



## Nonprofit Organizations – Staying Functional and Safe in the Age of Coronavirus

*By Dick Larkin, CPA, MBA*

**This article is aimed at helping nonprofit organizations plan to cope with the new challenges imposed by the coronavirus pandemic. The first part of the article focuses on matters external to the organization, while the second part focuses on internal matters. The article is intended to raise questions and get people thinking, not to provide pat answers; such would require a book. These challenges are in some ways pervasive among all organizations; in others there will be different effects on different types of organizations, e.g., educational institutions, the performing arts, membership organizations, religious organizations, charitable organizations, healthcare, etc.**

**The coronavirus has changed our world** in ways unimaginable a year ago. The events of Sept. 11, 2001 resulted in permanent changes to air travel. The coronavirus has resulted and will result in permanent changes to a much wider variety of aspects of our personal and business lives. Some of these changes affect both businesses and governments, as well as nonprofits. These articles will focus on those aspects unique to, or that will have a disproportionate effect on, nonprofits.

The most recent events of comparable nature, magnitude, and pervasiveness were the influenza pandemic of 1918-19, which killed tens of millions of people, and the Great Depression of the early 1930s. But, you are thinking: what about 9-11? World War II? 9-11 was over in a few hours; it directly affected only a small number of places and a limited number of people, and was unlikely to happen again. World War II, for most Americans—except those actually in battle and their close families—was not here; it was almost entirely “over there.” Yes there was rationing, and unavailability of some consumer products like new automobiles, but the daily impact of those was relatively small, and not dangerous for most people.

Coronavirus is here, it directly affects everybody everywhere, it is dangerous, and there is as yet no way to predict how long even its direct effects—much less the indirect effects—will last. Even if a preventive vaccine—and a cure for those already sick—were to be discovered tomorrow and made widely available next week, many of these changes still will not ever be completely reversed.



### Effect on Organizations' Revenue and Financial Health

Except for healthcare organizations (which of course are working overtime), the nonprofit sector is largely shut down. Educational institutions have closed their facilities and many are conducting classes online, but bookstore sales have largely ceased and athletic department income has completely dried up. Performing arts organizations are silent. Museums are closed, which reduces both admissions income and gift shop sales (some gift shops continue to sell online). Many houses of worship are conducting services online, which has resulted in a drop in “plate” collections. Membership organizations still have their dues income, for now, but meetings are canceled or postponed. Many charitable organizations are seeing increased need for their services, but trying to increase revenue to cover those added costs is challenging because many donors



are themselves in financial distress. Many individuals have lost their jobs or seen a reduction in pay. The 2017 income tax act had already reduced the incentive for some to make charitable contributions by doubling the standard deduction for individuals. Now Congress has eliminated the year 2020 required minimum distribution from deferred compensation plans (IRAs and the like), so seniors over age 70½ will have less incentive to make direct charitable rollovers from those plans. On the more incentive side, there is now a \$300 charitable deduction available to donors who do not itemize. Foundations have seen their investment portfolios lose value, so they have less available to make grants. State and local governments are seeing declines in sales, gasoline and income tax revenue, so they have less to distribute as support. Only the federal government is pumping money into the economy, some of which is flowing to nonprofits, but this cannot possibly make up for all the other revenue losses.

There are some offsets. It is well known that many performing arts organizations lose money on every performance they put on, so by cancelling performances, they may save more in expenses than they lose in revenue. The real losers there (besides the audiences) are the performers: actors, singers, orchestra musicians, etc., and the supporting staff: stagehands, technicians, ushers, etc. Those organizations that can afford to are doing what they can to keep some of these people on the payroll (there is a limited federal grant program expressly for that purpose), but that does not make everyone whole, and cannot go on indefinitely. Residential educational institutions have lost room and board revenue, but do not have to pay for food and kitchen staff (again a hardship for that staff), or pay for most dormitory current operating costs.

These are short-term effects. But what about the longer term? Will an orchestra or chorus or theater that has had to cancel the rest of its current season be able to attract its audience back when things are able to reopen? Will the performers still be available? (What will a choral concert sound like if all the singers are wearing face masks?) If half of this concert season has been canceled, will donors continue the same level of annual support next season? Will college students re-enroll next semester? Will individuals and companies that have had to cut back on expenditures due to lost income return to their previous levels of charitable giving? Will association members renew their memberships? Will people be willing to resume participating in and attending events in

spaces with large numbers of other people, for example, classes, concerts, conferences?

Planning for how to survive these effects is made even more difficult by the current uncertainty about when things will return to anywhere close to normal, if ever. Mounting a museum exhibit or a theater production, or getting all the pieces of a college curriculum in place, or organizing the annual convention of a trade or professional association cannot be done in a week, but at this point no one can be certain when, for example, colleges will be able to fully reopen: This summer session? The coming fall semester? Next year? None of the above? The answer will likely vary by locality. And what if there is a resurgence of the virus during the flu season next fall, as some healthcare experts are predicting is possible?

### Internal Effects on Nonprofits

Given the external effects discussed above, how will they affect the internal operations of nonprofits? The governing board and the CEO will take the lead here by first thoroughly understanding the organization's current situation, then communicating that to the staff (including volunteers), donors, clients (members, students, etc.) and the community. For example, how many months of anticipated expenditures do we now have available in liquid assets?

Some things are obvious. With **less income** and greater uncertainty, organizations must manage their expenditures even more carefully than they normally do. Expense budgets must be pared; revenue, expense and cash flow budgets must be closely monitored on a timely basis. Difficult choices may have to be planned for and made:

- Do we continue this program (academic department, publication, concert series, location) or that one? We no longer may be able to count on the availability of resources to do both.
- Should we consider pursuing a merger with [other nearby organization whose programs are similar to ours]?
- Do we have access to a line of credit? (If not, why did we not arrange for one before this crisis?)
- Would [Major Donor X] be willing to convert a previous restricted gift into an unrestricted gift, or to allow re-purposing of the gift to what is now a more important program?



We are ok for the moment, but what are our Plans B, C, and D if next year's revenue falls by 20%? 30%? 50%?

Donor and customer **relations** take on greater importance. Timely and clear communication is vital. Organizations must make every effort to keep the ones they have, motivate donors to increase their giving level, and to attract new donors to make up for the inevitable lost ones. Ditto for educational institutions (students), associations and houses of worship (members), museums (visitors), performing arts organizations (audiences), etc.

Management should become aware of all available governmental resources and take advantage of the ones that may pertain to the organization, such as the Paycheck Protection Program or the SBA Loan Program. Find out what insurance coverage is in place for things like cancellation of events. Would coverage be different depending on whether the cancellation was due to governmental quarantine regulations or the closure of a rented venue versus proactive action by management? Are there foundations which might be willing to help?

Many smaller nonprofits with few staff have always found it challenging to maintain adequate **internal controls** over their accounting and operational functions. With many staff now working off-site, this challenge is even greater. But the need for these controls is greater, not less. And remember, the responsibility for designing, implementing and monitoring these controls lies squarely with management, not with the auditors. Auditors will (and must under their own professional standards) continue to ask questions of management such as: "How do *you* satisfy *yourself* that (for example):

- All revenue intended for the organization—especially contributions—has been collected and properly recorded?
- All expenditures are for appropriate purposes, consistent with any applicable donor restrictions, in proper amounts, have been properly recorded, and that commensurate benefit has been (will be) received?
- All assets that properly belong to the organization are adequately secured, managed, and properly valued and recorded?
- All liabilities, and only true liabilities, of the organization are properly recorded and paid?

- The organization is in compliance with applicable laws, regulations and funder (private or governmental) restrictions?
- All of the organization's activities are being conducted in an ethical manner? Another way to phrase this is, "Is there anything about the organization, its personnel, or its operations that would cause embarrassment if reported on the front page of tomorrow's local newspaper?"

Auditors, in turn, are subject to various constraints in performing audit work. They may not have normal access to the client's personnel, office or other facilities, and thus may be unable to examine hard copies of documents or observe inventory of gift shops or bookstores. Examination of documents and interviews with client staff may have to be conducted electronically, and extra steps taken to verify the authenticity of documents and the proper functioning of internal control procedures.

With the greater risk that staff (including volunteers) may become infected and unable to work at all, and/or infect others, organizations should be sure that every function is backed up by at least one other person or that outsourcing arrangements are in place if needed. Government healthcare privacy regulations probably forbid explanation to the rest of the staff as to why "Mary" is not going to be at work for the next month. But if a virus case is identified in the organization, quarantine regulations may require that that fact (alone—no names) be disclosed to those who may have had contact with the infected person. Legal advice may be needed here.

Some operational areas that may be affected include anything involving travel—especially international, such as students studying abroad, bringing visiting performing artists in from other cities, travel by athletic teams to away games, out-of-town speakers at conferences, members traveling to attend conventions, etc. Technology is already being used in some of these areas, and such use will likely increase. (Ok, technology will not work for team sports: football, soccer, basketball, hockey or racquet sports such as tennis; but maybe it could if golf or a racing-type event such as track and field, swimming or skiing could be contested simultaneously in both home facilities, so the race is effectively against the clock.)



Organizations such as homeless shelters and soup kitchens will need to rearrange their spaces to allow for more social distancing by their clients. Even after the immediate threat of infection has largely passed, would-be users of such facilities may want to feel comfortable that they are adequately separated from their neighbors. An extreme example would be a charity dental clinic, which will have to take extraordinary steps to keep both its patients and staff feeling safe. These and similar organizations should also be certain they have adequate insurance coverage to protect from claims by someone who has accidentally been exposed while in their facility.

Houses of worship have some special challenges: how do they handle group events (apart from regular services) that often involve close personal contact, such as weddings, funerals, baptisms, confirmations, bar/bat mitzvahs, etc.? Even when in-person group services can be safely resumed, should the communion ritual be altered? Should congregants still pass the peace during the service? (There should be an understanding so there will not be embarrassment if one person wants to shake hands or hug a neighbor, but the neighbor does not.)

Some facilities may need to be re-purposed. Convention centers and sports arenas are being used to help meet medical needs of cities. Now-empty college dormitories and dining facilities could be used for helping people in need due to job loss or homelessness.

Now is definitely the time to be thoughtful and creative.



# Reforecasting Your Budget

By Barbara Finke, CPA

**Most organizations have an established budgeting process. Whether the entity uses a robust performance management tool or a spreadsheet, there is likely a thoughtful process to predict the next year's revenues and expenses. The budget is usually approved by the board of directors and/or other committee and memorialized in the meeting minutes. Once the budget is final, how an organization utilizes this tool varies. Most organizations utilize the budget as a tool for comparing actuals on a periodic basis while some revisit the budget and make changes based on certain events, and a rare few actually revisit the budget on a rolling schedule and update forecasts routinely.**

**Based on a survey** conducted by KPMG in 2016 with the Economic Intelligence Unit<sup>1</sup> (consisting of 544 global companies) only two thirds of organizations surveyed incorporated rolling budgets. Although experts often say reforecasting or rolling budgets are important, many organizations continue to operate with a static budget, citing time or computer system limitations. A static or fixed budget occurs when the organization prepares an annual budget, which remains untouched for the fiscal year. The organization compares actual performance to the budget at periodic reporting intervals. This common type of budgeting is a good tool for keeping spending within a predetermined threshold. A static budget remains useful when spending is generally predictable and consistent. However, it can become cumbersome and unhelpful when the organization sees major changes, and the variances, while explainable, render the static budget meaningless.

Consider the current reality of our unprecedented economic and social times. On Jan. 30, 2020, the World Health Organization (WHO) announced a global health emergency because of a new strain of coronavirus originating in Wuhan, China (COVID-19) and the risks to the international community as the virus spread globally. In March 2020, the WHO classified COVID-19 as a pandemic, based on the rapid increase in global exposure. The world is still determining the ultimate impact of the global pandemic. In the United States, shelter-in-place orders seem to change daily and differ not only by state, but by county or even potentially by neighborhood. Economic stimulus packages were enacted on March 27, 2020, under the Coronavirus Aid, Relief and Economic Security Act, with new grant opportunities, tax changes, and ever evolving lending



programs. In addition, we have seen historic stock market changes based on seemingly every announcement from the Centers for Disease Control and Prevention (CDC), the president and/or major corporations. Now, more than ever, organizations need to understand how to reforecast static budgets so that the executive teams can make real-time informed decisions.

Per an article from Kshitij Dayal, Workday, "...from March 23 to 27, our [Workday] cloud planning platform processed up to 30 times more forecasts and build-out scenarios than in a typical week. Since the emergence of the COVID-19 pandemic, we've [Workday] seen an overall average increase of 15 times the amount of modeling and recalibrating as organizations everywhere attempt to make sense of the ripple effects."<sup>2</sup> Based on that evidence, organizations seem to be aware of the need to reforecast budgets for fiscal year 2020 and beyond. Was your organization ready?

<sup>1</sup>Kothari, S.P et al. (2007, September) Forecasting With Confidence: Insights from Leading Finance Functions. Retrieved from <https://home.kpmg/content/dam/kpmg/pdf/2016/07/forecasting-with-confidence.pdf>

<sup>2</sup>Dayal, Kshitij (2020, April 15) How to Gain Business Agility in Uncertain Times. Retrieved from: <https://blog.workday.com/en-us/2020/how-to-gain-business-agility-in-uncertain-times.html>



Historically, the most common reason noted for using reforecasting or a rolling budget was the constantly changing nature of the business environment, whether it be technology innovations, stock market fluctuations or management changes, and the belief that a static budget would not provide organizations with a useful tool when making key decisions. In the past, your organization may have concluded your environment was not constantly changing, or that the headache of the reforecasting process was larger than the benefits. Now every organization is in a state of constant change, and reforecasting is critical.

Budgeting is a bit like road trip directions. In the past, you pulled out the road atlas, plotted your course and headed out. It was a surprise when you hit a major traffic jam or detour, and you were forced to wait patiently. Now, you put the destination into your favorite mapping app and start your route. As you drive, the app periodically notifies you of a shorter available route, or a major road blockage ahead that requires rerouting. Your mapping app provides all of the information you need to quickly make the decision to take a new course or stay on the original one. A budget that can be reforecast quickly gives your organization the same ability. If you want this capability for your organization, the next step is to decide whether you will use a reforecast or a rolling budget.

## What Is Reforecasting?

Reforecasting means updating the entire budget based on new facts and circumstances, taking a holistic look at your original budget and updating any elements as necessary. In the end there is a separate, fully revised budget, not an adjustment to just a line or two. The reforecast allows the operational group to understand the new route to follow and what will be ahead on the new path. It provides a more relevant decision tool than the static budget.

## When Should an Organization Reforecast?

As noted above, a reforecast should happen whenever there is a large or unexpected trigger event, such as the COVID-19 pandemic. However, it doesn't have to be that big of a trigger. It could be a large or unexpected change in one of the organization's major revenue streams or cost drivers, such as winning (or losing) a major contract. When the main driver of your budget is expected to change as a result of the event, a reforecast should be completed.

Organizations should also consider reforecasting when trends show that the original budget was not accurate, and you start to see recurring, significant variances in line items between actual and budgeted amounts.

The key message is that a reforecast is needed when the main driver of your budget suffers a significant enough impact that it is necessary to consider a holistic change in your original static budget.

## How Should an Organization Reforecast?

Before you determine the next steps in reforecasting, consider the budget process in your organization. Do you have a zero-based budget? In a zero-based budget, the organization builds the budget from scratch, considering each expense driving the budget from the expense side and attempting to grow profit by reducing expenses, rather than increasing price per unit or units sold. Or, does the organization look at historical trends and adjust revenues and expenses according to expected growth or shrinkage? Either way, break down the assumptions to the original drivers, whether it is variable costs or variable revenue sources that drive the bottom-line budget. This may require more thought if your organization has not done a zero-based budget recently. If you are struggling to identify your organization's drivers, consider what key performance indicators you report to the board of directors or what benchmarks you are tracking. These are likely the drivers to consider when you are reforecasting.

Once you have determined which costs or revenues are variable, then reforecast what impact the event will have on your variable drivers. If you budget based on costs, think about what costs are variable, such as operational payroll or supplies. Will these costs increase or decrease? If your costs increase, what will the organization need to do to increase revenues? Another approach is to start with the variable revenue drivers (such as patients served, units sold or students enrolled). Will the visit/unit sales rate increase or decrease? If the unit sales increase or decrease, what is the impact on costs? Will prices need to change? If prices change, what must the organization do in response? Remember as you change the cost driver, consider the impact on revenue, or vice versa.

Next, consider fixed costs and if there are any changes to these based on the trigger event. Typically, fixed costs would not be subject to change; however, in response to an event such as the COVID-19 pandemic,



organizations may be renegotiating administrative payroll or rent expenses and, therefore, those fixed costs should be reforecast as well. Perhaps the original fixed-cost assumptions were not accurate in the first place. It is worth looking at all significant line items to ensure the accuracy of the forecast. Take this time to be critical of all original assumptions. Review future debt payments, rental agreements or other recurring charges to ensure that the terms of those contracts have not substantially changed since the budget was originally prepared.

The main drivers of the budget are always program/operational related. Therefore, it is critical that you speak with the managers of each division to understand what their projections entail. Accounting and finance personnel must understand if a change to the budget is realistic and if operations can function with the parameters that have been assigned. For example, if you cut expenses to balance the budget from anticipated revenue losses, make sure operational/program managers agree that there are enough expenses to produce whatever is needed to meet anticipated demands. Finance teams have noted that siloed operations or lack of integrations are main reasons for preparing only a static budget and finding a lack of value in other models.<sup>3</sup>

While working on reforecasting, time is of the essence. The sooner the data is reforecast, the sooner the organization can use it as a tool for their decision making. It may be difficult the first time the organization works through a reforecast. Take notes on lessons learned and consider how you can set up the next period's budget in a format that may be easier to reforecast in the future.

### How Do I Predict the Unpredictable?

Reforecasting for a trigger event, such as a new contract, is relatively straightforward. Program managers will understand how drivers will be impacted and what considerations should be made. However, what should organizations do with something like the COVID-19 pandemic? How can the future be predicted?

Financial analysts have made a living out of creating models that consider scenarios such as these. Those scenarios are then stress tested to see what happens if certain assumptions change. Using the same thought process can help you "predict" the future.

One way to create a model is to understand your organization's cash burn. Most CFOs are acutely aware of cash trends. Look back at historical cash flows and calculate what your average spend rate is compared to your average collection rate. With this knowledge you could model a few scenarios.

Consider the worst case scenario first. If the organization is unable to collect cash from any revenue for an entire quarter what reforecast is needed on the budget? What happens if cash from revenue is only reduced a certain percentage over that same quarter? Essentially using this theory, you can start to build steps to respond to a prediction and implement those steps as necessary.

As an example, Organization Y has noted that the current cash position is \$1 million, and that fixed costs requiring cash for the next quarter are \$200,000. This leaves \$800,000 of potential spending. If the organization's variable expenses are \$900,000 a quarter, what steps would need to be taken to cover the shortfall of \$100,000 (\$1.1 million of variable and fixed costs for the quarter less cash on hand of \$1 million)? With a predicted shortfall number, the organization can decide if that means taking on new debt, curbing capital expenses or potentially cutting salaries.

The worst case scenario may not be the most likely. But rather if Organization Y forecasts that instead of the typical cash from revenue of \$1 million a quarter, they anticipate \$500,000 in cash from revenue this quarter. Now the organization has \$1.5 million (\$1 million of cash on hand plus the \$500,000) to spend over the quarter. If the cash needs are \$1.1 million, they know going into the next quarter that they have \$400,000 of cash available.

It is easy to establish the worst case scenario. It is harder to picture a realistic scenario, especially during situations like the COVID-19 pandemic. To assist your organization in determining the most realistic scenarios when reforecasting, look at what is happening in your industry in particular. If you are a member of a trade organization, it is likely that they are polling members and publicizing what member organizations are experiencing. You can also look to other sources of benchmarking, such as public companies, to see what the quarterly earnings or filings look like.

<sup>3</sup>Jelly, Robert (2007, May 1). The Reforecasting Report, 2006 Survey of Current Practices in the UK. Retrieved from [https://www.cimaglobal.com/Documents/ImportedDocuments/The\\_Reforecasting\\_Survey.pdf](https://www.cimaglobal.com/Documents/ImportedDocuments/The_Reforecasting_Survey.pdf)

Dayal, Kshitij (2020, April 15) How to Gain Business Agility in Uncertain Times. Retrieved from: <https://blog.workday.com/en-us/2020/how-to-gain-business-agility-in-uncertain-times.html>



Economic sources like IBISworld, Moody's Analytics, Morgan Stanley Economic Outlook, Morningstar Economic Outlook, or Placer.ai on Retail Foot Traffic provide data and information on economic trends experts are seeing. Organizations often forget to look at external sources to help predict the course of the budget drivers, which can be detrimental when creating an accurate forecast. When preparing any kind of budget, looking at external data sources is critical.

Even if your organization struggles with defining the most realistic scenario, the reforecast is still a helpful tool as it starts to put parameters (Organization Y has somewhere between a shortfall of \$100,000 or a surplus of \$400,000 to consider) that management can work with to make informed decisions about the best next direction rather than driving blind.

### What Is a Rolling Budget?

A rolling budget is similar to a reforecast, except a rolling budget was never intended to remain static and has a set time of when it should be adjusted (rather than waiting for trigger events). A common example of a rolling budget is where an organization would budget four quarters ahead. Each quarter the organization updates the next three quarters and adds a new fourth. Meanwhile monthly comparisons would be made to the monthly budget planned in the rolling budget. The organization would set a time period at which point the budget will be reviewed and updated using the same techniques as noted above for reforecasting. The rolling period could always be adjusted if a trigger event occurred outside of the normal update period. The rolling budget is always anticipating change, so an organization is set up to continuously monitor the trends and update either revenue or cost predictions, or both, to stay nimble.

### Which One Is Better?

The best budget method depends entirely on the attributes of your organization and the industry it operates in.

A static budget is likely the best option for a small organization with relatively small fluctuations year over year. It may also be helpful in organizations that are grant driven where the grant budgets will not change once adopted. While the budgeting process can be long, it only occurs once a year in this environment, which makes it easier for a small staff and limited software capabilities. If your organization utilizes a static budget, to ensure that the budget stays relevant, the organization should routinely compare actual results to budget.

Reforecasting is not always necessary, especially if there is no trigger event and no major variances from the static budget. However, because events like the COVID-19 pandemic are rarely foreseen, the ability to reforecast a static budget is beneficial for any organization. Right now, every organization should prepare a reforecast budget using the steps outlined above based on the impacts of the COVID-19 pandemic. While working on the reforecast, use this time to set up a process and policy of how and when to reforecast your budget in the future. For example, as a policy, an organization could define a trigger event. Try to use thresholds such as an event that would likely change the main budget driver by 20% . When a "roadblock" like the COVID -19 pandemic comes up, the organization needs the tools to create a new fiscal road map. It will likely also lead the organization to identify areas to improve in the static budget process.

If your organization is in a more volatile industry where the drivers are constantly changing and strategy is ever evolving, then the rolling budget is most likely the best method for your organization. Another benefit of a rolling budget is that it inherently pushes the organization to a forward-looking approach, as governance discussions center around how the budget was adjusted and why, versus the historical approach of comparing the static budget to actual and repeating oftentimes the same variances each time. To be successful, a rolling budget requires an ongoing assessment with quick changes to ensure that the periodic budget to actual reporting can be maintained. Reforecasting with a rolling budget also needs to be fairly quick since it is continuous.



If the organization adopts a rolling budget or a reforecasting model moving forward, it is important to make sure careful thought goes into preparing the original budget. Drivers should be clearly identified, and formulas used to show how the variable revenues and costs build from the drivers.

### Does My Organization Need Budgeting Software?

A budget could be a simple spreadsheet or prepared using budgeting software. The team should consider how complex the organization's drivers are when considering whether to utilize a spreadsheet or software. Organizations with multiple streams of revenue with different corresponding variable costs, may find it necessary to utilize software. Software often allows for more complex planning and reforecasting, allowing the organization to create various scenarios to see what an impact such as changing the price of a unit by 5% versus 7% would be. Software can aid collaboration amongst different teams or units, while using a spreadsheet could make maintaining version integrity when sharing with multiple users problematic.

Consider what the likely trend in budgeting will be for your organization to select a tool. In a study done by the Chartered Institute of Management Accountants in 2016, *The Reforecasting Report*, the authors note that “buying an increasingly complex software platform without full cooperation and negotiation may fail to reduce ‘noise’ in the planning and budgeting process.”<sup>4</sup> In addition, bad data in, bad data out, no matter what the tool, so an organization should first make sure the budget basics are in place and reliable data can be easily obtained to ensure a software or spreadsheet's ability to create a proper forecast is enhanced.

<sup>4</sup>Jelly, Robert (2007, May 1). The Reforecasting Report, 2006 Survey of Current Practices in the UK. Retrieved from [https://www.cimaglobal.com/Documents/ImportedDocuments/The\\_Reforecasting\\_Survey.pdf](https://www.cimaglobal.com/Documents/ImportedDocuments/The_Reforecasting_Survey.pdf)



# Strengthening Internal Control in the COVID-19 Environment

By Carla DeMartini, CPA

**Due to its mission-driven purpose, a nonprofit organization's financial and operational sustainability is significantly impacted by its environment. Natural disasters, economic slowdowns and unforeseen events are just a few factors that can adversely affect nonprofit organizations. That is why a strong internal control system has always been a priority for audit committees and management of nonprofit organizations. They've established policies to address the primary question—"what could go wrong?" Now nonprofits are facing the challenges of dealing with the results of the global novel coronavirus (COVID-19) pandemic, which include a scattered and remote workforce. As a result, management of nonprofit organizations are asking themselves—are the internal controls that were once effective still operating in a manner to achieve our objectives in this unprecedented time? What can nonprofit organizations implement in order to adapt to this remote environment, when their employees, resources, technology and documentation may only be accessible through virtual means?**

**Below are five tips** that nonprofit organization management should consider to strengthen their internal control environment in response to a remote environment:

## 1. Reevaluate Risks

Due to the ever-changing environment the pandemic has created, prior to reassessing internal control systems, risks must first be reevaluated. Every nonprofit organization's circumstances related to COVID-19 will be unique. Additional risks that impact the organization's financial position may arise. Audit committees and management should ask themselves questions such as "How has COVID-19 impacted the organization's liquidity and capital resources? Is there now uncertainty about our ability to meet the covenants of our debt agreements? Have new cybersecurity and data integrity risks resulted from our digital working environment? Does our business continuity plan need to be reassessed?" Developing plans and strategies to address questions such as these is crucial to help navigate this new reality.

## 2. Reassess the Existing Control Environment in Response to Reevaluated Risks

Although a nonprofit organization may periodically reassess and test its internal control system to ensure it is working properly, we have now entered an unprecedented time, where reassessing controls takes on a whole new meaning. What proved successful in the past may now result in control gaps when taking into consideration new risks such as a remote work environment, digital reviews/approvals



and virtual documentation. Internal controls should be reassessed to determine if current existing controls are in fact targeting the specific risks now at hand. Nonprofit organizations may have to make changes in order to use the information and resources available to them at this time. This could result in a change in both operational and financial policies and implementing new policies. Roles and responsibilities may have to be adjusted. Contingency plans may have to be formulated in response to the new risks that have arisen. For many nonprofit organizations, controls around donor-restricted and government grant funds may need to be enhanced. Current system capabilities may have to be explored to determine if there is the potential to automate controls. The overall implementation of amended controls is essential to thriving in this changing work environment.



### 3. Strengthen Segregation of Duties

Segregation of duties is often a challenge for nonprofit organizations, depending on their size and complexity—the smaller the size, the bigger the challenge. This challenge intensifies even more in a COVID-19 environment, where the separation of duties, which may have been enforced before, now appears less pragmatic when all parties are working remotely, and circumstances are constantly changing. Questions such as “Who is establishing the controls and who is monitoring them?” need to be revisited. For instance, in a virtual environment, is management able to clearly distinguish between who holds physical custody of an asset versus who does record keeping for that asset? Furthermore, who has the authorization to approve transactions? Leveraging technology to enhance controls is one way to assist in clearly distinguishing between roles and responsibilities. Technology can provide collaboration tools and additional layers of approval that can help ensure that controls are enforced and appropriate segregation of duties is maintained.

### 4. Document Key Areas

Key areas represent those higher-risk financial statement areas that require comprehensive and robust supporting documentation. Management of nonprofit organizations should exercise extreme caution in ensuring significant areas such as management estimates and expenditure/cost tracking are thoroughly supported by documentation. The expectation of well-documented management estimates has always existed—however, in this rapidly changing environment, reasons and explanations of how an estimate is being recorded are more imperative than ever. The estimation should include written assessments of the thought process as well as reasons for any changes from prior years. This especially comes into play when considering the impact of COVID-19 on goodwill impairment, going concern evaluation and any potential additional debt requirements. These represent areas that may likely need renewed consideration and reinforcement when documenting underlying rationales behind the estimates. Additionally, proper expenditure/cost tracking has become increasingly important. Whether nonprofit organizations are incurring expenditures specific to COVID-19-related costs or

receiving government relief funds, the methodology behind identifying and tracking these revenues and expenses is vital to a nonprofit organization's financial position. A nonprofit may consider recording COVID-19-related funds received and expense incurred in separate cost centers. Detailed supporting documentation needs to be maintained to support these amounts.

### 5. Don't Be Afraid to Seek Assistance From Outside Experts

In order to perform their oversight function, audit committees, boards of directors and management of nonprofit organizations might need assurance that the new information and data they are processing is of the utmost quality. As new matters arise, outside experts can help the organization better understand best practices as well as help to monitor and assess the effectiveness of internal controls. They can also address complex accounting and auditing questions or assist with reviewing controls related to cybersecurity and privacy risks. External experts can also identify opportunities for nonprofit organizations by helping them understand the eligibility provisions for additional relief funding with respect to the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Templates and tools can be provided to the organization to help them better understand the calculations behind the relief packages available to them.



# Looking Ahead – An Assessment of the Future of Higher Education Amidst the Impacts of COVID-19

*By David Clark, CIA, CFE, CRMA*

**The spring of 2020 was witness to an unprecedented disruption to life as we know it. The onset of the novel coronavirus (COVID-19) and rapid spread around the globe required an unexpected and immediate response to how businesses and individuals operate. Colleges and universities were no exception and, in many cases, were some of the most highly publicized organizations in terms of reaction and response and the change in the nature of the higher education industry.**

**Though higher education** has been operating distance learning activities and programs for decades, with a dramatic increase in online-only programs throughout the 21st century, the public concept of higher education still revolved around ivy-covered buildings and students rushing through the quad to get to their next lecture. However, amidst the public health emergency, campuses across the country shuttered and institutions rushed to establish the necessary protocols and infrastructure for fully remote operation.

In large part, the crisis response and new normal can be called a success. Institutions have transitioned the majority of all educational activities online and operate effectively with staff working remotely. Now, schools are beginning to focus on the opportunities created through the crisis, while also considering the risks and uncertainties to come. As the initial surge in activity associated with campus closures has ended, we're now left to evaluate the impact and review lessons learned from the transition.

## Immediate Lessons Learned

Evaluating the impact of campus response to date identifies several important considerations for higher education institutions:

- 1. Many activities can be offered remotely** – with the exception of certain research activities, hands-on lab work or higher-level courses requiring deep interaction and collaboration, university operations have been able to continue in the remote environment. While there is no replacement for the campus experience through this environment, institutions will likely rethink how they deliver courses and provide operational and administrative support in light of the success of remote options. Could this enable institutions to reduce space needs by moving more employees to full- or part-time remote work or signal the end to the slate of introductory courses packing lecture halls with hundreds of students?
- 2. Campus emergency response plans work (for the most part)** – though many institutions had likely not planned for an abrupt closure of all campus activities and ability to sustain remote operations for months afterward, the basic foundations and building blocks for rapid evaluation and response existed and enabled mobilization of key individuals and prompt decision making. As the full impact of COVID-19 unraveled, many campuses also saw the need to expand the sphere of individuals or roles included in the campus response, helping to further enhance the blueprint for disaster preparedness in the future.
- 3. Students want the campus experience** – though it's now evident that many institutions could permanently offer enhanced online courses, there is still strong demand and interest in the traditional experience of higher education.





## Considerations as We Look Forward

Though the initial response and reaction to the COVID-19 crisis has passed, the work is not over. Colleges and universities are now faced with potentially even more difficult decisions than the ones they've already tackled, with uncertainty continuing to loom over factors that are largely beyond their control. Considerations include:

- How do state or local reopening plans impact our ability to reopen campus?
- What will the impact be to enrollment as students and their families may face economic hardships, want to stay closer to home or question the cost-to-value proposition of traditional higher education?
- What changes should we make to how we operate for the immediate future when campuses can reopen? What aspects of that environment may be here to stay?
- Can we withstand and/or are we prepared to respond in the event of another outbreak or similar scenario?

While institutions continue to struggle with how and when they will answer these questions, they should also look introspectively at what has been learned through this crisis. The landscape and view of risks has changed, so it's important for leadership to take a step back and assess how they can grow and adapt for the better. This can also be a time to perform a post-action assessment and see if there were areas that may have been missed or overlooked that could be useful in designing the environment of the future. In many cases, institutions were developing and implementing responses simultaneously. Now, they have the chance to optimize and correct issues, implement or enhance controls and, ultimately, provide a more robust and strengthened program.

Overall, COVID-19 exacerbated issues and widened fissures already being discussed regarding the culture and standing of higher education. Schools were already feeling the impact of expanded online programs or other distance learning. Projected enrollment declines and concerns regarding college affordability were already raising concerns over the financial health and sustainability of the campus operating model and viability of maintaining the status quo with thousands of independent schools across the country.

It's impossible to know what changes will continue to hit higher education in the coming years, but I am offering a few predictions:

1. College closures will continue at a higher rate, with many small, private liberal arts colleges closing or consolidating.
2. Overall college enrollment and completion will hold steady, but more students will choose cost-conscious alternatives in the short term (next two to three years) such as:
  - State universities over private
  - Leveraging community colleges
  - Full or partial distance learning
3. Higher education will adapt and continue. Though the landscape of higher education is likely forever changed in certain ways, the demand and need for traditional colleges and universities is more evident now than ever.



# CARES Act Funds for Governments

By Susan Friend, CPA

**The Coronavirus Aid, Relief and Economic Security (CARES) Act enacted by Congress on March 27, established the Coronavirus Relief Fund and appropriated \$150 billion to the fund for COVID-19 related expenses for states, the District of Columbia, U.S. territories, tribal governments and local governments with populations over 500,000. The allocation of \$139 billion to the states was determined by a population-based formula, with states receiving a minimum of \$1.25 billion, with a reduction for payments made to local governments. A total of \$3 billion was reserved for the District of Columbia and U.S. territories, with allocations based on population. A total of \$8 billion was reserved for tribal governments, with 60% allocated based on population and the remaining 40% based on employment and expenditure data, with a minimum payment of \$100,000 to the smallest tribal governments.**

**According to guidance** provided by the Department of Treasury, recipients may use the payments received to cover costs that were necessary and incurred from March 1, 2020 through Dec. 30, 2020, to respond to the COVID-19 public health emergency. Relief fund payments received may not be used to fill shortfalls in government revenue to cover ineligible costs. Governments are responsible for making determinations as to what expenditures are necessary, and do not need to submit a proposed expenditure plan to the Department of Treasury. Eligible expenditures include those incurred to address medical or public health needs, as well as those incurred as a consequence of the pandemic, such as providing economic support to those who have suffered loss of employment or business interruptions due to closures.

Payments made by the recipients should only be used to cover costs that were not accounted for in the state or government budget most recently approved as of March 27, 2020, without considering supplemental appropriations or other budgetary adjustments made in response to the COVID-19 emergency. A cost meets this requirement if the cost either cannot lawfully be funded using a line item, allotment or allocation within that budget, or is for a substantially different use from any expected use of funds in such line item, allotment or allocation. Costs incurred for a substantially different use would, for example, include personnel costs that were included in the most recently approved budget, but, were diverted to substantially different functions due to the COVID-19 emergency. Regarding budgetary stabilization funds or other similar reserve funds, a cost is not considered to have been included in a budget simply because it could have been met using one of these reserve funds.



Recipients may deposit relief fund payments into interest-bearing accounts. If invested separately, interest earnings or other proceeds of those investments must be used only to cover eligible expenditures. If recipients deposit the payment in the government's general account, those monies can be used to meet immediate cash management needs provided that the full amount of the payment is used to cover necessary expenditures. Additionally, if assets were purchased consistent with limitations on the eligible use of relief funds and were disposed of prior to Dec. 30, 2020, proceeds from the disposal are subject to the restrictions of use of eligible expenditures.

The Inspector General of the Department of Treasury may recoup amounts not used in a manner consistent with the provisions of the CARES Act. The CARES Act also provides that if amounts received were not used to cover costs incurred by Dec. 30, 2020, those funds must be returned to the Department of Treasury. For all payments received from the Department of Treasury or



other federal agency, it is imperative that recipients of the funds maintain sufficient records and documentation to demonstrate compliance with requirements. Due to the significant amount of questions pertaining to eligible expenditures and the administration of amounts received from the relief fund, the Department of Treasury issued a FAQ document, which is updated periodically. Through the FAQ document, notification was given that relief fund payments are considered to be federal financial assistance subject to the Single Audit Act and the related provisions of the Uniform Guidance, 2 CFR §200.303 regarding internal controls, §200.330 through 200.332 regarding subrecipient monitoring and management, and subpart F regarding audit requirements. The document further advises that relief fund payments to subrecipients, such as a state transferring payments to its political subdivisions, would count toward the subrecipients threshold under the Single Audit Act.

In addition to the relief fund, multiple federal agencies have directed part of their allotted emergency aid to grant programs to provide support in the response to the COVID-19 pandemic. Relief fund payment recipients need to consider restrictions and limitations on other available federal programs since payments from the relief fund cannot be used to cover expenditures for which reimbursement will be received under another federal program.

Although the current guidance from the Department of Treasury indicated that payments from the relief fund could not be used to fill government revenue shortfalls, there is discussion as to whether to provide more flexibility to use these federal dollars to cover lost revenues, or if more funding will be provided. However, no conclusions have been reached on these issues yet.

Additional COVID-19 resources for governments can be found at the following links:

<https://home.treasury.gov/policy-issues/cares/state-and-local-governments>

<https://gfoa.org/gfoa-resource-center-coronavirus-response>



# COVID-19 and Privacy: What Do Nonprofits Need to Know?

*By Jim Amsler, CIPP/US, M, & E and FIP*

**In May 2020, The Big Payback held its annual fundraising drive in Middle Tennessee. For those unfamiliar, The Big Payback is a 24-hour, online giving event created to increase philanthropy in the 40 counties of Middle Tennessee. While many nonprofits are seeing shrinking donation pools, The Big Payback 2020 saw an almost 10% increase in 2020 donations compared with last year's record haul, despite the challenging economic conditions wrought by the novel coronavirus (COVID-19) pandemic.**

## **Forgive the pun, but what gives?**

The reason is simple: nonprofits are working on the front lines against the primary and secondary effects of COVID-19, and individuals recognize this. Nonprofit organizations lead efforts in critical care services, conducting research, and delivering personal protective equipment and other critical medical supplies. Others serve a secondary role, providing sustaining support for individuals and families who have been affected by the economic and societal impacts of the crisis. Private citizens who cannot serve in these capacities understand that services provided by our nonprofit organizations are more critical than ever and are increasing their support for these providers.

Therefore, in the midst of the most significant health crisis in a century, to say nothing of the accompanying economic effects, who has time to worry about privacy?

Maybe you should, or maybe not. For now.

## **Why Worry?**

The California Consumer Privacy Act (CCPA) took effect Jan. 1, 2020, and (with a few exceptions), does not apply to nonprofit organizations. The EU General Protection Regulation (GDPR), on the other hand, provides no exclusion for nonprofit organizations. Data Protection Authorities (DPAs) that enforce the GDPR on behalf of European states are unequivocal: the privacy protections that were enacted before the pandemic still apply and will continue to do so moving forward.

Translation: if your organization was required to comply with GDPR or CCPA before COVID-19, it still does in the midst of it, and will continue to in the post-COVID-19 world. While a few countries (Italy, for example) have amended or placed very specific and temporary suspensions on privacy controls in response to COVID-19, most have not! And why would they? There are indications that bad actors are successfully leveraging new attack vectors

brought about by the large number of new telecommuting employees. In many cases, employees who are doing work for the first time out of their home are using networks that lack the level of cybersecurity protections we take for granted in corporate office environments. In other cases, organizations hasten to move forward with new services or offerings, without first ensuring the proper protections and safeguards are implemented. The need for privacy controls in the midst of this kind of upheaval is as urgent as ever.

An increase in breaches inevitably leads to greater attention on organizational security and privacy practices. Failure to meet security expectations could lead to sanctions and loss of trust, particularly on the part of donors and sponsors. Many of the donations that pushed The Big Payback to this year's record were received from first-time donors, spurred to action by COVID-19. Those new donors, as well as long-time donors and sponsors supporting nonprofit missions to fight COVID-19, expect and deserve that their personal information will be protected. Losing donor trust, particularly for nonprofits who are perceived to be wanton or cavalier about security or privacy controls, is a real threat to be taken seriously. Even amidst the anxiety and urgency of the current circumstances, all organizations must avoid shortcuts, particularly related to the collection and processing of Personal Information (PI), particularly Personal Health Information (PHI).

What to do? Organizations who haven't taken stock of the data they hold, and how they use and share it, must do so immediately. Hilary Wandall, general counsel of the privacy technology leader TrustArc, advises: "While the current balance of safety and privacy risks weighs in favor of reducing further transmission of COVID-19, privacy issues arising in novel initiatives and processes related to dealing with the pandemic can still be mitigated effectively through responsible data minimization, anonymization, limited data retention, encryption and transparency." Is your organization doing this?



## Don't Special Times Call for Special Measures?

On the other hand, is it not true that we are living in an unprecedented time? Weren't these privacy regulations enacted in a simpler time, when public and private organizations had the luxury of worrying about privacy and security absent the concern that anyone within six feet might be carrying and potentially transmitting a deadly pathogen? In fact, special times DO INDEED call for special measures. Luckily, most privacy laws include provisions that allow for special processing in the name of humanitarian purposes, including for the monitoring and management of epidemics.

Consider the Health Information Portability and Accountability Act (HIPAA), enacted in 1996. HIPAA defines protections that "covered entities" (including nonprofits) must implement to protect PHI. HIPAA allows for limited disclosure of PHI under certain circumstances, including "to prevent a serious and imminent threat." In February, the Department of Health and Human Services [affirmed](#):

*Disclosures to Prevent a Serious and Imminent Threat: Healthcare providers may share patient information with anyone as necessary to prevent or lessen a serious and imminent threat to the health and safety of a person or the public ... Thus, providers may disclose a patient's health information to anyone who is in a position to prevent or lessen the serious and imminent threat, including family, friends, caregivers and law enforcement, without a patient's permission.*

GDPR, CCPA, and other omnibus privacy regulations also describe specific circumstances in which privacy protections may be temporarily suspended for humanitarian purposes. However, caution is required: these exceptions must be carefully documented, and the suspension of privacy controls must be very specific to the purpose. Nonprofit organizations involved in the COVID-19 response may disclose PHI in the name of their mission, but when asked by the HHS, a state attorney general, DPA, or other enforcement body, they need to be ready to explain their actions.

## What's Next?

Predicting the post-COVID-19 "new normal" in the privacy realm is a dicey proposition. TrustArc CEO Chris Babel believes that COVID-19 is going to refocus the

privacy landscape on PHI: "As legislatures focus on the most pressing public health and economic needs, we have seen a dramatic slowdown in the introduction and review of privacy legislation not only here in the U.S., but globally. We anticipate the next wave of privacy legislation will factor in public health considerations like we saw in the recently proposed [COVID-19 Consumer Data Protection Act of 2020](#)."

Organizations that never dealt with PHI may suddenly and unexpectedly find themselves doing so. For example, will a shelter implement temperature checks before admitting an individual? If so, what will it do with the information it collects?

However, a few trends have emerged that seem likely to shape how nonprofits approach assessment, implementation and ongoing management of their security and privacy programs:

- While existing regulations remain in force, the enactment of new laws will likely be delayed for the immediate future. Brazil, for example, delayed the implementation date of its sweeping privacy regulation until 2021.
- Cybercriminals, including state-sponsored actors, will increase their activity and broaden their approach to gaining access to PI. Nonprofit organizations in particular may be perceived as soft targets, which lack the resources of large for-profit organizations and are focused on the urgency of serving their mission in the midst of a public health crisis.
- National-level conversations around the handling of PHI will evolve, pitting individual privacy rights against broader concerns rooted in public health and pandemic response. South Korea granted sweeping surveillance powers to its national health agencies in response to earlier pandemic outbreaks, and then leveraged these to enact contact-tracing and quarantine measures that may have diminished the severity of the outbreak in that country.

Privacy and social justice organizations that exist to promote and protect human rights will need to be active participants in these dialogues, to ensure an optimal balance between public and private interests in the post-COVID-19 world.



# Managing Compensation in the 'New Normal'

*By Michael Conover*

**The novel coronavirus (COVID-19) crisis has affected all sizes and types of organizations including the nonprofit sector. Regardless of the type of nonprofit, they have been impacted by: forced office closures, dramatic swings (upward or downward) in demand for their services, actual or threatened loss of revenue, budgetary and staff cuts, etc. As the crisis has unfolded, each organization has struggled to respond as new information and guidelines for moving forward have changed. And there is no certainty as to when or how things will begin to change for the better.**

**Because compensation** is generally the largest expense for most nonprofit organizations, it should come as no surprise that many have been forced to reduce or eliminate salaries, and discontinue any bonus and incentive plans. Over time, additional compensation reductions may become necessary if revenues fail to recover to needed levels.

With the struggles to manage day-to-day operational issues a full-time affair, a discussion of compensation would seem to be a pretty low priority in most organizations ... particularly since there is likely no good news to report. Like most difficult topics, however, this does need to be raised.

While we cannot make many specific predictions about the future as far as compensation is concerned, I believe there are a few things we can expect as things move forward:

- Staff and salary reductions in response to the crisis will likely result in no or negligible wage growth for the year with possible negative growth in some cases.
- Interest normally devoted to surveys about salary increases for the coming year will likely be focused instead on surveys of trends for addressing the "no growth" situation which can include plans for restoration of salary cuts, use of one-time bonuses/spot awards, "premium"/ hazard pay for essential personnel, etc.
- Boards will wrestle with decisions about compensation for the executive team managing the organization through the crisis period—pondering a basis for evaluation of performance and an appropriate means for rewarding steps taken for the organization's survival versus a celebration of growth and profitability.



Under the best of circumstances, good advice for addressing an organization's compensation needs is based on an understanding of the facts and circumstances associated with that organization. These uncertain times underscore the need for specific information, but very little is available. With little or no information about when or how things will begin to emerge from the crisis, it might be best to offer some general guidelines for managing compensation in the new normal. A few that come to mind follow:

- Prior to implementing changes in any compensation practices (if not already made), organizations must check with state regulations about required periods of notice before changes can be made. Similarly, plans for eliminating, delaying or changing the terms of payment under any formal plans or employment agreements should be thoroughly researched to avoid any adverse compliance issues.
- Communication about compensation is always important and often not done well. In difficult situations it is more important and must be done better. Information must be shared and provided in advance of change (when possible) by board and management to staff.



- Periodic updates on compensation, particularly in cases where salaries have been reduced, is important. Ideally, plans for restoration can be shared. Until that can occur, communication of assurances that the subject has not been dropped and a plan will be announced as soon as one can be developed should be made. While employees may be reluctant to raise the topic, it is a top-of-mind issue on the home front.
- While board members are likely absorbed in many other issues, the annual compensation discussion may be delayed, but its return to the agenda is a certainty. Management has the same interest in and need for information about compensation as staff members.
- The typical review of actuals in relation to budget, personal objectives met and/or missed, etc. will likely be moot at this point. Similarly, efforts to reset bonus or incentive plans will likely be a pointless effort under current circumstances.
- Rather than delay consideration of management compensation decisions until several days beforehand, board members might do well to devote some time to identifying and discussing some new and/or revised criteria for assessing management's stewardship of the organization in the crisis. For example:
  - How well were employees treated?
  - How well were the organization's clients/service recipients treated?
  - How well were the organization's vendors treated?
  - How did the organization respond to the needs of the community?
- Explore some ideas and/or options for alternative compensation such as non-monetary alternatives for recognition, reward payments (e.g. one-time bonus / spot award, extra paid time off, etc.).
- As circumstances improve and plans for recovery begin to become clearer, communications with all parties about plans for compensation must be a priority. People should not be left in a position to wonder what will happen or be forced to ask. Proactive communication is the best approach.

We expect that in the weeks and months to come, there will be more information to share about trends that will impact compensation later in this year and into next. We will provide updates as they become available.



# How Many Unrelated Trades or Businesses Do You Have?

By Marc Berger, CPA, JD, LLM

**The recently issued proposed regulations interpreting Internal Revenue Code (IRC) Section 512(a)(6) provide additional guidance and builds on Internal Revenue Service (IRS) Notice 2018-67.**

On April 24, 2020, the U.S. Treasury Department and IRS published proposed regulations under IRC Section 512(a)(6) in the Federal Register, which was added to the tax law as part of the 2017 Tax Cuts and Jobs Act (TCJA). The provision requires tax-exempt organizations with more than one unrelated trade or business to calculate unrelated business taxable income (UBTI) separately with respect to each unrelated trade or business. The underlying purpose of the provision is to prevent a net loss from one activity from reducing the net income from a profitable activity. As a result of having to treat each unrelated activity separately, Section 512(a)(6) has become known as the “Silo” provision. The provision has been effective for tax years beginning on Jan. 1, 2018 and thereafter.

## Background

The IRS released Notice 2018-67 in August 2018 to provide organizations and their tax advisors some guidance on how to interpret Section 512(a)(6). The proposed regulations generally follow the guidance in the notice, although they make several modifications in response to comments received from the tax-exempt organization community.

The principal issue for organizations seeking to comply with Section 512(a)(6) is determining how many unrelated trade or business activities they have. Congress did not provide explicit criteria for determining whether an exempt organization has “more than one unrelated trade or business” or how to identify “separate” unrelated trades or businesses for purposes of computing UBTI in accordance with Section 512(a)(6). The proposed regulations seek to clarify these issues by establishing a method for determining whether an organization has more than one unrelated trade or business and by identifying separate unrelated trades or businesses. Most business activities will use the North American Industry Classification System (NAICS) business codes, and separate guidance is provided for investment activities. In each of these instances the proposed regulations start with the approach utilized in Notice 2018-67 but make

some additional changes to this guidance based on the comments received.

## Business Activities Other Than Investment Activities

The proposed regulations would classify most unrelated business activities pursuant to 2-digit NAICS codes, which differ from the more specific 6-digit NAICS codes proposed in Notice 2018-67. The 6-digit codes are described as follows: the first two digits designate the sector, each of which represents a general category of economic sector, e.g., real estate and rental and leasing (53), health care and social assistance (62), accommodation and food services (72); the third digit designates the subsector; the fourth digit designates the industry group; and the fifth digit designates the NAICS industry. When applicable, the sixth digit is used to designate the national industry, to reflect differences between the countries. A zero as the sixth digit generally indicates that the NAICS industry and the U.S. industry are the same.

After considering the comments received from its issuing Notice 2018-67, the Treasury Department and the IRS continue to view an identification method based on NAICS codes as administrable for exempt organizations and the IRS. However, in updating the guidance recommended in the notice, the proposed regulations provide that an exempt organization generally will identify its separate unrelated trades or businesses using the first two digits of the NAICS codes, i.e., by economic sector. While there are more than 1,000 NAICS 6-digit codes, the NAICS divides the economy into only 20 economic sectors. Using the 2-digit codes is expected to result in broader, less subjective identification of trades or businesses that would naturally permit the aggregation of similar activities. In addition, it was noted that the 2-digit codes are less likely to change over time because the codes are revised through notice and comment rulemaking (and OMB has historically not revised the codes at the 2-digit level).



Administratively, the proposed regulations provide that an exempt organization will report each NAICS 2-digit code only once. For example, a hospital organization may operate several hospital facilities in a geographic area (or multiple geographic areas), all of which include pharmacies that sell goods to the general public. Pharmacies are described under the NAICS 2-digit code for retail trade (44). Although each pharmacy potentially could be considered a “separate” trade or business under Section 512(a)(6), particularly if separate books and records exist for each pharmacy, the hospital organization would report all the pharmacies using the 2-digit code for retail trade (44), along with any other retail trades or businesses described by this code, on Form 990-T as one unrelated trade or business.

Finally, the proposed regulations provide that once an exempt organization has identified a separate unrelated trade or business using a particular 2-digit code, the organization may not change the 2-digit code describing that trade or business unless the organization can show that the 2-digit code chosen was due to unintentional error and that another 2-digit code more accurately describes the trade or business. This limitation will apply to codes reported on the first Form 990-T filed after final regulations under Section 512(a)(6) are published in the Federal Register. It is anticipated that the instructions to Form 990-T will be revised to describe how an exempt organization provides notification of such an error. In addition, the Treasury Department and the IRS are requesting comments regarding whether there are other circumstances in which an exempt organization should be permitted to change the selected 2-digit codes.

## Investment Activities

The proposed regulations provide that NAICS 2-digit codes are used to identify separate unrelated trades or businesses except to the extent provided in other paragraphs of the proposed regulations. An exempt organization’s investment activities fall under this exception as their rules are provided in other paragraphs of the proposed regulations.

The proposed regulations provide that exempt organizations may aggregate certain investment activities and treat them as one unrelated trade or business for purposes of Section 512(a)(6). For most exempt organizations those activities are limited to: (i) qualifying partnership interests (QPIs); (ii) debt-financed properties; and (iii) qualifying S corporation interests.

For partnership interests, Notice 2018-67 states that the category of “investment activities” should include only partnership interests in which the exempt organization does not significantly participate in any partnership trade or business. As in the notice, the proposed regulations define QPIs as partnership interests that meet one of two tests:

- **A de minimis test**, which the exempt organization satisfies if it holds directly no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership; or,
- **A control test**, which the exempt organization satisfies if it directly holds no more than 20% of the capital interest and does not control the partnership, taking into account all facts and circumstances.

In response to comments received on the notice, the percentage interests held by disqualified persons (e.g., directors) do not need to be taken into account under the proposed regulations in applying the percentage thresholds of the de minimis and control tests. In addition, interests held by controlled entities and supporting organizations no longer need to be taken into account for the de minimis test (but do need to be combined for the control test).

With respect to the control test, the notice looked to whether the exempt organization had “control or influence” over the partnership, while the proposed regulations only look to “control.” The proposed regulations provide that control is shown if the exempt organization “by itself” has the ability to require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operation of the partnership, or if it has the power to appoint or remove any of the partnership’s officers or employees or a majority of its directors. Like the notice, the proposed regulations also provide that control is shown if any of the exempt organization’s officers, directors, trustees or employees have rights to participate in the management of the partnership or conduct the partnership’s business at any time.

The proposed regulations allow exempt organizations to rely on the information in the annual Schedule K-1s provided to it for purposes of the de minimis and control tests. In addition, once an organization designates a partnership interest as a QPI, it cannot use the NAICS codes to subsequently identify trades or businesses of the partnership unless and until the partnership no longer



qualifies as a QPI (in which case it would be required to use the NAICS codes).

Additionally, the proposed regulations temporarily maintain the “transition rule” that was provided in the notice, under which a partnership interest acquired prior to Aug. 21, 2018 may be treated as comprising a single trade or business under Section 512(a)(6). However, the proposed regulations state that an organization’s ability to rely on the transition rule ends at the beginning of the first day of its first taxable year beginning after the final regulations under Section 512(a)(6) are published in the Federal Register.

The proposed regulations provide that income from debt-financed properties includible in unrelated business income (UBI) under Section 512(b)(4) should be included in an organization’s trade or business from ‘investment activities’ for purposes of Section 512(a)(6). This treatment supports the IRS belief that debt-financed properties are generally held for investment purposes. In addition, an S corporation interest that meets either the de minimis or control test for QPIs is considered a “qualified S corporation interest” and would also be included as part of an organization’s ‘investment activities’ unrelated trade or business. An S corporation interest that is not a qualified S corporation interest would be treated as an interest in a separate unrelated trade or business.

### Other Activities

The proposed regulations provide that all “specified payments” (i.e., interest, rents, royalties and annuities) received from controlled entities and includible in UBI under Section 512(b)(13) would be treated as a separate trade or business. Moreover, if a controlling organization receives these payments from two different controlled entities, the payment from each controlled entity would be treated as a separate unrelated trade or business.

The proposed regulations also provide that amounts received from controlled foreign corporations which are includible in UBI under Section 512(b)(17) would be treated as income from a separate unrelated trade or business. Finally, the proposed regulations clarify that inclusions of Subpart F income and global intangible low-taxed income (GILTI) are treated in the same manner as dividends for UBI purposes.

### Net Operating Loss Deductions (NOLS)

As enacted, Section 512(a)(6) requires organizations with more than one unrelated trade or business to determine any NOL deduction separately for each trade or business. By limiting the reportable unrelated business taxable income from a separate trade or business to zero, the statute supports the underlying purpose of the provision to prevent a loss incurred from one trade or business to offset income generated from another trade or business. To preserve NOLs from tax years prior to the effective date of the TCJA, Congress created a special transition rule for NOLs arising in a taxable year beginning before Jan. 1, 2018 (pre-2018 NOLs). Section 13702(b)(2) of the TCJA provides that Section 512(a)(6)(A) does not apply to pre-2018 NOLs, i.e., that they may be used without regard to the Section 512(a)(6) limitation. For organizations with pre-2018 NOLs, and NOLs arising from years beginning after Dec. 31, 2017 (post-2017 NOLs), a question arose regarding the order in which such losses should be taken. Notice 2018-67 did not affirmatively answer that question, however the proposed regulations do.

The proposed regulations provide that an exempt organization with both pre-2018 NOLs and post-2017 NOLs will deduct its pre-2018 NOLs from its total UBTI before deducting any post-2017 NOLs with regard to a separate unrelated trade or business’s UBTI. Moreover, the proposed regulations state that pre-2018 NOLs are deducted from total UBTI in the manner that results in maximum utilization of the pre-2018 NOLs in a taxable year. This result is organization-friendly in that it allows for the maximum use of these NOLs before their expiration (pre-2018 NOLs expire after 20 years; post-2017 NOLs do not expire).

### Charitable Contributions Deduction

For tax-exempt organizations that are corporations, Section 512(b)(10) limits the organization’s charitable contributions deduction to 10% of UBTI. The proposed regulations clarify that Section 512(b)(10)’s reference to ‘UBTI’ refers to UBTI after the application of 512(a)(6). This result is also organization-friendly in that activities with net losses will not lower UBTI for purposes of determining the 10% deduction limit since those loss activities will be limited to zero for purposes of Section 512(a)(6).



## Allocation of Expenses

Regarding the issue of allocating expenses between separate unrelated trades or businesses, Notice 2018-67 stated that the Treasury and IRS were considering modifying the “reasonable allocation method” described in Treas. Reg. Sec. 1.512(a)-1(c) and providing specific standards for allocating expenses under Section 512(a)(6). The preamble to the proposed regulations state that Treasury and IRS are still considering the issue and intend to publish separate proposed regulations providing further guidance on this issue. Until these proposed regulations are issued organizations are instructed to allocate deductions in accordance with any reasonable allocation method. Per the IRS, utilizing gross revenues as a method of allocation is not reasonable as it overstates the deduction(s) in determining UBTI.

## Proposed Applicability Dates and Approaches

The proposed regulations apply to taxable years beginning on or after the date they are published in the Federal Register as final regulations. For taxable years beginning before that effective date, exempt organizations may (1) rely on the proposed regulations in their entirety; (2) rely on the methods of aggregating or identifying separate trades or businesses provided in Notice 2018-67; or, (3) rely on a reasonable, good-faith interpretation of Sections 511 through 514, considering all of the facts and circumstances, when identifying separate unrelated trades or businesses under Section 512(a)(6).

## Summary

While some important questions remain unanswered (e.g., allocation of expenses among various UBI silos), the proposed regulations should provide organizations some comfort in the potential aggregation of activities, which may help the determination of how many unrelated trades or businesses they have. However, this may not ease the inevitable result of increasing their unrelated business income tax liability exposure from a provision that tilts the proverbial “level playing field” towards their taxable entity competitors.



# Federal Reserve Proposes Expanding Main Street Lending Program to Nonprofit Organizations

*By Robert Berdanier, CPA, David Duski, CPA, Paul Peterson, CPA, and Joyce Underwood, CPA*

**On June 15, the Federal Reserve announced a proposed expansion to its Main Street Lending Program (MSLP) to address the liquidity needs of nonprofit organizations that have been impacted by the COVID-19 pandemic. The MSLP was established by the Federal Reserve earlier this year when the Treasury Department carved out \$75 billion of the available \$454 billion under Title IV of the Coronavirus Aid, Relief, and Economic Security (CARES) Act to make an equity investment in a special purpose vehicle (SPV), which enabled the flow of credit to small and medium-sized businesses that were in good financial standing prior to the COVID-19 crisis.**

**Previously, nonprofit organizations** were not eligible to participate in the program given their absence of EBITDA, a key underwriting metric required for the three existing MSLP facilities. However, the Federal Reserve then evaluated the feasibility of adjusting the borrower eligibility criteria and loan eligibility metrics of the program for nonprofit organizations.

Under the proposed expansion, tax-exempt organizations under section 501(c)(3) or 501(c)(19) of the Internal Revenue Code would be eligible to apply. It's also important to note that organizations that have received loans under the Paycheck Protection Program (PPP) could also apply for a loan under the MSLP provided they are otherwise eligible. The Federal Reserve sought public feedback on the proposed expansion via email through June 22.

According to Federal Reserve Chair Jerome Powell, "nonprofit organizations are critical parts of our economy, employing millions of people, providing essential services to communities, and supporting innovation and the development of a highly skilled workforce. Nonprofits provide vital services across the country and we are working to help them through this difficult time."

## Proposed Loan Terms

The proposed nonprofit facilities are similar to the three MSLP facilities available to for-profit small and medium-sized businesses. The loan terms such as the interest rate, deferral of principal and interest payments, and a five-year term are the same. Principal payments would be fully deferred for the first two years of the loan, and interest payments would be deferred for one year.



The nonprofit loans would range between \$250,000 and \$300 million based upon an organization's operating performance, liquidity and ability to repay debt. Two loan facilities would be offered under the current proposal:

1. Organizations entering into loans with new lenders
2. Organizations wishing to increase an existing loan or line of credit with an existing lender.

Because a nonprofit does not have some of the financial characteristics of a for-profit to measure its finances, a nonprofit borrower's eligibility requirements will be modified from the for-profit facilities to reflect the operational and accounting practices of the nonprofit sector. The nonprofit loan program would be available to organizations that have been continuously operating for at least five years with a minimum of 50 and maximum of 15,000 employees. Organizations with endowments exceeding \$3 billion would be excluded from participation.



The chart below summarizes key proposed terms.

| Proposed Main Street Lending Program<br>Nonprofit Loan Options | Nonprofit New Loans  | Nonprofit Expanded Loans   |
|--|--|--|
| Term   | 5 years  |  |
| Minimum Loan Size  | \$250,000  | \$10M  |
| Endowment Cap  | \$3 billion  |  |
| Years in Operation   | At least 5 years   |  |
| Employee Min/Max   | Employees fewer than 15,000 and greater than 50                                |  |
| Revenue cap and source requirement                             | 2019 Revenues less than \$5 billion, with less than 30% sourced from donations |  |
| Maximum Loan Size  | The lesser of \$35M, or the borrower's average 2019 quarterly revenue          | The lesser of \$300M, or the borrower's average 2019 quarterly revenue |
| Risk Retention   | 5%   |  |
| Principal Repayment  | Principal deferred for two years; years 3-5: 15%, 15%, 70%                     |  |
| Interest Payments  | Deferred for one year  |  |
| Rate   | LIBOR + 3%   |  |

Source: <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200615b.htm>.

Detailed descriptions of the draft nonprofit MSLP programs are available via term sheets by the Federal Reserve:

[Nonprofit Organization New Loan Facility Term Sheet \(PDF\)](#)

[Nonprofit Organization Expanded Loan Facility Term Sheet \(PDF\)](#)

## Application Process

While the nonprofit Main Street loan application process is not yet open, we expect it will follow the for-profit Main Street loan application whereby the loan is requested at a federally insured lending institution, which will apply its own underwriting criteria. The Federal Reserve is expected to release nonprofit application forms and agreements to be completed in conjunction with a nonprofit loan application that will include borrower certifications and covenants.



## Other Items to Note

### Completion of the Data Collection Form on the Federal Audit Clearinghouse (FAC) Internet Data Entry System (IDES) System

The FAC has noted that when auditees are preparing their data collection form submissions on the FAC IDES, they should not utilize Google Chrome. The FAC has noted that certain issues are encountered only when using Google Chrome. Another browser should be utilized when working with the IDES system.

### The Grant Reporting Efficiency and Agreements Transparency (GREAT) Act Was Issued

On Dec. 30, 2019, the president signed the GREAT Act into law. Its main purpose is to modernize federal grant reporting by standardizing the information recipients of federal grants and cooperative agreements submit to federal agencies. The effect on how audits are summarized and reported to the FAC by both auditees and auditors in the future remains to be seen. The act's provisions are being incorporated into the proposed revisions to the Uniform Guidance.

### Private Foundation Excise Tax Rate Change

The Taxpayer Certainty and Disaster Relief Act of 2019 (the 2019 Act) changed the long-standing two-tiered excise tax regime applicable to net investment income (NII) of certain private foundations. Prior to the change, private foundations paid excise tax on its NII either at 1% or 2%, depending in part on the amount of qualifying distributions that were made during a year. The 2019 Act fixes that rate at 1.39%. This change is expected to increase the tax paid by some private foundations and decrease the amount paid by others. However, the administrative burden of calculating the tax will likely be reduced by most affected private foundations. This change is effective for tax years beginning after Dec. 20, 2019.

### Paper Forms 990-T & 4720

In 2020, the IRS will continue to accept paper forms. These include Form 990-T, Exempt Organization Business Income Tax Return and Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the IRC. The IRS plans to have these returns ready for e-filing in 2021 (reporting on tax year 2020).

### Form 8872 – Tax-Exempt Political Organizations

The IRS will no longer accept paper Forms 8872 for tax periods after 2019. Form 8872, reporting information for periods starting on or after January 2020, will be due electronically by Section 527 organizations. These include political parties, political action committees and campaign committees of candidates for federal, state or local office.