates in only one state and you therefore assume you are not required to register or comply with nonprofit regulations in any other state. Is this a safe assumption? Could you be required to register and comply with all the nonprofit regulations in any other states?

As online fundraising has become pervasive, the answer is this is not a safe assumption. Your organization could be subject to other state rules.

First, take note of the Charleston Principles, which were developed by the National Association of State Charity Officials (NASCO). [The Charleston Principles](#) address whether online charitable solicitations by a nonprofit constitute an activity that requires a nonprofit to register in a state. Simply put, the Charleston Principles state that so long as you do not specifically target persons located in a state, do not routinely receive contributions from persons in that state and do not otherwise have to register in that state, your nonprofit would not need to register in that state just by conducting a general online solicitation. The Charleston Principles are not mandatory, but were offered as a guide to be adopted or adapted on a state-by-state basis, and indeed many states have made use of them.

Thirteen states, however, didn't adopt the Charleston Principles. These states consider the "donate" button on a nonprofit organization's website an act of active solicitation in their state, triggering registration requirements. These states are Alabama, Florida, Georgia, Illinois, Kansas, Louisiana, Maine, New York, North Dakota, Ohio, Oklahoma, Rhode Island and Utah.

Then there is the state of California. The good news is that California did adopt the Charleston Principles. California, however, represents about 10 percent of the population of the United States. Almost all nonprofits with more than a purely local focus likely routinely receive contributions from Californians and are therefore likely required to register in California.

The annual filing in California is simple: completing a one-page form and submitting it by the deadline along with your latest Form 990 and a relatively small filing fee. However, nonprofits that are required to register in California are also subject to California's nonprofit annual audit requirement.

State nonprofit audit requirements are common—27 states require that certain nonprofits registered in that state have an audit. [Which nonprofits](#) are subject to the requirements varies state by state. Often, a nonprofit already obtaining an audit will have little extra to do other than submit the audit to the state. However, California's audit requirements are a bit different.

If a nonprofit is required by California law to have an audit, California has specific requirements as to the composition of the Audit Committee. Beyond requiring an Audit Committee, California law mandates that no more than half the Audit Committee can be comprised of individuals who are members of the Finance Committee, prohibits certain other individuals from serving on the Audit Committee and prohibits the chair of the Audit Committee from serving on the Finance Committee.

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**A Beginner's Guide to State Nonprofit Registration and Audit Requirement Rules (cont.)**

You may now be thinking that you may be required to register your nonprofit and file in other states, and it's tempting to wonder if you can just "let sleeping dogs lie" and only file in other states if it's requested. As a nonprofit advisor, I would be concerned if I heard an organization was only willing to consider pursuing compliance with state laws after being contacted by a governmental agency. There is a reputational risk that your organization's name might appear on the website of a state charity regulator with other non-compliant charities. It stands to reason that stakeholders and donors would prefer the organizations they support take a more proactive approach – knowing what state laws they are supposed to follow, then taking steps to comply before any issues arise. To me, proactively complying with all state laws is a fiduciary duty of those in governance roles.

Some may wonder if states like California really expect nonprofits domiciled in other states to register and follow their audit requirements. The answer is, of course, yes. California has the highest audit threshold in the U.S., \$2 million, which helps avoid over-burdening small nonprofits. But if you need to register in California and comply with the California nonprofit audit requirements, the state government believes you have no excuse not to do so.

Some organizations might think that a state government like California's is unlikely to reach out to inquire if they should be registered. This could happen if, for example, a California donor tries to research a nonprofit on the California Attorney General's website, doesn't find the nonprofit registered and submits an inquiry to the Attorney General. Not registering in a state when registration is required, or registering but then not complying with the audit requirements, risks losing that donor's support. Probably not a good business decision.

What can nonprofits do to ensure they avoid these compliance pitfalls?

1. If you are anything other than a relatively small nonprofit supported by and solely serving your local community, consult with a state compliance service provider to check that you are filing in all the states in which you are required to file.
2. If you are filing in multiple states, you should double-check on the specific audit requirements of each state, determine the most stringent of such requirements and comply with those.

As we discussed, many 501(c)(3) organizations with a national focus and online solicitations will likely find that they should be filing in California, if they are not already doing so. Organizations that meet the California audit requirement criteria should have Audit Committees constituted in accordance with the California requirements as noted above.

California law also spells out the five required duties of the Audit Committee and certain other requirements. Please contact the author if you would like more information on this.

Special thanks to California nonprofit attorney David Wheeler Newman and California-based Charity Compliance Solutions, Inc. for their assistance with this article.

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## OTHER ITEMS TO NOTE

### Final 2017 OMB Compliance Supplement Issued

The Office of Management and Budget (OMB) released the final 2017 *OMB Audit Requirements, Appendix XI – Compliance Supplement* (the Supplement) on Aug. 17, 2017.

#### Background:

As discussed in the [Summer 2017 Nonprofit Standard](#), due to delays in the OMB clearance process, a draft 2017 Supplement was posted to the AICPA Governmental Audit Quality Center (GAQC) website for purposes of 2017 single audit planning. Now that the final Supplement is available, the draft Supplement should no longer be used and only the final Supplement should be utilized. The 2017 Supplement applies to audits of fiscal years beginning after June 30, 2016.

#### 2017 Supplement:

OMB has stated that the only change from the draft Supplement to the final Supplement is an updated reference in Part 3 - *Compliance Requirements* to the recently revised Frequently Asked Questions (FAQ) document that is discussed below.

As we noted in the [Summer 2017 Nonprofit Standard](#), the 2017 Supplement includes several new pieces of guidance, as well as the normal types of changes made by OMB each year such as the addition, deletion and modification of various federal programs. Organizations should review Appendix V, *List of Changes* for the 2017 Compliance Supplement in detail, as well as the full Supplement, to familiarize themselves with the types of changes made and the specific programmatic changes by CFDA number.

#### Significance of the Supplement:

The Supplement identifies the existing important compliance requirements that the federal government expects to be considered as part of a single audit and is one of the most important pieces of guidance organizations should utilize. The Supplement provides a source of information for organizations to understand federal program objectives, procedures and compliance requirements.

#### Access the 2017 Supplement:

You can access the 2017 Supplement in the following locations:

[Office of Federal Financial Management section of the OMBs website](#)  
[“Information for Agencies” section of the OMB website on the “Circulars” page](#)

### Updated FAQ Document Available

#### Disbanding of COFAR:

In June 2017, the Office of Management and Budget (OMB) issued [Memorandum M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda](#) (the Memorandum), which announced the disbanding of the Council on Financial Assistance Reform (COFAR).

COFAR included the CFOs of the eight largest grant-making agencies and was originally created to provide recommendations to OMB on policies and actions to effectively deliver financial assistance, which culminated in the creation of the [Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards](#) (the Uniform Guidance or UG). The Memorandum states that COFAR completed its designated purpose and therefore is being disbanded. It goes on to state that the Chief Financial Officers Council (CFOC) will coordinate financial assistance priorities going forward.

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**Other Items to Note (cont.)**

During its existence, COFAR issued a series of FAQs on the Uniform Guidance. These FAQs and other previously available COFAR resources are now available on the “Grants Initiative” section of the CFOC website (<https://cfo.gov/>). OMB has stated that the FAQs continue to carry the same authority as they previously had. As per the 2017 OMB Compliance Supplement, the FAQs are meant to provide additional context, background, and clarification of the policies described in 2 CFR Part 200 and should be considered in the single audit work plan and reviews.

Update of the FAQs Issued:

The [July 2017](#) version of the FAQs contains 24 new FAQs and revisions to four previously issued FAQs. The table of contents identifies new questions with one asterisk and revised questions with two asterisks. New FAQs were added related to indirect costs and other auditee topics such as subrecipient monitoring and risk assessment.

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## UPDATE TO TERMINATING YOUR PRIVATE FOUNDATION

The article entitled, “So, You Want to Terminate Private Foundation Status and Become a Public Charity!” from the [Summer 2017 Nonprofit Standard](#) did not mention a few twists an organization may wish to consider when terminating pursuant to IRC §507(b)(1)(B).

As discussed in the article, you need to notify IRS Determinations of your intent to operate as a public charity in advance of a 60-month termination period. While the organization may be regarded as a public charity for certain purposes, during the termination period, it still must file a Form 990-PF and pay the excise tax on net investment income during this period. If the organization wishes to file Form 990-PF without paying the excise tax on net investment income, it must enter into a consent (Form 872-B) to extend the statute of limitations under IRC § 6501(c)(4) with IRS Determinations. In the last tax year of the 60-month termination period, the organization may file a Form 990 to show that the organization passed the public support test in Schedule A for the 60-month period. Within 90 days after the 60-month period, the organization should file a Form 8940 with sufficient information to allow the IRS to determine that they met the requirements to be classified as a public charity.

The twist is you may also request an advance ruling from IRS Determinations (using Form 8940) that the organization can be expected to satisfy the requirements to be treated as a public charity during the 60-month termination period along with the notification of its intention to operate as a public charity. If the advance ruling is granted, contributors may generally treat the organization as a public charity, and the organization will not be assessed penalties for not paying the excise tax on net investment income. The advance ruling doesn't mean the organization necessarily will qualify as a public charity during the 60-month period. Only that contributors can rely on them qualifying and there are no penalties for contributors if they do not. The organization will continue to file a Form 990-PF until the final tax year of the 60-month period without paying the excise tax on net investment income. Within 90 days after the 60-month period, the organization should file a Form 8940 with sufficient information to allow the IRS to determine that they met the requirements to be classified as a public charity.

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**For additional information regarding any article, please contact**

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