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# NONPROFIT **STANDARD**

## IRS Drastically Expands Electronic Filing Requirement for 2023 Tax and Information Returns

**By Paul Cheung, CPA, Norma Sharara, JD, and Joan Vines, CPA**

The Internal Revenue Service [finalized regulations] on Feb. 23, 2023, significantly expanding mandatory electronic filing of tax and information returns that require almost all returns filed on or after Jan. 1, 2024, to be submitted to the IRS electronically instead of on paper.

Under the new rules, filers of 10 or more returns **of any type** for a calendar year generally will need to file electronically with the IRS. Previously, electronic filing was required if the filing was more than 250 returns **of the same type** for a calendar year.

The discussion below focuses primarily on common workplace IRS information forms, such as Form W-2 and 1099 filings and employee benefit plan filings, but the new rules broadly apply to other types of returns.

**BDO INSIGHT.** Affected employers may need significant lead time to implement new software, policies and procedures to comply with the new rules. Thus, even though electronic filing is not required until 2024 for the 2023 tax year, employers should evaluate what changes may be needed. Simply doing the "same as last year" will not work for many employers.

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## GENERAL RULES

**Who is affected?** Practically all IRS filers of 10 or more information returns when counting any type, such as Forms W-2, Forms 1099, Affordable Care Act Forms 1094 and 1095 and Form 3921 (for incentive stock options) and other disclosure documents, are impacted by this change this year — that is, for 2023 returns that will be filed in 2024. Even workplace retirement plans may need to file Form 1099-Rs (for benefit payments) and other forms electronically with the IRS starting in 2024 for the 2023 plan or calendar year.

**Which returns are affected?** In addition to the information returns that are the primary focus of this article, the new rules cover a broad variety of returns, including partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns for U.S.-source income of foreign persons, registration statements, disclosure statements, notifications, actuarial reports and certain excise tax returns.

The rules are not relaxed under these regulations. Thus, returns that are already required to be filed electronically, including partnership returns with more than 100 partners, tax-exempt organization annual returns in the Form 990 series, Form 4720 (for certain excise taxes) and most Forms 5500 (Annual Return/Report of Employee Benefit Plan) continue to be subject to the electronic filing requirement. However, under the new regulations, any taxpayer with 10 or more returns, including income and information returns, must also file its income tax return electronically.

**How to count to 10?** A significant change introduced by the new regulations is that the 10-return threshold for mandatory electronic filing is determined on the aggregate number of different types of forms and returns. The aggregation rules are confusing because the filings included in the count change depending on which form the determination is made. Also, some filers must be aggregated with all entities within its controlled or affiliated service group to determine if 10 or more returns are being filed for the tax year. For instance, Form 5500 employee benefit plan filers (but not Form 8955-SSA employee benefit plan filers) must count the filings of the employer who is the "plan sponsor" and other entities in the employer's controlled and affiliated service group.

**Example 1:** Company A is required to file five Forms 1099-INT (Interest Income) and five Forms 1099-DIV (Dividends and Distributions), for a total of 10 information returns. Because Company A is required to file a total of 10 information returns, Company A must file all of its 2023 Forms 1099-INT and 1099-DIV electronically, as well as any other return(s) that are subject to an electronic filing requirement. The reason for this result is that "specified information returns" such as Forms 1099 and W-2 must be aggregated when counting to determine whether the new 10-or-more threshold for electronic filing is met.

**Example 2:** Company B is required to file nine Forms W-2 and one Form 8955-SSA. Company B is not required to file the Forms W-2 electronically because the aggregation rules for "specified information returns" take into account only other specified information returns that do not include Form 8955-SSA nor the income tax return. But Company B must file the Form 8955-SSA electronically because the aggregation rules for Form 8955-SSA takes all returns into account.

**Example 3:** Corporation X, a C corporation with a fiscal year end of Sept. 30, was required to file one Form 1120 (U.S. Corporation Income Tax Return) during the calendar year ending Dec. 31, 2023, six Forms W-2 (for employees), three Forms 1099-DIV (for dividend distributions), one Form 940 (Employer's Annual FUTA Tax Return) and four Forms 941 (Employer's Quarterly Federal Tax Return). Because the Form 1120 aggregation rules include returns of any type during the calendar year that ends with or in the taxable year and Corporation X is required to file more than 10 returns of any type during calendar year 2023, Corporation X is required to file its Form 1120 electronically for its taxable year ending Sept. 30, 2024.

**BDO INSIGHTS.** Any payers that currently file any returns on paper should consult with their tax advisor to determine if the new electronic filing requirements apply to them based on the number of returns that they anticipate filing in 2024 for tax year 2023.

Filers must, for the first time, pay particular attention to the total number of returns across all return types, because the new electronic filing threshold is determined based on the aggregate total, not the number of returns per return type. This might require coordination between different departments within an organization and immediate consultation with the IT department and/or software provider to ensure there is adequate time to implement technology solutions or software upgrades before the 2024 filing deadline.

The IRS's new — and free — online portal for filing these returns electronically, Information Returns Intake System (IRIS), is especially helpful for small filers dealing with electronic filing for the first time. According to the IRS, IRIS is secure, accurate and does not require any special software. This free service is available to filers of any size.

## RETIREMENT AND EMPLOYEE BENEFIT PLANS

**How do the new rules apply to retirement and benefit plan filings?** Different aggregation rules apply, depending on the type of form being tested for whether electronic filing is required, which can be confusing.

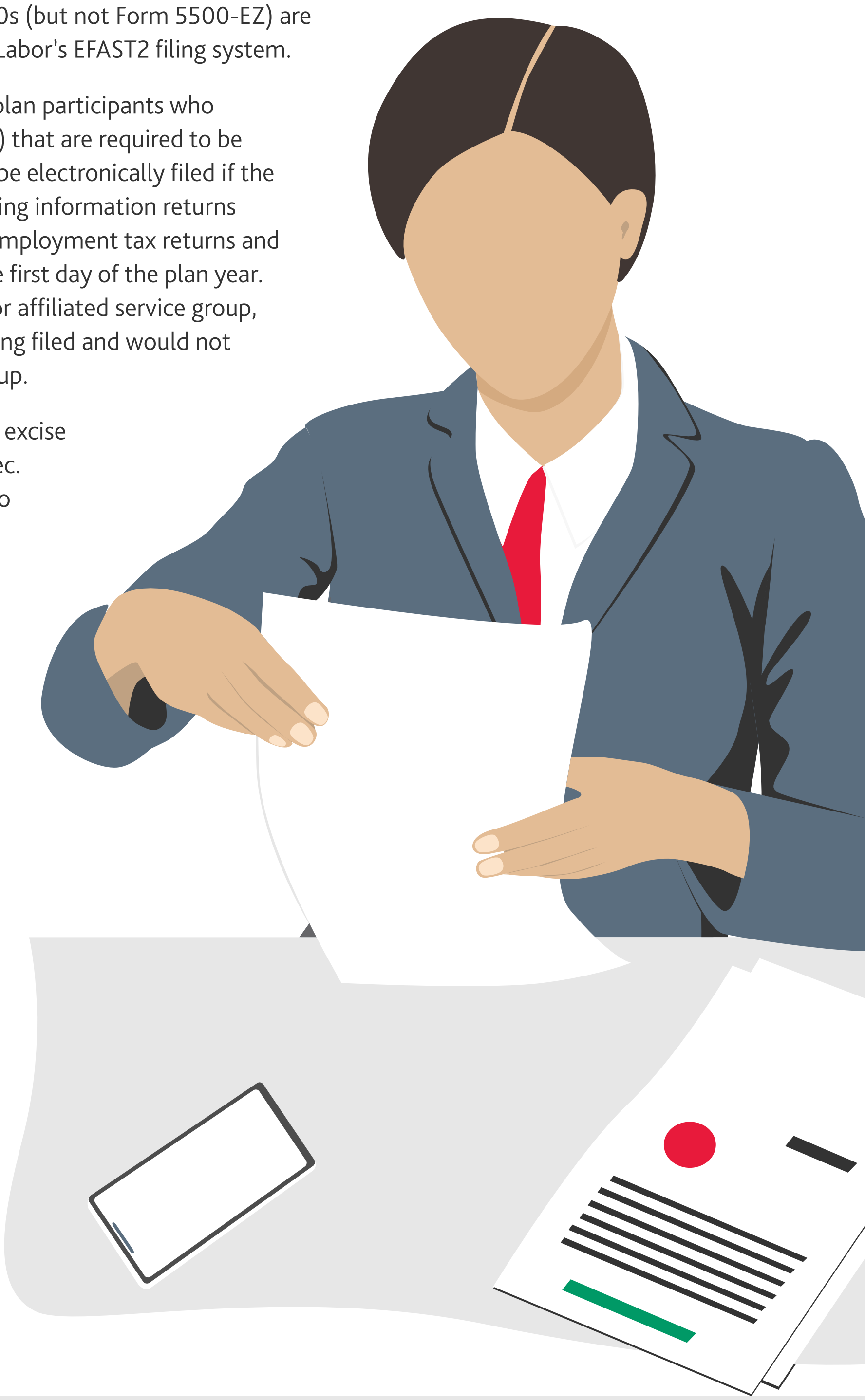
**Form 5500.** Filers of Form 5500 must file electronically for plan years that begin on or after Jan. 1, 2024, if they (together with any member of a controlled or affiliated service group) are required to file at least 10 returns of any type, including information returns (such as Forms W-2 and Forms 1099), income tax returns, employment tax returns and excise tax returns, during the calendar year that includes the first day of the plan year. Thus, Form 5500 filers are subject to an additional controlled group aggregation rule that does not apply to other types of filings. This means that Form 5500-EZ (plans that cover only the owner or owner and spouse) may need to be filed electronically depending on the number of Forms W-2, Forms 1099, etc. filed by the plan sponsor and affiliated businesses. Most Forms 5500s (but not Form 5500-EZ) are already filed electronically through the U.S. Department of Labor's EFAST2 filing system.

**Form 8955-SSA.** Forms 8955-SSA (identifying retirement plan participants who terminated employment but left vested benefits in the plan) that are required to be filed for plan years that begin on or after Jan. 1, 2024, must be electronically filed if the filer is required to file 10 or more returns of any type, including information returns (such as Forms W-2 and Forms 1099), income tax returns, employment tax returns and excise tax returns, during the calendar year that includes the first day of the plan year. But if the Form 8955-SSA filer is a member of a controlled or affiliated service group, the filer would count only the number of its own returns being filed and would not count the number of returns being filed by others in the group.

**Form 5330.** Forms 5330 (for certain employee benefit plan excise taxes) required to be filed for tax years ending on or after Dec. 31, 2023, must be filed electronically if the filer is required to file 10 or more returns of any type, including information returns (such as Forms W-2 and Forms 1099), income tax returns, employment tax returns and excise tax returns, during the calendar year in which the Form 5330 is due.

**Forms 1094, 1095, 1099 and 5498.** Forms 1094 and 1095 series (Affordable Care Act coverage reporting), Form 1099 series (including 1099-R for retirement plan benefit payments) and Form 5498 Series (for IRA contributions) required to be filed after Dec. 31, 2023, must be filed electronically if the filer is required to file 10 or more "specified information returns" during the calendar year that includes the first day of the plan year.

**Counting Rules for Each Form.** When determining whether a filer for a retirement plan's Forms 1099-R must file those forms electronically, the filer would count only its "specified information returns" (like Forms W-2, 1099 series, 1094 series and 1095 series). The requirement to include filings by entities in the sponsor's controlled or affiliated group applies only to electronic filing of the plan's Form 5500.



**Example 1:** If a retirement plan filer is required to file eight Forms 1099-R, one Form 5500 and one Form 8955-SSA, the filer is not required to file the Forms 1099-R electronically. However, it is required to file Forms 5500 and 8955-SSA electronically, because all returns, including Forms 1099-R, must be taken into account for determining Forms 5500 and 8955-SSA electronic filing status under the aggregation rules.

**Example 2:** In 2023, Company A (the plan sponsor and plan administrator of Retirement Plan B) is required to file a 2023 Form 5330 for its nondeductible contribution to Plan B. Company A and Plan B both operate on a calendar-year basis. In 2024, Company A (as plan administrator) is required to file 21 returns for 2023, including nine 2023 Forms 1099-R (for plan benefit payments), 10 2023 Forms W-2, one 2023 Form 5500 and one 2023 Form 1120 (federal corporate income tax return). Because Company A is required to file at least 10 returns of any type during the 2024 calendar year, Company A must file the 2023 Form 5330 for Plan B electronically.

**Example 3:** Assume plan sponsor A, who maintains retirement plan B, is required to file one Form 1099-R, one Form 5500 and one Form 8955-SSA. Assume plan sponsor A is not a partnership with 100 or more partners, and is required to file one Form W-2, four Forms 941, one Form 940 and one Form 1120 (federal corporate income tax return). Assume also that plan sponsor A owns 100% of entity C, which files 20 Forms W-2, four Forms 941, one Form 940 and one federal income tax return. The Form 1099-R for the plan and the Form 8955-SSA can be filed on paper (because the controlled and affiliated service group rules do not apply to those filings), but the Form 5500 for the plan must be electronically filed due to the aggregation rules.

**What about corrected returns?** Generally, if an original return is required to be filed electronically, any corrected return corresponding to that original return must also be filed electronically. If an original return is permitted to be filed on paper and is filed on paper, any corrected return corresponding to that original return must be filed on paper.

**Are there any waivers or exemptions?** Filers that are required to file fewer than 10 returns during the calendar year when counting all types may use IRS paper forms, but only if the paper form is machine-readable.

In cases of undue hardship, the IRS may waive the mandatory electronic filing requirement. The main factor in determining hardship is the amount, if any, by which the cost of electronic filing exceeds the cost of paper filing. Religious waivers will also be considered. Waiver requests must be made in accordance with applicable IRS revenue procedures and must specify the type of filing and the period to which it applies. Electronic filing is also generally waived if the IRS's system does not support it for a particular form or situation.

**Example:** If an employer is required to file a final return on Form 941 (Employer's Quarterly Federal Tax Return), or a variation thereof, and expedited filing of Forms W–2 (or applicable versions for Puerto Rico, the U.S. Virgin Islands, Guam or American Samoa) is required, but the IRS's systems do not support electronic filing, filers will not be required to file electronically.

**What are the penalties for noncompliance?** A failure to file in the required manner (for example, electronically or on machine-readable paper forms) is considered a failure to file. The penalties differ based on the type of return. For information returns, such as Forms W-2 and Form 1099 series, the penalty under Internal Revenue Code Section 6721 would apply, which is up to $310 per information return (for 2023 information returns required to be filed in 2024) with an annual maximum penalty of $3,783,000 ($1,891,500 for small businesses with annual gross receipts of no more than $5 million). Penalty amounts are indexed and change annually.

**When are the new rules effective?** The new mandate is generally effective for 2023 tax year returns that must be filed with the IRS on or after Jan. 1, 2024.

**BDO INSIGHT:** Even if filers are not required to file electronically under the new rules, they may want to consider doing so, as electronic filing has become more common, accessible and economical. Electronic filing may reduce administrative efforts compared to paper filing, can increase accuracy and improve record retention.

The new mandatory electronic filing rules are complicated and penalty exposure may be significant. BDO can help employers understand and comply with the new rules, which could include facilitating electronic filing.

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# Data Quality for Nonprofits

**By Jeff Lawton**

Data quality is a critical factor for organizations of all sizes, and nonprofits are no exception. Poor data quality can lead to inaccurate business decisions, missed opportunities and even financial losses. Further, poor data quality can impact contributions negatively in several ways. It can obfuscate the nonprofit's achievements year after year, which can erode donors' trust or describe fewer accomplishments to its contributors. Poor data quality can lead to marketing campaigns that fail to appeal to first-time donors or are insufficient to recapture previous donors.

## WHY DATA QUALITY IS A CHALLENGE

If data quality is a pervasive issue with real consequences, why have most organizations not solved it? This is the case because assessing and remediating data quality is fraught with challenges, such as:

1. Data is an intangible asset and, unlike other assets, does not give detectable signals , such as changing color, giving off smoke or changing smell. In fact, a single erroneous record normally can only be detected when a knowledgeable individual notices the value is not correct in the data.
2. It is not cost effective to confirm the accuracy of every data record. It requires real-world observations or corroboration by another source. These are expensive endeavors.
3. So much data is collected and processed so quickly now that bad records are not perceived as worth the effort to correct, as they will just be replaced soon.
4. Unless the root cause of data quality issues is discovered and resolved, organizations will continue to admit poor data quality into their systems.

Another challenge to data quality is defining what it means for data to be fit for purpose. That definition can change not only across different nonprofits, but within a single nonprofit's departments as well. In general, high-quality data tends to be defined as:

- **Accurate.** A data record presents what is found in reality without distortion (e.g., the ZIP code is the correct ZIP code for a donor).
- **Valid.** The data values follow the correct format (e.g., a U.S.-based ZIP code has five digits with no letters or special characters).
- **Complete.** A data record has no missing values where values are mandatory (e.g., a ZIP code is present for all donor address records).
- **Unique.** There are no duplicate data records for the same entity or event (e.g., the list of valid ZIP codes in a system presents each ZIP code only once, per entity).
- **Consistent.** There are no contradictions within a data record or across data records (e.g., a ZIP code is the correct ZIP code for the city and state in a donor record).
- **Timely.** The data record represents the most current known information (e.g., the ZIP code in a donor record exists for the donor's current address, not the prior one).
- **Auditable.** The parentage of the record can be traced so that the user knows whence the value was derived (e.g., the donor's ZIP code was pulled from the contributions database after a donation was made last week).

## WHAT CAN BE DONE

Nonprofits can take one of three stances with regard to data quality:

- **Do nothing.** Consider poor data quality a cost of doing business and accept the inherent risk.
- **Reactive remediation.** When data quality problems are discovered — often too late to prevent a damaging business outcome — fix the problem and the class of problems it represents. Over time, data quality will improve.
- **Proactive remediation.** Pick the data records that are most critical to the nonprofit, usually meaning they are used by more than one department more than once. Define the data quality rules for those data records. Codify those rules into a dashboard that searches for data record violations and aggregates them into a scorecard. When a rule breaks a threshold value —say 15% or more data records have missing values —take action and fix that class of problems.

The proactive remediation approach requires resources and should be taken if the perceived cost of data quality issues is greater than its remediation. In this vein, the approach should not treat all data as equal, but instead consider only the critical data of the entity.

## WHAT QUESTIONS TO ASK

Nonprofits' leadership should find out what they can about their data quality. Some questions leaders should ask include:

- Is the nonprofit's data considered trustworthy overall?
- How much time do staff spend cleaning data in preparation for a business analysis exercise?
- No organization has perfect data. Do the managers know where the data quality problems lie? Do they know why the problems occur?
- What steps have the managers taken to detect poor data quality? When found, do the managers fix the data record, fix the problem at the source or both?

The answers to these questions may suggest that leadership devote resources toward not only the assessment and remediation of data quality issues, but in identifying the root cause of those issues and remediating them as well.

## PARTING THOUGHTS

Data quality is a critical component of good governance and effective oversight. Nonprofits need accurate and timely information to make informed decisions about their donors and strategy. Poor data quality can distort decision-making, lead to missed opportunities, lower fundraising outcomes and even cause compliance issues. Data quality is also important for risk management, as poor data quality can increase the risk of fraud and cyberattacks, and create other business disruptions. Nonprofits should support data quality programs that identify the most critical data records, monitor those records for problems and address problems at the source when they occur.

For more information, contact Jeff Lawton, Managing Director, Data Strategy & Governance Practice Area Leader, at jlawton@bdo.com.

# Implementation of GASB Statement No. 96, *Subscription-Based Information Technology Arrangements*

**By Sam Thompson, CPA**

Governments are required to adopt the provisions of the Governmental Accounting Standards Board Statement (GASB) No. 96, *Subscription-Based Information Technology Arrangements* (GASB 96 or the Statement) for fiscal years ending after June 15, 2023. GASB 96 addresses accounting and financial reporting issues related to subscription-based information technology arrangements (SBITAs).

## BACKGROUND

SBITAs are frequently found in government entities and are expected to become even more prevalent as both the assortment of SBITAs available and the desire by governments to avoid purchasing physical information technology (IT) assets with perpetual licensing agreements expands. A common example of a SBITA is a cloud-based software application (such as an accounting or enterprise resource planning (ERP) system) which is accessed remotely.

The growing pervasiveness of SBITAs among governments, in conjunction with the absence of specific guidance in GAAP and inconsistent accounting and financial reporting of SBITAs, served as the catalyst for the GASB to undertake research related to the issue and eventually draft GASB 96.

## ACCOUNTING RECOGNITION

GASB 96 defines a SBITA as a contract that conveys control of the right to use another party's (a SBITA vendor's) IT software, alone or in combination with tangible capital assets (the underlying IT assets), as specified in the contract for a period of time in an exchange or exchange-like transaction.

A government should generally recognize a right-to-use subscription asset (an intangible asset) and a corresponding subscription liability. The subscription liability should be initially measured at the present value of subscription payments expected to be made during the subscription term, discounted to present value using the interest rate charged by the SBITA vendor or the government's incremental borrowing rate if the vendor's rate is not readily determinable. The subscription asset is initially measured as the sum of the initial subscription liability, pre-commencement payments made to the vendor and capitalizable implementation costs, less incentives received from the vendor at or before commencement. In subsequent financial reporting periods, a government should amortize the discount of the subscription liability as an outflow of resources (e.g., interest expense). The subscription asset should be amortized over the shorter of the subscription term or useful life of the underlying IT assets as an outflow of resources (e.g., amortization expense).

## KEY CONSIDERATIONS

### Short-term SBITAs

A SBITA with a maximum possible term under the SBITA contract of 12 months or less, including any options to extend, regardless of probability of being exercised, is considered a short-term SBITA. An asset or liability is only recognized in association with a short-term SBITA if there are advance payments or payments to be made subsequent to the reporting period. Otherwise, a government should recognize short-term SBITA payments as outflows of resources (e.g., expense) based on the payment provisions in the SBITA contract.

### Recognition of SBITAs in Governmental Funds

Governments should recognize an expenditure and other financing source in the period in which the subscription asset is initially recognized. Subscription payments should be accounted for similar to debt service payments on long-term debt.

### Contracts with Multiple Components and Combinations

Governments should account for contracts containing both a subscription and nonsubscription component as separate contracts.

Contracts entered into at or near the same time with the same SBITA vendor should be considered part of the same contract if the contracts are negotiated as a package with a single objective or the amount of consideration to be paid in one contract depends on the price or performance of the other contract.

### Outlays Other Than Subscription Payments

GASB 96 identifies three stages of implementation associated with SBITAs, as follows:

| Stage | Description of Related Activities | Accounting Recognition |
|---|---|---|
| **Preliminary** | Conceptual formation and evaluation of alternatives, determination of the existence of needed technology, final selection of alternatives for the SBITA | Outlays expensed as incurred |
| **Initial Implementation** | Ancillary charges related to designing the chosen path (e.g., configuration, coding, testing, installation associated with access to the underlying IT assets) | Capitalized as part of the subscription asset. If no asset is recognized (e.g., contract is a short-term SBITA) expense outlays as incurred |
| **Operation and Additional Implementation** | Maintenance, troubleshooting, other activities associated with the government's ongoing access to the underlying IT assets. May also include additional implementation activities | Outlays expensed as incurred, unless those outlays increase functionality or efficiency of the subscription asset, which should be capitalized |

### Relationship Between Leases and SBITAs

All SBITAs meet the definition of a lease. Whether or not the contract is accounted for under GASB 87, or GASB 96 depends on the composition of the underlying asset. The following chart summarizes which standard to apply based on the composition the underlying asset:

| Underlying Asset | Applicable Standard |
|---|---|
| **IT software alone** | GASB 96 |
| **Tangible capital assets alone** | GASB 87 |
| **IT software in combination with tangible capital assets** | ▶ If the software component is insignificant compared to the cost of the tangible capital asset, follow GASB 87<br>▶ Otherwise, follow GASB 96 |

Given the effective date of GASB 87 occurring one year prior to the effective date of GASB 96, any tangible capital asset associated with a SBITA recognized under GASB 87 will require restatement upon adoption of GASB 96.

### Discount Rates

Future subscription payments should be discounted using the interest rate charged by the SBITA vendor. In many contracts, the vendor's rate is not explicitly stated. If the interest rate cannot be readily determined by the government, the government should use its own estimated incremental borrowing rate. This rate will not be universal across all SBITAs and should be determined based on the relevant characteristics (e.g., subscription term, commencement date) of each subscription.



## IMPLEMENTATION CONSIDERATIONS

### Effective Date and Transition

Governments should recognize and measure subscription assets and liabilities using the facts and circumstances that existed at the beginning of the earliest period restated. For a government with a June 30, 2023 fiscal year-end presenting single-year financial statements, the effective date of adoption is July 1, 2022. A government with a June 30, 2023 fiscal year-end presenting comparative financial statements would implement GASB 96 as of July 1, 2021.

Governments are permitted, but not required, to include in the measurement of the subscription asset capitalizable outlays associated with the initial implementation stage and the operation and additional implementation stage incurred prior to the implementation of GASB 96.

### Preparation for Implementation

The effort required to implement GASB 96 will vary by government. Nevertheless, there are certain considerations and related procedures all governments should undertake regardless of their exposure to SBITAs.

Governments should review and update as necessary their internal policies and procedures, including internal controls. Governments should implement a system to capture relevant information associated with SBITAs (e.g., terms, payments and other components affecting the subscription asset and liability). A listing of potential SBITAs should be compiled along with subscription agreements and other relevant documents. This information should be reviewed to identify contracts meeting the definition of a SBITA. In situations where ambiguous terms are identified, legal counsel should be consulted.

For contracts meeting the definition of a SBITA, governments should review thoroughly to confirm the subscription term, payment provisions and any components that must be accounted for separately or require the allocation of the contract price. In situations where the contract does not explicitly state the interest rate charged by the vendor and the government uses its incremental borrowing rate as the discount rate, significant effort may be required to determine the appropriate rate for the arrangement.

Governments should reflect on their experience implementing GASB 87 when designing an implementation plan for GASB 96. In particular, governments should review the time spent and resources used to implement GASB 87 and assess whether the same will be necessary for GASB 96. Elements of GASB 87 that required the exercise of professional judgment, such as determining whether a contract met the definition of an exchange or an exchange-like transaction, the estimation of the discount rate or allocation of the contract price, are also likely to arise when implementing GASB 96.

## ITEMS TO COMMUNICATE TO THOSE CHARGED WITH GOVERNANCE

GASB 96 will improve financial reporting for governments by defining a SBITA and instituting uniform guidance for the accounting and reporting of SBITAs. Prior to GASB 96, determining a government's exposure to SBITAs through review of the financial statements was next to impossible. With the implementation of this Statement, assets and liabilities related to SBITAs will be clearly recorded in the financial statements, representing a government's right-to-use IT assets and the corresponding obligation due in future periods. The cost to use IT assets in the reporting period will be clearly stated. Other useful information, such as scheduled principal and interest payments on SBITA liabilities in future periods and the current period amortization of right-to-use IT assets will be included in the notes to the financial statements.

Implementation of GASB 96 will not be easy and will require management be provided with the appropriate resources. Time and money spent now to assist in implementing GASB 96 will provide a positive return in future periods.

For more information, contact Sam Thompson, Assurance Technical Director, Industry, at sthompson@bdo.com.

# Managing Pay for Disqualified Individuals

**By Mike Conover and Judy Canavan**

The title of this article might have caught the eye of some readers, who may have thought it provides tips on managing pay for poor performers or offers a rationale for employing individuals without proper job qualifications. However, this article focuses on "disqualified individuals" in the context of IRS intermediate sanctions — IRC Section 4958 — and the management of compensation paid to those individuals. It is an area that receives considerable attention from the IRS and the general public. Failure to manage it well can result in lingering reputational damage, as well as punitive taxes and penalties for all involved.

The term "disqualified individuals" is defined as individuals in a position to exercise considerable influence or control over the affairs of an IRC Section 501(c)(3) or Section 501(c)(4) tax-exempt organization. They are singled out as individuals who might be in a position to exercise their influence or control over the organization for personal benefit at the expense or to the detriment of the organization with which they are associated. This personal benefit, defined as an excess benefit transaction by IRC Section 4958, could arise in almost any type of transaction involving the organization and a disqualified individual. Some examples include the purchase or sale of goods and services and the provision of special personal benefits. This article explores IRC Section 4958, disqualified individuals and excess benefit transactions as they apply to compensation.

Most commonly, questions regarding compensation for disqualified individuals will arise in the context of pay for an organization's executive-level positions. These disqualified individuals, both individually and collectively, exercise great control over the affairs of an organization, including its financial resources. The organization's principal executive officer (e.g., CEO or executive director) and principal financial officer (e.g., CFO or finance director) are almost always deemed disqualified individuals. There are, however, individuals in the management hierarchy of some organizations that might qualify as well, such as chief operating officer and top program executive. These other positions must be determined on a facts-and-circumstances basis to determine whether the individuals meet the criteria to be considered disqualified individuals.

The Section 4958 definition of disqualified individual is considerably broader than executive roles for the organization. The types of individuals and relationships that qualify and may be associated with compensation include:

- Other influential persons such as voting members of the governing body
- Family members of a disqualified individual, such as siblings, spouse, children, grandchildren, great grandchildren and the spouses of each.

Managing all forms of pay for disqualified individuals is the responsibility of the tax-exempt entity's governing board (i.e., organization manager(s)). Section 4958 defines these individuals as any officer, director, trustee of an organization or individual (i.e., board members) who serve in that capacity. As stewards of the organization and its financial resources, board members are accountable for ensuring that pay for any individual is not unreasonable (i.e., results in an excess benefit transaction).

In the event of an excess benefit compensation transaction, the consequences are potentially costly for all involved, specifically:

- The individual receiving the excess benefit must repay the gross amount of the excess benefit (not just the net amount they were paid) to the organization with interest, to make the organization "whole." An excise tax on the benefit amount ranging from 25% to 225% may also be levied on the individual.
- Members of the organization's governing body (the organization managers) and management (disqualified individuals) who knowingly authorized the transaction may also be personally subject to penalties of up to $20,000 per occurrence.

These penalties are commonly referred to as "intermediate sanctions." The intermediate sanctions provisions provide guidance to exempt organizations to avoid excess benefit transactions and offer possible protection from excise taxes and penalties that could arise from them. The guidelines, known as the rebuttable presumption of reasonableness, provide that if an organization meets the listed requirements, any payments it makes to a disqualified person under a compensation arrangement are presumed to be reasonable, and a transfer of property or the right to use property is presumed to be at fair market value. In other words, the organization will be presumed to have met the test for a reasonable transaction and the burden of proof will be placed on the IRS to prove it was not reasonable.

The requirements to meet the rebuttable presumption of reasonableness are:

- The transaction must be approved by an authorized body of the organization, composed of individuals who do not have a conflict of interest in the transaction (outside/independent board members). Many boards have a subcommittee focused on compensation composed of outside directors.
- Before authorizing the compensation, the authorized body must obtain and rely on comparable data and/or expert advice as to the reasonableness of the transaction. Board members may rely on published compensation surveys or Form 990 filings by other organizations for comparable positions in similar organizations as the basis for their decision.
- The authorized body must adequately document the proceedings that were the basis for its determination in a timely manner. Meeting minutes that meet this requirement must be thorough and include the following information:
  - The comparability data obtained and relied on by the authorized body and how the data was obtained;
  - The basis for any determination that reasonable compensation is higher or lower than the range of comparability data obtained;
  - The members of the authorized body who were present when the transaction was debated;
  - The identity of the members who voted on the transaction;
  - The terms of the compensation and the date it was approved;
  - Any actions taken with respect to consideration of the transaction by a regular member of the authorized body who had a conflict of interest (for example, the conflicted party was excused from the meeting during the discussion);
  - Information related to the date the minutes were drafted as well as approved by those in attendance.

It should be noted that the organization's Form 990 and Schedule J filings include annual declarations about an organization's adherence to each of the three broad requirements of the rebuttable presumption of reasonableness.

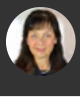
The most common difficulties in complying with these factors include:

- Maintaining appropriate and timely documentation and not simply "checking the box" on the organization's 990 filings; and
- Insufficient information about competitive compensation practices for similar positions among comparable organizations.

BDO has recently undertaken a significant campaign to create a special compensation survey covering the CEO and CFO positions for nonprofit organizations of all types. These positions are disqualified individuals and found in nearly all exempt organizations. If we obtain a high level of participation, this survey could become a valuable and pertinent source of information for use in the compensation governance process.

Judy Canavan has provided the following information about the survey. Organizations that complete the online questionnaire for their CEO and CFO positions will receive a complimentary copy of a report with the compiled survey results for the nonprofit participating organizations. Of course, individual data submitted will be kept confidential and only participating organizations will receive the report. The survey will accept completed questionnaires from June 15 through August 15 with a report in mid- to late October pending timely participant submission of information. More details about the survey and the online questionnaire for participation can be found **here**.

For more information, contact Mike Conover, Managing Director, Global Employer Services – Compensation and Benefits, at wconover@bdo.com, and



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# Global ERP Considerations for International Organizations

**By Andrea Espinola Wilson, Kasra Mojtahedi, CPA, and CJ Myers**

Modern **Enterprise Resource Planning (ERP) systems** empower organizations of all sizes, structures and industries when it comes to financial and operational management. However, some industries suffer unique challenges, particularly those that provide goods and services worldwide. International non-governmental organizations (INGOs) are typically nonprofit organizations established to serve a purpose and achieve objectives on a global scale. Such goals can include aiding or advocating for a humanitarian cause, protecting an environment and its wildlife, as well as providing healthcare or financial services to developing nations. The missions of these organizations span international borders, sometimes requiring operations in either remote, underdeveloped or even high-risk areas. Due to the unpredictable nature of INGO work, business transformation through ERP system modernization can be challenging for these organizations.

The world's most impactful organizations utilize ERP systems to streamline operations across industry-standard business cycles, such as opportunity to cash, procure to pay, record to report, plan to deliver and hire to retire. In fact, according to a survey of INGOs, which BDO recently conducted, 80% of respondents indicated that they have already invested or are planning to invest in modern ERP technology. ERP system implementation stands to provide myriad benefits to these organizations, including process automation and workflow standardization, data analytics and benchmarking through dashboarding, enforcement of internal controls and flexible management, and regulatory reporting capabilities. However, for INGOs, realizing these benefits can come at a significantly higher level of effort and cost compared to other industries and nonprofit sectors. Difficulties often emerge with the integration of headquarter and country office operations under a single, holistic ERP solution.

Although implementation of a modern ERP system provides organizations with long-term return on investment through cost and resource savings, INGOs face unique challenges in the deployment of ERP solutions across country offices. The nature of INGO missions generally results in decentralized organizational structures and siloed operations, with each country managing its own procedures and maintaining its own statutory reporting requirements. Challenges arise when organizations require streamlined business processes between headquarters, regional and country offices that help the organization operationalize its mission and goals. Examples of these challenges, according to BDO's latest INGO CFO survey and roundtable discussions, include the need for organizations to:

- Implement organization-wide process controls to mitigate risks
- Maintain a comprehensive source of employee information for domestic and international offices
- Roll up country office transactions for donor- or funder-specific reporting requirements
- Comply with localization and statutory reporting requirements
- Have real-time access to organization financial data and the ability to easily create dynamic reports with that data
- Mitigate risks for regional and field finance teams that lack adequate human capital
- Fill in gaps when there is a lack of reliable IT infrastructure to provide adequate bandwidth for modern day enterprise-wide tools to function properly
- Adapt to turnover of leadership and staff personnel
- Calculate accurate indirect cost rates to recover maximum reimbursable funds
- Automate reconciliation processes during month, quarter or year-end close
- Track organization-wide commitments and encumbrances

To address the ERP challenges above, INGOs have primarily two options to successfully dismantle the financial and operational silos between hea○dquarters, regional and field offices:

1. Implement one universal ERP solution: a holistic, global solution that can handle country, regional and headquarters offices within a single system; or
2. Implement a two-tier ERP solution: a core ERP system at the headquarters that fully integrates with a second distinct ERP system utilized only at the regional or country offices.

There is not a one-size-fits-all ERP solution and implementation approach for complex organizations such as INGOs. The correct choice between the above options is dependent on each individual organization's business model. However, it is ultimately more beneficial to maintain a single source of truth for financial data either through a single ERP system or a fully integrated two-tier ERP model. Aside from evaluating the performance of a core ERP system to meet organizations' needs, other factors that INGOs should take into consideration when exploring ERP solutions include but are not limited to:

- Integration ability with supplemental tools
- Ease of use and user interface
- Simplicity and flexibility in the system design
- Footprint and customer satisfaction in the INGO market and similar organizations
- Low bandwidth capability
- Modular design to enable scalability
- License and implementation costs
- Simplified application architecture
- Business process design and definition
- Organizational change management
- Flexibility of reporting and analytics capabilities

The right collaborator can help INGOs navigate ever-changing ERP system needs and help organizations develop their global enterprise applications strategy, assess the current state of processes and controls, gather and develop future state requirements, identify gaps, evaluate various available solutions and implementation partners, and recommend a holistic global solution that best fits organization-specific needs.

Article adapted from the Nonprofit Standard blog.

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# Demystifying Nonprofit Cost Allocations

**By Dan Durst, MBA, and Gina McDonald, CPA**

When asked what is at the top of their finance department "to-do" list, many nonprofits name the need for an updated cost allocation plan. An effective cost allocation strategy is essential to organizations' understanding of how their resources are being deployed. It is also integral to performing cost analyses, such as evaluating funding requirements and comparing actual versus budgeted costs.

Allocations are an efficient and effective way to distribute costs across activities, including programmatic, administrative and fundraising work. However, many find the practical application of allocation concepts challenging to navigate. While some costs are easily assigned to specific activities and do not need to be allocated at all, there are certain costs that need to be proportionately distributed across activities and the organization, magnifying the potential for complexity and errors.

## ALLOCATION METHODS

When determining an organization's allocation strategy, limiting the number of different methods utilized can avoid overcomplication, although most organizations use at least two different allocation methods based on the type of cost.

Payroll and related costs are typically a nonprofit's most significant expense. Organizations determine employee time worked and how that information is documented and substantiated in different ways. However, the goal is ultimately the same: to report these costs in a way that reflects where employees spend their time—that is, where resources are actually being deployed.

For costs other than payroll, or other than personnel service (OTPS) costs, allocation can be accomplished via various methods, including:

- **Full-time equivalent (FTE):** The FTE method allocates OTPS in the same proportion as employee time worked in different activities.
- **Percent of salary dollars:** The salary dollars method allocates OTPS in the same proportion as payroll dollars assigned to different activities.
- **Square footage (SF):** The SF method, typically applied to occupancy costs, allocates costs proportionate to an activity's share of facility space.
- **Per participant:** The participant-based method, typically applied to OTPS across programs, allocates costs proportionate to the ratio of participants in each activity.

## ALLOCATING GRANT COSTS

Grant agreements add a layer of complexity to nonprofit cost allocation. Commonly, grants require related costs to adhere to funder-approved, line-item budgets and conform to defined terms and conditions. That is true regardless of whether the funding is from another nonprofit, an individual or a government entity. Adopting and implementing both a consistent organizational cost allocation methodology and a consistent grant allocation methodology is critical. Special attention to grant allocations helps organizations:

- Understand progress against each grant's budget
- Avoid the risk of double charging (charging the same cost to two different grants)
- Avoid potential consequences of violating such agreements

To provide an example of how an organizational cost allocation methodology interacts with grant allocations, let's consider the allocation of program supplies expense for a nonprofit with two different grants supporting a certain program:

The nonprofit has chosen to allocate OTPS using the FTE approach. Under this approach:

1. The program's share of personnel time and effort is 20%, so the program also is allocated 20% of shared supply costs.
2. The program's supply expense can be further assigned to the two grants, barring any limitations based on grant budgets and related allowability of those costs per the contracts.

Costs allocated to grants need to be done so with a consistently applied methodology.

From a practical perspective, nonprofit financial systems need to accommodate such multi-dimensional expense tracking. The ability to automate allocation calculations, as opposed to calculating allocations using spreadsheets, is a significant efficiency opportunity. In any case, generating financial reports at different levels of detail, by both activity and grant, directly from the financial system is key.

Once an organization has effectively applied these concepts, the result should be a fair representation of the costs incurred in each program area and in each supportive service. This information is valuable for a variety of reasons. Knowing the cost of programs and the costs covered by grants allows organizations to make more informed choices when evaluating funding opportunities, planning for operational changes and monitoring ongoing activities.

Article adapted from the Nonprofit Standard blog.

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# Best Practices in Subrecipient Risk Assessments and Monitoring for Federal Grant Recipients

**By Dan Durst, MBA and Sly Atayee**

Subrecipient risk assessments and monitoring are critical aspects of federal grants management. These practices ensure that funds are used in accordance with federal regulations, that grant objectives are met and that the risk of fraud, waste and abuse is minimized. The federal government has set forth guidelines in the *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) found in 2 Code of Federal Regulations (CFR) 200, which outlines the requirements and responsibilities of grant recipients and their subrecipients. This article will delve into common pitfalls around performing subrecipient risk assessments and monitoring, and the best practices for organizations looking to improve their processes in these areas.

## BACKGROUND

The Uniform Guidance addresses the requirements that subrecipients must comply with in section 2 CFR 200.332. This section describes the required procedures for performing monitoring and risk assessments to evaluate the likelihood of noncompliance, fraud or other issues when selecting subrecipients that could impact the performance and success of the grant.

Effective risk assessments and monitoring are crucial for various reasons, including:

- **Compliance with federal regulations:** Adhering to 2 CFR 200 requirements is essential to avoid penalties, such as disallowed costs or even suspension or termination of the funding.
- **Mitigating risks:** Timely identification and addressing risks can reduce the potential for mismanagement, waste or fraud, ensuring that federal funds are used effectively and efficiently.
- **Performance and outcome achievement:** Proper monitoring helps grant recipients track progress, confirm that milestones are met and determine if adjustments are necessary to achieve desired outcomes.

## COMMON PITFALLS

Below are some of the common pitfalls that plague pass-through entities (prime recipients) that work with subrecipients:

- **Inadequate risk assessments:** Failing to perform a comprehensive risk assessment prior to executing the subaward agreement or relying solely on historical information may result in an incomplete understanding of a subrecipient's risk profile.
- **Insufficient monitoring:** Not allocating enough resources to monitor subrecipients or only relying on self-reporting can leave gaps in understanding that can allow certain risks to go unaddressed.
- **Lack of documentation:** Inadequate documentation of risk assessments, monitoring activities and communications with subrecipients can hinder an organization's ability to demonstrate compliance with federal regulations and address potential issues effectively.
- **Ineffective communication:** Poor communication between grant recipients and subrecipients can lead to misunderstandings, missed deadlines and noncompliance with grant requirements.

## BEST PRACTICES FOR SUBRECIPIENT RISK ASSESSMENTS

Below are some of the best practices that BDO recommends:

- **Develop a risk assessment framework:** Create a structured process that outlines risk categories, scoring criteria, and the frequency of risk assessments. This framework should consider factors such as prior audit findings, debarment, financial stability and the subrecipient's experience managing federal funds.
- **Conduct pre-award evaluations:** Before entering into a subaward agreement, assess the subrecipient's capacity to manage the grant, considering its technical expertise, financial management systems and internal controls. Performing this required risk assessment in the pre-award phase allows for the determination and inclusion of the monitoring procedures as part of the subaward agreement.
- **Implement ongoing risk assessments:** Regularly reassess subrecipient risk throughout the grant period to identify any changes in circumstances that may affect its ability to meet grant requirements.

## BEST PRACTICES FOR SUBRECIPIENT MONITORING

- **Develop a monitoring plan:** Establish a systematic approach to subrecipient monitoring that includes a schedule, tools and documentation requirements. This plan should consider the risk level of each subrecipient and the nature of the grant activities.
- **Provide training and technical assistance:** Offer support to subrecipients in the form of training, resources and guidance on federal grant requirements, financial management and performance reporting.
- **Conduct regular communication and site visits:** Maintain open lines of communication with subrecipients and schedule site visits as deemed appropriate to review progress, verify compliance and address any concerns.
- **Review financial and performance reports:** Regularly analyze subrecipient financial and performance reports and included data to identify potential issues, ensure compliance with grant terms and track progress toward grant objectives.
- **Tailor monitoring efforts to risk level:** Allocate resources for monitoring based on the risk profile of the subrecipient, with higher-risk subrecipients receiving more oversight and attention.
- As mentioned above, incorporate monitoring procedures directly into subaward agreements.

## CONCLUSION

Effective subrecipient risk assessment and monitoring are essential for federal grant recipients to ensure compliance with 2 CFR 200, mitigate potential risks and achieve desired outcomes. By implementing best practices and avoiding common pitfalls, organizations can strengthen their grant management processes and ensure the responsible stewardship of federal funds.

Article adapted from the Nonprofit Standard blog.


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