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Noncompliance with ERC Eligibility Requirements
Accounting & Auditing Considerations

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As practitioners conduct their audit engagements, some are concluding that certain clients were not eligible for, or eligibility was questionable for, employee retention credits (ERCs). Social media anecdotes (examples: here and here), which are consistent with those seen by and independently reported to CPEA staff, indicate that entities are being approached by tax credit companies with aggressive positions in which "virtually every business" under 500 employees is eligible to claim the ERC. Some tax credit companies charge a fee of 20% of the ERC. Others note that "while the ERC is a powerful means to provide relief to employers who have been impacted by COVID-19, it should not be misconstrued as being universally available." Large ERC claims, conflicting interpretations, and financial motivations have created a combustible recipe for disagreements and conflict.

In this report, we address the related accounting and auditing implications and responsibilities. This report addresses situations where management's noncompliance with ERC regulations is not the result of fraudulent activity.[1] It should be noted that an in-depth analysis of the tax laws and regulations for the ERC is beyond the scope of this report but may be necessary to make the judgments discussed herein. Practitioners should consult appropriate tax personnel to inform the accounting and auditing judgments regarding ERC tax laws and regulations.

Regulations put in place to ensure proper use of the funding provided by ERCs can be complex, including the definition of full-time equivalent, eligible wages, and interaction with other COVID-19 relief programs. The complexity of these regulations, combined with the fact that claims for ERCs were submitted quickly with accounting staff working remotely for the first time, may have led to a heightened risk of inadvertent noncompliance

[1] ERCs claimed by entities are subject to IRS audit until the statute of limitations expires.

with regulations. Further, ERC claims generally are not scrutinized prior to payment. This contrasts with the PPP loan forgiveness process. Many firms have responded to this heightened risk on audit engagements with specific procedures. For example, firms have adopted quality control procedures (e.g., required consultation) related to funding received from government assistance programs. Also, many firms, through their risk assessment procedures, have identified funding received from government assistance programs as areas that warrant additional audit scrutiny and procedures, such as eligibility testing.

When an auditor identifies situations where it appears that the regulations related to ERCs were not complied with, such as eligibility requirements, that noncompliance may be material to the financial statements. Auditors would need to evaluate possible accounting misstatements and noncompliance with laws and regulations.

Accounting Implications

If an auditor believes that an entity failed to meet, or is uncertain if the entity met, the regulations related to the ERC program, such as eligibility requirements, the noncompliance may indicate the accounting for the amounts recognized from the program may be misstated and material to the financial statements. Refer to the our CPEA report, *Employee Retention Credit: Financial Reporting & Disclosure Examples*, for guidance on the accounting for ERCs.

As described in that report, entities have options when it comes to accounting for ERCs, as indicated below:

ERC Accounting

Depending on whether an entity is a for-profit or not-for-profit (NFP), the following models can be used to account for ERCs:

- FASB ASC 958-605, *Not-for-Profit Entities: Revenue Recognition*
- International Accounting Standard (IAS) 20, *Accounting for Government Grants and Disclosure of Government Assistance*
- FASB ASC 450-30, *Contingencies: Gain Contingencies* (However, we generally do not feel the FASB ASC 450-30 gain contingency model is a preferred accounting policy for the ERC.)

Retroactive Application of the ERC to 2020 (2020 periods only)

As previously indicated in our ERC report referenced above, the CPEA believes that the accounting for retroactively applying the ERC to 2020 involves different accounting compared to prospective accounting of the ERC. We stress that this position only applies to 2020 periods. At that time, until enactment of the Consolidated Appropriations Act

(CAA) on December 27, 2020, ERC claims where not permitted if PPP loans were received. The CAA retroactively permitted qualifying entities to take ERC and have a PPP loan. We believe that the recovery of amounts previously paid and expensed to an employee (with no expectation of recovery at the time) is best analogized a loss recovery. Prevailing practice in financial reporting for a loss recovery is to use guidance in FASB ASC 410, *Asset Retirement and Environmental Obligations*, specifically FASB ASC 410-30-35-8, which indicates that a claim for recovery should be recognized only when the claim is probable as it is defined in FASB ASC 450, *Contingencies*, more specifically in FASB ASC 450-20-25-1. Accordingly, if an entity feels that it is probable that it is entitled to recover amounts previously paid in 2020 via the ERC, then the entity should recognize a receivable for amounts to be received for the amounts paid in 2020 to be recovered via the ERC. Any uncertainties related to qualifying for the ERC should be assessed as to whether the claim for the credit is probable.

As for income statement presentation, we believe that either classifying the amounts as a reduction to payroll tax expense or as other income would be acceptable with appropriate disclosure of the election made by management. Our review of recent public entity filings indicates that more public entities are crediting the associated expense rather than recognizing the amounts on a separate line item.

Accounting Under the FASB ASC 958-605 (Conditional Contribution) Model & the IAS 20 Model

Entities that apply a FASB ASC 958-605 model to accounting for ERCs recognize the related revenue (credits) when conditions (barriers) are substantially met (overcome) by the entities. Under the IAS 20 model, entities recognize revenue (credits) when there is reasonable assurance (similar to the "probable" threshold in U.S. generally accepted accounting principles) that (1) any conditions attached to the program will be met and (2) the revenue (credits) will be received. NFP entities are not able to use the IAS 20 model for transactions that are within the scope of FASB ASC 958-605.

If the auditor determines that an entity failed to meet eligibility requirements related to ERCs or failed to meet other conditions of the program, a misstatement in recognizing the related revenue (credits) may have occurred because the conditions were not substantially met (FASB ASC 958-605 model) or reasonable assurance that the conditions would be met was lacking (IAS 20 model). Under the FASB ASC 958-605 model, if conditions have not been substantially met and amounts received, the ERC should be accounted for as a refundable advance (liability) (FASB ASC 958-605-25-5F). Under the IAS 20 model, if reasonable assurance does not exist that the conditions have been met (or will be met), the ERC amounts received should be accounted for as a refundable advance as well. Based on our understanding of the current IRS process for

ERC claims, receipt of the funds for ERC may not be sufficient to alleviate the uncertainty of compliance.

Addressing Uncertainties

In some cases, noncompliance with ERC regulations/eligibility requirements may be clear to the auditor. In other cases, the auditor may be uncertain about whether noncompliance exists. Disagreements with management may occur when evaluating whether an entity complied with ERC regulations. These uncertainties should be resolved through application of the recognition threshold of the applicable accounting model, either IAS 20 (reasonable assurance) or FASB ASC 958-605 (conditions substantially met). Those models require the exercise of considerable judgment at times in determining whether conditions are substantially met (FASB ASC 958-605) or whether reasonable assurance exists that the conditions will be met (IAS 20). We note any uncertainties will need to clear a significant bar to be recognized since the recognition threshold of either IAS 20 or FASB ASC 958-605 is high. Finally, entities and their auditors should reevaluate judgments (including estimates and whether positions remain uncertain) at each financial reporting date for new developments including new regulatory interpretations and case law.

Evaluation and Implications of Misstatements

If noncompliance with ERC program requirements result in misstatements in the financial statements, auditors should follow the requirements in AU-C 450, *Evaluation of Misstatements Identified During the Audit*. Based on the requirements of AU-C 450, the auditor may need to:

- Determine whether the overall audit strategy and audit plan need to be revised
- Communicate with the appropriate level of management
- Determine whether the misstatements remain, if management corrects them
- Obtain an understanding of management's reasons for not correcting the misstatements and take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement
- Reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results
- Determine whether uncorrected misstatements are material

Practice Note: Auditors also should be aware of any responsibilities under the AICPA's *Code of Conduct*. At its February 2022 meeting, the Professional Ethics Executive Committee (PEEC) adopted a new Interpretation, *Responding to Noncompliance With Laws and Regulations,* (ET sec. 1.170.010 and 2.170.010) under the *Integrity and Objectivity Rule* (ET sec. 1.100.001 and 2.100.0010). Notice of the new interpretation will

appear in the Journal of Accountancy online in June 2022. The new interpretation is effective June 30, 2023, and early implementation is allowed.

Recognition of a Liability When an Entity is Determined to be Ineligible for ERCs Previously Received

Noncompliance with ERC regulations may result in repayment of amounts received and fines. The IRS can audit entities' eligibility for ERCs in the future and seek return of the related amounts. The American Rescue Plan Act of 2021 (ARPA) extended the statute of limitations for the IRS to audit ERC claims to five years. The normal period is three years, and this extension may indicate that the IRS intends to pursue a more rigorous enforcement approach regarding the ERC program. News reports indicate that the IRS will train agents to audit ERCs by March, with audits beginning afterwards. Auditors may wish to obtain legal advice about the consequences of noncompliance and governmental audits. The CPEA is of the opinion that ineligibility for ERCs generally indicate that a legal liability for the amounts received exists. Additionally, disclosure of the liability and a description of the related circumstances may be warranted.

CPEA Position – Ineligible ERC Recipient Liability is Not a Contingent Liability

The likelihood of payment or likelihood of a governmental authority pursuing an enforcement action does not factor into the determination of whether a liability exists if settlement is required by law or regulation (no uncertainty exists). No contingency is present because the obligating event (noncompliance with the eligibility requirements) has taken place. As such, we do not believe that a liability generally would be considered a loss contingency under FASB ASC 450-20, *Contingencies: Loss Contingencies*, if regulations make it clear that no uncertainty exists about the fact that the IRS can demand repayment of ERCs when noncompliance with related regulations is determined. In other words, if it has been determined that the entity was not eligible for ERC and no uncertainty exists that the IRS can demand repayment of ERCs claimed by ineligible entities, the liability is not a contingent liability.

Derecognition of ERC Liability for Ineligible Recipient

In accordance with FASB ASC 405-20, *Liabilities: Extinguishments of Liabilities*, specifically FASB ASC 405-20-40-1, the liability for the ERCs owed would be derecognized if and only if it has been extinguished. A liability is extinguished when either the debtor pays the creditor and is relieved of its obligation or the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. Generally, this would occur when the entity pays back the ERCs it received and was ineligible for, or when the statute of limitations expires, or when the IRS upholds the ERC claim upon examination.

Further Auditing Implications

Compliance with laws and regulations fall under AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. AU-C 250.02 indicates “The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements.…Noncompliance with laws and regulations may result in fines, litigation, or other consequences for the entity that may have a material effect on the financial statements.”

> Noncompliance is defined as “Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.” (AU-C 250.11)

When auditors become aware of noncompliance or suspected noncompliance with regulations related to ERCs, he or she should obtain further information to evaluate the possible effect on the financial statements (AU-C 250.17). In addition, the auditor should discuss the matter with management (at a level above those involved with the suspected noncompliance, if possible) and, when appropriate, those charged with governance (TCWG). If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with the relevant regulations and, in the auditor’s professional judgment, the effect of the suspected noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice (AU-C 250.18).

Procedures When Noncompliance Is Identified or Suspected

If sufficient information about suspected noncompliance cannot be obtained, the auditor should evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor’s opinion. Also, the auditor should evaluate the implications of noncompliance in relation to other aspects of the audit, including the auditor’s risk assessment and the reliability of written representations, and take appropriate action (AU-C 250.19-20)

Reporting Noncompliance to TCWG

Unless all of TCWG are involved in management of the entity and aware of identified or suspected noncompliance with ERC regulations already communicated by the auditor, the auditor should communicate with TCWG matters involving noncompliance with the

regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential. If, in the auditor's professional judgment, the noncompliance is believed to be intentional and material, the auditor should communicate the matter to TCWG as soon as practicable. If the auditor suspects that management or TCWG are involved in noncompliance, the auditor should communicate the matter to the next higher level of authority at the entity, if it exists. When no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure about the person to whom to report, the auditor should consider the need to obtain legal advice about options and next steps (AU-C 250.21-23).

Reporting Noncompliance in the Auditor's Report on the Financial Statements

If the auditor concludes that the noncompliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor should, in accordance with AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, express a qualified or adverse opinion on the financial statements (AU-C 250.24).

If the auditor is precluded by management or TCWG from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit, in accordance with AU-C 705 (AU-C 250.25).

If management or TCWG refuse to accept a modified opinion on the financial statements, the auditor may withdraw from the engagement, when withdrawal is possible under applicable law or regulation, and indicate the reasons for withdrawal in writing to TCWG (AU-C 250.A27).

If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by management or TCWG, the auditor should evaluate the effect on the auditor's opinion, in accordance with AU-C 705 (AU-C 250.26).

Finally, in September 2020, the CPEA issued a report titled, *Auditing PPP Loans*. While not focused on ERCs, elements of the report may be helpful to auditors addressing ERCs.

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