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SSARS 25 Effective Date is Around the Corner

Statement on Standards for Accounting and Review Services (SSARS) 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, is effective for engagements performed in accordance with the SSARS for periods ending on or after December 15, 2021. Early implementation is permitted.

SSARS 25 amends AR-C 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*; AR-C 70, *Preparation of Financial Statements*; AR-C 80, *Compilation Engagements*; and AR-C 90, *Review of Financial Statements*.

Significant Provisions

SSARS 25 includes an explicit requirement for accountants to determine materiality for the financial statements as a whole and apply the materiality benchmark in designing procedures and evaluating results. It also requires accountants to design and perform analytical procedures and inquiries to address all material items in the financial statements and disclosures as a basis for concluding on the financial statements as a whole.

The statement allows accountants to issue an adverse conclusion in their review reports when there is evidence of pervasive and material misstatement of the financial statements. Prior to SSARS 25, accountants could not modify the standard report and could only withdraw from the engagement.

SSARS 25 requires a statement in the accountant's review report that the accountant is required to be independent with respect to the entity and to comply with ethical responsibilities under the relevant professional standards relating to the review engagement.

Specific Amendments to AR-Cs

AR-C 60. SSARS 25 revises and adds definitions of certain terms to be consistent with definitions in auditing standards and other SSARS.

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AR-C 70. SSARS 25 requires accountants to disclose material financial statement misstatements when they become aware of incomplete, inaccurate, or otherwise unsatisfactory documents, explanations, and significant judgments used in preparing the financial statements and management does not provide additional or corrected information.

In addition, when the accountant intends to withdraw from the engagement due to an inability to include a statement on each page of the financial statements that (at a minimum) "no assurance is provided," or management does not provide the additional or corrected information in the situation referred to in the previous paragraph, SSARS 25 requires the accountant to inform management of the reasons for withdrawing from the engagement.

AR-C 80. For accountant's reports on special purpose financial statements prepared in accordance with the regulatory or contractual basis of accounting, SSARS 25 eliminates the requirement to disclose the purpose for which the financial statements are prepared.

In addition, for accountant's reports prepared in accordance with the contractual basis of accounting, SSARS 25 adds a statement that the financial statements may not be suitable for another purpose.

AR-C 90. SSARS 25 adds a number of explicit requirements about planning and performing the review in the areas of applying professional skepticism, agreeing on the terms of the engagement, determining and applying materiality, making inquiries, identifying related parties and related party transactions, and preparing documentation.

It also revises requirements related to accountant's reports on special purpose financial statements prepared in accordance with the regulatory or contractual basis of accounting.

SSARS 25 also revises the format of the review report to add a Basis for Conclusion section when there is a modified conclusion.

Practical Consideration:

See the April 2020 edition of *PPC's Nonprofit Update* for additional information. SSARS 25 is available on the AICPA website at **www.aicpa.org** and on Checkpoint at **www.checkpoint.riag.com/**.

Auditing Accounting Estimates

The process of preparing financial statements requires individuals to make accounting estimates. Auditors are required to assess risks and perform procedures in response to those risks of material misstatements for accounting estimates and related disclosures. This area has been a concern in peer reviews in recent years because firms were found to not have adequately tested management's estimates.

In periods of economic uncertainty and volatility, like the current challenges from the COVID-19 pandemic and economic shutdowns, management's estimates are especially important to financial reporting. Management may have incentives and pressures to introduce bias into their estimates and assumptions to make the financial statements more appealing to users. In these times, it is very important for auditors to be aware of upcoming changes to guidance on auditing accounting estimates.

Current Rules

The current guidance for auditing estimates is SAS 122, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

New Rules Coming

In July 2020, the AICPA's Auditing Standards Board issued SAS 143, *Auditing Accounting Estimates and Related Disclosures*. It is part of the AICPA's Enhancing Audit Quality Initiative. This standard requires auditors to evaluate, based on audit procedures performed and evidence obtained, whether the accounting estimates and related disclosures are reasonable based on the applicable financial reporting framework.

SAS 143 provides guidance to auditors in addressing new accounting standards that require the use of estimates for accounting and related disclosures, including fair value estimates. It also provides requirements for evaluating misstatements of accounting estimates and related disclosures, and indicators of possible management bias in estimates.

SAS 143 supersedes SAS 122. It is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

SAS 143 includes matters for auditors to consider in evaluating how management develops and selects estimates used in financial reporting. These include how management selects and applies the data, methods, and assumptions used in their estimates, monitors the need for changes, considers key performance indicators, and documents their reasoning for significant judgments made. Disclosures about accounting estimates must include how the estimates were developed and explain estimation uncertainty. The standard also provides guidance on identifying financial or other incentives that may motivate management bias.

Some of the specific changes in SAS 143 auditors will be required to apply in their audit procedures for accounting estimates include:

- Requires a separate assessment of inherent risk and control risk for accounting estimates and related disclosures at the relevant assertion level
- Provides enhanced risk assessment requirements specific to estimates, including understanding the entity's environment and internal controls relevant to its accounting estimates
- Calls for further audit procedures (including tests of controls) responsive to reasons for assessed risks of material misstatement at the relevant assertion level
- Calls for exercising and documenting professional skepticism in determining whether management's estimates are reasonable, especially for estimates with greater estimation uncertainty, subjectivity, complexity, or potential for management bias or fraud.

Practical Consideration:

SAS 143 is available on the AICPA's website at **www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/sas-143.pdf**.

Changes in AU-C Sections Other Than AU-C 540. SAS 143 also provides requirements that relate to existing guidance for accounting estimates contained in other AU-C sections. These include:

- AU-C 230—Audit documentation.
- AU-C 260 and 265—Communication with those charged with governance and management.
- AU-C 315—Identifying and assessing risks of material misstatement, including obtaining an understanding of the entity and its environment.
- AU-C 330—Responding to assessed risks of material misstatement—Designing and performing further audit procedures in response to assessed risks, including tests of controls, and obtaining more persuasive audit evidence in areas of higher assessed risk.
- AU-C 450—Overall evaluation based on audit procedures performed—Evaluating appropriateness of assessments of risks of material misstatement, overall financial statement presentation in accordance with the applicable framework, and audit evidence obtained.
- AU-C 500—Evaluate relevance, reliability, appropriateness, and sufficiency of audit evidence.
- AU-C 501—Evaluate management's use of specialists and appropriateness of using their work as audit evidence.
- AU-C 700—Evaluate fair presentation of financial statements including disclosures.
- AU-C 705—Determine form of auditor's opinion based on audit evidence.

Practical Consideration:

The AICPA resource providing linkages between SAS 143 and other AU-C sections is available at **www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/linkages-between-sas-143-and-other-auc-sections.pdf**.

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Auditing Brief

2021 AICPA AUDIT GUIDE, *GOVERNMENT AUDITING STANDARDS AUDITS AND SINGLE AUDITS*, RELEASED. The AICPA released the 2021 edition of its Audit Guide, *Government Auditing Standards and Single Audits*, in late September. We'll provide more details on the Audit Guide in an upcoming edition of *The PPC Nonprofit Update*.

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Priority Guidance Plan for Exempt Organizations

The Treasury Department has released its Priority Guidance Plan (PGP) for 2021–2022 based on recommendations from taxpayers, tax practitioners, and industry groups. The PGP lists 193 priority projects that the Treasury Department and the IRS aim to address between July 1, 2021, to June 30, 2022. This issue will discuss several issues relevant to tax-exempt organizations.

Group Exemptions

Subordinate organizations (chapters) can obtain tax-exempt status as a group and file a combined 990 if they are under the supervision and control of a central organization (headquarters). However, the IRS stopped accepting new group exemption ruling requests after June 17, 2020. The IRS issued Notice 2020-36 (2020-21 IRB 840), proposing new procedures for obtaining and maintaining a group exemption. The PGP indicates that finalizing these procedures is a priority for the IRS.

The original guidance for group exemptions was in Rev. Proc. 80-27 (1980-1 CB 677). Notice 2020-36 contains updated procedures that must be followed by the chapters and by headquarters. These updated procedures are designed to promote compliance, increase efficiency, improve accuracy, and enhance the transparency of group exemptions.

The procedures require that the headquarters have no more than one group exemption. There could no longer be two or more groups of chapters under a single headquarters organization. The headquarters would be required to have at least five chapters when applying for a group exemption, and it must maintain at least one chapter in all subsequent years.

The procedures would strengthen the level of supervision and control that the headquarters organization is required to exercise over the chapters, such as appointing a majority of each chapter's governing body. In general, the headquarters organization would no longer be allowed to have a tax-exempt status that differs from the chapters. For example, if the headquarters is exempt under IRC Sec. 501(c)(4), it couldn't request a group exemption for chapters that are exempt under IRC Sec. 501(c)(3). Each chapter would be required to adopt uniform governing documents, with certain exceptions for charitable organizations with differing missions. Also, chapters other than those described in Section 501(c)(3) would all need to have a similar purpose as defined by their NTEE codes.

The procedures would allow a chapter to operate in a foreign country as long as it is organized in the United States. Group exemptions could not include Type III supporting organizations or Section 501(c)(29) organizations. Chapters that have had their exempt status revoked and not yet reinstated would not be eligible for inclusion in a group exemption. The procedures include enhanced requirements for the headquarters to maintain and update the list of chapters included in the group exemption. Every chapter operating as a Section 501(c)(4) must submit its own Form 8976, Notice of Intent to Operate Under Section 501(c)(4), or authorize the headquarters organization to file the form on its behalf.

A *transition rule* allows preexisting group exemptions one year to ensure that the headquarters organization has no more than one group exemption, and that each group has at least one chapter. Under a *grandfather rule*, preexisting group exemptions would not be required to comply with the new procedures for stricter supervision over and qualification of chapters.

Supporting Organizations

Supporting organizations are Section 501(c)(3) public charities that avoid classification as private foundations even though they may be unable to pass the public support tests of IRC Sec. 509(a)(1) or (2). There are proposed regulations regarding supporting organizations. The PGP indicates that finalizing these regulations is a priority for the IRS.

The proposed regulations clarify the due date for the supporting organization to supply certain required information to the organization it supports. Specifically, the information must be postmarked no later than the end of the fifth month after the end of the tax year. For example, a supporting organization with a June year end must submit all the required documentation to the supported organization no later than November 30. The postmark date is deemed to be the date of delivery.

The proposed regulations clarify that a supporting organization must demonstrate that it meets the requirements of the responsiveness test for *all* the organizations it supports. The regulations address Type III functionally integrated supporting organizations, including when the supported organization is the parent or is a governmental entity. They also clarify the definition of a non-functionally integrated Type III supporting organization.

Unrelated Trade or Business Expenses

Exempt organizations reporting income from more than one unrelated trade or business (UTB) on Form 990-T must report each activity separately. Losses from one activity may not be used to offset net income from other activities (siloing). In general, net operating losses (NOLs) may not be carried back to previous tax years. However, the CARES Act passed in 2020 provided that NOLs from tax years beginning after December 31, 2017, and before January 1, 2021, may be carried back five years. Some of those carryback years may be prior to the implementation of the siloing rules.

The PGP indicates that issuing new regulations addressing the use of CARES Act NOLs in relation to the siloing rules is an IRS priority. The regulations are also expected to provide much needed guidance on how exempt organizations should allocate expenses to an unrelated trade or business.

IRS Disclosure of Information to State Officials

IRC Sec. 6104 discusses the disclosure requirements related to exempt organizations. Prior to the Pension Protection Act of 2006, the IRS was only able to disclose to state officials that it had denied an exemption application, revoked the exempt status of a charity, or issued a notice of deficiency for termination or excise taxes. It could provide additional information to state officials related to such issues. The Pension Protection Act expanded the permissible IRS disclosures to include *proposed* denials and revocations prior to final appeal, as well as identifying information about organizations that have applied for Section 501(c)(3) status.

Proposed regulations provide that the disclosures are no longer automatic and are generally limited to the state's interest in regulating charitable solicitations. Disclosures are subject to confidentiality requirements under federal law. The IRS may make the disclosures on its own initiative when it determines that state laws have been violated.

The PGP indicates that the IRS intends to finalize the proposed regulations, particularly with respect to whether the regulations completely describe the types of organizations for which the state officials might need such information.

Church Tax Inquiries and Examinations

IRC Sec. 7611 states that the IRS may make a tax inquiry into a church only if an appropriate high-level Treasury official reasonably believes that the church may not be exempt or is carrying on taxable activities. Previous regulations had defined the appropriate official as a Regional Commissioner, a position that was eliminated in 1998. In 2009, a federal district court held that the IRS official who authorized a church inquiry, the Director of Exempt Organizations Examinations, lacked the political accountability and national policy viewpoint to be considered an appropriate high-level Treasury official. While the former Regional Commissioner was only one management level below the IRS commissioner, the Director of Exempt Organizations Examinations was four levels below.

The IRS had not undertaken any procedures to amend its own policies. After the court's determination, the IRS issued a proposed regulation assigning responsibility for making the required determination regarding a church tax inquiry to the Director of Exempt Organizations. The PGP indicates that finalizing these regulations is an IRS priority.

Defining How an LLC Can Qualify as a 501(c)(3)

Tax-exempt organizations generally do not have owners. The common structures for a Section 501(c)(3) organization are corporation, trust, or association. A limited liability company (LLC) is a business entity with one or more members that can operate for various purposes. The IRS will not grant tax-exempt status directly to an LLC because its members are typically owners of the business.

Usually, a nonprofit organization is formed as a corporation, and the corporation can become the single member of an existing LLC. The nonprofit corporation

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would have full control over the activity and assets of the LLC. The LLC's organizing documents must meet 12 conditions imposed by the IRS, most of which apply to its activities and ownership structure. The PGP indicates the IRS intention of providing further guidance on circumstances where an LLC can qualify for recognition under IRC Sec. 501(c)(3).

Donor Advised Funds

A donor advised fund (DAF) is a separately identifiable account maintained by a Section 501(c)(3) organization (sponsoring organization). The donor is granted advisory privileges with respect to the distributions made from the DAF by the supporting organization.

The IRS can impose excise taxes on the sponsoring organization if the DAF is used to provide impermissible economic benefits to the donor or the donor's family. The IRS can impose excise taxes on a donor who receives impermissible economic benefits in the form of grants, loans, excess compensation, or similar payments from a DAF. The PGP indicates that the IRS intends to issue regulations regarding the excise taxes applicable to DAFs.

Private Foundation Partnership Investments

IRC Sec. 4941 imposes a tax on self-dealing between a private foundation and a disqualified person. The PGP indicates that the IRS will provide guidance on whether self-dealing occurs when a private foundation holds an investment in a partnership in which one or more of the other partners is a disqualified person with respect to the private foundation.

Practical Consideration:

The Priority Guidance Plan (PGP) is the Treasury's projection of what they want to accomplish during the 2021–2022 fiscal year. Available resources and other unplanned projects may prevent completion of all items on their plan. However, the PGP does provide organizations with an idea of where Treasury wants to focus. Exempt organizations should review the list, note any items that may impact the organization, and provide appropriate feedback on the items in the PGP.