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FASB Updates the Definition of *Collections*

In March 2019, the FASB issued ASU 2019-03, *Not-for-Profit Entities (Topic 958): Updating the Definition of Collections*. The ASU eliminates diversity in practice by aligning the definition of *collections* in GAAP with the definition used by the American Alliance of Museums (AAM). Additionally, the ASU requires additional disclosures for an entity that has collection items. The ASU applies to all entities, including business entities, that have collection items.

Originally, the definition of collections in FASB 116, *Accounting for Contributions Received and Contributions Made*, was derived from the AAM's Code of Ethics for Museums, which most museums use for accreditation purposes. After the issuance of FASB 116, the AAM revised its definition of collections. The issuance of ASU 2019-03 realigns those definitions.

Practical Consideration:

How FASB defines collections is important because under GAAP, a collection-holding entity does not have to capitalize contributions of works of art, historical treasures, and similar assets if the donated items are added to collections and meet certain criteria.

What Are the Changes?

New Definition. Before the issuance of ASU 2019-03, to meet the definition of a collection item, works of arts, historical treasures, and similar assets must—

- be held for public exhibition, education, or research instead of financial gain;
- be reserved and protected; and
- when sold, the proceeds are reserved to acquire other items for collection.

In this Issue:

ASU 2019-03 amends the last requirement. Under the clarified definition, proceeds from the sale of collection items can be used for either of the following purposes—

- acquiring new collection items; and/or
- the direct care for existing collection items.

Practical Consideration:

Collections are usually held by museums; botanical gardens; libraries; aquariums; arboretums; historical sites; planetariums; zoos, art galleries; nature, science, and technology centers; and similar educational, research, and public service organizations that have such divisions. The definition may apply to other entities as well. Also, not all items held by these entities will meet the definition.

New Disclosure Requirements. ASU 2019-03 requires an entity to disclose the policy for using proceeds from deaccessioned collection items. The disclosure must include—

- whether the proceeds can be used to acquire new collection items, pay for the *direct care* of existing collection items, or both; and
- if the proceeds can be used for *direct care*, how the entity defines *direct care*.

Why Are the Changes Important?

New Definition. ASU 2019-03 eliminates the diversity in practice that exists between the definition in GAAP compared with the definition that many entities use for accreditation purposes. Additionally, permitting an entity to use the proceeds for the care of existing collections items is consistent with FASB's objective to permit entities to not recognize contributed collections, that are preserved and protected, in the financial statements.

New Disclosures. The disclosure of a collection-holding entity's policy for the use of proceeds from deaccessioned collection items promotes transparency, clarifies for financial statement users how the entity may use the proceeds from deaccessioned collection items, and provides users with information that may be useful in making decisions. The disclosure of how the entity defines *direct care* will also provide financial statement users with a better understanding of the costs associated with preserving and protecting collection items and what the entity considers to be a *direct care* expense.

What Is *Direct Care*?

FASB ASU 2019-03 does not define or provide additional guidance on *direct care*. The FASB's basis for conclusions indicated that each industry should be able to determine what it considers to be *direct care*. The Board was concerned that if FASB defined direct care, that definition could result in a new misalignment between the GAAP and AAM's definition of collections. Additionally, the Board also had concerns that it would be unable to develop a definition that would apply to all types of collections that an entity may hold.

Practical Consideration:

The AAM white paper (*Direct Care of Collections—Ethics, Guidelines and Recommendations*, which was published in April 2016) provides guidance to help entities determine what is considered direct care for collection items.

Effective Date and Transition

The guidance in ASU 2019-03 must be applied prospectively and is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted.

Independence Requirement Changes in the 2018 Yellow Book

The Government Accountability Office (GAO) issued the *Government Auditing Standards, 2018 Revision* (the 2018 Yellow Book) on July 17, 2018. The 2018 Yellow Book was revised in response to changes in the auditing environment and to align with commercial auditing standards. In this issue, we will take a close look at the changes affecting the guidance on independence.

Practical Consideration:

Start considering the effect of the new independence requirements on your engagements and the additional time that will be required for documentation. Because these new provisions require compliance throughout the period under audit, they need to be implemented as of the first day of the period, thus backing that date up to July 1, 2019, for many audits.

What's Changing?

The 2018 Yellow Book expands the guidance on independence, including:

- Expanding factors to consider when determining the significance of a threat.
- Identifying services provided by audit organizations in government entities that do not create a threat.
- Expanding application guidance on management's ability to oversee nonaudit services to include determining the reasonableness of the results and the recognition of material errors or misstatements of results.

However, the most significant change is to state that preparation of a client's financial statements in their entirety using a client's trial balance or underlying accounting records *automatically* creates *significant* threats to independence for which safeguards must be applied and documented to eliminate or reduce the threat to an acceptable level.

In addition, threats to independence may result from any services related to preparing accounting records and financial statements, such as:

- Recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an entity's general ledger.
- Preparing certain line items or financial statement sections based on trial balance information.
- Posting entries to an audited entity's trial balance that have been approved by management.
- Preparing account reconciliations that identify reconciling items for audited entities to be evaluated by management.

Using professional judgment, auditors should document their evaluation of the significance of threats to independence created when providing these additional services. Safeguards must then be applied to eliminate or reduce significant threats to an acceptable level. An *acceptable level* is defined as a level at which a reasonable and informed third party would likely conclude that an audit organization or auditor is independent. If auditors are unable to document and apply sufficient safeguards, then they should not perform the services.

Factors to consider when evaluating the significance of threats created by providing these services include:

- Whether the outcome of the service could have a material effect on the financial statements.
- The level of subjectivity involved in determining the appropriate amounts or treatment for those matters.
- The extent of the entity's involvement in determining significant matters of judgment.

Examples of safeguards include:

- Consulting an independent third party.
- Involving another firm to perform or re-perform part of the engagement.
- Having an auditor who is not a member of the engagement team review the work performed.
- Removing an auditor from an engagement team when that auditor's financial interests or relationships pose a threat to independence.

Practical Consideration:

A new flowchart has been added as Figure 2 at the end of Chapter 3 of the Yellow Book to illustrate the auditor's consideration of the financial statement preparation threat.

When Is It Effective?

The 2018 Yellow Book is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020, and for performance audits beginning on or after July 1, 2019. Early implementation is *not* permitted.

Auditing Brief

NONATTEST HOSTING SERVICES FAQS. On February 25, 2019, the AICPA updated the frequently asked questions relating to hosting services in its document, Frequently Asked Questions: Nonattest Services. The FAQs are available at **www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/nonattestservicesfaqs.pdf**. That document includes general nonattest services FAQs as well as FAQs on several other specific nonattest services: bookkeeping; controllership; tax; information technology; appraisal, valuation, and actuarial; training; project management; and cybersecurity. The FAQs on hosting services cover topics such as use of a subscription clearinghouse, client access to data or records, and third-party software.

The interpretation on hosting services was issued in August 2017 and was to become effective on September 1, 2018. The AICPA later delayed the effective date to July 1, 2019. The Interpretation issued in August 2017 (with the old effective date) can be found at **www.aicpa.org/interestareas/professionalethics/community/exposuredrafts/downloadabledocuments/2017/2017augustofficialrelease.pdf** and on Checkpoint at **checkpoint.riag.com**.

Elements of Responsible Grant Making

Grant making is a major activity of many exempt organizations. While organizations classified as private foundations have always operated with expenditure responsibilities, many public charitable entities are new to the rules and guidelines of expenditure responsibility. An organization exercises expenditure responsibility if it exerts all reasonable efforts and establishes adequate procedures to—

1. see that the grant is spent solely for the purpose for which it is made,
2. obtain full and complete reports from the grantee on how the funds are spent, and
3. make full and complete reports on the expenditures to the IRS as requested.

The law imposes similar expenditure responsibilities on all organizations organized under IRC Sec. 501(c)(3). In addition, foreign grants require extensive documentation.

Domestic Organizational Grants

Grants issued to domestic recipients should include a pre-grant inquiry (or information-gathering process), monitoring during the grant term, and post-grant procedures.

Pre-grant Inquiry. For grants to U.S.-based organizations, the grant-making organization can complete its pre-grant inquiries with a small amount of effort. The inquiry should at a minimum—

- obtain a copy of the recipient organization's determination letter,
- check the recipient organization's current exempt status through the IRS's Tax Exempt Organization Search (TEOS) feature at **www.irs.gov/**,
- review the recipient organization's most recent Form 990, and
- obtain a written request for the grant that includes the grant's purpose.

In addition, consider reviewing other information, such as financial statements prepared by a certified public accountant, and organizational documents.

Written Agreement. Once the organization selects a grant recipient, it may wish to enter into a formal written grant agreement with the recipient organization. The agreement might include: (1) the grantee's responsibilities, (2) the grantee's reporting requirements to the grantor, (3) the amount of funds to be provided and the schedule of the funds' provision, (4) description of the proposed use of the funds, (5) situations that will cause grant forfeiture, and (6) a provision for unexpended funds.

Grant Monitoring. Often, grants to other organizations recognized as exempt under IRC Sec. 501(c)(3) may not require monitoring (i.e., an operating fund grant). However, if the organization secures the grant for a specific purpose or program, the awarding organization may need to obtain periodic reports on the project's progress, the proposed completion date, and continuing budget projections. The results should be compared with the original information submitted to determine grant compliance.

Post-grant Procedures. The grantor should determine if the grantee met the organization's expectations. Evaluating a grant recipient on a post-grant basis (an important organization best practice) allows the organization to determine if the grantee should be eligible for future grants.

Domestic Individual Grants. The IRS allows organizations to operate programs that benefit a charitable class. This can occur through programs that meet direct needs of individuals (i.e., programs that assist distressed persons by providing assistance with medical expenses, food, and housing). It can also occur through programs that assist with specific purposes such as educational scholarship programs. Documentation is needed to show the expenditures support the exempt purpose. Programs involving payments to individuals should include a detailed plan describing the program and its purpose, details of the qualifications to participate in the program, a completed application to document an individual's qualification for the program, the name and address of the recipient, an acknowledgment of the assistance received by the individual, and provisions to provide privacy assurance to the participants in the program.

Employee Assistance. An organization should determine whether an employee of the organization will be eligible to participate in any individual grant programs when it creates the program. In many instances, grant recipients are not taxed on proceeds from grant programs due to the exclusion of gifts from tax under IRC Sec. 102. However, IRC Sec. 102 does not apply to amounts given to employees.

Qualifying Disaster Exceptions. Under IRC Sec. 139, an employer may make tax-free payments to employees in the event of a qualifying disaster. This exclusion may apply to family members of the employees and major donors as long as the recipient meets a charitable class and are objectively chosen by an independent selection committee. A *qualifying disaster* is defined as a disaster resulting from a terroristic or military action; federally declared disaster; disaster resulting from an accident involving a common carrier, or any other event, as determined by the Secretary to be of a catastrophic nature; or disaster determined by an applicable federal, state, or local authority to warrant assistance.

Foreign Grants

Charitable organizations are required to maintain control over the funds given to foreign organizations and foreign individuals. All organizations, including charities, are prohibited from transacting business or supporting individuals or organizations that either have been identified as terrorists or are suspected of participating in terrorist activities. Both the U.S. Treasury and the U.S. Department of State maintain databases of persons or entities designated as terrorists or suspected terrorists. Organizations should review these lists prior to disbursing funds to foreign nationals or organizations. These lists include—

- Specially Designated Nationals List at **www.treasury.gov/resource-center/sanctions/SDN-List/pages/default.aspx**
- National Surveillance Agency Telephones and Terrorism at **www.nsatt.org**
- Terrorist Exclusion List at **www.state.gov/j/ct/rls/other/des/123086.htm**

For guidance on creating a grant program that includes foreign recipients, nonprofit organizations should review two sources of information provided by the U.S. Department of Treasury.

Best Practices. The first tool is the "U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S. Based Charities" guide. The full text of the publication is located at **www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/guidelines_charities.pdf**. Some of the information that should be collected about a foreign recipient organization (grantee) according to this publication are highlighted as follows.

Information Gathering. The charity should collect the following basic information about a foreign grantee:

1. The grantee's name in English and in the language of origin.
2. The place where the grantee maintains a physical presence.
3. The jurisdiction where the grantee is incorporated or formed and copies of formation documents.
4. The address and phone number of any place of business of the grantee.
5. The principal purpose of the grantee, including a detailed report of their projects and goals.
6. The names and addresses of organizations to which the grantee currently provides or proposes to provide funding, services, or material support, to the extent known.
7. The names and addresses of any subcontracting organizations used by the grantee.
8. Copies of any public filings or releases made by the grantee, including most recent official registry documents, annual reports, and annual filing with the pertinent government, as applicable.
9. The grantee's existing sources of income, such as official grants, private endowments, and commercial activities.

Vetting Potential Recipients. The charity should conduct basic vetting of a foreign grantee:

1. Be able to demonstrate that it conducted a reasonable search of public information to determine whether the grantee is or has been implicated in any questionable activity.
2. Be able to demonstrate that it verified that the grantee does not appear on any list of the U.S. government, United Nations, or European Union identifying it as having links to terrorism or money laundering.
3. Obtain the full name (in English as well as native language) as well as nationality, citizenship, current country of residence, and place and date of birth for key employees at the grantee's principal place of business.
4. Require grantees to certify that they do not employ or deal with any entities or individuals on the lists referenced previously, or with any entities or individuals known to the grantee organization to support terrorism.

Review Financial Operations. The charity should review the financial operations of the foreign grantee:

1. Require periodic reports from the grantee on its operational activities and use of the disbursed funds.
2. Require the grantee to undertake reasonable steps to ensure that funds provided by the charity are not ultimately distributed to terrorist organizations. Periodically, the grantee should inform the charity of the steps it has taken to meet this goal.
3. The charity should perform routine, on-site audits of grantees whenever possible, consistent with the size of the disbursement and the cost of the audit.

Risk Matrix. The second tool that the U.S. Treasury has issued to assist U.S. charities in assessing potential foreign grant recipients is a risk matrix. The matrix table can be found at **www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/charity_risk_matrix.pdf.**

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Practical Consideration:

An organization with strong governance creates policies, systems, and procedures for making pre-grant inquiries, grant monitoring, post-grant reporting, and compliance with required reporting. Conducting operations in other countries without structures, policies, and procedures designed to address the concerns of the U.S. government can result in increased scrutiny of the U.S. organization.

Excessive Compensation Tax Trap

The February 2019 issue of this newsletter included an overview of the interim guidance provided by Notice 2019-9 (2019-4 IRB 403) regarding the Section 4960 excise tax enacted by the 2017 Tax Cuts and Jobs Act. Recall that the 21% excise tax is imposed on *applicable tax-exempt organizations* (ATEOs) or a related organization paying remuneration of more than $1 million and any excess parachute payments to *covered employees*. In identifying the five highest-compensated (covered) employees, the ATEO must include remuneration paid for the tax year by any *related organization*, including that paid by a related for-profit organization for services performed as an employee of such related organization. (The italicized terms are defined in the February article.)

Beware of Donated Employees and Board Members

Sometimes highly-compensated employees of taxable entities, compensated by a related taxable organization, serve as unpaid officers and directors of an ATEO. For example, a taxable corporation's employee serves as an uncompensated director of a related private foundation. Recently, the IRS informally indicated that these ATEOs could incur Section 4960 excise taxes even if they paid no compensation to the employees and directors supplied and the individuals were entirely compensated by the related taxable entity. This seems odd for a tax that was primarily designed to apply to large amounts of compensation paid by ATEOs.

Perhaps the excessive compensation of a taxable entity being subjected to the Section 4960 excise tax is an unintended consequence. The IRS has informally acknowledged that Notice 2019-9, which provides interim guidance (including 39 questions and answers) on the excise tax, did not clarify that the statutory provisions under IRC Sec. 3401 should apply to defining an employee.

A Covered Employee Forevermore

Once an employee is a covered employee, the employee continues to be covered for all subsequent tax years. There is no minimum dollar threshold for an employee to be a covered employee. Consequently, an employee can be a covered employee in the current year even though not paid excess remuneration or an excess parachute payment or not be highly compensated under IRC Sec. 414(q) (Notice 2019-9, Q&A 9).

IRS May Address Issue

A spokesperson for the IRS recently commented that they are looking at this issue and hope to provide additional guidance soon.