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OMB Compliance Supplement Addendum 2 Released

The February issue of *The PPC Nonprofit Update* included an article about the December 2021 release of Addendum 1 to the 2021 Compliance Supplement. In January 2022, OMB released Addendum 2 to the 2021 Compliance Supplement.

Addendum 2

Addendum 2 adds guidance to Part 4 of the Compliance Supplement, and includes the following programs:

- Pandemic Electronic Benefit Transfer (P-EBT) Food Benefits (Assistance Listing 10.542);
- Pandemic Electronic Benefit Transfer (P-EBT) Administrative Costs Grant (Assistance Listing 10.649);
- Child Care and Development Block Grant (Assistance Listing 93.575)* [this program is part of the Child Care and Development Fund (CCDF) Cluster];
- Low Income Household Water Assistance Program (Assistance Listing 93.499);
- Temporary Assistance for Needy Families (Assistance Listing 93.558)*;
- Section 8 Housing Choice Vouchers (Assistance Listing 14.871)* (this program is part of the Housing Voucher Cluster); and
- National Railroad Passenger Corporation Grants (Assistance Listing 20.315).

* Programs denoted with an asterisk were included in the original 2021 Compliance Supplement. Addendum 2 updates these Part 4 sections for compliance implications and guidance resulting from ARP.

Practical Consideration:

For ARP-related programs that are not included in the Addenda, auditors should continue to use the guidance in Part 7 of the 2021 Compliance Supplement to identify and document compliance requirements that are applicable, and direct and material, to the program. The practice aids for *PPC's Guide to Single Audits* and *PPC's Guide to Audits of Nonprofit Organizations* include an audit program based on Part 7.

In this Issue:

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Transition Guidance—Looking Back and Forward

Both Addendum 1 and Addendum 2 indicate that single audit reports dated prior to the issuance of the respective addenda are not required to retroactively go back and apply their guidance. Prior to the addenda being released, AICPA representatives, industry opinion leaders, and our authors had strongly urged auditors of organizations that received ARP awards (whether through new or existing programs) that were expected to be addressed in the addenda not to complete and report on their June 30, 2021, or later single audits until the Compliance Supplement addenda had been analyzed, unless expenditures under these awards were clearly immaterial. The OMB has indicated that there will not be further revisions or addenda to the 2021 Compliance Supplement until it is superseded by the 2022 Compliance Supplement that will be effective for audits of fiscal years beginning after June 30, 2021 (fiscal years ending June 30, 2022, and later).

Practical Consideration:

The Compliance Supplement Addenda can be accessed at **www.cfo.gov/2021-addendum-1and2/** (separate PDF files by program).

Additional Planning Considerations for Remote Audits

In the January 2022 issue of *The PPC Nonprofit Update*, we included an article focused on initial planning issues for remote audits. That article covered general planning issues, planning considerations within the firm, and planning issues for clients. This article focuses on additional remote auditing considerations once the audit begins.

Planning Considerations Once the Audit Begins

Here are some specific planning considerations in a remote environment.

Internal Controls. Auditing standards require the auditor to obtain an understanding of internal controls and assess their design and operation. Because client employees are working remotely and many organizations have experienced employment reductions during the pandemic, clients are processing transactions differently. It may not be sufficient to use last year's understanding. There can be new risks of material misstatement for this year's audit.

Internal controls may not be operating as designed. Segregation of duties may not be in place, and management may not have modified other controls. In addition, there can be greater potential for management override of internal controls if there have been staff changes or reductions. Different internal controls could be in place at different points of the year under audit.

All of these concerns can affect overall planning and documentation, testing of controls, and substantive procedures. Auditors may need to revise audit programs, even for clients that have been audited for years, to address the new environment, and it may not be possible or efficient to rely on controls.

Auditors may need to perform walkthroughs differently in a remote environment. If walkthroughs and tests of controls cannot be performed, substantive testing may have to increase. There can be new risks of material misstatement for this year's audit.

New Audit Risk Areas. The pandemic and changes to the economy and market conditions have increased potential for audit risk in areas that the auditor should consider during planning, including materiality assessments, going concern considerations, accounting estimates, significant client assumptions and judgments, fair value, revenue recognition, collectability of accounts receivable, impairment of tangible and intangible assets, and subsequent events. Management may have new incentives and pressures to introduce bias into their estimates and assumptions.

Auditors may need to reevaluate prior risk assessments for their clients in these areas to address current circumstances. They may also need to change their use of analytics in planning and procedures, because historical comparisons may not be useful in the current audit.

Fraud. The risk of fraud has increased as organizations are facing changes to operations, customers, vendors, and liquidity. Auditors should perform their initial risk assessment during planning and consider whether they should modify procedures for this year's audit in certain areas of higher risk.

Auditors need to reconsider this evaluation throughout the audit as circumstances change. Required audit procedures for fraud interviews with clients and brainstorming fraud risks can be more challenging remotely. Auditors should also consider introducing procedures to incorporate unpredictability. Additional procedures may be needed to ensure key records provided by the client are authentic and accurate and haven't been altered, because auditors may be looking at scanned images or videos rather than original documents.

Inventory Observations. The requirement for inventory observation hasn't changed because of the pandemic. If inventory is material, auditors should obtain sufficient evidence of the existence and condition of inventory by observation. If auditors cannot observe inventory at year-end and audit risks cannot be reduced to an acceptable level, there could be a scope limitation and a qualified audit opinion.

Because auditors may have limited or no access to inventory locations, they may use technology to perform observation procedures. This includes using mobile devices or Go-Pro, and real-time (not recorded) video streaming to watch the inventory count and observe the facility and existence of inventory during the count. They may need to supplement virtual observation with additional procedures, such as reviewing shipping and receiving records, or performing roll-forward procedures from earlier inventory observations or client cycle counts.

Confirmations. In the current environment, confirmations may not be completed and returned to auditors. Receivable balances could be larger or older because of the economic situation. Auditors need to perform alternative procedures to test account balances when they don't receive confirmations.

New Accounting Issues. The pandemic response has created new accounting issues, including new forms of government assistance, that auditors must be prepared to address in their audits for the first time. The accounting guidance for government assistance is complex and continues to evolve over time. There have also been deferrals to effective dates of new accounting standards because of the pandemic.

Practical Consideration:

PPC's Guide to Single Audits, PPC's SMART Practice Aids—Single Audit Suite, and *PPC's Guide to Audits of Nonprofit Organizations* are helpful tools when performing single audit engagements. See **tax.thomsonreuters.com** for more information.

Management Representations. Management must still provide representations before the audit report is released, despite working remotely. Auditors can obtain signatures electronically or by email. It may be advisable to add additional representations to the letter this year to address certain of the audit risk areas noted above. Auditors shouldn't over rely on management representations.

Summary

Remote auditing can provide significant benefits for auditors and their clients. However, auditors must maintain audit quality while working remotely to achieve these benefits, by maintaining professional skepticism, performing timely planning, and using technology to collect sufficient, reliable audit evidence.

Although auditing standards generally address what evidence the auditor must obtain, they rarely dictate how auditors obtain the evidence. Auditors may need to apply some innovation to change their audit approach for this year's audits, but the outcome should be worth the effort.

Engagement Letters and Reports for Yellow Book and Single Audits

The 2021 edition of the AICPA's Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), released in September 2021, was updated to include guidance and illustrative auditor's reports for use after the implementation of SAS Nos. 134–140. Because this guidance was not available when certain PPC governmental and nonprofit products, such as *PPC's Guide to Audits of Nonprofit Organizations*, were updated in 2021, appendixes and practice aids were reserved for engagement letters and auditor's reports that were compliant with the new reporting SASs. The reporting SASs were effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141.

We have posted illustrative Yellow Book and single audit engagement letters and reports to the Thomson Reuters customer support website at **https://thomsonreuterstaxsupport.secure.force.com/pkb**, which have been updated for the new reporting SASs. Please note that the 2022 editions of these products, such as *PPC's Guide to Audits of Nonprofit Organizations*, which is expected to be available in late March 2022, will include these engagement letters and auditor's reports for use after the implementation of these reporting SASs.

Note: The 2021 edition of *PPC's Guide to Single Audits* includes the new reporting guidance.

Private Foundation Grant-making Procedures

Two recent taxpayer-favorable rulings involving grant-making activities serve as a reminder of the importance of complying with established guidance when making grants to individuals to avoid the excise tax. One ruling involves educational grants to support the development of original and creative content intended to inspire and educate the public (Ltr. Rul. 202202016). The other ruling relates to awarding scholarships to under-resourced students (Ltr. Rul. 202204009).

Let's Review

Grants by private foundations to individuals for travel, study, or other similar purposes are generally taxable expenditures subject to a 20% initial tax, unless the grants are awarded on an objective and nondiscriminatory basis to achieve a specific goal [IRC Sec. 4945(d)(3)]. In addition, to avoid taxable expenditure status, the grant-making process must be approved *in advance* by the IRS and must demonstrate one of the following [IRC Sec. 4945(g) and Reg. 53.4945-4(a)(3)]:

1. The grant is a scholarship or fellowship to be used for study at an education institution that qualifies as a public charity by maintaining a regular faculty and curriculum [IRC Sec. 4945(g)(1)].
2. The grant is a prize or award made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement and for which the recipient was selected from the general public, without having entered a contest or proceedings and without being obligated to render substantial future services [IRC Sec. 4945(g)(2)].
3. The purpose of the grant is to achieve a specific objective; produce a report or other similar product; or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee [IRC Sec. 4945(g)(3)].

Note: The Tax Court has held that grants to individuals in advance of obtaining IRS approval were taxable expenditures (*John E. Thorne*, 99 TC 67, 1992).

Example. The Do Good Foundation (a private foundation) provides 100 four-year college scholarships for children of county residents. Children of all residents (other than disqualified persons to the foundation) who have lived in the county for at least one year can apply. Previously, the number of eligible children averaged 2,000 per year. Selection of scholarship recipients from among the applicants is made by three prominent educators in other states who have no other connection with the foundation or county residents. The selections are made based on the applicants' prior academic performance, performance on certain tests, and financial need.

Under these circumstances, the operation of the scholarship program by Do Good (1) is consistent with its exempt status, (2) uses objective and nondiscriminatory criteria in selecting recipients from among the applicants, and (3) uses a selection committee that appears likely to make objective and nondiscriminatory selections of grant recipients. Therefore, the scholarships are not taxable expenditures.

Procedures and Records Are Critical

The IRS considers a foundation's compliance with the grant-making requirement to obtain advance approval. To receive advance approval of grant procedures, a private foundation must show the following [Reg. 53. 4945-4(c)]:

- The grant procedure includes an objective and nondiscriminatory selection process.
- These procedures are reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance.
- The foundation plans to obtain reports to determine whether the recipients have performed the activities that the grants were intended to finance.

To secure advance approval from the IRS, it is not necessary for the grant-making program of every foundation to follow the same procedure or set of procedures for making grants. Procedures may vary depending on factors such as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved [Reg. 53.4945-4(c)(1)].

Additionally, private foundations that make grants to individuals for travel, study, or other similar purposes must retain the following records [Reg. 53.4945-4(c)(6)]:

1. All information used to evaluate the qualifications of potential grantees.
2. Identification of grantees, including any relationship of the grantee to the foundation that would make him a disqualified person.
3. The amount and purpose of each grant.
4. Any follow-up information obtained while complying with the grant-making requirements.

A grant recognizing a person's past achievement is not a taxable expenditure and does not need to comply with procedures approved by the IRS if the funds are unrestricted and not earmarked for future travel or study.

Employer-related Scholarship Programs

The employer/employee relationship suggests that grants to employees and their children are compensatory in nature or otherwise further a private rather than a public purpose. Preferential grants to employees or their children also suggest a purpose to compensate or otherwise provide a fringe benefit. This situation commonly arises in employer-funded private foundations that grant scholarships or make educational loans to employees and their dependents. As a result, the IRS exercises an enhanced degree of oversight for these programs.

Revenue Procedure 76-47 (1976-2 CB 670) provides guidelines in determining whether a grant awarded under a program is a scholarship or fellowship grant subject to the provisions of IRC Sec. 117, which may also satisfy the requirements of IRC Sec. 4945(g)(1). If the grants are not Section 117 scholarships or fellowships and do not otherwise qualify under the provisions of IRC Sec. 4945(g)(2) or (3), they are taxable expenditures. To receive a favorable advance ruling from the IRS, an employer-related grant program must satisfy the following seven conditions and either a percentage test or the facts and circumstances test specified in Rev. Proc. 76-47.

Seven Conditions

Inducement. The program is not used as an employee recruiting tool or to induce employees to continue their employment or otherwise follow a course of action.

Selection Committee. Grant recipients must be selected by a committee consisting of individuals who are totally independent and separate from the private foundation, its organizer, and the employer concerned.

Eligibility Requirements. The program must impose identifiable minimum requirements for grant eligibility related to the purpose of the program.

Objective Basis of Selection. Selection of grant recipients must be based solely on substantial objective standards completely unrelated to the employment of the recipients or their parents and to the employer's line of business.

Employment. The grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer after the grant is awarded.

Course of Study. The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation.

Other Objectives. The terms of the grant and the courses of study for which grants are available meet all other requirements of IRC Sec. 117 and the regulations, and must be consistent with a disinterested purpose of enabling the recipients to obtain an education solely for their personal benefit.

Percentage Test

In the case of a program that awards grants to children of employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to the employees' children does not exceed 25% of the number of employees' children who (1) were eligible, (2) were applicants for such grants, and (3) were considered by the selection committee in selecting the recipients of grants in that year. If this requirement can't be met, the percentage test is met if the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year equal 10% or less.

In the case of a program that awards grants to employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such employees does not exceed 10% of the number of employees who (1) were eligible, (2) were applicants for such grants, and (3) were considered by the selection committee in selecting the recipients of grants in that year.

Facts and Circumstances Test

If a private foundation's grant program satisfies the conditions but fails the percentage test, the IRS will consider all the relevant facts and circumstances to determine whether the primary purpose of the program is to further the private interests of the employer or to educate recipients in their individual capacities.

Note: Rev. Proc. 80-39 (1980-2 CB 772) provides guidelines for determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures. Similar to Rev. Proc. 76-47 (1976-2 CB 670), it specifies seven conditions and a percentage test that must be satisfied to receive an advance ruling that the loans will not be taxable expenditures.

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How to Apply for Advance Approval

A foundation seeking advance approval of its scholarship/grant procedures must request a determination letter from the IRS [Rev. Proc. 2022-5, 2022-1 IRB 256, Sec. 4.02(6)].

If, by the 45th day after proper submission of the foundation's grant making procedures, the IRS has not responded, the foundation may consider the procedures approved from the date of submission until receipt of notice from the IRS that such procedures do not meet the regulatory requirements [Reg. 53.4945-4(d)(3)].

Form 1024—Recent Changes

Beginning January 3, 2022, applications for recognition of exemption on Form 1024 [Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code] must be submitted electronically online at **www.pay.gov**. The user fee for Form 1024 will remain $600 for 2022. The IRS is providing a 90-day grace period during which it will continue accepting paper versions of Form 1024 and letter applications. Electronic filing reduces errors and shortens the processing time so that applicants will not wait as long for a response from the IRS.

Filing organizations expanded. In addition to the organizations previously allowed to file Form 1024, the following entities also apply using the electronic Form 1024:

- Organizations requesting determinations under IRC Sec. 521 that previously would have filed Form 1028 (Application for Recognition of Exemption Under Section 521 of the Internal Revenue Code).
- Organizations applying for recognition of exemption under IRC Secs. 501(c)(11), (14), (16), (18), (21), (22), (23), (26), (27), (28), (29) or IRC Sec. 501(d) that previously would have submitted letter applications.

Section 501(c)(3) organizations continue to electronically file Form 1023 or 1023-EZ, and Section 501(c)(4) organizations must continue to file Form 1024-A (electronically).

Practical Consideration:

Organizations described In IRC Secs. 501(c) [other than 501(c)(3) and (c)(4)] and 501(d) must now use the electronic Form 1024 to request tax-exempt status.

Tax Brief

REQUESTING COPIES FROM THE IRS. New Form 4506-B (Request for a Copy of Exempt Organization IRS Application or Letter) may be submitted by mail, fax, or e-mail to request copies of exemption applications or determination letters. Form 4506-A (Request for a Copy of Exempt or Political Organization IRS Form) has been revised to request copies of an exempt or political organization's return, report, or notice and may be submitted by mail or fax. Check **www.irs.gov** (searching for "TEOS") to determine if the requested document is available there before submitting the forms request.