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THE PPC
NONPROFIT UPDATE

MAY 2021, VOLUME 28, NO. 5

COVID-19 Implications for Audit Planning

The COVID-19 pandemic created significant and unique challenges for nonprofit organizations, their boards and audit committees, and auditors. Economic pressures and risks to personal health have created new and heightened risks unlike any in recent history.

For auditors beginning audits in the middle of this pandemic, planning is critical and involves new considerations, even for existing clients. There will likely be new and changed risks and changes to internal controls as a result of COVID-19 that may require changes to the nature, timing, and extent of audit procedures.

Auditors are required by the first standard of fieldwork to properly plan the audit and supervise staff. The paragraphs that follow discuss specific planning areas to consider in the current environment.

Understanding the Organization

Audit planning requires obtaining an understanding of the entity and its environment, including internal controls and risk factors. Many nonprofit organizations have made significant changes to their operations in response to COVID-19, and these changes may require adjustments to the audit plan. The pandemic has affected different organizations and industries differently, so it's important to consider industry-wide issues along with what has changed at the organization since the prior audit.

Auditors should re-evaluate and document client acceptance and continuance procedures based on these changes. This includes assessing the impacts of COVID-19 on the client and on the engagement team's ability to serve the client.

Auditors should discuss with management upfront whether there have been any of the following: significant new or unusual transactions: supply chain changes; lost customers or donors; decreases in revenues or profits; new types of expenses; changes in strategic plans; new borrowings or liquidity issues; debt covenant or grant compliance issues; new contingencies; litigation changes; new contracts; employee or management turnover; and system changes.

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Practical Consideration:

PPC's Guide to Audits of Nonprofit Organizations, at NPO-CX-6.3, "COVID-19 Audit Considerations," provides a checklist and discussion of COVID-19 related audit issues.

Risk Assessment

Auditors need to evaluate the potential for increased risks of material misstatements to the financial statements and how management has assessed the impacts of COVID-19. In addition to the risks related to changes in the organization discussed above, the following are other areas to consider as part of the overall risk assessment:

Fraud Risk. Fraud risk is heightened because of the pandemic. Many organizations are struggling financially, so there are more operational and liquidity pressures on management and employees. In addition, closures and shutdowns and employee furloughs and terminations put new pressures on the workforce and can create new opportunities and incentives to commit fraud. Auditors should refer to the requirements of AU-C 240 and consider the need to change audit procedures to address changes in internal controls relating to fraud risks.

Remote Working. Remote working creates new risks because both client personnel and auditors are likely working from home. Access to client personnel and records may have changed since the last audit and may require additional planning and communication. Internal controls over financial reporting have probably changed and need to be evaluated. There are likely new controls and changes to existing controls (like segregation of duties, because of employees working remotely or furloughs or terminations) to be evaluated, documented, and tested.

Cybersecurity Risks. Cyber risks have become more of an issue, as nonprofit organizations have increasingly been the targets of cyber incidents. Many clients have transitioned more data to the cloud to facilitate working remotely, among other reasons. As part of planning, auditors should identify and assess the potential risks of material misstatement to the financial statements from cybersecurity risks and adjust the audit plan to test internal controls that mitigate those risks.

Accounting Issues. Areas of increased accounting risk as a result of the pandemic that may require different audit planning for current audits include the following: asset impairment, management estimates, timing/cutoff of revenues and expenses, debt covenant compliance, and investment valuation. As a result of the pandemic, new disclosures may be required for those issues, along with risks and uncertainties and subsequent events. In addition, organizations may have implemented new accounting standards that auditors must address, such as revenue recognition and accounting for leases. Going concern may be a new issue for many organizations, so auditors should review the requirements of AU-C 570 relating to audit procedures, disclosures, and the audit report.

Compliance with Laws and Regulations. In assessing risks of material misstatement to the financial statements, auditors should consider the risk of noncompliance with laws and regulations, including new COVID-19 federal awards such as the CARES Act. The audit plan should include procedures to review the specific compliance requirements and related controls over them to provide reasonable assurance of detecting noncompliance. These procedures include understanding and evaluating how the client is complying with the relevant provisions of laws, regulations, contracts, and grant agreements, along with the accounting for new awards and expenditures.

Audit Timing

More time may be needed to complete the audit, and the audit fee may need to be adjusted in response. In addition to addressing many new audit risks, working and auditing remotely may take more time. Clients working remotely may be less available, less engaged, and have less of a sense of urgency about the audit. The engagement team may have more difficulty accessing client records and obtaining needed information, may be less productive, and the work may take longer. It's important to set expectations about audit timing with the client before and revisit them during the audit. If extensions or waivers are needed from financial statement users, they should be planned for in advance.

Auditors should review the overall audit timeline and phases of fieldwork up to the completion date with management and get their agreement upfront. It may be necessary to schedule regular discussions with the client upfront, so everyone is aware of open issues and knows what needs to be done to complete the audit.

Information Technology Issues

The audit plan should incorporate any needed changes to the audit team's technology and processes so they are able to access client data and systems and avoid delays. Additional precautions may be needed to ensure security and confidentiality of data transmissions and communications with the client and others.

Changes to Audit Approach

Following are a few specific areas where the auditor may need to alter processes and procedures.

Communications. Communications with the client may need to be more frequent and timely because of working remotely. Auditors may need to plan to communicate differently because access to management and audit committees is different and they are under additional demands because of the pandemic that could affect their availability.

New risks and accounting issues that are expected to affect the audit plan and timing should be discussed in advance, and more may come to the auditor's attention as the audit (and pandemic) continues. Frequent communications with management and the board to see how they are addressing new issues that might affect the audit are critical.

Practical Consideration:

The PCAOB issued a paper summarizing how audit committees are thinking about the effect of COVID-19 on financial reporting and the audit as they perform their oversight duties. It can be useful for auditors of all types of organizations to consider and is available at **https://pcaobus.org/Documents/Conversations-with-Audit-Committee-Chairs-Covid.pdf**.

Specific Procedures. Walkthroughs and internal control tests may be difficult to perform if clients and auditors aren't at the clients' locations, which may require more substantive testing. Preliminary analytics of year-over-year actuals and budget-to-actual may produce different results than in prior audits if the current year results have been significantly impacted (negatively or positively) by the economy and the pandemic. Auditors may need to change their audit plan and procedures in response.

If preliminary audit work was already performed, auditors should inquire about changes in internal controls since that time. Where internal controls are relied on, auditors need to evaluate whether they can continue to rely on controls that weren't in place for the full year.

Because of the many new risks and new accounting issues, auditors may—for the first time—need to engage specialists to assist them. These include economists, valuation experts, cybersecurity experts, fraud specialists, and tax advisors. As part of planning, auditors should review existing and proposed auditing standards relating to use of specialists and consider independence issues.

Practical Consideration:

The AICPA, International Ethics Standards Board for Accountants, and International Auditing and Assurance Standards Board guidance on using specialists is available at **www.ethicsboard.org/publications/using-specialists-covid-19-environment**.

Audit Wrap-up Activities

Subsequent event procedures are very important in the current environment. Both recognized and unrecognized events need to be evaluated to make sure they are properly recognized or disclosed in the financial statements. Management representation letters, confirmations, and attorney letters can be delayed because of the current environment and working remotely, which can delay the audit report. Management representation letters may need to include new representations because of the pandemic (going concern, risks and uncertainties, significant estimates, subsequent events), and this should be discussed with management in advance.

Modified Audit Opinions

There is a greater potential for issuing a modified audit opinion in the current environment. The auditor may not be able to obtain sufficient appropriate audit evidence, even if it is not within the organization's control due to government lockdowns, access to organization records, or employee health issues. There may be material misstatements in the financial statements because accounting policies were not followed or new standards were not appropriately implemented. There could be incomplete or misleading disclosures relating to risks, estimates, judgments, subsequent events, and material uncertainties as a result of the pandemic, including going concern. Auditors should review the requirements of AU-C 706 and discuss any required modification to the audit report with management as soon as possible.

Single Audit Implications

For organizations subject to single audit requirements, auditors should be aware of the August 2020 OMB Compliance Supplement and the December 2020 Compliance Supplement Addendum.

Practical Consideration:

AICPA COVID-19 A&A resources are available at **www.aicpa.org/interestareas/frc/covid19.html**. Previous issues of The *PPC Nonprofit Update* include articles about the OMB Compliance Supplement and Addendum. *PPC's Guide to Single Audits* and *PPC's Guide to Audits of Nonprofit Organizations* also provide information about COVID-19 and single audits.

Employee Retention Credit Update

The employee retention credit (ERC) was enacted by the CARES Act on March 27, 2020. It was a refundable payroll tax credit equal to 50% of the qualified wages (including certain health plan expenses), up to $10,000, an eligible employer (including tax-exempt organizations) paid to employees after March 12, 2020, and before January 1, 2021. The Consolidated Appropriations Act (CAA) of 2021 extended the ERC through June 30, 2021, increased the credit rate from 50% to 70% of qualified wages, increased the limit on per-employee creditable wages from $10,000 for the year to $10,000 per quarter, and expanded eligibility. (See the May 2020, September 2020, and February 2021 editions of this newsletter for coverage.)

Recent Developments

On March 1, 2021, the IRS released guidance in Notice 2021-20 about the ERC as it applies to qualified wages paid from March 13, 2020, through December 31, 2020. Notice 2021-23 (2021-16 IRB) was released on April 2, 2021, providing guidance on the ERC that applies to qualified wages paid in the first and second quarters of 2021. Additionally, on March 11, 2021, the American Rescue Plan Act (ARPA) of 2021 (P.L. 117-2) was signed into law, extending the ERC through December 31, 2021.

IRS Guidance for Claiming the ERC in 2020

Notice 2021-20 (2021-11 IRB 922) addresses the ERC as it applies to qualified wages paid from March 13, 2020, through December 31, 2020. The guidance, which is similar to the FAQs published on **www.irs.gov**, clarifies the credit, includes examples, and describes retroactive changes under the Taxpayer Certainty and Disaster Tax Relief Act of 2020. The notice provides answers to the following questions:

1. Who are eligible employers?
2. How do the aggregation rules affect the ERC?
3. What orders from an appropriate governmental authority are taken into account for determining credit eligibility?
4. What constitutes full or partial suspension of trade or business operation?
5. Which gross receipts does a tax-exempt employer use to determine a significant decline?
6. How is the maximum amount of an eligible employer's ERC determined?
7. What are qualified wages and how is the average number of full-time employees determined?
8. How are allocable qualified health plan expenses determined?
9. How do PPP loans and ERC eligibility interact?
10. How is the ERC claimed?
11. What special issues can affect the ERC?
12. How is the ERC substantiated?

Caution: The guidance provided in Notice 2021-20 does not address changes that apply to qualified wages paid after December 31, 2020.

ERC Modified and Extended through 2021

Notice 2021-23. Many of the questions answered in Notice 2021-20, as listed in our previous discussion, are answered in Notice 2021-23. However, this guidance does provide that the advance payment of the ERC (by filing Form 7200) is available only to 2021 small employers.

ARPA. In addition to extending the ERC through December 31, 2021, the ARPA codifies the credit by creating new IRC Sec. 3134 effective for calendar quarters beginning after June 30, 2021. The ERC rate for 2021 is 70% [IRC Sec. 3134(a)], and the qualified wages limit for any calendar quarter remains at $10,000 [IRC Sec. 3134(b)(1)(A)]. So, an employer can potentially have up to $40,000 in qualified wages per employee during 2021.

Credit limitations. The ERC in any calendar quarter may not exceed the applicable employment taxes on the wages paid with respect to the employment of all the employees of the eligible employer. The credit is allowed to be claimed against Medicare (1.45% portion) taxes only [IRC Sec. 3134(b)(2)]. Under the CARES Act and CAA (2021), the credit could be taken against social security (6.2% portion) taxes.

Practical Consideration:

Since there will be a smaller amount of taxes to claim the credit against, it could take longer to fully claim the credit for the third and fourth quarters of 2021.

The ARPA adds an overall limitation on the credit of $50,000 per calendar quarter for an eligible employer that is a recovery startup business [IRC Sec. 3134(b)(1)(B)]. For this purpose, a *recovery startup business* is any employer (a) that began carrying on any trade or business after February 15, 2020; (b) for which the employer's average annual gross receipts (under the qualified small business exception to the limitations of the cash accounting method) for the three-taxable-year period ending with the tax year which precedes the calendar quarter for which the ERC is determined does not exceed $1 million; and (c) which, with respect to the calendar quarter, is not a business subject to a suspension under a government order or had a significant decline in gross receipts [IRC Sec. 3134(c)(5)].

Coordination with other relief. The ARPA also provides that qualified wages paid by an employer taken into account as payroll costs under second draw Paycheck Protection Program (PPP) loans, shuttered venues assistance grants, and restaurant revitalization grants are not eligible for the ERC. However, payroll costs paid during the covered period do not fail to be treated as ERC-qualified wages to the extent that a covered loan is *not* forgiven. Thus, PPP recipients are eligible for the ERC if the loan did not pay the wages in question.

Sick and Family Leave Credits Update

Effective April 1, 2020, through December 31, 2020, the Families First Coronavirus Response Act (FFCRA) required certain employers to provide paid leave to workers who are unable to work or telework due to circumstances related to COVID-19 (qualified paid leave). The FFCRA offset the costs of providing qualified paid leave, up to certain amounts, with refundable tax credits against employment taxes for qualified leave wages taken April 1, 2020, through December 31, 2020. The CAA of 2021 extended the period for which the tax credits could be taken through March 31, 2021. The paid sick leave credit for each employee is equal to the lesser of the amount of his or her leave pay or either: (1) $511 per day while the employee is receiving paid sick leave to care for himself or herself up to a total of $5,110 for ten days; or (2) $200 per day, up to a total of $2,000 for 10 days, if the sick leave is to care for a family member or child whose school or place of care is closed. The paid family leave credit for each employee is the amount of his or her leave pay limited to $200 per day with a maximum of $10,000.

Recent Developments

Generally, for amounts paid with respect to calendar quarters beginning after March 31, 2021, the ARPA codifies these FFCRA credits by creating new IRC Secs. 3131 (credit for paid sick leave), 3132 (payroll credit for paid family leave), and 3133 (special rule related to tax on employers). It also extends the sick and family leave credits through September 30, 2021. Additionally, ARPA made modifications to the credits beginning with wages paid on April 1, 2021. Some of these changes are highlighted in this article.

Calculating and applying the credits. Section 3133(a) provides that paid sick and family leave credits may be claimed for the employer's share of social security tax (6.2%) and Medicare tax (1.45%) on qualified leave wages. The credit is applied against the Medicare portion (only) of payroll taxes of all employees, not just the employees to whom qualifying leave wages are paid. In addition, the IRS may waive Section 6656 penalties for failure to deposit applicable employment taxes (employer's share of Medicare tax) if the failure to deposit is due to an anticipated credit.

Credit expansions. The paid sick and family leave credits may be claimed by employers who provide paid time off for employees to obtain the COVID-19 vaccination or recover from an illness related to the immunization. Also, the credits are increased by the employer's (1) qualified health plan expenses [IRC Secs. 3131(d) and 3132(d)] and (2) certain collectively bargained benefits [IRC Secs. 3131(e) and 3132(e)].

Credit limitations. For both credits, the following limitations are added:

- A nondiscrimination requirement providing no credit is permitted to any employer who discriminates in favor of highly-compensated employees as defined under IRC Sec. 414(q), full-time employees, or employees on the basis of employment tenure [IRC Secs. 3131(j) and 3132(j)].
- A denial of double benefit rule providing that any wages taken into account in determining the paid sick and family leave credits may not be included for determining the credits allowed under IRC Secs. 45A, 45P, 45S, 51, 3131 or 3132, and 3134 [IRC Secs. 3131(f)(3) and 3132(f)(3)].
- IRC Secs. 3131(f)(5) and 3132(f)(5) clarifying that while no credits may be claimed by the federal government or any federal agency or instrumentality, this prohibition does not apply to any organization described under IRC Sec. 501(c)(1) and exempt from tax under IRC Sec. 501(a), including state and local governments.
- Rules requiring coordination of the credits with second draw Payroll Protection Program (PPP) loans and certain government grants.

Changes to sick leave credit only. The 10-day limitation on the maximum number of days that an employer can claim the paid sick leave credit for wages paid to an employee is reset, following the current 10-day limitation that runs from the start of the credits in 2020 through March 31, 2021 [IRC Sec. 3131(b)(2)].

Changes to family leave credit only. The amount of wages that an employer may claim the paid family leave credit in a year is increased from $10,000 to $12,000 per employee [IRC Sec. 3132(b)(1)(B)]. Also, the paid family leave credit is expanded to allow employers to claim the credit for leave provided for the reasons included under the previous employer mandate for paid sick time.

The PPC Nonprofit Update is published monthly by Thomson Reuters/Tax & Accounting, P.O. Box 115008, Carrollton, Texas 75011-5008, (800) 431-9025.

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Practical Consideration:

The COVID-19 pandemic has been the catalyst for much tax legislation and necessary guidance. It seems unlikely that the ARPA is the last major piece of legislations we'll see this year. Stay tuned.

Form 990—Common Preparation Errors

As the Form 990 filing deadline (for calendar year organizations) and the extended deadline for June 30 year end organizations approaches, consider some common errors that can be prevented with careful preparation and review of the return. A few are highlighted here:

Schedule A, with all it's tricky definitions, inclusions, and exclusions, is ripe for error which can include:

- When required, is not included with the return or is incorrectly completed.
- Unusual grants are not properly identified and consequently not properly excluded.
- Donations from major contributors are not tracked and therefore not properly considered.
- Contributions from private foundations and Section 509(a)(2) organizations are not included in the public support test.
- Form 990 is prepared using a different method of accounting from the one used for donor contributions reported in Schedule A.
- Income from special events is improperly reported.
- Public support percentages are trending down for the first five years, yet, the organization does not monitor this trend or make support changes within the five-year period.
- Organizations improperly analyze and report membership fees for Schedule A.

See Resource R511 in *PPC's 990 Deskbook* for more information on common errors.

Tax Brief

FORM 990-T ELECTRONIC FILING BEGAN APRIL 15TH. As indicated in the March 2021 edition of this newsletter, the IRS has revised Form 990-T [Exempt Organization Business Income Tax Return (and Proxy Tax Under Section 6033(e))] and modified its systems to enable mandatory electronic filing. Any 2020 Form 990-T due on or after April 15, 2021, must be filed electronically and not on paper. A limited exception applied for 2020 Form 990-T returns submitted on paper that are postmarked on or before March 15, 2021. See **www.irs.gov/charities-non-profits/current-edition-of-exempt-organizations-update** for more information.

PAYCHECK PROTECTION PROGRAM (PPP) EXTENSION. The PPP Extension Act of 2021, signed into law on March 30, 2021, extends the PPP application deadline to May 31, 2021, and extends the PPP authorization through June 30, 2021 to provide the Small Business Administration (SBA) additional time to process applications.