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Board Independence

Independence is viewed by federal and state regulators and by donors as being a cornerstone of good governance for exempt organizations. Both the IRS and state attorney generals believe it is difficult for an organization to avoid violating the prohibitions against private benefit and private inurement if there are not enough independent directors. Independent directors are those that are free from a conflict of interest. Both state and federal laws define when a conflict of interest arises. Generally, a director has a *conflict of interest* when that director or a family member has an interest different from that of the corporation. Usually the interest is financial, but some states have extended the *conflict-of-interest* definition to include personal relationships. Where a director has a conflict, only the independent directors (defined later) can evaluate and vote on the relevant transaction.

Note: The lack of independence may be limited to one specific transaction and not impact the director's independence as it relates to the organization as a whole.

Nonprofit organizations should consider whether increasing the number of independent governing board members would improve the oversight abilities of their boards. Nonprofit organizations often select board members because of their ability to raise funds or because they have strong ties to the organization's mission. Those board members may not be sufficiently independent of the organization's management or have sufficient business acumen to challenge management and hold it to high standards of stewardship. Ideally, independent directors are a source of advice, wisdom, and perspective. They also provide a sounding board for the executive director and influence critical external constituencies, such as donors and regulators. However, to effectively perform those functions, board members must have relevant backgrounds, be actively involved in governance, and be independent.

In this Issue:

990 Reporting

The IRS is curious about an exempt organization's board composition. Form 990, Part VI specifically requires both the number of (1) voting members and (2) independent voting members be reported.

Number of Voting Members of Governing Body. The governing body is the group authorized under state law to make governance decisions for the organization and its shareholders or members, if applicable. Typically, the governing body is the board of directors or the board of trustees (or trustee). In Form 990, Part VI, line 1a, the number of voting members of the governing body is reported. Only those members, as of the tax year end, of the organization's governing body with power to vote on all matters that may come before the governing body (other than when disqualified from voting by a conflict of interest) are included. Any material differences in the members' voting rights must be explained in Form 990, Schedule O.

In addition, if at any time during the organization's tax year the governing body or governing documents delegated authority to act on its behalf to another committee (e.g., executive committee, finance committee), the organization should describe in Form 990, Schedule O, the composition of the committee and the scope of its authority. Indicate whether those committee members are also members of the governing body. However, limited scope delegations (i.e., an audit committee, investment committee, or compensation committee) do not need to be described in Form 990, Schedule O.

Note: The governing body members with voting authority should be defined in an organization's governing documents. It is important to review these documents to determine who is included in the definition. Because this is a count as of the end of the filing year, the number may be different than the number of persons indicated in Form 990, Part VII for compensation reporting.

Independent Voting Members. Enter the number of *independent* voting members of the governing body as of the organization's tax year end. Members of the governing body are considered independent only if all of the following applied at all times during the tax year:

1. They were not compensated as an officer or other employee of the organization (or a related organization). In addition, the member was not compensated by an unrelated organization or individual for services provided to the filing organization (or a related organization) if the compensation met the thresholds requiring reporting in Form 990, Part VII, Section A.
2. They did not receive more than $10,000 of total compensation or other payments from the organization (or a related organization) as an independent contractor (other than expense reimbursements under an accountable plan or *reasonable compensation* for services performed in the capacity as a member of the governing body). The $10,000 threshold is based on the organization's tax year (including a short year, regardless of whether the compensation is reported in Part VII of Form 990).

   Note: Reasonable compensation is determined using the Section 162 standards—for detailed coverage see Key Issue 34G in *PPC's 990 Deskbook*.
3. They (or a family member) were not involved in a transaction with the organization (whether directly or indirectly through an affiliated organization) that is required to be reported in the organization's current tax year Form 990, Schedule L.
4. They (or a family member) were not involved in a transaction with a taxable or tax-exempt related organization (whether directly or indirectly, through affiliation with another organization) of a type and amount that would be reported in Form 990, Schedule L, if required to be filed by the related organization.

A member of the governing body is not considered to lack independence merely because the member—

1. has received compensation that is not excessive (i.e., reasonable compensation for services as a member of the filing organization's governing body);
2. is a donor to the organization, regardless of the contribution amount;
3. receives financial benefits from the organization solely in the capacity of being a member of the class served by the organization in the exercise of its exempt function [i.e., being a member of a Section 501(c)(6) organization], so long as the financial benefits comply with the organization's terms of membership.

Observation: A board member does not lack independence simply because they are a board member of another charity that received funding from the reporting organization. Additionally, a board member does not lack independence simply because they are related to another board member or is in a business arrangement with another board member.

Independence Examples

Effect of compensation paid to board member on independence. Xcel School (X)'s bylaws designate the following as officer positions: board chair, secretary, and treasurer. Chairman of the Board (C) officiated at board meetings, coordinated development of board policy and procedure, was an ex officio member of all board committees, conducted weekly staff meetings, and performed teacher and staff evaluations. X compensated C during the tax year for C's board and committee activities and for C's non-director services involving staff meetings and performance evaluations. Because X compensated C for services as an officer/employee, C is not an independent member of the governing body.

Variation 1: Assume the Board Chair position was not designated as an officer position under X's bylaws, board resolutions, or state law. However, because X compensated C for non-director services (e.g., staff meetings and performance evaluations), C is deemed to have received compensation as an employee for those activities. Therefore, C is not an independent member of the governing body. However, C would be considered independent if the total compensation did not exceed $10,000 for the tax year and C was properly classified as an independent contractor.

Variation 2: Assume C conducted only director and committee activities during the tax year. X paid C a reasonable amount for C's Board Chair services during the tax year but did not provide any other compensation to C. C's board member independence is not impaired by receiving compensation from X only as a board member.

Legal fees paid to a board member's law firm. B is a voting member of the HS board of directors. B is also a partner with a greater than 35% interest in a law firm, CC, that charged $120,000 to HS for legal services. The transaction between CC and HS must be reported on Form 990, Schedule L, because it is a transaction between HS and an entity of which B is a more than 35% owner, and because the payment from HS to CC exceeded the $100,000 threshold. B is not an independent member of the governing body because the $120,000 payment must be reported on Form 990, Schedule L, as an indirect business transaction with B.

Variation: If B were an associate attorney (an employee) rather than a partner with a greater than 35% interest and not an officer, director, trustee, or owner of CC, then the transaction would not affect B's status as an independent member of the organization's governing body and would not be reported on Form 990, Schedule L.

Practical Consideration:

Lack of an independent governing body is often cited as one of the reasons the IRS may deny tax-exempt status to an organization.

Asset Basis When Foundation Is a Former Public Charity

The IRS recently addressed how to determine an asset's basis for capital gain net income purposes under IRC Sec. 4940 when a Section 501(c)(3) exempt organization ceases to be a public charity and becomes a private foundation. When an organization no longer qualifies as a public charity and becomes classified as a privation foundation, it becomes subject to the excise tax imposed under IRC Sec. 4940(a) and must determine the basis of its property when determining capital gain or loss from the sale or other disposition of property. IRC Sec. 4940(a) generally imposes a 1.39% excise tax on the net investment income (including net capital gains) of a private foundation for the tax year.

Questions existed about whether the basis of these assets is equal to the fair market value (FMV) at the date of conversion (i.e., stepped up basis), or whether it is determined under the usual income tax rules.

Reg. 53.4940-1(f)(2)(i) provides that the basis is the greater of the following:

1. FMV on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the usual income tax rules, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition [IRC Sec. 4940(c)(4)(B)].
2. Basis as determined under the usual income tax rules subject to the provision of Section 4940(c)(3)(B) (i.e., special rules for depreciation and depletion) and without regard to IRC Sec. 362(c) (i.e., special rule for certain contributions to capital).

For determining loss from the sale or other disposition of property, basis as determined using Reg. 53.4940-1(f)(2)(i)(b) [Reg. 53.4940-1(f)(2)(ii)].

In a Program Manager Technical Assistance memorandum, PMTA 2022-001, the IRS has advised that for calculating gain or loss from the sale or other disposition of property, the asset's basis is determined under the usual income tax rules and not stepped up to FMV. They found no provision in the law for increasing the basis to FMV on the date the organization becomes a private foundation, except for the one-time step up in basis provided for assets held by privation foundations as of December 31, 1969.

Note: PMTAs are not guidance that may be cited as precedent; however, they are internal legal advice providing insight into the IRS's position on issues.

Changes to Presentation and Disclosures for Contributed Nonfinancial Assets

The FASB issued ASU 2020-07, *Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, in September 2020. All nonprofit organizations that receive contributed nonfinancial assets, also known as gifts-in-kind, must apply this standard, which requires new presentation on the statement of activities and additional disclosures. The intent of this ASU is to increase transparency and reduce diversity in practice in the presentation and disclosures about types of nonfinancial assets received, how they are measured, and how they are used by the organization.

Contributed nonfinancial assets include property and equipment, materials and supplies, intangible assets, services, and unconditional promises to receive these assets. They do not include donations of cash or investments.

Effective Date

The ASU is effective for annual periods beginning after June 15, 2021, and for interim periods within annual periods beginning after June 15, 2022. It should be applied on a retrospective basis to all periods presented. Thus, nonprofit organizations should be prepared to provide the required disclosures for comparative financial statements for fiscal years beginning after June 15, 2020 that accompany 2022 financial statements applying the new standard. Early application is permitted.

New Requirements

The changes could be significant for many nonprofit organizations. The new requirements include:

- Presentation of contributed nonfinancial assets as a separate line item from contributed cash and other financial assets on the statement of activities.
- Quantitative disclosure in a note to the financial statements of amounts of contributed nonfinancial assets by category based on type of gift, with a total that agrees to the amount presented on the statement of activities.
- Qualitative disclosures in notes to the financial statements about—
    - for each category of contributed nonfinancial assets, whether the assets were monetized (sold) or used during the reporting period, and in what programs and activities;
    - the organization's policy for monetizing or using these assets;
    - any donor-imposed restrictions on the assets;
    - valuation inputs and techniques used to recognize the assets' initial fair values; and
    - the principal market (market with greatest level and volume of activity for the asset) or most advantageous market (market that maximizes the amount that would be received to sell the asset or minimizes the amount paid to transfer the liability) used in the fair value measurement of the assets in accordance with FASB ASC 820 if it is a market in which the recipient is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial asset.

ASU 2020-07 provides implementation guidance and examples of new disclosures. It does not change existing requirements for recognizing, measuring, and disclosing contributed assets under FASB ASC 958-605, or disclosures already required for contributed services. It also does not change disclosure requirements relating to donor-imposed restrictions on contributed nonfinancial assets.

Practical Consideration:

ASU 2020-07 is available on Checkpoint at **checkpoint.riag.com**. It also can be accessed at **www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176175227486&acceptedDisclaimer=true**.

AUP Engagements

Agreed-upon procedures (AUP) engagements are attestation engagements in which entities hire practitioners to perform specific procedures on the subject matter of the engagement or an assertion and to report the procedures and findings, without providing any opinion or conclusion. The party engaging the practitioner must agree to the procedures and acknowledge they are appropriate for the intended purpose of the engagement before the report is issued.

The procedures may not involve the organization's financial statements. Practitioners can perform procedures on financial and non-financial data.

SSAE 19

Statement on Standards for Attestation Engagements (SSAE) 19, *Agreed-Upon Procedures Engagements*, was issued in December 2019 and was effective for reports dated on or after July 15, 2021, with early implementation permitted. The new standard provides additional flexibility for practitioners performing these engagements, including eliminating the requirement for end users of the report to approve the appropriateness of the procedures and permitting the procedures to be developed and adjusted over the course of the engagement.

Using AUP Engagements for Nonprofit Organizations

AUP engagements can be a useful alternative to a financial statement audit by external auditors for nonprofit organizations. They can be performed at a lower cost and still meet users' fiduciary and accountability requirements. For example, these engagements can be used to address nonprofit organization boards' concerns with how internal controls are designed and operated, and contributors' concerns about safeguarding and use of their donations. A nonprofit organization might also want an AUP engagement performed if they suspect fraud or noncompliance with regulations or laws.

Financial statement audits look at the controls over financial reporting, but AUP engagements can look at specific controls and business processes that are important to nonprofit organizations, such as controls over cash receipts and disbursements and government agency compliance. The procedures can identify potential internal control weaknesses and can satisfy requirements in contracts or grants. However, nonprofit organizations need to determine in advance of the engagement whether grantors and regulators will accept an AUP report in place of an audit opinion.

Other areas where nonprofit organizations can use AUP engagements include meeting third-party requirements relating to how employees are paid and bank statements are reconciled, and meeting agency program compliance requirements in the areas of applications, attendance records, and reporting. There can be parties outside of the entity, such as lenders or prospective partners, who are interested in specific areas of the organization's assets or operations and want specific procedures performed to provide independent verification.

AUP engagements can be performed in addition to reviews or audits, for nonprofit organizations that need both, to address specific areas of management or board concern. Nonprofit organizations should talk to their accountants about how they could use agreed-upon procedures to benefit their organizations and potentially save money.

Practical Consideration:

SSAE 19 is available on Checkpoint at **checkpoint.riag.com** and on the AICPA's website at **https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/at-c-00215.pdf**.

Nonprofit Audit Committee Toolkit

The AICPA Not-for-Profit Section recently issued a new *Audit Committee Toolkit for Not-for-Profit Entities*. It's designed for use by nonprofit organizations of all sizes, their CEOs and CFOs, and their boards and audit committees, and it replaces the 2015 version.

Here's a summary of what's included in the toolkit chapters. Appendixes to each of the chapters expand on the concepts and provide additional background materials for reference, along with practical tools and questionnaires. An appendix of additional resources for audit committees contains a list of organizations and websites to assist audit committee members in fulfilling their responsibilities.

Audit Committee Basics

Effective audit committees provide fiscal accountability and governance in the areas of internal controls, risk management, and financial reporting oversight. They can create and maintain an effective fraud prevention and detection program and encourage the creation of an ethics and compliance program. They oversee the external auditors (and internal audit function, for those entities that have one). The audit committee can communicate independence and trust and build confidence with the organization's external stakeholders. The audit committee's functions are different from the finance committee's, and certain states have specific legal requirements relating to each of them.

Audit Committee Structure

Reporting directly to the board of directors, the audit committee ideally consists of no fewer than four independent members, one of which is a financial expert. There is normally a chair designated by the board, and there may be subcommittees. Key qualities of effective audit committee members include independence, industry knowledge, and financial expertise (GAAP, financial statements, internal controls, and understanding of the financial and regulatory issues of the entity and its sector).

Audit Committee Administration

Best practices for audit committee procedures include developing a charter, setting a meeting calendar and agendas for the year, preparing minutes and an annual committee report, and conducting an annual self-assessment.

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Financial Reporting Oversight

Audit committees help ensure the integrity of an organization's financial reporting. Their responsibilities in this area include oversight of financial statements and disclosures and related internal controls over financial reporting, addressing any material weaknesses identified by the auditors, reviewing critical accounting policies and estimates, understanding unique and unusual transactions including related-party transactions, assessing the effect of new accounting and financial reporting and regulatory requirements, understanding significant variances between budgets and actuals and comparisons with other organizations, and reviewing annual audited financial statements and federal and state tax filings. Where applicable, audit committees must ensure compliance with the Single Audit Act and OMB's regulations. They also review communications with the auditors and facilitate resolution of any disagreements between management and the auditors on financial reporting issues. Audit committees should receive regular reports from management as a basis for discussing financial reporting matters, and the Toolkit includes a list of matters to be included along with a sample issues report.

Internal Audit Function and Financial Statement Audit Oversight

The audit committee hires, evaluates, and dismisses the external auditors. They also pre-approve audit and non-audit services, review the audit plan and scope, and review fees. They assess auditor independence and performance each year and review the results of the audit. They also must understand the requirements for peer review of CPA firms and how they can use the peer review standards in their assessment of their auditors. Where there is an internal audit function, the audit committee provides oversight of its effectiveness. The Toolkit provides required communications audit committees should receive from their auditors.

Risk Oversight

Risk management and oversight is a best practice in not-for-profit governance. Although the full board is usually responsible for overall risk management, audit committees must understand management's process and perform certain procedures to oversee it. These include reviewing management's overall risk assessment, discussing risks and controls with the auditors, and specifically focusing on oversight of financial and compliance risks. Audit committees should take an active role in preventing and deterring fraud, including financial statement fraud, corruption, and asset misappropriation, along with developing the actions to be taken if fraud is discovered.

Ethics and Compliance Oversight

The audit committee helps the board design and oversee a code of ethics and compliance program for the organization, including promoting ethical behavior and creating a tone at the top. This includes developing a code of conduct and training employees, monitoring the board's conflict of interest and whistleblower policies, and overseeing that there is an effective process in place to handle internal complaints received.

Practical Consideration:

The complete *Audit Committee Toolkit for Not-for-Profit Entities* is only available to AICPA members that are also Not-for-Profit Section members at **https://future.aicpa.org/resources/**.