



# ACCOUNTING

CONTINUING EDUCATION

Accounting and Auditing Update  
(AAU4)



# Accounting and Auditing Update

(AAU4)

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ACCOUNTING AND AUDITING UPDATE (AAU4)

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# Unit

# 1

## FASB Update

### LEARNING OBJECTIVE

*After completing this unit, participants will be able to:*

- › Apply recently issued Accounting Standard Updates (ASUs)

### INTRODUCTION

This section reviews ASUs issued in 2020, and those issued in 2021 to the date of writing this program.

The purpose of this section is to provide an overview of the more recently issued ASUs such that if participants have to apply these new standards, you will have a foundation sufficient to understand the accounting and/or disclosure issues and the reference sources for the material. The beginning of this section also includes FASB's Technical Agenda to enable you to anticipate the new ASU topics that will be issued in 2021 and beyond.

### FASB's TECHNICAL AGENDA

FASB's Technical Agenda is organized by project in five different areas:

- Framework Projects
- Recognition and Measurement: Broad Projects
- Recognition and Measurement: Narrow Projects
- Presentation and Disclosure Projects
- Research Projects

As of March 1, 2021, the following are topics included in each of the five project areas.

## Framework Projects

Framework projects are designed to improve FASB's basis or foundation for developing future accounting standards.

- *Conceptual Framework: Elements*—such as definitions of assets, liabilities, revenues, expenses, gains, and losses
- *Conceptual Framework: Measurement*—such as for initial measurement as well as the costs recognized at initial measurement
- *Conceptual Framework: Presentation*—such as the nature and type of information that should be included in financial statements

## Recognition and Measurement: Broad Projects

Recognition and measurement projects are designed to identify the criteria, timing, and financial statement elements and the criteria necessary for measuring these elements initially and subsequently.

- *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*—The objective of this project is to revisit the subsequent accounting for goodwill and identifiable intangible assets broadly for all entities.

## Recognition and Measurement: Narrow Projects

Due to the narrow nature of these projects, only their titles are listed here.

- *Accounting by a Joint Venture for Nonmonetary Assets Contributed by Investors*
- *Codification Improvements*
- *Codification Improvements—Amendments to Remove References to the Concepts Statements*
- *Codification Improvements —Financial Instruments—Credit Losses*
- *Codification Improvements—Hedge Accounting*
- *Consolidation of a Not-for-Profit Entity by a For-Profit Sponsor*
- *Consolidation Reorganization and Targeted Improvements*
- *Distinguishing Liabilities from Equity Phase 2*
- *Effects of Underwrite Restrictions on Fair Value Measurements*
- *Goodwill—Triggering Event Assessment Alternative for Private Companies and Not-for-Profit Entities*

- *Hedging—Last of Layer Method*
- *Improving the Accounting for Asset Acquisitions and Business Combinations*
- *Issuer’s Accounting for Certain Modifications of Freestanding Equity Classified Forwards and Options (EITF 19-C)*
- *Leases—Targeted Improvements*
- *PCC Issue No. 2018-01, Practical Expedient to Measure Grant-Date Fair Value of Equity-Classified Share-Based Awards*
- *Recognition and Measurement of Revenue Contracts with Customers Under Topic 805*
- *Revenue Recognition—Contract Modifications of Licenses of Intellectual Property (EITF 19-B)*

## **Presentation and Disclosure Projects**

Presentation and disclosure projects are designed to improve the effectiveness of disclosures based on the issuance of Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 8, Notes to Financial Statements*.

- *Disclosure Framework: Disclosure Review —Income Taxes*
- *Disclosure Framework: Disclosure Review—Inventory*
- *Disclosure Framework: Disclosures—Interim Reporting*
- *Disclosure Improvements in Response to the SEC’s Release on Disclosure Update and Simplification*
- *Disclosure of Supplier Finance Programs Involving Trade Payables*
- *Disclosures About Business Entities About Government Assistance*
- *Financial Performance Reporting—Disaggregation of Performance Reporting*—The objective of this project is to improve the decision-usefulness of the income statement through the disaggregation of performance information.
- *Simplifying the Balance Sheet Classification of Debt*—The objective of this project is to provide guidance that will reduce the cost and complexity of determining the current versus noncurrent balance sheet classification of debt.

## **Research Projects**

The following research projects are in various stages of completion:

- Accounting for the Disclosure of Intangibles

- Agenda Consultation
- Effect of Sales Restrictions on Fair Value Measurements
- Financial Performance Reporting: Financial Statements of Not-for-Profit Entities
- Hedge Accounting—Phase 2
- Targeted Improvements to the Statement of Cash Flows

## **FASB UPDATE - 2021**

### **ASU 2020-01, *INVESTMENTS-EQUITY SECURITIES (TOPIC 321), INVESTMENTS—EQUITY METHOD AND JOINT VENTURES (TOPIC 323), AND DERIVATIVES AND HEDGING (TOPIC 815)— CLARIFYING THE INTERACTIONS BETWEEN TOPIC 321, TOPIC 323, AND TOPIC 815***

#### ***Objective***

Clarify the interaction between accounting standards related to equity securities, equity method investments, and certain derivatives due to the issuance of ASU 2016-01, *Financial Instruments-Overall* (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*.

#### ***Background***

In 2016, FASB issued ASU 2016-01, which added a new Codification Topic—Topic 321, Equity Securities, and made targeted improvements to address certain aspects of financial instruments. As noted by FASB, among other changes made by the ASU, the ASU permitted a reporting entity with the ability to measure certain equity securities without a readily determinable fair value at cost, minus impairment, if any, unless an observable transaction for an identical or similar security occurs (a measurement alternative). FASB concluded that it should clarify how this guidance should interact with equity method investments.

FASB was also asked whether certain forward contracts and purchased options to purchase securities that, upon settlement or exercise, would be accounted for under the equity method of accounting should be accounted for in accordance with Topic 321, 323, or 815. These forward contracts and purchased options do not meet the criteria for derivative accounting in Topic 815 and do not represent in-substance common stock within the scope of Topic 323.

**NOTE:** Topic 815 only applies to forward contracts and purchased options having all of the following characteristics:

- The contract is intended to purchase securities that will be accounted for under either Topic 320, *Investments-Debt and Equity Securities*, or Topic 321.
- The contract's terms require physical settlement of the contract by delivery of the securities.

- The contract is not a derivative instrument otherwise subject to the guidance in Topic 815.
- The contract, if a purchased option, has no intrinsic value at acquisition.

## ***Provisions***

### *Issue 1: Accounting for Certain Equity Securities Upon the Application or Discontinuation of the Equity Method of Accounting*

ASU 2020-01 clarifies that a reporting entity **should consider observable transactions** that require the reporting entity to either apply or discontinue the equity method of accounting under Topic 323, *Investments-Equity Method and Joint Ventures*, for the purposes of applying the measurement alternative in accordance with Topic 321, *Investments-Equity Securities*, immediately before applying or upon discontinuing the equity method.

The ASU notes the following: *The current basis of the investor's previously held interest in the investee should be re-measured in accordance with Topic 321 immediately before adopting the equity method. For an investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or similar investment of the same issuer that results in it applying Topic 323, the reporting entity should re-measure its previously held interest at fair value immediately before applying Topic 323.*

### *Issue 2: Scope Considerations for Forward Contracts and Purchased Options on Certain Securities*

ASU 2020-01 also clarifies that, when determining the accounting for certain forward contracts and purchased options, a reporting entity **should not consider**, whether upon settlement or exercise of the purchased option, individually or with existing investments, the underlying securities would be accounted for under 1) the equity method in Topic 323 or 2) the fair value option in Topic 825, *Financial Instruments*, if those securities otherwise would have been accounted for under Topic 323. A reporting entity should evaluate the remaining characteristics in Topic 815 to determine the accounting for those forward contracts and purchased options.

## ***Transition and Effective Date***

ASU 2020-01 is effective for public business entities for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years.

For all other reporting entities, ASU 2020-01 is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.

Early adoption is permitted.

**ASU 2020-02, FINANCIAL INSTRUMENTS—CREDIT LOSSES (TOPIC 326) AND LEASES (TOPIC 842)—AMENDMENTS TO SEC PARAGRAPHS PURSUANT TO SEC STAFF ACCOUNTING BULLETIN NO. 119 AND UPDATE TO SEC SECTION ON EFFECTIVE DATE RELATED TO ACCOUNTING STANDARDS UPDATE NO. 2016-02, LEASES (TOPIC 842)**

***Objective***

SAB No. 119 was issued to align the staff's interpretations and practices followed by the staffs of the Division of Corporate Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws in the areas of financial instruments—credit losses and leases.

***Background***

In November 2019, the SEC issued Staff Accounting Bulletin No. 119. This staff accounting bulletin updates portions of the interpretive guidance included in the Staff Accounting Bulletin Series to align the staff's guidance with the FASB's Accounting Standards Codification, *Financial Instruments—Credit Losses* (Topic 326).

In addition, in December 2019, the SEC announced transition guidance for certain entities when applying for the first time ASU 2016-02, *Leases*.

***Provisions***

SAB 119 codifies the following credit loss topics from Topic 326 in the "S" section of FASB's Codification:

- Measuring current expected credit losses
- Development, governance, and documentation of a systematic methodology for determining its allowance for credit losses
- Documenting the results of a systematic methodology
- Validating a systematic methodology

In addition, ASU 2020-02 incorporates an SEC staff announcement related to lease accounting for certain SEC registrants. This announcement is as follows:

At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting Topic 842, *Leases*, for fiscal years beginning after December 15, 2020, and interim periods

within fiscal years beginning after December 15, 2021. These dates are consistent with the effective dates for Topic 842 as amended in ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*.

**NOTE:** A public business entity is defined by FASB in ASU 2013-12 as a business entity meeting any one of the following criteria. Neither a not-for-profit entity nor an employee benefit plan is a business entity:

- It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (e.g., interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

### ***Transition and Effective Date***

ASU 2020-02 is effective upon issuance.

## **ASU 2020-03, *CODIFICATION IMPROVEMENTS TO FINANCIAL INSTRUMENTS***

### ***Objective***

To clarify or improve the FASB Codification in the area of financial instruments to make the Codification easier to understand and easier to apply by eliminating inconsistencies and providing clarifications.

## ***Background***

Similar to prior Codification Improvement ASUs, ASU 2020-03 improves the FASB Codification in the areas of financial instruments for items brought to FASB's attention by stakeholders.

## ***Provisions***

### *Issue 1: Fair Value Option Disclosures*

Stakeholders questioned whether reporting entities other than public business entities are required to provide the fair value option disclosures in Topic 825 (825-10-50-24 through 50-32). ASU 2020-03 clarifies that all reporting entities are required to provide the fair value option disclosures in Topic 825. These disclosures are as follows:

- Information to enable users of its financial statements to understand management's reasons for electing or partially electing the fair value option
- Information to enable users to understand how changes in fair values affect earnings for the period
- The same information about certain items (such as equity investments and nonperforming loans) that would have been disclosed if the fair value option had not been elected
- Information to enable users to understand the differences between fair values and contractual cash flows for certain items.

As of each date for which a **balance sheet** is presented, entities should disclose all of the following:

- Management's reasons for electing a fair value option for each eligible item or group of similar eligible items
- If the fair value option is elected for some but not all eligible items within a group of similar eligible items, both of the following are required:
  - A description of those similar items and the reasons for partial election
  - Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position
- For each line item in the balance sheet that includes an item or items for which the fair value option was elected, both of the following are required:
  - Information to enable users to understand how each line item in the balance sheet relates to major classes of assets and liabilities presented in accordance with the fair value disclosure requirements of Topic 820

- The aggregate carrying amount of items included in each line item in the balance sheet that are not eligible for the fair value option, if any
- The difference between the aggregate fair value and the aggregate unpaid principal balance of each of the following:
  - Loans and long-term receivables (other than securities subject to Topic 320) that have contractual principal amounts and for which the fair value option has been elected
  - Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected
- For loans held as assets for which the fair value option has been elected, all of the following are required:
  - The aggregate fair value of loans that are 90 days or more past due
  - If the entity’s policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in nonaccrual status
  - The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in nonaccrual status, or both
- For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, the information required by Topic 323, *Investments-Equity Method and Joint Ventures*.

For each period for which an **income statement** is presented, reporting entities should disclose all of the following about items for which the fair value option has been elected:

- For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported. This subtopic does not preclude an entity from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains and losses for other items measured at fair value, such as items required to be measured at fair value.
- A description of how interest and dividends are measured and where they are reported in the income statement. This subtopic does not address the methods used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option was elected.
- For loans and other receivables held as assets, both of the following are required:
  - The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk

- How the gains or losses attributable to changes in instrument-specific credit risk were determined
- For liabilities, all of the following about the effects of the instrument-specific credit risk and changes in it:
  - The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk
  - How the gains and losses attributable to changes in instrument-specific credit risk were determined
  - If a liability is settled during the period, the amount, if any, recognized in other comprehensive income that was recognized in net income at settlement

### Other Required Disclosures

In annual periods only, a reporting entity should disclose the methods and significant assumptions used to estimate the fair value of items for which the fair value option was elected.

#### *Issue 2: Applicability of Portfolio Exception in Topic 820, Fair Value Measurement, to Nonfinancial Items*

A reporting entity that holds a group of financial assets and financial liabilities is exposed to market risks and to the credit risk of each counterparty. If certain Topic 820, *Fair Value Measurement*, conditions are met, a reporting entity is permitted to measure the fair value of a group of financial assets and financial liabilities with offsetting risk positions on the basis of their net exposure. This is called a **portfolio exception**.

Topic 820 is amended to include nonfinancial items accounted for as derivatives can apply this portfolio exception.

#### *Issue 3: Disclosures for Depository and Lending Institutions*

ASU 2020-03 clarifies that the disclosure requirements in Topic 320, *Investments-Debt and Equity Securities*, apply to the disclosure requirements in Topic 942, *Financial Services, Depository and Lending*.

#### *Issue 4: Cross-Reference to Line-of-Credit or Revolving-Debt Arrangements Guidance in Subtopic 470-50, Debt: Modifications and Extinguishments*

ASU 2020-03 provides this cross-reference.

#### *Issue 5: Cross-Reference to Net Asset Value Practical Expedient in Subtopic 820-10, Fair Value Measurement: Overall*

ASU 2020-03 adds a cross-reference to explain that the disclosure requirements in Topic 820 do not apply to reporting entities using the net asset value per share practical expedient.

*Issue 6: Interaction of Topic 842, Leases, and Topic 326, Financial Instruments–Credit Losses*

ASU 2020-03 clarifies that the contractual term of a net investment in a lease determined in accordance with Topic 842 should be the contractual term used to measure expected credit losses under Topic 326.

*Issue 7: Interaction of Topic 326, Financial Instruments–Credit Losses, and Subtopic 860-20, Transfers and Servicing: Sales of Financial Assets*

ASU 2020-03 clarifies that when a reporting entity regains control of financial assets sold, an allowance for credit losses should be recorded following the guidance in Topic 326.

***Effective Date***

Issues 1, 2, 4, and 5 are effective for public business entities upon issuance of ASU 2020-03. For all other reporting entities, ASU 2020-03 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years beginning after December 15, 2020. Early application is permitted.

Issues 3, 6, and 7 are effective consistent with the effective dates for ASU 2016-13, *Credit Losses*.

***ASU 2020-04, REFERENCE RATE REFORM (TOPIC 848): FACILITATION OF THE EFFECTS OF REFERENCE RATE REFORM ON FINANCIAL REPORTING***

***ASU 2021-01, REFERENCE RATE REFORM (TOPIC 848): SCOPE***

***Objectives***

To provide temporary optional guidance to ease the potential burden in accounting for reference rate reform.

***Background***

FASB has issued this ASU in response to concerns about structural risks (risks that are a cost of doing business—they are out of an entity’s control) of interbank offered rates (IBORs), and, particularly, the risk of cessation of the London Interbank Offered Rate (LIBOR). Regulators in several jurisdictions around the world have undertaken reference rate reform initiatives to identify alternative reference rates that are more observable or transaction-based and less susceptible to manipulation.

FASB notes that LIBOR transition is impacted by the significant volume of outstanding contracts and other arrangements, such as debt agreements, lease agreements, and derivative instruments,

which will be modified to replace references to discontinued rates with references to replacement rates. For accounting purposes, these contract modifications must be evaluated to determine whether these modifications result in the **establishment of new contracts or the continuation of existing contracts**.

In addition, users indicated that changes in a reference rate could disallow the application of certain hedge accounting guidance, and certain hedge relationships may not qualify as highly effective during the period of the marketwide transition to a replacement rate. The inability to apply hedge accounting because of reference rate reform could result in financial reporting outcomes that do not reflect reporting entities' intended hedging strategies.

**NOTE:** The SEC's Division of Corporate Finance issued a statement on LIBOR transition in August 2019 noting that the anticipated LIBOR discontinuation could trigger a need for market participants to provide disclosures under different SEC rules and regulations, including those addressing risk factors, MD&A, board risk oversight, and financial statements. All reporting entities should assess their potential risk exposures because those that are counterparties to LIBOR-linked contracts could be affected by this LIBOR transition.

### ***Provisions—ASU 2020-04***

ASU 2020-04 provides optional guidance for a limited period (for contract modifications made through December 31, 2022) to ease the potential burden in accounting for (or recognizing the effects of) reference rate reform on financial reporting.

ASU 2020-04 provides **optional expedients and exceptions** for applying GAAP to contract modifications and hedging relationships, subject to meeting certain criteria that reference LIBOR or another rate that is expected to be discontinued. If a debt agreement or lease agreement has to be changed to use a new interest rate, the modification would be accounted for as a continuation of the contract rather than the establishment of a new contract.

Hedge accounting would be preserved when the contract is modified, and reporting entities would not have to recreate certain contracts like forwards or swaps tied to LIBOR to determine whether applying a new interest rate disqualifies them from hedge accounting treatment.

ASU 2020-04 includes a general principle that applies to FASB Codification topics permitting reporting entities to

- consider modification of contracts or agreements due to reference rate reform to be a continuation of these contracts, and
- not have to reassess previous determinations.

Specifically, the following optional expedients are available to reporting entities:

- Modifications of contracts within the scope of Topics 310, Receivables, and 470, Debt, should be accounted for by prospectively adjusting the effective interest rate in the contract

- Modifications of contracts within the scope of Topic 842, Leases, should be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and the discount rate or remeasurements of lease payments that otherwise would be required under those topics for modifications not accounted for as a separate contract
- Modifications of contracts do not require a reporting entity to reassess its original conclusion about whether that contract contains embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract following the guidance in Topic 815, Derivatives and Hedging

ASU 2020-04 also provides exceptions to the guidance in Topic 815 related to changes to the critical terms of a hedging relationship due to reference rate reform when certain criteria are met.

### ***Provisions—ASU 2021-01***

Derivative instruments that use certain interest rate indexes for determining variable cash flows and for valuation and other purposes are also transiting to alternative reference rates. Changes in interest rates used for margining, discounting, or contract-price alignment for derivative instruments are being implemented as part of the marketwide transition to new reference rates—Discounting Transition. ASU 2021-01 clarifies the scope of Topic 848 to explain that derivatives affected by the discounted transition are explicitly eligible for certain optional expedients and exceptions established in Topic 848.

Furthermore, FASB clarified that a receive-variable-rate, pay-variable-rate cross currency interest rate swap may be considered an eligible hedging instrument in a net investment hedge if both legs of the swap do not have the same repricing intervals and dates as a result of reference rate reform.

### ***Effective Date and Transition***

ASU 2020-04 is effective for all reporting entities upon issuance.

## ***ASU 2020-05, REVENUE FROM CONTRACTS WITH CUSTOMERS (TOPIC 606) AND LEASES (TOPIC 842): EFFECTIVE DATES FOR CERTAIN ENTITIES***

### ***Objectives***

Due to the current COVID-19 pandemic adversely impacting businesses and economic conditions, FASB issued this ASU to support and assist stakeholders during this difficult time.

### ***Provisions***

ASU 2020-05 provides a limited deferral of the effective dates of the following ASUs to provide immediate, near-term, relief for certain reporting entities for whom these ASUs are either currently effective or soon to be effective:

- ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, as amended
- ASU 2016-02, *Leases (Topic 842)*, as amended

ASU 2020-05 defers, for one year, the required effective date of Topic 606 for certain reporting entities who have not yet issued their financial statements reflecting the adoption of Topic 606. These reporting entities may elect to adopt Topic 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020.

ASU 2020-05 defers, for one year, reporting entities that are nonpublic and public not-for-profit reporting entities that have not yet issued their financial statements reflecting the adoption of Topic 842. Topic 842 is now effective for nonpublic and public not-for-profit reporting entities for annual reporting periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

## **ASU 2020-06, *DEBT—DEBT WITH CONVERSION AND OTHER OPTIONS (SUBTOPIC 470-20) AND DERIVATIVES AND HEDGING-CONTRACTS IN ENTITY’S OWN EQUITY (SUBTOPIC 815-40): ACCOUNTING FOR CONVERTIBLE INSTRUMENTS AND CONTRACTS IN AN ENTITY’S OWN EQUITY***

### ***Objective***

ASU 2020-06 is part of FASB’s Simplification Initiative designed to make narrow-scope simplifications and improvements and to reduce unnecessary complexity in U.S. GAAP to issued accounting topics through a series of short-term projects. The objective of this ASU is to make targeted improvements to reduce cost and complexity in financial reporting for convertible instruments and contracts in a reporting entity’s own equity.

### ***Background***

As stated by FASB in this ASU:

The Board is issuing this Update to address issues identified as a result of the complexity associated with applying GAAP for certain financial instruments with characteristics of liabilities and equity. Complexity associated with the accounting is a significant contributing factor to numerous financial statement restatements and results in complexity for users attempting to understand the results of applying the current guidance. In addressing this complexity, the Board focused on **amending the guidance on convertible instruments and the guidance on the derivatives scope exception for contracts in an entity’s own equity**.

A convertible instrument is a security that is convertible into another security based on a conversion rate (e.g., convertible preferred stock that is convertible into common stock).

GAAP, before this ASU (Subtopic 505-10), included four accounting models for **convertible preferred stock**. Three of these models include different measurement guidance requiring that the convertible preferred stock be separated—using different separation approaches—into an equity and debt component. The four models in Topic 505-10 were:

- *Traditional Convertible Preferred Stock*—There is no separation; the entire instrument is carried at historical cost in paid-in-capital.
- *Convertible Preferred Stock with an Embedded Derivative*—The embedded derivative is recognized at fair value as a liability and the remainder is allocated paid-in-capital.
- *Convertible Preferred Stock With Beneficial Conversion Feature*—A beneficial conversion feature is recognized separately initially at its intrinsic value and allocated to paid-in-capital while the remainder is allocated to the host contract in equity. Intrinsic value is calculated at the commitment date as the difference between the conversion price and the fair value of the common stock or other securities that the security is convertible, multiplied by the number of shares into which the security is convertible.
- *Mandatorily Redeemable Preferred Stock*—Accounted for as convertible debt (single liability) with a cash conversion feature.

GAAP, before the ASU (Subtopic 470-20), included five accounting models for **convertible debt instruments**. Four of these models include different measurement guidance requiring that the convertible debt instrument be separated—using different separation approaches—into a debt component and an equity or derivative component. The five models in Topic 470-20 were:

- *Traditional Convertible Debt*—Debt and equity are not separated and all proceeds are recorded as debt
- *Convertible Debt Instruments Issued With Substantial Premiums for Which the Premiums are Recorded as Paid-in-Capital*—Debt is measured at its principal amount and the remainder is allocated to paid-in-capital
- *Convertible Debt Instruments Issued With an Embedded Derivative That is Not Clearly and Closely Related to the Host Contract*—These do not qualify for a scope exception from derivative accounting. The embedded derivative is measured at fair value and the remainder is allocated to the host contract.
- *Convertible Debt Instruments With a Cash Conversion Feature*—The carrying amount of the liability is determined by measuring its fair value without the equity component and the remainder is allocated to equity
- *Convertible Debt Instruments with a Beneficial Conversion Feature*—A beneficial conversion feature is recognized separately initially at its intrinsic value and allocated to paid-in-capital while the remainder is allocated to the host contract. Intrinsic value is calculated at the commitment date as the difference between the conversion price and the fair value of the common stock or

other securities that the security is convertible, multiplied by the number of shares into which the security is convertible.

In addition, ASU 2020-06 amends the guidance for the **derivative scope exceptions** in contracts in an entity's own equity as previously found in Subtopic 815-40-15-3 by deleting subparagraph "a," which stated: *The guidance in this Subtopic does not apply to any of the following: Either the derivative instrument component or the financial instrument if the derivative instrument is embedded in and not detachable from the financial instrument.*

The ASU also addresses whether a freestanding contract in a reporting entity's own equity (normally a warrant) qualifies for a scope exception from derivative accounting.

## **Provisions**

### **Convertible Preferred Stock**

Two of the four models described earlier are eliminated: 3) Convertible Preferred Stock With Beneficial Conversion Feature and 4) Mandatorily Redeemable Preferred Stock.

### **Convertible Debt**

Two of the five models described earlier are eliminated: 4) convertible debt instruments with a cash conversion feature and 5) convertible debt instruments with a beneficial conversion feature. These instruments are now accounted for as a single liability measured at its amortized cost, as long as no other features require bifurcation and recognition as derivatives.

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## **EXAMPLE**

### *Convertible Debt With a Cash Conversion Feature*

Facts:

- Ainsley, Inc., issues debt with the following terms:
  - \$1,000 par value
  - 6% annual coupon
  - 5-year term
  - Convertible into 100 shares
- Upon conversion, Ainsley, Inc., may satisfy the obligation with cash or shares or any combination thereof
  - Ainsley's share price at issuance was \$20
  - Similar debt instruments without the conversion feature offer an annual coupon rate of 9%

Legacy GAAP:

- The \$1,000 par value would be separated into a liability and equity—liability \$650 and equity at \$350 (PV 1,000 @9% for 5 years)

ASU 2020-06:

- The \$1,000 par value is recorded as a liability—cash proceeds at issuance. The conversion feature is not separated
- 

ASU 2020-06 also increased the disclosure requirements for convertible instruments at Subtopic 470-20-50-1 by adding the following:

- Information about events or conditions that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed (amount or timing of future cash flows)
- Information on which party controls the conversion rights
- Align disclosure requirements for contingently convertible instruments with disclosure required for other convertible instruments
- Requires that existing fair value disclosures in Topic 825, *Financial Instruments*, be provided at the individual convertible instrument level rather than in the aggregate
- For convertible debt instruments with substantial premiums accounted for as paid-in capital, the fair value amount and the level of fair value hierarchy of the entire instrument for public business entities and the premium amount recorded as paid-in capital

### *Contracts in a Reporting Entity's Own Equity*

Contracts in a reporting entity's own equity are financial instruments that could be potentially settled in a reporting entity's own equity shares. For example, as part of a financing arrangement, a reporting entity issues an option on its own common stock.

In addition to the deletion of the derivative scope exception described in the earlier background section, ASU 2020-06 also addresses whether a freestanding contract in an entity's own equity (normally a warrant) qualifies for a scope exception from derivative accounting. The analysis to determine whether a contract meets this scope exception includes two criteria:

- The contract is indexed to an entity's own stock
- The contract is equity classified (settlement criteria—settlement in cash would not meet this criteria)

If both of these criteria are not met, the contract must be recognized as an asset or liability. Subtopic 815-40 is amended to simplify the settlement criteria conditions related to the derivative scope exception. The amendments are as follows:

- Remove the following conditions from the settlement guidance: settlement in unregistered shares, collateral, and shareholder rights
- Regarding the condition about failure to timely file in the settlement guidance, clarify that penalty payments do not provide equity classification

- Require instruments that are required to be classified as an asset or liability to be measured subsequently at fair value, with changes reported in earnings and disclosed in the financial statements
- Clarify that the scope of the disclosure requirements in Topic 815, *Derivatives and Hedging*, applies only to freestanding instruments. Embedded features are not subject to these disclosures
- Clarify that the scope of the reassessment guidance in Subtopic 815-40-35 on subsequent measurement applies to both freestanding instruments and embedded features

### ***Effective Date and Transition***

ASU 2020-06 is effective for public business entities, excluding smaller reporting companies, for fiscal years beginning after December 15, 2021, including interim periods and for all other reporting entities, fiscal years beginning after December 15, 2023, including interim periods.

Reporting entities can adopt this guidance through either a modified retrospective method of transition or a fully retrospective method of transition.

Early adoption is permitted.

## ***ASU 2020-07, NOT-FOR-PROFIT ENTITIES (TOPIC 958): PRESENTATION AND DISCLOSURES BY NOT-FOR-PROFIT ENTITIES FOR CONTRIBUTED NONFINANCIAL ASSETS***

### ***Objective***

ASU 2020-07 is designed to improve GAAP by increasing the transparency of contributed nonfinancial assets for non-for-profit reporting entities through enhancements to presentation and disclosure.

### ***Background***

This ASU addresses certain stakeholders' concerns about the lack of transparency about the measurement of contributed nonfinancial assets recognized by not-for-profits, as well as the amount of those contributions used in a not-for-profit's programs and other activities. As noted in the ASU, this contribution revenue may take the form of gifts, donations, grants, gifts-in-kind, donated services, or other items.

Subtopic 958-605, *Not-for-Profit Entities-Revenue Recognition*, specifies requirements for the recognition and initial measurement of contributions and disclosure requirements for contributed services. The subtopic does not include specific presentation requirements for contributed nonfinancial assets or specific disclosure requirements for contributed nonfinancial assets other than contributed services.

A **contribution** is defined in the FASB Codification as:

An unconditional transfer of cash or other assets, as well as an unconditional promise to give to an entity or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from:

- exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately commensurate value;
- investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and
- other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers.

In a contribution transaction, the resource provider often receives value indirectly by providing a societal benefit, although that benefit is not considered to be of commensurate value. In an exchange transaction, the potential public benefits are secondary to the potential direct benefits to the resource provider. The term *contribution revenue* is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains).

A **nonfinancial asset** is defined in the FASB Codification as:

An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

### ***Provisions***

ASU 2020-07 requires a not-for-profit reporting entity to present contributed nonfinancial assets as a separate line item in the statement of activities, apart from contributions of cash or other financial assets.

## EXAMPLE

958-205-55-14 Format B (a multicolumn format) is as follows.

Not-for-Profit Entity A Statement of Activities Year Ended June 30, 20X1 (in thousands)			
	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains, and other support:			
<b>Contributions</b>	\$ 8,640	\$ 8,300	\$ 17,030
Contributions of cash and other financial assets	\$ 6,790	\$ 7,430	\$ 14,220
Contributions of nonfinancial assets	1,850	960	2,810
Fees	5,200		5,200
Investment return, net	6,650	18,300	24,950
Gain on sale of equipment	200		200
Other	150		150
Net assets released from restrictions (Note D):			
Satisfaction of program restrictions	8,990	(8,990)	
Satisfaction of equipment acquisition restrictions	1,500	(1,500)	
Expiration of time restrictions	1,250	(1,250)	
Appropriation from donor endowment and subsequent satisfaction of any related donor restrictions	7,500	(7,500)	
Total net assets released from restrictions	19,240	(19,240)	-
Total revenues, gains, and other support	40,080	7,450	47,530
Expenses and losses:			
Program A	13,296		13,296
Program B	8,649		8,649
Program C	5,837		5,837
Management and general	2,038		2,038
Fundraising	2,150		2,150
Total expenses (Note F)	31,970		31,970
Fire loss on building	80		80
Actuarial loss on annuity trust obligations		30	30
Total expenses and losses	32,050	30	32,080
<b>Change in net assets</b>	8,030	7,420	15,450
Net assets at beginning of year	84,570	186,070	270,640
Net assets at end of year	\$ 92,600	\$ 193,490	\$ 286,090

Note: See paragraph 958-205-55-21 for the notes to financial statements.

For each category of contributed nonfinancial assets recognized, ASU 2020-07 requires a not-for-profit reporting entity to disclose the following:

- Qualitative information about whether the contributed nonfinancial assets were either monetized or utilized during the reporting period; if utilized, a description of the programs or other activities in which these assets were used
- The not-for-profit reporting entity's policy (if any) about monetizing rather than utilizing contributed nonfinancial assets
- A description of a donor-imposed restrictions associated with the contributed nonfinancial assets
- A description of the valuation techniques and inputs used to arrive at a fair value measurement in accordance with the requirements of Topic 820, *Fair Value Measurement*, at initial recognition

- The principal market (or most advantageous market) used to arrive at a fair value measurement if it is a market in which the recipient not-for-profit reporting entity is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets

### ***Effective Date and Transition***

ASU 2020-07 is effective for annual reporting periods beginning after June 15, 2021, and interim periods within annual reporting periods beginning after June 15, 2022. Retrospective adoption is required.

Early adoption is permitted.

## ***ASU 2020-08, CODIFICATION IMPROVEMENTS TO SUBTOPIC 310-20, RECEIVABLES-NON-REFUNDABLE FEES AND OTHER COSTS***

### ***Objective***

This ASU improves the Codification and corrects for an unintended application in financial instruments.

### ***Background***

ASU 2020-08 amends the previously issued guidance in ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities (Subtopic 310-20, Receivables-Non-Refundable Fees and Other Costs).

ASU 2017-08 noted the following: when a reporting entity holds debt instruments acquired at a discount or premium, the discount or premium is amortized over the life of the instrument as an adjustment of yield. In the past, the period used for amortization was the contractual life of the instrument.

When a debt security is acquired at a premium, *and* it is callable, the investor may be confident that the call feature will be exercised because it is so economically advantageous for the issuer to do so. When this happens, the unamortized balance in the premium account must be written off to earnings when the debt security is called. As a result, there has been concern that use of the contractual life (i.e. period to maturity) to amortize the premium is not meaningful. (This is not an issue for debt securities with discounts.)

ASU 2017-08 shortened the period used to amortize premiums on certain callable debt securities from the contractual life of the instrument to the period from acquisition to the earliest call date. (This date is specified in the terms of the security). Accounting for securities held at a discount will still be based on the maturity date. This change, FASB observed, better aligns the carrying value to the expectations incorporated in market pricing of these instruments.

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## **EXAMPLE**

An entity purchases \$100,000 face value of callable bonds with a 10-year life and a stated rate of 6% at a price of 105 (\$105,000.) The bonds are callable at face value after 4 years.

Under ASU 2017-08, the \$5,000 premium would be amortized over 4 years instead of 10 years.

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ASU 2017-08 is codified in Subtopic 310-20-35-33. The intent of FASB in issuing ASU 2017-08 was that if the security contained additional future call dates, the reporting entity should consider whether the amortized cost basis exceeded the amount repayable by the issuer at the next call date. If so, the excess should be amortized to the next call date. Unfortunately, this intention was not clear to many stakeholders.

## ***Provisions***

Subtopic 310-20-35-33 is amended to state the following:

For each reporting period, to the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the next call date, the excess (that is, the premium) shall be amortized to the next call date, unless the guidance in paragraph 310-20-35-26 is applied to consider estimated prepayments.

For purposes of this guidance, the next call date is the first date when a call option at a specified price becomes exercisable. Once that date has passed, the next call date is when the next call option at a specified price becomes exercisable, if applicable. If there is no remaining premium or if there are no further call dates, the reporting entity shall reset the effective yield using the payment terms of the debt security.

Securities within the scope of this paragraph are those that have explicit, noncontingent call options that are callable at fixed prices and on preset dates at prices less than the amortized cost basis of the security. Whether a security is subject to this paragraph may change, depending on the amortized cost basis of the security and the terms of the next call option.

## ***Effective Date and Transition***

For public business entities, this ASU is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2020. Early application is not permitted.

For all other reporting entities, this ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years after December 15, 2022. Early application is permitted for all other reporting entities for fiscal years and interim periods within those fiscal years, beginning after December 15, 2020.

Transition is on a prospective basis.

## **ASU 2020-09, DEBT (TOPIC 470)— AMENDMENTS TO SEC PARAGRAPHS PURSUANT TO SEC RELEASE NO. 33-10762**

### ***Objective***

Amend and supersede SEC paragraphs in the FASB Codification to reflect the issuance of SEC Release No. 33-10762 related to financial disclosure requirements applicable to registered debt offerings that include credit enhancements for subsidiary issuers and guarantors of registered debt securities and affiliates whose securities are pledged as collateral for registered securities.

### ***Background***

The SEC adopted clarified rules on March 2, 2020, with the issuance of SEC Release No. 33-10762, *Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities*, that make it easier for a registrant to qualify for an exception to the requirement to file separate audited financial statements of a subsidiary issuer or guarantor of registered debt securities.

Existing Rules 210.3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered and 210.3-16, Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered both affect disclosures made in connection with registered debt offerings and subsequent reporting:

- Rule 3.10 requires financial statements to be filed for all issuers and guarantors of securities that are registered or being registered, but also provides several exceptions to that requirement. These exceptions are typically available for individual subsidiaries of a parent company when certain conditions are met, including the parent company provides certain disclosures in its consolidated financial statements. If the conditions are met, separate financial statements of each qualifying subsidiary issuer and guarantor may be omitted.
- Rule 3-16 requires a registrant to provide separate financial statements for each affiliate whose securities constitute a substantial portion of the collateral, based on a numerical threshold, for any class of registered securities as if the affiliate were a separate registrant.

These clarified rules reduce and simplify the financial disclosure requirements applicable to registered debt offerings for guarantors and issuers of guaranteed securities, as well for affiliates whose securities collateralize a registrant's securities. The amendments revise Rules 210.3-10 and 210.3-16 of Regulation S-X, and it relocates parts of Rule 3-10 and all of Rule 3-16 to the new Article 13 in Regulation S-X, which is comprised of new Rules 13-01 and 13-02.

Quoting from the SEC's press release issued March 2, 2020:

*Amendments to Rule 3-10 - The amendments will:*

- *Replace the condition that a subsidiary issuer or guarantor be 100%-owned by the parent company with a condition that it be consolidated in the parent company's consolidated financial statements;*
- *Replace condensed consolidating financial information, as specified in existing Rule 3-10, with certain new financial and non-financial disclosures. The amended financial disclosures will consist of summarized financial information, as defined in Rule 1-02(bb)(1) of Regulation S-X, of the issuers and guarantors, which may be presented on a combined basis, and reduce the number of periods presented. The amended non-financial disclosures, among other matters, will expand the qualitative disclosures about the guarantees and the issuers and guarantors. Consistent with the existing rule, disclosure of additional information about each guarantor will be required if it would be material for investors to evaluate the sufficiency of the guarantee;*
- *Permit the amended disclosures to be provided outside the footnotes to the parent company's audited annual and unaudited interim consolidated financial statements in all filings; and*
- *Require the amended financial and non-financial disclosures for as long as an issuer or guarantor has an Exchange Act reporting obligation with respect to the guaranteed securities rather than for as long as the guaranteed securities are outstanding.*

*Amendments to Rule 3-16 – The amendments will:*

- *Replace the existing requirement to provide separate financial statements for each affiliate whose securities are pledged as collateral with amended financial and non-financial disclosures about the affiliate(s) and the collateral arrangement as a supplement to the consolidated financial statements of the registrant that issues the collateralized security. The registrant will be permitted to provide the amended financial and non-financial disclosures outside the footnotes to its audited annual and unaudited interim consolidated financial statements in all filings; and*
- *Replace the requirement to provide disclosure only when the pledged securities meet or exceed a numerical threshold relative to the securities registered or being registered with a requirement to provide the proposed financial and non-financial disclosures in all cases, unless they are immaterial.*

The direct impact of the SEC's clarified rules is that for registrants that have been filing separate audited financial statements for subsidiary issuers or guarantors will now qualify to provide only summarized financial information and narrative disclosures. Also, for registrants who have provided condensed consolidating financial information in the past will now qualify under one of four expedients to not provide any financial disclosure and provide only narrative disclosures instead.

These amendments are effective on January 4, 2021.

## ***Provisions***

ASU 2020-09 amends the SEC paragraphs in the FASB Codification as noted earlier: Topic 460, *Guarantees-Overall*, Topic 470, *Debt*, Topic 505, *Equity* and Topic 270, *Interim Reporting*.

## ***Effective Date***

These Codification amendments are effective on January 4, 2021.

## **ASU 2020-10, *CODIFICATION IMPROVEMENTS***

### ***Objective***

To clarify disclosure issues in the FASB Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most reporting entities.

### ***Background***

This ASU improves the consistency of the FASB Codification by including disclosure guidance in the appropriate disclosure sections (Section 50) of Codification topics. This ASU is considered necessary because FASB, in the past, has provided an option to give certain disclosure information either on the face of the financial statements or in notes to financial statements and that option was only included in the Other Presentation Matters Section (Section 45) of the Codification.

### ***Provisions***

The Codification topics updated by this ASU are the following:

- Subtopic 205-10—*Presentation of Financial Statements-Overall*
- Subtopic 220-10—*Income Statement-Reporting Comprehensive Income-Overall*
- Subtopic 250-10—*Accounting Changes and Error Corrections-Overall*
- Subtopic 260-10—*Earnings Per Share-Overall*
- Subtopic 270-10—*Interim Reporting-Overall*
- Subtopic 835-30—*Interest-Imputation of Interest*
- Subtopic 852-10—*Reorganization-Overall*
- Subtopic 942-360—*Financial Services-Depository and Lending-Property, Plant and Equipment*
- Subtopic 946-220—*Financial Services-Investment Companies-Income Statement-Reporting Comprehensive Income*

- Subtopic 965-205—*Plan Accounting-Health and Welfare Benefit Plans-Presentation of Financial Statements*

Other minor Codification changes were made to correct wording and references.

### **Effective Date**

This ASU is effective for annual periods beginning after December 15, 2020, for public business entities. For all other reporting entities, the amendments are effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022.

Early application of this ASU is permitted for public business entities for any annual or interim period for which financial statements have not been issued. For all other reporting entities, early application of the amendments is permitted for any annual or interim period for which financial statements are available to be issued.

ASU 2010-10 should be applied retrospectively. A reporting entity should apply the ASU at the beginning of the period that includes the adoption date.

### **ASU 2020-11, FINANCIAL SERVICES-INSURANCE (TOPIC 944): EFFECTIVE DATE AND EARLY APPLICATION**

#### **Objective**

To assist insurance companies adversely affected by the coronavirus pandemic by giving them an additional year to implement ASU 2018-12, *Financial Services-Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI).

#### **Provisions**

For insurance companies that need extra time, the ASU permits them to delay implementation by one year as follows:

- For SEC filers, excluding smaller reporting companies, ASU 2018-12 is effective for fiscal years beginning after December 15, 2022, and interim periods within those years.
- For all other reporting entities, ASU 2018-12 is effective for fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025.

## **ASU 2021-02, *FRANCHISORS-REVENUE FROM CONTRACTS WITH CUSTOMERS (SUBTOPIC 952-606)***

### ***Objective***

FASB decided to issue this ASU to address the issues raised by stakeholders who expressed concerns about the level of effort required to account for pre-opening services provided by private company franchisors. The specific issue is the cost and complexity of applying Topic 606, *Revenue from Contracts with Customers*, to determine the amount and timing of revenue recognition for initial franchise fees.

### ***Provisions***

ASU 2021-02 includes amendments that introduce a practical expedient for franchisors that are not public business entities, allowing them to account for pre-opening services provided to a franchisee as distinct from the franchise license if the services are consistent with those included in a predefined list within the guidance. Additionally, an accounting policy election can be made to recognize the pre-opening services as a single performance obligation.

Pre-opening services include the following:

- Assistance in the selection of a site
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation
- Training of the franchisee's personnel or the franchisee
- Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping
- Bookkeeping, information technology, and advisory services, including settling up the franchisee's records, and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business
- Inspection, testing, and other quality control programs

A franchisor may account for pre-opening services as a single performance obligation by

- simplifying step 2 of the revenue recognition model—identify performance obligations—by providing a list of acceptable services;
- leveraging existing concept of initial services, with some modifications; and
- retaining standalone selling price guidance.

Franchisors that elect the practical expedient will be required to determine whether the pre-opening services are distinct from one another unless it makes the accounting policy election to account for the services as a single performance obligation.

### ***Effective Date***

If a reporting entity has not yet adopted Topic 606, the existing transition provisions and effective date of Topic 606 are required—effective for annual reporting periods beginning after December 15, 2019.

If a reporting entity has already adopted Topic 606, this ASU is effective for annual periods beginning after December 15, 2020.

Early application is permitted.

## ***ASU 2021-03, INTANGIBLES – GOODWILL AND OTHER (TOPIC 350) ACCOUNTING ALTERNATIVE FOR EVALUATING TRIGGERING EVENTS***

### ***Objective***

FASB decided to issue ASU 2021-03 in response to stakeholders' concerns about the cost and complexity of performing a goodwill triggering event evaluation during the reporting period (at an interim date), rather than completing the analysis as of the end of the reporting period (year end), and the relevance of the triggering event evaluation (in 2021 due to COVID-19, for example) with the financial information reported to and used by stakeholders (users).

### ***Provisions***

The amendments in ASU 2021-03 provide private companies and not-for-profit entities with an accounting alternative to perform the goodwill impairment triggering event evaluation as required in Subtopic 350-20 as of the end of the reporting period, whether the reporting period is an interim or annual period. A reporting entity that elects this alternative is not required to monitor for goodwill impairment triggering events during the reporting period but, instead, should evaluate the facts and circumstances as of the end of each reporting period to determine whether a triggering event exists and, if so, whether it is more likely than not that goodwill is impaired.

A reporting entity that does not elect the accounting alternative for amortizing goodwill and that performs its annual impairment test as of a date other than the annual reporting date should perform a triggering event evaluation only as of the end of the reporting period. The amendments in ASU 2021-03 do not require incremental disclosures beyond the existing requirements in Topic 235, *Notes to Financial Statements*, and Subtopic 350-20.

### ***Effective Date***

ASU 2021-03 is effective on a prospective basis for fiscal years beginning after December 15, 2019. Early adoption is permitted for both interim and annual financial statements that have not yet been

issued or made available for issuance as of March 30, 2021. A reporting entity should not retroactively adopt ASU 2021-03 for interim financial statements already issued in the year of adoption.

ASU 2021-03 also includes an unconditional one-time option for reporting entities to adopt the alternative prospectively after its effective date without assessing preferability under Topic 250, *Accounting Changes and Error Corrections*.

## **ASUS EFFECTIVE IN 2021**

### ***For Public Business Entities***

- ASU 2018-14, *Disclosure Framework—Changes to Disclosure Requirements for Defined Benefit pension Plans*
- ASU 2019-12, *Simplifying the Accounting for Income Taxes*
- ASU 2020-01, *Clarifying the Interactions between Topic 321, Topic 323, Equity Method and Joint Ventures, and Topic 815, Derivatives and Hedging*
- ASU 2020-04, *Facilitation of the Effects of Reference Rate Reform on Financial Reporting*
- ASU 2020-08, *Codification Improvements to Subtopic 310-20, Receivables—Non-Refundable Fees and Other Costs*
- ASU 2020-09, *Debt (Topic 470)—Amendments to SEC Paragraphs Pursuant to SEC Release No. 33-10762*
- ASU 2020-10, *Codification Improvements*
- ASU 2021-01, *Reference Rate Reform*

### ***For Nonpublic Business Entities***

- ASU 2017-08, *Premium Amortization on Purchased Callable Debt Securities*
- ASU 2017-11, *Accounting for Certain Financial Instruments with Down Round Features*
- ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*
- ASU 2018-07, *Improvements to Non-Employee Share-Based Payment Accounting*
- ASU 2018-09, *Codification Improvements*
- ASU 2018-15, *Customers Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*
- ASU 2018-17, *Targeted Improvements to Related Party Guidance for Variable Interest Entities*

- ASU 2018-18, *Collaborative Arrangements: Clarifying the Interaction between Topic 808 and Topic 606*
- ASU 2019-02, *Improvements to Accounting for Costs of Films and License Agreements for Program Materials*
- ASU 2020-04, *Facilitation of the Effects of Reference Rate Reform on Financial Reporting*
- ASU 2021-01, *Reference Rate Reform*

# Unit 2

## Revenue Recognition (Topic 606), Leasing (Topic 842), and Credit Losses (Topic 326)

### LEARNING OBJECTIVE

*After completing this section, participants will be able to:*

- › Summarize the significant implementation issues associated with recently issued standards in the areas of revenue recognition, leasing, and credit losses

### IMPLEMENTATION ISSUES

#### Revenue Recognition (Topic 606)

In September 2002, the FASB and the International Accounting Standards Board (IASB) formally agreed to join efforts to develop a standard-setting project for revenue recognition, which would more closely align the topic between the two standard-setting boards. It wasn't until 2014 though that the boards had a new standard available, which was issued by the FASB on May 14, 2014. ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606) in essence did away with industry-specific revenue guidance for a new, principle-based standard that employs a six-step approach to the revenue recognition process.

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price

4. Allocate the transaction price to the performance obligations
5. Recognize revenue as performance obligations are satisfied
6. Disclose information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the reporting entity's contracts with customers

The core principle of Topic 606 is that **a reporting entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the reporting entity expects to be entitled in exchange for those goods or services.**

As is the case with all standards, the use of common terms in the proper context is important. Topic 606 includes many **key definitions**, some of which are defined as follows:

**Contract.** An agreement between two or more parties that creates enforceable rights and obligations.

**Contract asset.** A reporting entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

**Contract liability.** A reporting entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

**Performance obligation.** A promise in a contract with a customer to transfer to a customer either:

1. A good or service (or a bundle of goods or services) that is distinct, or
2. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer

**Revenue.** Inflows or other enhancements of assets of an entity or settlements of its liabilities (or combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

**Transaction price.** The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Public reporting entities applied Topic 606 for the first time in 2018. Non-public entities applied Topic 606 for annual reporting periods beginning after December 15, 2018, and interim and annual periods beginning after December 15, 2019.

## **Selected Revenue Implementation and Reporting Issues**

Now that reporting entities (both public and non-public) have had time to apply this new topic, we will cover some of the common implementation and reporting issues that companies have incurred.

In our findings, it appears that companies overall are still trying to determine if they are properly applying the standard.

Under the new standard, when **variable consideration** is present, the potential to recognize revenue earlier may be possible versus legacy GAAP due to the certainty around achieving milestones.

Private companies will want to consider how their **comparative periods** will appear in their annual 2020 financial statements if they do not early adopt in 2019 for interim periods. If a private company does not early adopt for interim periods, they will have to determine how their 2019 interim periods will need to be restated for their comparative periods in the 2020 annual financial statements. This may not be a widespread concern among private companies as many do not have interim period reporting, but will need to be considered for those that do.

**Disclosures** under the new guidance will be expanded to generally include more detail around the revenue recognition process. Companies should be sure that CEOs (owners) and other members of management have time to review disclosures to be aware of sensitive materials that may now be included within financial statement disclosures.

- Private companies should not plan to go find the disclosures filed by a public company competitor to simply mirror. Public companies have more disclosure requirements than private companies; therefore, it is important to understand the reporting requirements specific to your company.

**Costs to obtain a contract** should be re-evaluated under the new guidance. Costs that are only incurred to get a new contract in place, such as sales commissions, must be capitalized if certain criteria are met. Under legacy GAAP, capitalization of these types of costs were generally optional.

Specifically, the following implementation issues were identified by E&Y for non-public reporting entities when addressing revenue recognition challenges:

- **Contract term.** Evaluating contract provisions, such as termination provisions, and their effect on contract duration
- **Identifying performance obligations.** Determining whether identified promises of goods and services in a contract should be combined into a single performance obligation
- **Principal versus agent considerations.** Determining the nature of the reporting entity's promises by identifying the specified good or service (i.e., unit of account) and assessing whether the entity controls the specified good or service prior to transfer to the customer
- **Customer options.** Distinguishing between a customer option to purchase additional goods or services and variable consideration based on a variable quantity of goods or services, such as a usage-based fee, and determining whether a customer option, such as a renewal option, provides a material right
- **Variable consideration (including the constraint).** Estimating and constraining the estimate of variable consideration to the amount for which it is probable that a significant reversal in the

amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is resolved. An example is determining whether a minimum amount of revenue should be recognized when there is uncertainty related to variable consideration

- **Variable consideration allocation exception.** Determining whether a reporting entity meets the criteria to apply the variable consideration allocation exception and can allocate the consideration entirely to one or more (but not all) performance obligations in the contract. An example is whether the terms of a variable payment relate specifically to the entity's efforts to satisfy a performance obligation
- **Residual method.** Determining whether the historical selling price is highly variable, and the reporting entity may apply the residual method to estimate the standalone selling price
- **Performance obligations satisfied over time rather than at a point in time.** Determining whether control of goods and services is transferred over time or at a point in time
- **Contract costs (costs to obtain).** Determining whether contract acquisition costs are incremental, and the reporting entity expects to recover them
- **Contract costs (costs to fulfill).** Determining whether costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future

Focusing on non-public reporting entities, the new revenue recognition standard has put extraordinary pressures on **private companies**. Issues that have been an obstacle to private companies' reporting include:

- Small business analysis of the business's revenue transactions and the standard's adoption and implementation into the 2019 financial reporting period
- Independence considerations of the attesting (audit or review) CPAs when providing the non-attest services in support of Topic 606 implementation for/with the attest client
- Ensuring that the accounting principles reflect U.S. GAAP without the CPA performing managerial responsibilities

For decades, small businesses, without a robust accounting department to maintain and ensure continued, accurate, and up-to-date maintenance of accounting principles based on an acceptable financial reporting framework, utilized their outside accountants to provide the support services necessary to prepare their financial statements. These supporting services to assist the client came in the form of fixed assets (and related depreciation, capitalization levels, and gain/loss on dispositions), accrued liabilities, certain allowances (such as doubtful account reserves), current and deferred tax liabilities/assets provided, and even determinations between operating and capital lease treatment (Legacy Topic 840).

These services, resulting in proposed adjustments, would be presented to the client for discussion and review, context and necessary explanations, and then ultimate agreement/approval or countering perspective taken by management, leading to adjusted accounting information to be the basis of

audited, reviewed, or compiled financial statements. Management’s role and involvement in signing off as designee-overseer of the services generally resulted in a conclusion of sufficient safeguard for independence purposes.

Private company CPAs generally saw these supporting services as “ancillary services” that would be viewed as routine services considered normal and routine part of performing an attest service, and conceivably outside the prevue of ET 1.295, *Non-Attest Services*.

However, the overall significance or a completely revamped approach and application of recognizing revenue contained in Topic 606, including the extensive complexity of the new principle (as amended, in the neighborhood of 1,000 pages of standard), had created great uncertainty of whether the assistance with this accounting principle could fall within the context of “routine services.” Since the majority of larger CPA firms performing PCAOB engagements for public companies have taken a “hands off – educational and informational resource support only” approach, private companies and their CPAs wrestled with the matter in its entirety, with CPAs realizing that the ultimate assessment might be overturned in a subsequent peer review!

Accordingly, while the principal threat areas to CPAs’ independence are from self-review, advocacy, and management participation, the latter, management participation, is by far the most pervasive as often no safeguards could be sufficient to bring “independence in appearance” to an acceptable level.<sup>1</sup> Therefore, avoiding the performance of managerial responsibilities is paramount, and a dangerously fine line to assess and evaluate.

The Professional Ethics Executive Committee (PEEC) guidance contained within existing *Frequently Asked Questions: Non-Attest Services* (as of February 25, 2019) provides practitioners with two options to ensure that the Topic 606 implementation is done with sufficient safeguards to provide an acceptable level that independence is not impaired:

1. The attest client can outsource (client or non-client personnel) the non-attest services oversight functions to a third party with applicable skills, knowledge, and expertise pertaining to Topic 606 to serve as the individual designated by the attest client to oversee the non-attest services performed by the CPA attest firm.
2. The attest client can outsource the actual non-attest services functions to a third party with applicable skills, knowledge, and expertise pertaining to Topic 606 to serve as the project leader, director, and decision-maker to ultimately implement Topic 606 (all journal entries and footnote disclosures).

Of the two available options above, option 1, which has the attesting CPAs providing the non-attest implementation, still has potential problems for a firm due to client personnel not always having the skills, knowledge, and expertise to perform the necessary oversight. Accordingly, for the smaller CPA firm, option 2 may be the best for independence compliance.

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<sup>1</sup> AICPA Code of Professional Conduct ET 1.295.030.01: “If a member were to assume a management responsibility for an attest client, the management participation threat would be so significant that no safeguards could reduce the threat to an acceptable level and independence would be impaired...”

The AICPA's Professional Ethics Division has issued *Frequently Asked Questions: Non-Attest Services* (January 31, 2020), where among other guidance, it provides sample language to document the understanding with the attest client for the providing of non-attest bookkeeping or tax services to identify safeguards to ensure independence is not impaired.

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## **EXAMPLE**

### *Objectives of the Engagement and Services to be Performed*

1. We will provide the bookkeeping and tax services outlined as follows:
  - At the end of each month, CPA Firm agrees to perform the following:
    - Post client coded transactions to ABC Company's general ledger. Propose adjusting or correcting journal entries to be reviewed and approved by ABC Company management. Prepare a trial balance based on the adjusted general ledger.
    - Prepare monthly sales and payroll tax returns [insert applicable tax jurisdictions] for ABC Company management's review and approval. Upon receipt of approval, we file the electronic returns on the Company's behalf.
  - At the end of the year, CPA Firm agrees to perform the following:
    - Propose adjusting or correcting journal entries to be reviewed and approved by ABC Company management.
    - Prepare federal and state income tax returns [insert applicable tax jurisdictions].
    - Prepare year-end sales and payroll tax returns [insert applicable tax jurisdictions].
    - Answer inquiries on specific tax matters.
  - CPA Firm will not assume management responsibilities on behalf of ABC Company. However, we will provide advice and recommendations to assist management of ABC Company in performing its responsibilities.
2. ABC Company's responsibilities are as follows:
  - ABC Company agrees to perform the following responsibilities in connection with CPA Firm's provision of the bookkeeping and tax services:
    - Assume all management responsibilities, including determining account coding and approving all proposed journal entries.
    - Assign [name of competent client employee] to oversee the bookkeeping and tax services and evaluate the adequacy and results of the services.
    - Accept responsibility for the results of the bookkeeping and tax services, including the journal entries, general ledger, trial balance, and tax returns.
3. CPA Firm's responsibilities and limitations of the engagement are as follows:
  - CPA Firm will perform the services in accordance with applicable professional standards, including the Statements on Standards for Tax Services issued by the AICPA.
  - This engagement is limited to the bookkeeping and tax services previously outlined. CPA Firm, in its sole professional judgment, reserves the right to refuse to do any procedure or take any action that could be construed as making management decisions or assuming management responsibilities, including determining account coding and approving journal entries. CPA Firm

will advise ABC Company with regard to tax positions taken in the preparation of the tax return, but ABC Company must make all decisions with regard to those matters.

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Another issue to be considered is the audit report implications of non-compliance with the revenue standard when issuing GAAP financial statements. Revenue and its recognition is fundamentally deemed material and pervasive. Thus, the proper application of Topic 606 is crucial to support an unqualified opinion.

In a February 2020 edition of *Ethically Speaking*<sup>2</sup> presented by the AICPA PEEC division, Bob Dohrer, chief auditor of the AICPA audit and attest team, explained:

- That since revenue and its recognition is both material and pervasive, if the company did not satisfactorily adopt and apply Topic 606, the CPA may be required to disclaim an opinion.
- If it could be determined that revenue and its recognition was material but not pervasive, and if the company did not satisfactorily adopt and apply Topic 606, the CPA may be able to issue a qualified opinion.
- The auditing CPA may only issue an adverse opinion when sufficient evidence has been gathered to support a conclusion that the financial statements are materially misstated.

Accordingly, the adoption, implementation, and application of Topic 606 will have a material impact of the entirety of the audit and the auditors' report.

**NOTE:** SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, provides guidance for the expression of an adverse review conclusion when financial statements are materially and pervasively misstated.

## **Leases (Topic 842)**

FASB issued ASU 2016-02, *Leases*, as amended (Topic 842), to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

Topic 842 was effective for public business entities for fiscal years beginning after December 15, 2018. The effective date for all other reporting entities was for periods beginning after December 15, 2020. **NOTE:** ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, defers for one year, reporting entities that are non-public and public not-for-profit reporting entities that have not yet issued their financial statements reflecting the adoption of Topic 842. Topic 842 is now effective for non-public and public not-for-profit reporting entities for annual reporting periods beginning after December 15, 2021.

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<sup>2</sup> Episode 10: 606 SOS -- What happens if... Ethically Speaking (AICPA Professional Ethics) – [https://www.aicpa.org/content/aicpa/interestareas/professionalethics/ethically-speaking/ep-10-606-sos-what-happens-if.html?utm\\_source=mn:cpald&utm\\_medium=email&utm\\_campaign=17Feb2020](https://www.aicpa.org/content/aicpa/interestareas/professionalethics/ethically-speaking/ep-10-606-sos-what-happens-if.html?utm_source=mn:cpald&utm_medium=email&utm_campaign=17Feb2020)

The core principle of Topic 842 is that **a reporting entity should recognize assets and liabilities arising from a lease**. A lessee will recognize a liability to make payments and a right-of-use (RoU) asset representing its right to use the leased asset for the lease term. Under legacy guidance (Topic 840), operating leases were only required to be disclosed in the footnotes of financial statements. Under Topic 842, the only leases that can be omitted from financial statements are short-term leases with an original lease term of less than 12 months.

### ***Scope***

According to Topic 842, a lease conveys the right to control the use of an identified property, plant, and equipment (an identified asset) for a period of time in exchange for consideration. A reporting entity should apply Topic 842 to all leases, including subleases. Topic 842 does not apply to the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas, and similar assets
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to extend the lease term or purchase the underlying asset that the lessee is reasonably certain to exercise.

**NOTE:** “Reasonably certain” is defined as a high degree of confidence (for example, 85% to 90%) that an event will take place.

The lessee has an accounting policy option to recognize payments on a short-term lease on a straight-line basis over the lease term. If the accounting policy option is elected, short-term leases would not be reflected on the lessee’s balance sheet—policy note disclosure is required.

### ***Lease Definition – Contract***

A lease is a contract or part of a contract that conveys the right to control the use of an identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A contract is (or contains) a lease when the following two criteria are met:

1. The contract explicitly or implicitly specifies the use of an identifiable asset:
  - a. Asset is physically distinct.
  - b. Lessor does not have any substitution rights. A protective right defines the scope of the lessee’s right of use within applicable laws and regulations but does not, in isolation, prevent the lessee (customer) from having the right to direct the use of the asset.

2. The lessee (customer) controls the use of the asset for that period of use:
  - a. The lessee has the right to obtain substantially all of the economic benefits from use of an identified asset, and
  - b. The lessee has the right to direct the use of the identified asset during the period of use. Note that the period of time can be expressed in months or years or it can be expressed in terms of the amount of use of the identified assets such as production units.

Examples of decision-making rights that would normally grant the right to direct how and for what purpose an asset is used include the following:

- The right to change the type of output that is produced by the asset
- The right to change when the output is produced
- The right to change where the output is produced
- The right to change whether the output is produced and the quantity of that output

At the inception of a contract, a reporting entity must determine whether the contract is or contains a lease. If the lessee has the **right to control the use of an identified asset** for only a portion of the term of the contract, the contract contains a lease for that portion of the term. In identifying the asset, the lessor must not have substantive substitution rights for the identified asset; meaning the lessor has no practical ability to substitute or would not benefit from substituting. An entity would reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

### ***Lease Classification***

According to Topic 842, a reporting entity must classify each lease component within a lease contract at the commencement date. A reporting entity should not reassess this lease classification after the commencement date unless the lease contract is modified and the modification is not accounted for as a separate contract. However, the lessee is required to reassess this lease classification after the commencement date if there is a change in the lease term or a change in the assessment as to whether the lessee is reasonably certain or not to exercise an option to purchase the underlying asset.

A lessee will **classify** a lease as a **finance lease** and a lessor will **classify a lease as a sales-type lease** when the lease contract meets any of the following criteria at the lease commencement date. This criterion classifies a lease based on whether the lease contract effectively reflects a purchase of the underlying asset:

- The lease **transfers ownership** of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an **option to purchase the underlying asset** that the lessee is reasonably certain (probable) to exercise.

- The lease term is for the **major part** (legacy GAAP 75%) of the remaining economic life of the underlying asset – note that if the commencement date falls at or near the end of the economic life of the underlying asset, this specific criterion should not be used for purposes of classifying the lease.
  - If a single lease component contains the right to use more than one underlying asset, the reporting entity should consider the remaining economic life of the predominant asset in the lease component for the purpose of applying this criterion.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments, **equals or exceeds substantially all of the fair value** (legacy GAAP 90%) of the underlying asset.
- The underlying asset is of such a **specialized nature** that it is expected to have no alternative use to the lessor at the end of the lease term.

When **none of the criteria for a finance lease are met**, a lessee classifies the lease as an operating lease. When none of the criteria for a sales-type lease are met, a lessor will classify the lease as either a direct financing lease or an operating lease. The lessor will classify the lease as an operating lease unless both of the following criteria are met:

- The present value of the sum of the lease payments and any residual value guarantee by the lessee that is not already reflected in the lease payments and/or any other third party guarantee unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset; and
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

When both of the above criteria are met, a lessor must classify the lease as a direct financing lease.

**NOTE:** The reason it is important to determine the lease classification of a lease is because the subsequent accounting for a lessee is based on the lease classification (pattern of expense measurement and recognition) and for a lessor, the initial and subsequent measurement is based on whether the lease is classified as a sales-type lease, direct financing lease, or an operating lease.

### ***Lessee Initial Measurement***

At the lease commencement date, a lessee should recognize in the statement of financial position both of the following:

- A **lease payment liability** based on the present value of the lease payments, discounted using the discount rate for the lease, and
- A **right-of-use (RoU) asset** representing the lessee's right to use the underlying asset for the lease term.

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## EXAMPLE

### *Initial Measurement*

DB:     Right-of-Use Asset  
      CR:     Lease Payment Liability

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When calculating the lease payment liability, if the rate implicit in the lease is not readily determinable, the lessee will use its incremental borrowing rate for borrowings of the similar amounts and terms. A lessee may use a single discount rate to apply to a portfolio of leases, assuming the result would not be significantly different than individual lease discount rates.

**NOTE:** Non-public reporting entities are permitted an accounting policy election to use a risk-free discount rate for the lease (normally the federal funds rate).

The RoU asset and the lease payment liability may not be the same on commencement, nor throughout the lease term, because the RoU asset is calculated as the amount of the initial measurement of the lease payment liability plus payments made by a lessee to the lessor at or before the lease commencement date minus any lease incentives the lessee received from the lessor and any initial direct costs incurred by the lessee.

When initially measuring the **lease payment liability** at the commencement date, the lease payments consist of the following payments relating to the use of the underlying asset during the lease term:

- **Fixed payments**, including in substance fixed payments, less any lease incentives paid or payable to the lessee
- **Variable lease payments** that depend on an index or rate, initially measured using the index or rate at the commencement date
- The **exercise price of an option** to purchase the underlying asset if the lessee is reasonably certain to exercise this option
- **Payments for penalties for terminating the lease** if the lease term reflects the lessee exercising the option to terminate the lease
- **Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.** These fees are not included in the fair value assessment of the underlying asset for purposes of determining fair value for lease classification purposes.
- For the lessee only, amounts probable of being owed by the lessee under **residual value guarantees**

From the **lessee's perspective**, to determine whether a lease is a finance lease or an operating lease, we must evaluate the lease classification criteria presented earlier in this section. The following example evaluates these classification criteria to make the lease classification decision.

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### **EXAMPLE**

ABC Lessee enters into a five-year equipment lease (no renewal options) with Lessor Inc. with annual lease payments of \$24,000. The economic life of the equipment is seven years and its fair value is \$150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1 of each year. The rate implicit in the lease is 6%. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term.

Using the five lease classification criteria, we can determine whether this lease is a finance or operating lease:

1. Transfer of ownership – Ownership does not transfer to the lessee.
2. Option to purchase the underlying asset – The lease does not contain a purchase option.
3. Lease term is for the major part of the remaining economic life of the underlying asset – Five-year lease term is a major part of the economic life of the asset ( $5/7 = 71\%$ ).
4. Present value of the sum of the lease payments and any residual value guarantee amounts to substantially all of the fair value of the underlying asset – Present value of 5 payments of \$24,000 at 6% is \$107,163 – this is approximately 71% of the fair value of the leased asset and is not substantially all of the fair value of the underlying asset.
5. Underlying asset is of such a specialized nature – There is no indication that this equipment is of a specialized nature.

Based on this analysis, the lease term is for a major part of the economic life of the asset, and therefore, this lease is a finance lease.

Year 1 (January 1):

DB:	RoU Asset	\$107,163	
	CR:	Lease Payment Liability	\$107,163
DB:	Lease Payment Liability	\$24,000	
	CR:	Cash	\$24,000

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### ***Subsequent Measurement – Finance Lease***

The lease payment liability is increased by recognizing periodic interest on the lease liability and decreased by payments made during the lease periods. The RoU asset is amortized on a straight-line basis from the commencement date to the earlier of the end of the lease term or the useful life of the RoU asset. The RoU asset is reduced by accumulated amortization and any impairment losses based on reassessment requirements. If the RoU asset will be transferred to the lessee at the end of the lease term or it is reasonably certain that the lessee will exercise a purchase option for the RoU asset, then the RoU asset's amortization period should be to the end of the useful life of the RoU asset.

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## EXAMPLE

### *Finance Lease – Subsequent Measurement*

ABC Lessee enters into a five-year equipment finance lease (no renewal options) with Lessor Inc. with annual lease payments of \$24,000. The economic life of the equipment is six years and its fair value is \$150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1 of each year. The rate implicit in the lease is 6%. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term.

Year 1:

January 1

DB:	RoU Asset	\$107,163
	CR: Lease Payment Liability	\$107,163

(Present value of 5 payments of \$24,000 at 6% is \$107,163)

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

DB:	Lease Amortization Expense	\$21,433
	CR: RoU Asset	\$21,433

(RoU asset of  $\$107,163/5 = \$21,432.60$ )

December 31

DB:	Interest Expense	\$4,990
	CR: Lease Payment Liability	\$4,990

(Lease payment liability of  $\$107,163 - \$24,000$  payment =  $\$83,163 * 6\% = \$4,990$ )

Year 2:

January 1

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

DB:	Lease Amortization Expense	\$21,432
	CR: RoU Asset	\$21,432

December 31

DB:	Lease Expense	\$3,849
	CR: Lease Payment Liabilities	\$3,849

Year 3:

January 1

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

DB:	Lease Amortization Expense	\$21,433
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	CR:	RoU Asset	\$21,433
December 31			
DB:		Interest Expense	\$2,640
	CR:	Lease Payment Liability	\$2,640
Year 4:			
January 1			
DB:		Lease Payment Liability	\$24,000
	CR:	Cash	\$24,000
DB:		Lease Amortization Expense	\$21,432
	CR:	RoU Asset	\$21,432
December 31			
DB:		Interest Expense	\$1,358
	CR:	Lease Payment Liability	\$1,358
Year 5:			
January 1			
DB:		Lease Payment Liability	\$24,000
	CR:	Cash	\$24,000
DB:		Lease Amortization Expense	\$21,432
	CR:	RoU Asset	\$21,432

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### ***Subsequent Measurement - Operating Lease***

As stated previously, when none of the criteria for a finance lease are met, the lease is classified as an operating lease. The lessee recognizes a right-of-use (RoU) asset and a lease payment liability in the statement of financial position in the same manner as a finance lease. The lessee though, in an operating lease, will recognize a **single lease cost**, calculated so that the undiscounted cost of the lease is allocated over the lease term, generally on a straight-line basis. This is accomplished by amortizing the lease liability on an effective interest basis and then amortizing the RoU asset by adjusting (plugging) the lease asset's amortization to arrive at a constant lease expense amount.

Stated differently, the lease payment liability is reduced over time by recognizing the present value of the remaining lease payments not yet paid. The initial RoU asset balance is reduced by periodically adjusting the amortization of the RoU asset by the effective interest on the lease payment liability to arrive at a constant straight-line expense amount. As with finance leases, the RoU asset may also be impacted by any prepaid or accrued expenses, the remaining balance of any lease incentives received, unamortized initial direct costs, or any impairment.

For clarity purposes, Topic 842-20-25-6a, *Recognition*, states the following as it relates to operating lease recognition:

A single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern which benefit is expected to be derived from the right to use the underlying asset unless the right of use asset has been impaired.

## EXAMPLE

### *Operating Lease – Subsequent Measurement*

ABC Lessee enters into a five-year equipment lease (no renewal options) with Lessor Inc. with annual lease payments of \$24,000. The economic life of the equipment is 10 years and its fair value is \$150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1 of each year. The rate implicit in the lease is 6%. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term. None of the five finance lease criteria are met; therefore, the lease is an operating lease.

Year 1: (January 1)

DB:	RoU Asset	\$107,163
	CR:	Lease Payment Liability
		\$107,163

(Present value of 5 payments of \$24,000 at 6% is \$107,163)

DB:	Lease Payment Liability	\$24,000
	CR:	Cash
		\$24,000

Year 1: (December 31)

DB:	Lease Expense	\$24,000
	CR:	Lease Payment Liability
		\$4,990
	CR:	Accumulated Amortization
		\$19,010

[The lease payment liability is increased by calculating the effective interest ( $\$107,163 - \$24,000 = \$83,163 * 6\% = \$4,990$ ).]

The reduction in the RoU asset is calculated by subtracting the effective interest ( $\$4,990$ ) from the required straight-line expense amount ( $\$24,000 = \$19,010$ ).

Year 2: (January 1)

DB:	Lease Payment Liability	\$24,000
	CR:	Cash
		\$24,000

Year 2: (December 31)

DB:	Lease Expense	\$24,000
	CR:	Lease Payment Liability
		\$3,849
	CR:	Accumulated Amortization
		\$20,151

[The lease payment liability is increased by calculating the effective interest ( $\$107,163 - \$24,000 - \$19,010 = \$64,153 * 6\% = \$3,849$ ).]

The reduction in the RoU asset is calculated by subtracting the effective interest ( $\$3,849$ ) from the required straight-line expense amount ( $\$24,000$ ) =  $\$20,151$ .

Year 3: (January 1)

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

Year 3: (December 31)

DB:	Lease Expense	\$24,000
	CR: Lease Payment Liability	\$2,640
	CR: Accumulated Amortization	\$21,360

[The lease payment liability is increased by calculating the effective interest ( $\$107,163 - \$24,000 - \$19,010 - \$20,151 = \$44,002 * 6\% = \$2,640$ ).]

The reduction in the RoU asset is calculated by subtracting the effective interest ( $\$2,640$ ) from the required straight-line expense amount ( $\$24,000$ ) =  $\$21,360$ .

Year 4: (January 1)

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

Year 4: (December 31)

DB:	Lease Expense	\$24,000
	CR: Lease Payment Liability	\$1,359
	CR: Accumulated Amortization	\$22,641

[The lease payment liability is increased by calculating the effective interest ( $\$107,163 - \$24,000 - \$19,010 - \$20,151 - \$21,360 = \$22,642 * 6\% = \$1,359$ ).]

The reduction in the RoU asset is calculated by subtracting the effective interest ( $\$1,359$ ) from the required straight-line expense amount ( $\$24,000$ ) =  $\$22,641$ .

Year 5: (January 1)

DB:	Lease Payment Liability	\$24,000
	CR: Cash	\$24,000

Year 5: (December 31)

DB:	Lease Expense	\$24,000
	CR: Accumulated Amortization	\$24,000

NOTE: Each year the credit to the RoU asset (amortization) gets larger. This is the only way to achieve straight-line lease expense while the interest decreases each year on the lease payment liability.

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## ***Related Party Leases***

FASB has stipulated in Topic 842 that the recognition and measurement for all leases should be applied by related party lessees and lessors on the basis of legally **enforceable terms and conditions** of the contract, rather than at substance over form. Therefore, in the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

In related party arrangements where little documentation exists, nothing in writing, and the related parties frequently are under common control, the determination of whether the lease contract in those situations creates enforceable rights and obligations is, at the least, problematic. To mitigate subjectivity threats, legal counsel assessment may be necessary. Whether deemed subject to or exempt from Topic 842, reporting entities must comply with the disclosure requirements of Topic 850, *Related Party Disclosures*.

The essential practice determination here surrounds assessing a lease contract is enforceable—a lease contract is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Accordingly, neither party would have enforceable rights or obligations.

However, also consider what setting a shorter lease term will have on the amortization period of leasehold improvements. GAAP guidance indicates that leasehold improvements should be amortized over the shorter of (1) the useful life of those leasehold improvements, and (2) the remaining lease term (unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case, the lessee should amortize the leasehold improvements to the end of their useful life).

Private companies and their CPA practitioners will face many challenges, and many matters will be leveraged extensively on management estimates and CPAs exercising professional judgment. The obstacles of common ownership with related party leases that have no bright-line certainty are challenging with regards to (a) whether the lease is a Topic 842 lease that contains legally enforceable terms and conditions, rights, and obligations, and (b) if subject, what lease term would be applied.

## ***Lessee Disclosures***

The objective of the disclosure requirements in Topic 842, *Leases*, is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. These disclosures will be both qualitative and quantitative:

1. Information about the nature of the entity's leases, including:
  - A general description of its leases
  - The basis, terms, and conditions on which variable lease payments are determined
  - The existence and terms of any options to extend or terminate the leases

- Narrative disclosure about options that are recognized as part of its RoU assets and lease payment liabilities and those that are not
  - The existence, terms, and conditions any residual value guarantees provided by the lessee
  - Any restrictions or covenants imposed by leases (e.g., dividends, additional financial obligations, etc.)
  - If the entity has subleases, the entity should identify the information relating to subleases as indicated above
2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction of the underlying asset.
  3. Information about significant **assumptions and judgments** made in applying Topic 842, which may include the following:
    - The determination of whether a contract contains a lease
    - The allocation of the consideration in a contract between lease and non-lease components
    - The determination of the discount rate for the lease
  4. In addition, for each period in the financial statements, a lessee must disclose the following amounts relating to a **lessee's total lease cost**. These amounts include both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other GAAP, and the cash flows arising from lease transactions:
    - **Finance lease cost** segregated between the amortization of the RoU assets and the interest on the lease liabilities
    - **Operating lease cost** including its amortization allocation, variable lease payments, and impairments (if any)
    - **Short-term lease cost** excluding expenses relating to leases of one month or less
    - **Variable lease cost** not included in the lease liability in the period in which those obligations are incurred
    - **Sublease income** disclosed on a gross basis, separate from the finance or operating lease expense
    - **Net gain or loss** recognized from any sale and leaseback transactions
    - **Amounts segregated** between those for finance and operating leases for the following items:

- Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
  - Supplemental non-cash information on lease liabilities arising from RoU assets
  - Weighted-average remaining lease terms
  - Weighted-average discount rates
5. A **maturity analysis** of the lessee’s finance lease liabilities and its operating lease liabilities, separately, presenting the undiscounted cash flows on an annual basis for a minimum of five years and a total of the amounts for the remaining years. The lessee should present a reconciliation of the undiscounted cash flows to the financial lease and operating lease liabilities recognized in the statement of financial position.
6. Other lessee disclosures, include:
- Lease transactions between related parties.
  - If the lessee elects the accounting policy option for short-term leases, the lessee must disclose that fact.
  - If the short-term lease expense for the period does not reasonably reflect the lessee’s short-term lease commitments, the lessee must disclose that fact and the amount of its short-term lease commitments.
  - A lessee that elects the practical expedient on not separating lease components from non-lease components must disclose its accounting policy election and which class or classes of the underlying assets it has elected to apply the practical expedient.
  - Main terms and conditions of any sales-leaseback transactions.

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## **EXAMPLE – LESSEE DISCLOSURE**

### *Note 7 – Leases*

We lease retail stores in shopping centers, office facilities, warehouses, computers, and transportation equipment. Variable lease payments are included in most retail store leases based on the achievement of certain sales targets. These variable lease payments are recognized as lease expense when and if the targets are achieved. Most retail store, office facilities, and warehouse leases have options to extend the lease terms as well as options to terminate the leases. Lease termination clauses include penalties for early termination.

Forty percent of the retail store, office facilities, and warehouse leases include options to extend the lease terms and these amounts are included in the Company’s right-of-use assets and lease payment liabilities. Sixty percent of the retail store, office facilities, and warehouse leases do not have options to extend the lease terms. As a matter of Company policy, we do not provide any residual value guarantees to lessors’ assets that we lease. Any restrictions or performance covenants imposed by lessors are limited to certain

debt and income metrics and the Company is in full compliance with these restrictions and performance covenants. Subleases entered into by the Company are immaterial to operations.

We are a party to the construction of two shopping malls, one in Phoenix, Arizona, and one in Atlanta, Georgia. These shopping malls are expected to be completed and open for business in 201Z. We will be the lead tenant in both malls and have signed long-term leases for 20 years each to occupy 110,000 square feet in the Phoenix location and 125,000 square feet in the Atlanta location. Once these leases commence, we will have significant rights and financial obligations throughout the 20 years of these leases.

Based on Topic 842, Leases, we have established policies and procedures to assist the Company in determining whether a contract contains a lease, we separate non-lease components from lease components in our lease contracts and account for non-lease components based on other U.S. GAAP. Lease components in our lease contracts are accounted for following the guidance in Topic 842 for the capitalization of long-term leases. Discount rates used in our capitalization policies are the discount rates implicit in our lease contracts as established through negotiation with our lessors. Based on the length of a lease contract, as well as any variable lease payments, these discount rates currently range from 6% to 10%.

	20X9	20X8
Lease Cost:		
Finance lease cost:		
Amortization of right-of-use assets	\$ XXX	\$ XXX
Interest on lease	XXX	XXX
Total finance lease cost	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	\$ XXX	\$ XXX
Other information:		
Gain/(loss) on sale-leaseback transactions, net	\$ XXX	\$ XXX
Cash paid for amounts included in lease liabilities:		
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Total cash paid	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX

Weighted-average remaining lease term – finance leases	XX years	XX years
Weighted-average remaining lease term – operating leases	XX years	XX years
Weighted-average discount rate – finance leases	XX %	XX %
Weighted-average discount rate – operating leases	XX %	XX %

Maturity Analysis:		
	Finance Lease Liabilities	Operating Lease Liabilities
201X	\$XX	\$XXX
210Y	XX	XXX
201Z	X	XX
201A	X	XX
201B	XX	XXX
Total Undiscounted Cash Flows	\$XXX	\$X,XXX
Interest at a Weighted Average Rate of 7.4%	(XX)	(XXX)
Lease Payment Liabilities	\$XXX	\$X,XXX

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## EXAMPLE – LEASES

Wal-Mart – Fiscal Year Ended January 31, 2020

### Note 1. Summary of Significant Accounting Policies (in Part)

#### *Leases*

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires lease assets and liabilities to be recorded on the balance sheet. The Company adopted this ASU and related amendments as of February 1, 2019, under the modified retrospective approach and elected certain practical expedients permitted under the transition guidance, including to retain the historical lease classification as well as relief from reviewing expired or existing contracts to determine if they contain leases. For leases subject to index or rate adjustments, the most current index or rate adjustments were included in the measurement of operating lease obligations at adoption.

The adoption of this ASU and related amendments resulted in a \$14.8 billion increase to total assets and a \$15.1 billion increase to total liabilities in the first quarter of fiscal 2020. In the first quarter of fiscal 2020, the Company recognized \$16.8 billion and \$17.5 billion of operating lease right-of-use assets and operating lease obligations, respectively, and removed \$2.2 billion and \$1.7 billion, respectively, of assets and liabilities related to financial obligations connected with the construction of leased stores. Several other asset and liability line items in the Company's Consolidated Balance Sheet were also impacted by immaterial amounts. Additionally, the adoption resulted in a cumulative-effect adjustment to retained

earnings of approximately \$0.3 billion, net of tax, which primarily consisted of the recognition of impairment. The Company's Consolidated Statement of Income and Consolidated Statement of Cash Flows were immaterially impacted. Accounting policies as a result of the adoption of this ASU are described below. Refer to Note 7 for additional lease disclosures.

For any new or modified lease, the Company, at the inception of the contract, determines whether a contract is or contains a lease. The Company records right-of-use (ROU) assets and lease obligations for its finance and operating leases, which are initially recognized based on the discounted future lease payments over the term of the lease. As the rate implicit in the Company's leases is not easily determinable, the Company's applicable incremental borrowing rate is used in calculating the present value of the sum of the lease payments.

Lease term is defined as the non-cancelable period of the lease plus any options to extend or terminate the lease when it is reasonably certain that the Company will exercise the option. The Company has elected not to recognize ROU asset and lease obligations for its short-term leases, which are defined as leases with an initial term of 12 months or less.

For a majority of all classes of underlying assets, the Company has elected to not separate lease from non-lease components. For leases in which the lease and non-lease components have been combined, the variable lease expense includes expenses such as common area maintenance, utilities, and repairs and maintenance.

## Note 7. Leases

The Company leases certain retail locations, distribution and fulfillment centers, warehouses, office spaces, land and equipment throughout the U.S. and internationally.

The Company's lease costs recognized in the Consolidated Statement of Income consist of the following:

<i>(Amounts in millions)</i>	<b>Fiscal Year Ended January 31, 2020</b>
Operating lease cost <sup>(1)</sup>	\$ 2,670
Finance lease cost:	
Amortization of right-of-use assets	480
Interest on lease obligations	306
Variable lease cost	691

(1) Rentals (including amounts applicable to taxes, insurance, maintenance, other operating expenses and contingent rentals) under operating leases and other short-term rental arrangements were \$3.0 billion and \$2.9 billion in fiscal 2019 and 2018, respectively.

Other lease information is as follows:

<i>(Dollar amounts in millions)</i>	<b>Fiscal Year Ended January 31, 2020</b>
Cash paid for amounts included in measurement of lease obligations:	
Operating cash flows from operating leases	\$ 2,614
Operating cash flows from finance leases	278
Financing cash flows from finance leases	485
Assets obtained in exchange for operating lease obligations	2,151
Assets obtained in exchange for finance lease obligations	1,081
Weighted-average remaining lease term - operating leases	15.6 years
Weighted-average remaining lease term - finance leases	14.4 years
Weighted-average discount rate - operating leases	5.4%
Weighted-average discount rate - finance leases	8.6%

The aggregate annual lease obligations at January 31, 2020 are as follows:

<i>(Amounts in millions)</i>		
<b>Fiscal Year</b>	<b>Operating Leases</b>	<b>Finance Leases</b>
2021	\$ 2,587	\$ 797
2022	2,358	757
2023	2,138	640
2024	1,932	552
2025	1,728	492
Thereafter	15,514	5,612
<b>Total undiscounted lease obligations</b>	<b>26,257</b>	<b>8,850</b>
Less imputed interest	(8,293)	(4,032)
<b>Net lease obligations</b>	<b>\$ 17,964</b>	<b>\$ 4,818</b>

## ***Lease Implementation and Reporting Issues***

Below we will cover some of the common implementation and reporting issues that companies are incurring when applying Topic 842, *Leases*. In review of public company implementation issues, the following were some of the most common and problematic:

- Companies who have made the transition to the new lease accounting guidance have consistently reported that the **transition** was more difficult than they had initially expected and they should have started the transition efforts earlier.
- Identifying **embedded leases** continues to be a challenge for many companies. An arrangement includes an embedded lease if there is an explicit or implicit identified asset in the contract and the customer controls the use of the identified asset. Once an asset is identified within a contract, the reporting entity should determine if they have both the right to obtain substantially all of the economic benefit of that asset throughout the contract term and the right to direct the use of the identified asset. In order to verify completeness of lease inventory, the reporting entity should obtain a listing of all the service contracts and review for leases.
- When using the **practical expedient** within Topic 842, which does not require the reporting entity to reassess the classification of their existing lease classification, an operating lease under Topic 840 can remain an operating lease under Topic 842 and a capital lease under Topic 840 can remain a finance lease under Topic 842. However, this practical expedient does not apply if there are errors with the initial classification of any leases.
- Lessees have to now disclose how they determine the **discount rate** for their leases, which in the majority of cases will be the incremental borrowing rate (IBR). If the discount rates are material to the reporting unit, this disclosure should be detailed enough to include how those rates were determined, what inputs were used, and what adjustments were made to those inputs. Many public companies assumed determining the IBR would be straightforward, however, that did not prove to be true. (Private companies can use an alternative, a risk-free rate. However, this rate generally results in a higher lease liability.)
- When a lessee elects the **practical expedient** to not separate lease and non-lease components:
  - The total lease liability to be recorded on the balance sheet will be increased. A majority of companies that have applied the new standard were surprised that lease liabilities increased by such large amounts.
  - The lessee must disclose both (1) its election of the practical expedient, and (2) the class or classes of underlying asset or assets for which the lessee has elected it.

## **Financial Instruments – Credit Losses (Topic 326)**

Financial instruments are defined in the FASB Codification as:

*Cash, evidence of an ownership interest in an entity, or a contract that both:*

- Imposes on one entity a contractual obligation either:
  - To deliver cash or another financial instrument to a second entity, or
  - To exchange other financial instruments on potentially unfavorable terms with the second entity.
- Conveys to that second entity a contractual right either:
  - To receive cash or another financial instrument from the first entity, or
  - To exchange other financial instruments on potentially favorable terms with the first entity.

ASU 2016-13, *Financial Instruments – Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*, was issued to provide financial statement users with more decision-useful information about a reporting entity’s (1) **expected credit losses** on financial assets, and (2) other commitments to extend credit.

Before the ASU, legacy guidance set credit loss recognition thresholds at a high “probable” level for incurred losses. The impact was to delay credit loss recognition, even though the reporting entity may be expecting a future credit loss. Legacy guidance did not allow financial statement preparers to recognize expected credit losses because it was difficult to reach the probable threshold due to future uncertainties.

Overall, Topic 326 results in more-timely reporting of credit losses, forward-looking measurements, greater transparency, and enhanced comparability. Financial statement users benefit (and reduce costs) because **forward-looking information** is how they generally analyze financial instrument risk and valuation based on the user’s own expectations.

### **Topic 326**

Scope of Topic 326 includes:

- Loans receivable
- Debt securities
- Trade receivables
- Net investment in leases
- Off-balance sheet credit exposure
- Reinsurance receivables

This topic produces the following:

- Earlier credit loss recognition and measurement, including changes during the reporting period

- Increased transparency of credit loss expectations
- Increased transparency of financial asset realizability
- Enhanced comparability of financial asset credit quality

Topic 326 also provides new guidance for recognizing, measuring, presenting, and disclosing credit losses (also referred to as credit impairment) on trade and reinsurance receivables, loans, debt securities, net investments in leases, off-balance-sheet credit exposures, and certain other financial instruments that have the contractual right to receive cash.

**Application considerations follow:**

- Financial assets measured at amortized cost and certain other financial instruments:
  - This would include held-to-maturity debt securities. The topic requires using a **current expected credit loss (CECL)** model to estimate credit losses over the financial asset’s life. Because this is **forward-looking**, it is based on forecasts of future economic conditions, which is a significant change from legacy guidance. The result will be earlier credit loss recognition. Because the forecast is over the financial asset’s life, the result will also generate greater loss amounts than in legacy guidance.
  - The CECL model requires if losses exist, the carrying value of the investment equals amortized cost minus the allowance for credit losses, that is, the amount expected to be collected. Contractual life should incorporate expected prepayments, but possible extensions should not be included.
  - In estimating credit losses, all relevant information should be considered:
    - Past events
    - Current conditions
    - Reasonable, supportable forecasts
  - Forecasted information need not extend to the instrument’s entire contractual life
  - CECL may be applied to each asset or to groups of assets (unit of account). Assets can be evaluated on a collective pool basis. If an instrument does not share risk characteristics with other instruments, it should be evaluated individually. A particular asset may have to be moved from one pool to another pool if risk characteristics change over time.
- Available-for-sale debt securities (AFS):
  - This topic changes the form of expected loss recognition for available-for-sale debt securities. It requires recognizing an **allowance for credit losses** instead of the legacy guidance that required a direct reduction in the debt security’s amortized cost. The new approach means

now reversing a credit loss allowance when there is a credit improvement, which will result in increased earnings.

- AFS debt securities are still considered impaired if their carrying value exceeds their fair values.
  - In addition, Topic 326 no longer permits using the length of time a debt security has been in an unrealized loss position to determine that a credit loss does not exist.
- Certain beneficial interests in securitized financial assets:
    - The topic requires companies holding financial assets that are of low credit quality to follow one of the two credit loss models above depending on whether the beneficial interest is classified as held-to-maturity or available-for-sale.

Excluded from Topic 326 are:

- Loans made to participants in certain employee benefit plans
- An insurance entity's policy loan receivables
- A not-for-profit's pledge receivables
- Related-party loans and receivables between entities under common control

Guidance for these excluded items will still follow the existing model for loss contingencies in Topic 450-20, *Loss Contingencies*. The topic amends Topic 450-20 to exclude financial instruments that are now in-scope for Topic 326.

Topic 326 also eliminates legacy guidance in Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, for purchased credit impaired (PCI) loans and debt securities. Legacy guidance considered only loans or debt securities, and now a reporting entity must determine whether all purchased financial assets qualify as PCI financial assets. Guidance for PCI financial assets requires recording both (1) the purchase price, and (2) a reduction for the estimate of credit losses at the acquisition date. Combined, these two become the initial amortized cost.

### ***Topic 326 Disclosures***

- Assets carried at amortized cost. Disclose the factors and methodology used to estimate future credit losses, including reasons for any changes in factors or methodology.
- Financing receivables and net investment in leases measured at amortized cost. A financing receivable is a financing arrangement that is a contractual right to receive money recorded as an asset. The net investment is a lease definition, depends on the type of lease:
  - Sales-type lease is the sum of the lease receivable and the unguaranteed asset residual value.

- Direct financing lease is the sum of the lease receivable and the unguaranteed asset residual value, reduced by any deferred selling profit.
- Expanded disclosure disaggregating the amortized cost basis by each credit quality indicator and asset’s year of origination for the prior five years. A credit quality indicator example is an internally developed risk grade.
- Available-for-sale debt securities – disclose the roll forward of the new credit loss allowance.

### ***Implementation Considerations of ASU 2016-13—Credit Losses***

- A common misperception is that the ASU applies only to financial institutions; however, it has a broader impact. It **impacts any entity that has financial assets not measured at fair value** (measured at amortized cost) with the right to receive cash.
  - Examples are trade receivables (which apply to most all entities), held-to-maturity debt securities; financing receivables; contract assets recorded under Topic 606, the new revenue recognition standard; and a lessor’s net investment in sales-type and direct-financing leases.
- Start now, because collecting **historical information** and system changes may be significant, even though the ASU is not effective until 2020 for public business entities and in 2023 for private companies. Starting now also means a company will have collected the internal and external data that will become the historical basis for estimating credit losses upon implementation of the new update.
- The entity needs to determine whether it will **early adopt** at the earliest-allowable date in 2019, or follow the 2020 effective date for public business entities.
- **Modify the existing credit risk model.** The guidance states that historical credit loss data, both internal and external, are good starting points for estimating expected credit losses (future expectations).
- Reporting entities that provide **extended customer payment terms** (three to five years), or hold long-term financial assets, will generally need different forecast processes than entities that primarily have traditional short-term trade receivables.
- **Non-financial indicators** may also become part of the new credit risk model. For example, forecasts of future unemployment rates, interest rates, or economic growth.
- Legacy **trade receivable expected losses** based on the aging method may need to be modified. A reporting entity may document that its internal historical loss information is a reasonable basis for estimating expected credit losses. The entity may determine that the impact of improving economic conditions, such as a decreasing unemployment rate, may reduce (improve) the historical aging losses.
- **Modify accounting policies, processes, and controls** to comply with the ASU. Generally, credit losses will be recognized sooner.

- Determine whether **enterprise and information technology systems** need to be changed.
- Determine any **secondary impact** on other company functions such as human resources for incentive compensation, debt covenant compliance, and income taxes.
- **Disclosures** will most likely increase due to the greater judgment of forecasting inputs and conclusions.
- The FASB established a **Transition Resource Group (TRG)** for credit losses. Participants should continuously monitor TRG discussions.

## NOTES

# Unit

# 3

## AICPA Update – Auditing and Attest

### LEARNING OBJECTIVES

*After completing this section, participants will be able to:*

- › Describe recent audit issues and how these issues are being addressed.
- › Identify and describe recently issued SASs (audit standards).
- › Identify and describe recently issued SSAEs (attestation standards).

### INTRODUCTION

In the years following the significant audit convergence project (2012) to bring U.S. standards as close as possible to international standards (International Standards on Auditing, or ISA), the Auditing Standards Board (ASB) was relatively quiet in terms of promulgating new standards until 2019/2020. The years 2019/2020 were exciting years of activity for the AICPA. Of the many projects and responsibilities of the AICPA, the following committees and boards have finalized numerous standards and guidance for the CPA practitioner.

In addition to the tasks of addressing the impact of technology changes, the responsible authoritative bodies are addressing and issuing proposed exposure drafts in multiple areas of attest engagements to bring these further in line with the ISA. The intent is to provide guidance for the current and future the fast-paced environment of rapidly changing business activities and technology. Practitioners should be alert for the changes to respond appropriately in their practices. The focus of this section will be on the activities of the following bodies that provide guidance and establish standards:

- The ASB promulgates the audit standards for nonpublic entities in the United States, known as Statements on Auditing Standards (SAS).
- The ASB also promulgates the Statements on Standards for Attestation Engagements (SSAE).

Because this course was written in March 2021, it is not possible to exactly predict the contents of future exposure drafts or any additional new audit or attest standards that will result from the completion of these projects. Topics to be covered in this section include the following:

- AICPA Audit Quality Initiative Update
- Peer Review—Risk Assessment—A Continuing Issue
- Peer Review—Other Issues
- Audit Issues Implementing the New Revenue and Lease Accounting Standards
- Statements on Auditing Standards (SASs)
- Attestation Standards (SSAEs)

## **AICPA AUDIT QUALITY INITIATIVE UPDATE**

In 2014, the AICPA launched an initiative, *Enhancing Audit Quality*, to address the changing, complex business and regulatory environment in an effort to renew the profession's commitment to quality engagement performance in audit and other assurance-related services. The six-point plan was developed to integrate quality throughout the audit process from prelicensure to enforcement:

1. Prelicensure
2. Standards and Ethics
3. CPA Learning and Support
4. Peer Review
5. Practice Monitoring
6. Enforcement

Let's look at a couple of the issues identified earlier.

### **Proposed Model for Licensure Changes**

The National Association of State Boards of Accountancy (NASBA) and the AICPA jointly initiated *CPA Evolution*.

The proposed model was designed to evolve newly licensed CPA skills and knowledge. The current body of knowledge requires a more robust understanding of systems controls, SOC engagement, and data analysis than previously required. The new license model is a two-layer approach which will include the following:

- Common core level of competencies

- Accounting
- Audit
- Tax
- Technology
- Second level of competencies that would involve more in-depth skills and knowledge of one of three disciplines:
  - Business reporting analysis
  - Information systems and controls
  - Tax compliance and planning

No matter what the chosen discipline when added to the core level, this would result in the same CPA license.

In developing the new model, the NASBA and AICPA developed five guiding principles:

- Principle #1: The CPA profession must adapt quickly due to the technological disruptions in areas such as data analytics, robotics, artificial intelligence, and more. As such, the competencies, services, and attitudes of CPAs must continually evolve in order to protect the public interest.
- Principle #2: The CPA profession and state boards of accountancy recognize that technological and analytical expertise are essential to performing assurance work, as well as the other services that are currently, or will be in the future, core to professional accounting.
- Principle #3: The CPA profession and state boards of accountancy acknowledge that sustaining the profession and continued public protection require rethinking initial licensure requirements.
- Principle #4: The CPA profession, and therefore entry into the profession, must be redesigned to attract individuals with technological and analytical expertise. This includes non-CPA professionals whose technology and analytics skills are critical to the performance of assurance and other core services, as well as nonaccounting major students. All must demonstrate minimum required competencies necessary to perform professional accounting services as a CPA.
- Principle #5: The changes must be rapid, transformational, and substantive without negatively impacting candidates currently in the pipeline.

## **Peer Review - Risk-Based Auditing: A Continuing Issue**

For peer review, **risk-based auditing** is a continuing issue that needs to be reviewed by firms, especially because of the significant changes made by the auditing standards issued in 2019 (SAS 134, 135, 136, 137, 138, 139) and the many proposed new exposure drafts for audit. The risk assessment

model is not replaced; rather, it is enhanced and more robust with more required proceeds, documentation, and changes in definitions of what will constitute a presumed risk that must be addressed.

The ASB revised its risk assessment model in 2006. The eight audit risk standards, SAS Nos. 104–111, were prepared in response to the conclusions of the Joint Risk Assessments Task Force of the ASB, the International Auditing and Assurance Standards Board (IAASB), and the recommendations of the August 2000 report of the Panel on Audit Effectiveness of the Public Oversight Board.

The overall conclusion of the Panel on Audit Effectiveness was that the audit process, which had not been formally updated for many years, was not considered to be flawed, but it needed enhancements to reflect the then-current audit environment and audit expectations. The corporate failures that surfaced in the 1990s and early 2000s served to highlight some of the issues with the audit process at the time.

Prior to the risk assessment standards, many auditors focused very little on internal controls as a means to reduce the level of substantive testing. Many believed that the client's controls could not be relied upon, and others believed that a substantive approach to audits was more efficient. This resulted in engagement teams assessing control risk as high without a full understanding of the ways in which the client's internal controls structure, or lack thereof, could impact the audit.

Firms also tended to focus their audit procedures on the balance sheet and perform a fluctuation analysis on the income statement. This resulted in a lack of understanding of how errors or fraud in transactions taking place throughout the year could or did occur.

The risk-based approach offered a more holistic approach to auditing in that it assessed the risk of fraud or error in the financial statements based on a much more rigorous process, including a verification of the existence (or lack) of internal controls. It also requires the auditor to perform audit procedures on every significant account balance and class of transactions.

The auditor's overall objectives when conducting **risk-based audits** of financial statements are to

- obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether due to error or fraud, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- report on the financial statements, or otherwise, as required by the SASs, in accordance with the auditor's findings, outlined in AU-C 315, Understanding the Entity and Its Environment and Assessing Risks of Material Misstatements, throughout the conduct of the audit.

The risk assessment process described in AU-C 315 consists of the following activities:

1. Perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. These procedures include:

- Making inquiries of management and other members of the client team who may have information that can assist in identifying risks of material misstatement due to fraud or error
  - Performing both financial and nonfinancial analytical procedures to assist in understanding the client and its environment, and to identify areas that may present risks of material misstatement due to fraud or error
  - Assessing prior experience with the audit client and audit procedures performed in prior audits, as well as the relevancy of information obtained, particularly if the intent is to use that information for purposes of the current period audit. This may require the auditor to conduct certain audit procedures (such as walkthroughs of relevant systems) in order to determine whether or not changes have occurred that may affect the relevancy of the information previously obtained
2. Facilitate discussions among the audit engagement team regarding the susceptibility of the audit client's financial statements to material misstatement due to errors or fraud
  3. Develop an understanding of the audit client, its environment, and internal controls relevant to the audit. Understanding internal control relevant to the audit means understanding the design of the systems of controls, and whether the controls have been implemented (D&I). Performing walkthroughs of significant accounting processes by tracing transactions through accounting process steps from the initiation of a transaction through its posting to the appropriate general ledger accounts confirms that controls are implemented as designed.
  4. Identify the risk of material misstatement due to fraud or error at both the financial statement and relevant assertion levels (i.e., assertion risks). Revisions to this risk assessment should be made during the course of the audit where additional audit evidence, or new information obtained, produces inconsistencies with the audit evidence upon which the auditor originally based the assessment.
  5. Identify the accounting processes that include assertion risks
  6. Identify the key controls within the accounting processes
  7. Assess the risk of material misstatement identified as high, moderate, or low. Ensure that significant and fraud risks are identified.
  8. Develop tailored audit procedures linked to the risks of material misstatement identified. Note that this is a critical step in the audit planning process, which is necessary to reduce these risks.
  9. Document key aspects of the risk assessment process, including
    - significant decisions reached in engagement team discussions, as well as timing of those discussions, and audit team members who participated in those discussions;
    - key elements associated with obtaining an understanding of the audit client, its environment, internal control components, sources from which the understanding was obtained, and the risk assessment procedures performed;

- identified and assessed risks of material misstatement at both the financial statement and relevant assertion levels; and
- risks and controls related to those risks that require special audit consideration (i.e., fraud risk, risks associated with significant related party transactions, economic and accounting matters, etc.).

In reviewing peer review reports over the last 10 years, **deficiencies in the risk-based audit model** include the following (not in any particular order of occurrence):

- Assessing and responding to risk
- Testing internal control over financial reporting
- Auditing estimates (AU-C 342 and AU-C 328)
- Audit sampling (completeness of the population and adequate sample sizes continue to be an issue)

Looking at the risk-based audit standards today, it appears that some auditors continue to take a balance sheet approach when conducting audits resulting in little attention being paid to internal controls as an input into the overall audit risk of errors or fraud. Furthermore, documentation of the risk-based decisions and audit procedures being performed is often lacking in audit workpapers.

The risk-based audit approach emphasizes the use of analytical procedures in planning as a means to identify unusual and/or unexpected variations in reported outcomes to assist in identifying errors or fraud. To perform planning analytical procedures effectively, auditors must develop financial statements, trends, and ratio expectations in order to compare client outcomes to these expectations. Frequently, expectations are not developed or, if developed, are not documented.

The results of ignoring internal controls, not documenting audit approaches and conclusions, and not creating planning analytical procedures expectations causes the effectiveness of risk-based audits to be less effective than they would be if auditors complied with the risk assessment model created in 2006. Among the highest audit deficiencies noted, revenue was the financial statement area most often identified. This does include receivables, allowances, and deferred revenues. This is of significant concern for the new revenue recognition model that is currently being implemented.

The **four most common risk assessment deficiencies** identified by the AICPA include the following:

1. Internal Control—40% of identified issues related to failure to gain an understanding of internal control when identifying the client's risks
2. No Linkage of Risks Identified to Procedures Performed—24% of issues related to auditors not linking their risk assessments to their audit responses
3. Insufficient Risk Assessment—14% of issues related to incomplete or nonexistent risk assessment

4. Improper Control Risk—13% of issues related to auditors assessing control risk as less than high without appropriately testing internal controls

The **five most common risk assessment problems** according to state societies' professional and technical standards personnel include the following:

1. Improper use of third-party practice aids—defaulting to a basic set of procedures without assessing risk and assessing risk at the financial statement level rather than at the financial assertion level
2. Defaulting to high control risk without adequately assessing and documenting the internal control or control risks
3. Reducing control risks to less than high without testing internal controls
4. Not identifying a significant risk in areas such as revenue recognition or other material nonroutine transactions that require significant professional judgment
5. Not linking risk assessment and audit response and not tailoring programs to the unique risks identified at the client

In the current **coronavirus environment**, heightened audit risks include the following:

- Internal control
- Fraud risks
- Noncompliance with laws and regulations
- Accounting estimates
- Going concern
- Subsequent events

## **Other Peer Review Findings**

- **Documentation**—Lack of adequate documentation, or nonexistence of documentation, is a frequent finding in nonconforming engagements. The AICPA has responded by developing and making available a free toolkit on documentation which can be found at [www.aicpa.org/documentation](http://www.aicpa.org/documentation).
- **Must-select engagements** (i.e., single audit and employee benefit plan audits) resulted in unusually high levels of noncompliance. To address these issues, the AICPA has created webcasts, alerts, and other resources to reach out to auditors and other stakeholders to raise awareness of the issues. Of the tools developed, many are available for free, but others are only available to members of the related audit quality center.

In the recent **Peer Review Alert**, enhanced guidance for peer reviewers in the area of nonconforming single audit engagements and employee benefit plan audit engagement reinforces the need for recall or reissuance of reports when such engagements are considered not performed or reported in all material respects in compliance with professional standards.

Examples of issues that might cause additional audit procedures to be performed or the report to be reissued are the following:

- Single Audit Engagements
  - Missed major program resulting from an improper risk assessment
  - Improper clustering of programs
  - Failure to meet the coverage percentage
  - Improper calculation of type A/B threshold
  - Inadequate testing of controls over compliance
  - Schedule of Expenditures of Federal Awards (SEFA) not properly added
  - Language in auditor report not consistent with AU-C 265 (communicating internal control matters) or AU-C 935 (compliance audits)
  - Missing required footnotes for SEFA
- Employee Benefit Plan Audit Engagements
  - Participant data —failure to test eligibility, allocations, or forfeitures
  - Inadequate or failure to document understanding of internal control
  - No audit work performed on contributions
  - Failure to test elective deferrals on payroll audit procedures
  - Failure to test year-end investment values
  - No testing on benefit payments
  - Reducing sample sizes to levels that are too low

Auditors, for **2021-2022 peer reviews**, should focus on the following areas:

- Firm's system of quality control
- Independence potential impairments and documentation

- Implementation of new standards; especially, revenue recognition
- Recurring deficiencies in audits and review engagements
- Other matters including cybersecurity, omitted procedures, and adequate documentation

## **Proposed Audit Quality Standards**

Thursday, February 4, 2021, the AICPA's ASB issued three proposals to replace Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* and SAS 122, *Statements on Audit Standards: Clarification and Recodification*. These three proposals are:

- Proposed Statement on Quality Management Standards (SQMS) 1, *A Firm's System of Quality Management*
- Proposed Statement on Quality Management Standards (SQMS) 2, *Engagement Quality Reviews*
- Proposed Statement on Auditing Standards, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*

These proposed standards are designed to bring changes to the way accounting firms will manage quality in their accounting and auditing practices. These proposed standards

- include a new, proactive, risk-based approach to quality management systems within firms;
- are designed to improve the scalability of standards because the risk-based approach promotes a system tailored to the nature and circumstances of an individual firm and its engagements;
- are based on the IAASB's quality management standard; and
- use the terms *quality management* instead of *quality control*, and *engagement quality review* instead of *engagement quality control review*.

As stated in the proposal:

- The development of the proposed standards has been influenced by concern about audit quality, as indicated by the results of peer reviews and studies by other regulators, such as the following:
  - Risks to audit quality correlated with audits, reviews, and attestation engagements performed by engagement partners who perform low volume of such engagements
  - Consistency issues in the performance of engagements and a lack of focus on planning
  - Over-reliance on intellectual resources, such as third-party quality control materials, that are not sufficiently tailored to the nature and circumstances of the firm
  - Challenges experienced by smaller firms in applying the standards

- A need to improve firm governance and leadership and the culture and tone at the top of the firm

For your information, the proposed system of quality control in proposed SQMS No. 1 includes the following eight components:

1. The firm's risk assessment process (new)
2. Governance and leadership (adopted from the leadership responsibilities for quality within the existing firm component in QC section 10)
3. Relevant ethical requirements (same name as component in QC section 10)
4. Acceptance and continuance of client relationships and specific engagements (same name as component in QC section 10)
5. Engagement performance (same name as component in QC section 10)
6. Resources (adopted from the human resources component in QC section 10)
7. Information and communication (new)
8. The monitoring and remediation process (adopted from the monitoring component in QC section 10)

Comment period for these proposals ends June 11, 2021.

## **REMOTE AUDITING CHALLENGES IMPACTED BY THE CORONAVIRUS**

### **Challenges or Opportunities?**

- Coronavirus needs to be considered in audit planning and throughout the audit
- Heightened significant risk circumstances when considering material estimates, going concern, subsequent events, PPP loans, and related party transactions
- Increased risk of management override
- Working remotely due to social distancing
- Potential travel restrictions
- Availability of client records and personnel
- Breakdown of internal controls or the need for new internal controls

- Implementation of new accounting standards effective in 2020/2021

## **Planning the Remote Audit**

Planning an audit engagement when auditing remotely requires consideration of the following:

- Risk Assessment Procedures—Inquiries may be a challenge if they cannot be performed in person. At a minimum, the inquiries should be face to face (Zoom/Webex, etc.) to enable the auditor to evaluate body language and facial expressions. Furthermore, the expectations developed by the auditor for analytical procedures will require extensive knowledge of the changes that took place or are taking place during 2020/2021 and not just rely on past trends or relationships for these expectations.

Walkthroughs will need to increase to identify the changes that have taken place due to the coronavirus and determine the impact these changes have had on the client's internal controls.

- Accounting Estimates—Accounting estimates the client made (or did not make) will require the auditor to focus more extensively on these estimates by paying specific attention to the reasonableness, or not, of the estimates by independently developing auditor estimates to confirm or question the client's estimates. This will be especially critical in this coronavirus environment when there may be management bias to reduce the adverse consequences of the pandemic. Specific issues include revenue, leasing, impairments, valuation, and predicting future cash flows.
- Client Confidentiality—A secure portal should be used for the processing of documents or other client information necessary to perform the audit.
- Documentation—Existing documentation standards in the audit literature still apply during the coronavirus. In general, documentation evidence will need to be developed, including its source, appropriateness, sufficiently, completeness, and accuracy, and linked to the risks of material error or fraud.
- Reporting—For reporting purposes, auditors will have to consider the possibility of an emphasis-of-matter paragraph in the report identifying the possible uncertainty associated with significant estimates, going concern, future expected cash flows, scope limitations, subsequent events, and risks and uncertainties due to the coronavirus.
- Managing the Remote Audit—Managing in a remote environment will require the engagement team to be flexible, available, create expectations, establish policies and procedures, and maintain communications. Stated another way, managing a remote audit in today's environment requires the following:
  - Establishing clear expectations between the client and engagement team
  - Establish periodic deadlines with monitoring meetings in between the deadlines
  - Plan for unexpected contingencies

- Always be flexible
- Effectively use technology
- Establish updated materiality benchmarks
- Daily communication is a priority

## **AUDIT ISSUES IN IMPLEMENTING THE NEW REVENUE AND LEASE ACCOUNTING STANDARDS**

### **Audit Issues for Consideration in Implementing the New Revenue Recognition Standard—Topic 606, *Revenue from Contracts with Customers***

Many financial statements of public companies issued to date have reflected significant impact from the new revenue standard, others not so much. Whatever the effect(s) of Topic 606 on entity financial statements, revenue recognition continues as a significant audit risk and it is much riskier during the effective date transition (i.e., learning curve into the new standard).

Whatever the effect will be on the financial statements, significant audit risk will exist in auditing revenue based on the change in the accounting standard—normally the largest amount in a company’s financial statements. Industry-specific guidance was replaced with the six-step model, which is principles-based. The six-step model requires the following:

1. Identify the contract(s)
2. Identify the performance obligation(s) (promises) in the contract
3. Identify the transaction price
4. Allocate the transaction to the performance obligations
5. Recognize revenue when a performance obligation is satisfied—control has transferred to the customer
6. Disclose information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the reporting entity’s contracts with customers

Challenges the auditor should consider in planning audit engagements as the new revenue standard is implemented revolve around several areas:

- How business and accounting processes (procedures) have changed
- Systems that have been developed to accumulate data from these processes

- Change in controls to support the systems
- Considerations of the use of estimates (principle-based standard)
- Required new and expanded qualitative and quantitative disclosures

The significance of these changes will increase the risks of material misstatement. Implementation of the new revenue recognition standard will be particularly challenging in assessing risk of material misstatement in several areas:

- Determining if revenue is in compliance with the new six-step model
- Determining if a contract exists between the client and customers
- Determining if contract modifications are being accounted for properly and consistently
- Determining how performance obligations were identified and whether the conclusions as to whether they are “distinct” or not are appropriate
- Determining that any variable consideration in the contract price has been accounted for in the proper time period and in the correct amount (constraint)
- Identifying evidence supporting recognizing revenue over time (transfer of control)
- Evaluating internal controls over the financial statement reporting process
- Identifying and evaluating fraud risk factors
- Auditing the transition adjustments
- Determining that required disclosures are included in the notes to the financial statements

The auditor’s procedures to identify the risk of material misstatement due to error or fraud require an understanding of a reporting entity’s selection and application of accounting principles and to consider any change in accounting principle as it relates to conformity with generally accepted accounting principles. Upon transition to the new revenue recognition standard, the entity has two transition methods available to consider as well as optional practical expedients that can be applied during the transition.

Auditing standards require that procedures be performed on transitional disclosures to evaluate the effect on the financial statements and the auditor’s report, particularly to assure the disclosures are not omitted, incomplete, or inaccurate.

The auditor must design and develop responses to the risk of material misstatement identified in the transition adjustments by considering the internal controls, any data that previously was not audited, and any misstatements from prior periods that have been identified in the current period as well as any opportunities for committing fraud. In auditing the transitional adjustments, the auditor must

obtain information from management and obtain assurance by testing that the evidence is adequate for the audit.

In implementing new standards, there always exists the potential incentive for fraud by management's selection of incorrect accounting policies and procedures that could achieve a desired result. With the revenue standard, this could result in achieving a financial performance metric through adopting new methods for estimates for accounting or even due to controls that have not been designed properly to implement the standard. Auditors should be aware of these possibilities and respond with the appropriate audit procedures.

Auditors should also be aware of the risk of fraud from management override, especially in smaller companies, because the smaller company has more involvement of senior management in the review of the year-end financial reporting process.

### **Audit Issues for Consideration in Implementing the New Leases Standard—Topic 842, *Leases***

Although similar to the revenue recognition standard in that this new standard also has broad applicability, there is a huge difference in the impact these two standards are likely to have.

Many reporting entities have found, or will find if they have not yet implemented the new revenue standard, that the new revenue standard does not change by one dollar the amount of revenue from a particular transaction (how could it?). Disclosure is a different matter. All entities will have to make much more robust disclosures about revenue.

The lease standard is different because all entities that have leases will have to put new assets and liabilities on the balance sheet. The income statements and statement of cash flow will also be different because of the differing treatment of finance and operating leases.

In any case, there are challenges for auditors presented by the new lease standard. Experience tells us that most, if not all, of the participants at our CPE programs focus on leasing from the lessee perspective more so than from the lessor perspective. Accordingly, we will focus on the issues facing an auditor of an entity that is a lessee. The issues include the following:

- Considering whether management will be biased in favor of keeping the right-to-use asset and related liability artificially low
- Determining that management is following an allowable implementation method and properly applying elected practical expedients
- Determining if there is a lease, particularly for leases that might be embedded in contracts not labeled as a lease
- Determining if the lease is a finance or operating lease
- Determining if there are nonlease components and how management has allocated payment amounts, or if management elected not to make such an allocation

- Determining the appropriate lease term
- Determining the appropriate interest rate to use to calculate the present value of the liability
- Determining that variable consideration is handled properly
- Determining that the lease payments are properly accounted for as rent, or interest and principal, and that amortization of the related assets is calculated appropriately
- Determining that required disclosures are included in the notes to the financial statements

## **AUDIT UPDATE – 2021**

### **INTRODUCTION**

The ASB and the IAASB have agreed to merge in the future and as a result, both boards are attempting to eliminate as many differences between them in preparation for the merger. Between May 2019 and May 2020, the ASB issued the following auditor reporting standards to generate more consistency with the international auditing standards:

- SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
- SAS 135, *Omnibus Statement on Auditing Standards-2019*
- SAS 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*
- SAS 137, *Information in Documents Containing Audited Financial Statements*
- SAS 138, *Amendments to the Description of the Concept of Materiality*
- SAS 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes from SAS 134*
- SAS 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes from SASs 134 and 137*
- SAS 141, *Amendment to the Effective Dates of SAS Nos. 134 to 140*

SAS 141 is effective upon issuance; SASs 134–140 are effective for audits of financial statements for periods ending on or after December 15, 2021.

In July 2020, the ASB issued SASs 142 and 143:

- SAS 142, *Audit Evidence*—Effective for audits of financial statements for periods ending on or after December 15, 2022.

- SAS 143, *Auditing Accounting Estimates and Related Disclosures*—Effective for audits of financial statements for periods ending on or after December 15, 2023.

The following provides an overview of these newly issued audit standards. SAS 134, *AUDITOR REPORTING AND AMENDMENTS, INCLUDING AMENDMENTS ADDRESSING DISCLOSURES IN THE AUDIT OF FINANCIAL STATEMENTS*

### **Objective**

SAS 134 and SAS 135 are designed to enhance the communication value of the auditor’s report and align generally accepted auditing standards with the standards issued by the IAASB and the Public Company Accounting Oversight Board (PCAOB).

SAS 134 addresses the auditor’s responsibility to form an opinion on the financial statements and provides new guidance for the form and content of the report. SAS 134 also contains requirements for when the auditor concludes that a modification to the auditor’s opinion on the financial statements is necessary, and when additional communications are necessary in the auditor’s report.

### **Provisions**

SAS 134 includes a new section AU-C Section 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* and replaces the following AU-C sections in the AICPA Professional Standards:

- Section 700, *Forming an Opinion and Reporting on Financial Statements*
- Section 705, *Modifications to the Opinion in the Independent Auditor’s Report*
- Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*

AS 134 contains the following sections:

- Section 700, *Forming an Opinion and Reporting on Financial Statements*—Prescribes the form and content of the auditor’s report when issuing an unmodified opinion.
- Section 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*—Addresses the auditor’s responsibility to communicate key audit matters in the auditor’s report when the auditor is engaged to do so.
- Section 705, *Modification to the Opinion in the Independent Auditor’s Report*—Addresses the form and content of the report when the auditor concludes that an unmodified auditor’s opinion in accordance with Section 700 is not appropriate.
- Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*—Addresses additional required communications in the auditor’s report.

## ***Basis for Opinion***

SAS 134 requires that the Opinion section of the auditor's report (AU-C Section 700) precede the Basis for Opinion section. SAS 134 also describes the **Basis for Opinion section**, which is now required for audit reports, not just those with modified opinions. The Basis for Opinion section will set users' expectations for the auditor's report and will

- state that the audit was conducted in accordance with Generally Accepted Auditing Standards (GAAS) and identify the United States as the country of origin of those standards;
- refer to the section of the auditor's report that describes the auditor's responsibilities under GAAS;
- include a statement that the auditor must be independent of the reporting entity and meet other ethical responsibility requirements; and
- state whether the auditor believes the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

## ***Auditor's Responsibilities***

Additionally, the audit report includes an expanded description of the auditor's responsibilities relating to professional judgment and professional skepticism, and the auditor's communications with those charged with governance. These responsibilities include the following:

- Exercising professional judgment and maintain professional skepticism throughout the audit
- Identifying and assessing the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements
- Obtaining an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the reporting entity's internal control
- Evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements
- Concluding whether, in the auditor's judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the reporting entity's ability to continue as a going concern for a reasonable period
- Stating that the auditor must communicate with those charged with governance regarding among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that the auditor identified during the audit

## ***Disclosures in the Audit of Financial Statements***

The auditor should evaluate whether

- the financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor should consider the relevance of the accounting policies to the reporting entity and whether they have been presented in an understandable manner;
- the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- the accounting estimates made by management are reasonable;
- the information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor should consider whether all required information has been included, and whether such information is appropriately classified, aggregated, or disaggregated, and presented;
- the financial statements provide adequate disclosure to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- the terminology used in the financial statements, including the title of each financial statement, is appropriate.

### ***Going Concern***

New requirements are also included in SAS 134 for going concern (AU-C Section 570). If the financial statements do not include adequate disclosure about a reporting entity's ability to continue as a going concern for a reasonable period, these new requirements for the auditor include stating in the Basis for Qualified (Adverse) Opinion section that

- substantial doubt exists about the reporting entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter, or
- substantial doubt exists about the reporting entity's ability to continue as a going concern has been alleviated by management's plans but the financial statements do not adequately disclose this matter

### ***Key Audit Matters***

Finally, if the auditor is engaged to do so, SAS 134 provides a framework to communicate Key Audit Matters (KAMs) (AU-C Section 701) in the audit report.

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## **EXAMPLE**

### **Independent Auditor's Report**

*[Appropriate Addressee]*

#### **Report on the Audit of the Financial Statement**

##### **Opinion**

We have audited the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

##### **Basis for Opinion**

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

##### **Responsibilities of Management for the Financial Statements**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

##### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute assurance, and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

*[Signature of the auditor's firm]*

*[City and state where the auditor's report is issued]*

*[Date of the auditor's report]*

**NOTE:** Additional report examples are included in SAS 134.

## **SAS 135, OMNIBUS STATEMENT ON AUDITING STANDARDS—2019**

### ***Objective***

SAS 135 and SAS 134 are designed to enhance the communication value of the auditor's report and align GAAS with the standards issued by the IAASB and the PCAOB.

### ***Provisions***

SAS 135 amends:

- AU-C Section 260, *The Auditor's Communication with Those Charged with Governance*
- AU-C Section 550, *Related Parties*
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C, *Section 260, The Auditor's Communication with Those Charged with Governance*

Changes to AU-C Section 260 include guidance from PCAOB AS 1301 that is intended to improve the quality of audits for nonissuers of financial statements. The required communication with those charged with governance adds the following:

- The auditor's views related to significant unusual transactions could include
  - policies and practices management used to account for these transactions and
  - auditor's understanding of the business purpose.
- Matters, that the auditor consulted outside the engagement team, that were contentious or difficult regarding the responsibility of those charged with governance to oversee the financial reporting process
- Potential effects of uncorrected misstatements on future periods
- Any matters underlying those uncorrected misstatements, even if immaterial to the period under audit, could potentially cause misstatements in future periods
- If management has communicated detailed information about matters that are required communication by the auditor, any omitted or inadequately described matter does not have to be communicated to those charged with governance as long as the auditor
  - participated in management's discussion with those charged with governance and
  - affirmatively confirmed with those charged with governance that management has adequately communicated these matters.
- Audit documentation should include a copy or summary of management's communication provided to those charged with governance.

Application material has been added as guidance in

- communication of the possible implication of uncorrected misstatements,
- communication of complaints or concerns about accounting or auditing matters (that came to the attention of the auditor), and
- documentation of the communication.

### *AU-C Section 550, Related Parties*

Changes to AU-C Section 550, *Related Parties*, addresses the auditor's responsibilities with regard to related party relationships and transactions. SAS 135 adds and specifically expands procedures to focus on the transactions and relationships of related parties in the following areas:

- Understanding of the entity and its environment
- Assessing the risks of material misstatement
- Performing audit procedures to respond to the risks

- Evaluating the audit evidence obtained
- Consideration of fraud related to risk of misstatements

**Understanding the entity** adds inquiries of not only management but others within the entity concerning the following:

- The nature of the related party relationships including ownership structure
- Background information, (e.g., physical location, industry, size, and extent of operations)
- The business purpose for which the related party entered into the transaction as opposed to an unrelated party
- Any modifications or termination of transactions during the period and the type of business purpose for doing so

**Assessing the risks of material misstatement** should now include inquiries related to whether any of the related party transactions:

- Have not been authorized in accordance with the entity's policies and procedures
- Had exceptions granted to the policies and procedures
- When granted exceptions, what were the reasons for doing so

**NOTE:** The auditor is now required to consider significant unusual transactions that are identified as related party transactions as giving rise to significant risk.

In **performing audit procedures** to respond to the risks of material misstatements, the auditor should evaluate the following:

- Has the entity properly identified its related party relationships and transactions?
- To identify these relationships and transactions, has the auditor included procedures to test the accuracy and completeness?
- Have procedures on balances with affiliated entities been considered as of concurrent dates such as:
  - Has the underlying documentation been read to determine that terms and information are consistent with explanations and another audit evidence?
  - Has authorization been consistent with policies and procedures?
  - Has the transaction been accounted for properly?
  - Has adequate disclosure been made?

**Evaluating the audit evidence obtained** requires the auditor to remain alert for related party information when reviewing records or documents and consider the following:

- Confirming the business purpose taking into consideration the likelihood that the entity could influence the related party in their responses to the auditor
- Evaluating information about the financial capability of the parties to a transaction

**Consideration of fraud related to risk of misstatements** notes that fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. The risk of management override is higher if management has relationships that involve control or significant influence with parties with which the reporting entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud.

*AU-C Section 240, Consideration of Fraud in a Financial Statement Audit*

AU-C Section 240 defines significant unusual transactions as:

Significant transactions that are outside the normal course of business for the reporting entity or that otherwise appear to be unusual due to their timing, size, or nature.

Considering this definition:

- Adding to management's inquiries an inquiry regarding whether the reporting entity has entered into significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties
- When an internal audit function exists at the reporting entity, the auditor should inquire as to whether the internal auditor is aware that the reporting entity has entered into any significant unusual transactions
- Inquire of those charged with governance whether the reporting entity has entered into any significant unusual transactions
- Evaluate whether the business purpose (or lack thereof) of significant unusual transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal the misappropriation of assets. Required procedures include
  - reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or lack thereof) of the transaction,
  - determining whether the transaction has been authorized and approved in accordance with the reporting entity's established policies and procedures, and
  - evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements.

## **SAS 136, FORMING AN OPINION AND REPORTING OF EMPLOYEE BENEFIT PLANS SUBJECT TO ERISA**

### ***Objective***

In an effort to enhance the communication value and transparency of the auditor's report, SAS 136 reflects a new reporting model (based on SAS 134) for audits of ERISA plans that, among other things, changes the form and content of the auditor's report when management elects to exclude from the audit certain investment information held and certified by a qualified institution, as permitted by ERISA.

The Department of Labor (DOL) has long advocated for increased transparency in reporting standards when management elects to exclude from the audit certain investment information held and certified by a qualified institution, which is permitted by ERISA. The redesign of the auditor's report should make it easier to understand and more relevant, which will lead to improved employee benefit plan (EBP) audit quality.

### ***Provisions***

New guidance for reporting and performance requirements will now be codified in new AU-C Section 703, *Forming an Opinion and Reporting on ERISA Plan Financial Statements*, which replaces AU-C Section 700 for ERISA plans. The SAS only applies to audits of EBPs that are subject to ERISA. AU-C Section 703 is not all inclusive, as the other AU-C sections apply except when specifically noted in the standard. Plans that are subject to ERISA—whether a single employer, multiple employers, or multiemployers—are affected.

The DOL, IRS, and the Pension Benefit Guaranty Corporation (PBGC) jointly developed the Form 5500 series so EBPs could use the Form 5500 series forms to satisfy annual reporting requirements under Title I and Title IV of ERISA and the IRC. The Form 5500 series is part of ERISA's overall reporting and disclosure framework, which is intended to assure that EBPs are operated and managed in accordance with certain prescribed standards and that participants and beneficiaries, as well as regulators, are provided or have access to sufficient information to protect the rights and benefits of participants and beneficiaries under EBPs. The Form 5500 series includes Form 5500, Annual Return/Report for Employee Benefit Plan, and related schedules (hereinafter referred to as Form 5500).

### ***AU-C Section 703 amends***

- SAS No. 119, as amended [AICPA, Professional Standards, AU-C Section 725];
- Various sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, as amended* [AICPA, Professional Standards, AU-C Sections 220, 240, 330, 450, 501, 510, 540, 550, 560, 580, and 708];
- SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, [AU-C Section 570];

- Section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*;
- Section 240, *Consideration of Fraud in a Financial Statement Audit*;
- Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*;
- Section 450, *Evaluation of Misstatements Identified During the Audit*;
- Section 510, *Opening Balances—Initial Audit Engagements, Including Pre-audit Engagements*; and
- Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

### ***Specific Changes***

1. Significant changes were made to the form and content of the auditor's report letter, which now will align with SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, and SAS 135, Omnibus Statement on Auditing Standards-2019.
2. Emphasis in report letter of permitted election by ERISA when management elects to exclude certain investment information held and certified by a qualified institution.
3. Limited scope audit will now be referred to as an ERISA Section 103(a)(3)(C) audit.
4. Areas of new and/or expanded requirements include the following:
  - Engagement acceptance
  - Audit risk assessment and response, which includes consideration of plan provisions
  - Forming an opinion on ERISA financial statements
  - Reporting on ERISA-required supplemental schedule, including performing specific procedures
  - Communication with those charged with governance of reportable findings that have been identified
  - Written representations requested from management
  - Considerations for Form 5500, *Annual Return*
  - Communicating key audit matters

## **Form and Content**

Practitioners should pay particular attention to the following:

- The Scope and Nature of ERISA Section 103(a)(3)(C) Audit Section is presented first.
- The Auditor's Opinion section follows the Scope and Nature section.
- The Basis for the Opinion section follows the Auditor's Opinion section.
- The Basis for the Opinion section is new and more focused on the obligations relating to independence and clarifies that there are ethical requirements of the audit engagement.

The section related to auditor's responsibilities is revised particularly as it relates to communications with those charged with governance. The section should be headed as *Auditor's Responsibilities for the Audit of the Financial Statements*. It makes clear that the ERISA Section 103(a)(3)(C) audit does not include the certified investment information with the exception of certain procedures.

- Improved reporting specific to going concern issue is required. Management and the auditor's responsibilities are in evaluating and considering the conditions that give rise to the entity's ability to continue as a going concern. AU-C Section 570 now includes a separate section when substantial doubt exists.
- ERISA-required supplemental schedules are required to be recorded in other-matter paragraph, non-ERISA Section 103(a)(3)(C) reports.

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### **EXAMPLE**

#### **Independent Auditor's Report**

*[Appropriate Addressee]*

#### **Opinion**

We have audited the financial statements of XYZ Pension Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), which comprise the statements of net assets available for benefits and of accumulated plan benefits as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the net assets available for benefits and accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the changes in its net assets available for benefits and changes in its accumulated plan benefits for the year ended December 31, 20X2, in accordance with accounting principles generally accepted in the United States of America.

#### **Basis for Opinion**

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of XYZ Pension Plan and to meet our other ethical responsibilities, in accordance with the

relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Responsibilities of Management for the Financial Statements**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

Management is also responsible for maintaining a current plan instrument, including all plan amendments, administering the plan, and determining that the plan's transactions that are presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants, to determine the benefits due or which may become due to such participants.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of XYZ Pension Plan's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Pension Plan's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

## Other Matter—Supplemental Schedules Required by ERISA

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplemental schedules of [identify title of supplemental schedules and periods covered] are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS.

In forming our opinion on the supplemental schedules, we evaluated whether the supplemental schedules, including their form and content, are presented in conformity with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA.

In our opinion, the information in the accompanying schedules is fairly stated, in all material respects, in relation to the financial statements as a whole, and the form and content are presented in conformity with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA.

*[Signature of the auditor’s firm]*

*[City and state where the auditor’s report is issued]*

*[Date of the auditor’s report]*

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## EXAMPLE

### Independent Auditor’s Report

*[Appropriate Addressee]*

#### Scope and Nature of the ERISA Section 103(a)(3)(C) Audit

We have performed audits of the financial statements of ABC 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), as permitted by ERISA Section 103(a)(3)(C) (ERISA Section 103(a)(3)(C) audit). The financial statements comprise the statements of net assets available for benefits as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the related notes to the financial statements.

Management, having determined it is permissible in the circumstances, has elected to have the audits of ABC 401(k) Plan’s financial statements performed in accordance with ERISA Section 103(a)(3)(C) pursuant to 29 CFR 2520.103-8 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA. As permitted by ERISA Section 103(a)(3)(C), our audits need not extend to any statements or information related to assets held for investment of the plan (investment information) by a bank or similar institution or insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency, provided that the statements or information regarding assets so held are prepared and certified to by the bank or similar institution or insurance carrier in accordance with 29 CFR 2520.103-5 of the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA (qualified institution).

Management has obtained certifications from a qualified institution as of December 31, 20X2 and 20X1, and for the year ended December 31, 20X2, stating that the certified investment information, as described in Note X to the financial statements, is complete and accurate.

## Opinion

In our opinion, based on our audits and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:

- The amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.
- The information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

## Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC 401(k) Plan and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our ERISA Section 103(a)(3)(C) audit opinion.

## Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management's election of the ERISA Section 103(a)(3)(C) audit does not affect management's responsibility for the financial statements.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

Management is also responsible for maintaining a current plan instrument, including all plan amendments, administering the plan, and determining that the plan's transactions that are presented and disclosed in the financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants, to determine the benefits due or which may become due to such participants.

## Auditor's Responsibilities for the Audit of the Financial Statements

Except as described in the Scope and Nature of the ERISA Section 103(a)(3)(C) Audit section of our report, our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ABC 401(k) Plan's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for a reasonable period of time.

Our audits did not extend to the certified investment information, except for obtaining and reading the certification, comparing the certified investment information with the related information presented and disclosed in the financial statements, and reading the disclosures relating to the certified investment information to assess whether they are in accordance with the presentation and disclosure requirements of accounting principles generally accepted in the United States of America.

Accordingly, the objective of an ERISA Section 103(a)(3)(C) audit is not to express an opinion about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

#### **Other Matter—Supplemental Schedules Required by ERISA**

The supplemental schedules of [identify the title of supplemental schedules and periods covered] are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information included in the supplemental schedules, other than that agreed to or derived from the certified investment information, has been subjected to auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS. For information included in the supplemental schedules that agreed to or is derived from the certified investment information, we compared such information to the related certified investment information.

In forming our opinion on the supplemental schedules, we evaluated whether the supplemental schedules, other than the information agreed to or derived from the certified investment information, including their form and content, are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

In our opinion:

- The form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, are presented, in all

material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

- The information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

*[Signature of the auditor's firm]*

*[City and state where the auditor's report is issued]*

*[Date of the auditor's report]*

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**NOTE:** Additional report examples are in SAS 136

## **SAS 137, THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION INCLUDED IN ANNUAL REPORTS**

### ***Objective***

SAS 137 addresses the responsibility of the auditor related to other information included in an annual report. The information could be financial or nonfinancial information. SAS 137 is expected to reduce diversity in practice and improve transparency related to the auditor's responsibilities for other information and documents that are within the scope of the standard.

### ***Provisions***

SAS 137 requires the auditor to read and consider consistency with the financial statements or the knowledge the auditor has obtained in the audit of the financial statements which might indicate a material misstatement of the financial statements or the other information.

SAS 137 clarifies that the auditor must apply procedures only to other information (OI) included in annual reports or similar documents. SAS 137 revises the work effort to require the accountant to remain alert for information that is misleading, including because it omits or obscures information necessary for a proper understanding of a matter disclosed in OI. SAS 137 also requires a separate section be included in the auditor's report addressing OI.

**NOTE:** Form 5500 is not considered an annual report under SAS 137.

SAS 137 supersedes SAS 118, *Other Information in Documents Containing Audited Financial Statements*, as amended AU-C 720.

### ***SAS 137 Amends***

- SAS 119, *Supplementary Information in Relation to the Financial Statements as a Whole*
- SAS 120, *Required Supplementary Information*
- SAS 122, *Clarification and Recodification*

- Section 210, *Terms of Engagement*
- Section 230, *Audit Documentation*
- Section 260, *The Auditor’s Communication with Those Charged with Governance*
- Section 450, *Evaluation of Misstatements Identified During the Audit*
- Section 600, *Special Considerations-Audits of Group Financial Statements*
- Section 810, *Engagements to Report on Summary Financial Statements*
- SAS 133, *Auditor Involvement with Exempt Offering Documents*
- SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
  - Section 700, *Forming an Opinion and Reporting on Financial Statements*
  - Section 705, *Modification to the Opinion in the Independent Auditor’s Report*
  - Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*

**SAS 137 does not**

- Constitute an assurance engagement
- Require the auditor to obtain assurance about the other matter
- Include any obligation by laws or regulations related to other information
- Apply to supplemental information under AU-C Section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- Apply to required supplementary information under AU-C Section 730, *Required Supplementary Information*

Examples of amounts and other items that may be included in other information include:

- Management report, management commentary, or operating and financial review or similar reports by those charged with governance (i.e., a director’s report)
- Chairman’s statement
- Corporate governance statement
- Management’s internal control and risk assessment reports

- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data
- Tables, charts, or graphs containing extracts of the financial statements
- A disclosure providing greater detail about a balance or account shown in the financial statements
- Description of the financial results, such as *Total Research and Development Expenses*

### ***Requirements of the auditor***

- Obtaining the other information requires:
  - Determining which documents comprise the annual report
  - Obtaining management’s written acknowledgement related to the documents
  - Obtaining entity’s manner and timing of the issuances of the documents
  - Making arrangements with management to obtain the final version of the documents in a timely manner, preferably before the date of the auditor’s report
  - Requesting management to provide written representation that a final version will be provided if after the date of the auditor’s report
- Communication of the following with those charged with governance:
  - Auditor’s responsibility related to the other information
  - Procedures performed
  - Result of procedures performed

Reading and considering the other information for the following:

- Whether a material inconsistency exists between the financial statements and the other information
- Comparing selected amounts or other items in the other information to the financial statements

- If a material inconsistency exists between the auditor's knowledge and the other information
- Existence of a material misstatement of fact or other information that is misleading

**NOTE:** Searching for omitted or incomplete information is not required of the auditor.

To respond when the other information appears to be misstated or is materially inconsistent, the auditor should, after discussion with management, perform procedures to determine if

- the other information contains a material misstatement,
- the financial statements contain a material misstatement, or
- the understanding of the entity and the environment needs to be updated.

### ***Reporting***

A separate section in the auditor's report titled *Other Information* should include statements of the following:

- Management's responsibility for the other information
- Identification of the other information
- Other information does not include the financial statement and the auditor's report
- Auditor's opinion does not cover or express an opinion or assurance on the other information
- Auditor's responsibility is to read the other information to determine if a material inconsistency exists concerning a material misstatement
- Should the auditor conclude that there exists an uncorrected material misstatement, that fact will be required to be described in the auditor's report

### ***Documentation***

Required documentation includes:

- Procedures performed
- Final version of the other information on which the procedures were performed

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### **EXAMPLE**

Illustration 1: The Auditor Has Not Identified an Uncorrected Material Misstatement of the Other Information

Other Information [Included in the Annual Report]

Management is responsible for the other information [included in the annual report]. The other information comprises the [information included in the annual report] but does not include the financial statements and our auditor’s report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

#### **Illustration 2: The Auditor Has Concluded That an Uncorrected Material Misstatement of the Other Information Exists**

##### **Other Information [Included in the Annual Report]**

Management is responsible for the other information [included in the annual report]. The other information comprises the [information included in the annual report] but does not include the financial statements and our auditor’s report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

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## **SAS 138, AMENDMENTS TO THE DESCRIPTION OF THE CONCEPT OF MATERIALITY**

### ***Objective***

SAS 138 amends various AU-C sections in AICPA *Professional Standards*, to align the materiality definition with the description of materiality used in the U.S. judicial system, the auditing standards of the PCAOB, the SEC, and the FASB. The ASB believes it is in the public interest to eliminate inconsistencies between the AICPA *Professional Standards* and the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators.

### ***Provisions***

The description of materiality has been revised as follows:

Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

### ***SAS 138 amends***

- SAS No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended

- Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards* [AICPA, Professional Standards, AU-C Section 200];
- Section 320, *Materiality in Planning and Performing an Audit* [AICPA, Professional Standards, AU-C Section 320];
- Section 450, *Evaluation of Misstatements Identified During the Audit* [AICPA, Professional Standards, AU-C Section 450]; and
- Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* [AICPA, Professional Standards, AU-C Section 600]
- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, as amended
  - Section 700, *Forming an Opinion and Reporting on Financial Statements* [AICPA, Professional Standards, AU-C Section 700]
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* [AICPA, Professional Standards, AU-C Section 703]

**NOTE:** It is not anticipated to change practice in audit and attest engagements.

## **SAS 139, AMENDMENTS TO AU-C SECTIONS 800, 805 AND 810**

### **Objective**

SAS 139 was issued to incorporate reporting changes from SAS 134 into sections 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with a Special Purpose Framework*, 805 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, and 810, *Engagements to Report on Summary Financial Statements*.

### **Provisions**

SAS 139 conforms sections to coincide with the codification sections for recently issued standards on auditor reporting and the auditor’s responsibility related to other information in annual reports. It will also conform the recently issued concept of materiality. These revised auditor’s reports involving special purpose accounting frameworks and other unique reporting scenarios provide additional transparency into the basis for the auditor’s report and the responsibilities of both management and the auditors.

Changes from SAS 134 are in the following sections:

- Section 800, *Special Considerations—Special Purpose Frameworks*

- Section 805, *Special Considerations—Specific Elements, Accounts, or Items*
- Section 810, *Summary Financial Statements*
- Reflects guidance in new SASs 136 and 137

There are three areas of particular concern:

- Section 800 is amended to require a statement in the audit report when the financial statements are prepared on a regulatory or contractual basis of accounting or any other basis and the use is restricted that alerts the user to the fact the financial statements may not be suitable for another purpose other than the intended purpose. In lieu of the report letter, there should be reference to the note to the financial statements with the required information of the purpose of the financial statements.
- Section 805 adds factors to consider when reporting on a single financial statement or a specific element of a financial statement.
- Section 810 includes application paragraphs when the auditor’s report includes communication about key audit matters that the auditor is not required to describe the individual key audit matters in the auditor’s report on the summary financial statements.

As noted in SAS 139, special purpose financial statements may or may not be prepared in accordance with an applicable financial reporting framework for which the going concern basis of accounting is relevant. The going concern basis of accounting is relevant to a special purpose framework if the special purpose framework requires management, in specified circumstances, to use a basis of accounting other than the going concern basis of accounting.

For example, the AICPA’s Financial Reporting Framework for Small- and Medium-Sized Entities requires management to assess whether the going concern basis of accounting is appropriate, and if not, to use the liquidation basis of accounting. In contrast, the cash or tax bases of accounting do not specify any alternative basis of accounting to be considered and, thus, do not require management to assess whether the going concern basis of accounting is appropriate. Therefore, the going concern basis of accounting is not relevant to special purpose financial statements prepared using those bases of accounting.

Depending on the applicable financial reporting framework used in the preparation of the special purpose financial statements, the description in the auditor’s report of management’s responsibilities relating to going concern may need to be adapted as necessary. The description in the auditor’s report of the auditor’s responsibilities may also need to be adapted as necessary depending on how Section 570, *Auditor’s Responsibilities Regarding the Entity’s Ability to Continue as a Going Concern*, applies in the circumstances of the engagement.

In addition, irrespective of whether the going concern basis of accounting is relevant to the preparation of the special purpose financial statements, the requirements of Section 570 apply regarding the auditor’s responsibilities to perform the following tasks:

- Based on the audit evidence obtained, conclude whether, in the auditor’s judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern for a reasonable period.
- When such substantial doubt exists, evaluate the adequacy of the financial statement disclosures.

## **SAS 140, AMENDMENTS TO AU-C SECTIONS 725, 730, 930, 935, AND 940**

### ***Objective***

SAS 140 conforms sections to coincide with the codification sections for recently issued standards on *Auditor Reporting and the Auditor’s Responsibilities* in SAS 134 and related to the *Auditor’s Responsibilities Relating to Other Information included in Annual Reports* in SAS 137. Other significant revisions were revisions to AU-C 930, 935, and 940. AU-C Sections 725 and 730 were aligned with SAS 137 on reporting on supplementary information.

### ***Provisions***

SAS 140 amends the following:

- SAS No. 117, AU-C 935, *Compliance Audits*
- SAS No 119, AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- SAS 120, AU-C 730, *Required Supplementary Information*
- SAS 122, *Statements on Auditing Standards: Clarification and Recodification*
  - Section 920, *Letters for Underwriters and Certain Other Requesting Parties*
  - Section 930, *Interim Financial Information*
- SAS 124, AU-C 910, *Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country*
- SAS 130, AU-C 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*
- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
  - Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*

AU-C Section 930 related to reviews of interim financial statements is revised to coincide with the PCAOB's Auditing Standard 4105, *Reviews of Interim Financial Information*. This change puts the auditor's review conclusion at the beginning of the review report on interim statements.

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## **EXAMPLE**

### **Independent Auditor's Review Report**

*[Appropriate Addressee]*

#### **Results of Review of Interim Financial Information**

We have reviewed the accompanying [describe the interim financial information or statements reviewed] of ABC Company and its subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes (collectively referred to as the interim financial information).

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information for it to be in accordance with [identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America].

#### **Basis for Review Results**

We conducted our review in accordance with auditing standards generally accepted in the United States of America (GAAS) applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. A review of interim financial information is substantially less in scope than an audit conducted in accordance with GAAS, the objective of which is an expression of an opinion regarding the financial information as a whole, and accordingly, we do not express such an opinion. We are required to be independent of ABC Company and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our review. We believe that the results of the review procedures provide a reasonable basis for our conclusion.

#### **Responsibilities of Management for the Interim Financial Information**

Management is responsible for the preparation and fair presentation of the interim financial information in accordance with [identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America]; and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of interim financial information that is free from material misstatement, whether due to fraud or error.

AU-C Section 935 is revised to be consistent with the Uniform Guidance, changes in the OMB Compliance Supplement, and the Yellow Book. The more significant changes include:

- Presenting requirements for a combined report on compliance and internal control as the default form of the report, followed by requirements addressing when the auditor chooses to issue separate reports on compliance and on internal control over compliance. This is the reverse of what is presented in extant AU-C Section 935 because in practice, combined reports are more common.
  - Amends the definition of material noncompliance to align with the SAS No. 138, Amendments to the Description of the Concept of Materiality, description of materiality.
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## **EXAMPLE**

### **Independent Auditor's Report**

*[Addressee]*

#### **Report on Compliance**

Opinion on [indicate the reporting level pursuant to governmental audit requirement]

We have audited Example Entity's compliance with the [identify the applicable compliance requirements or refer to the document that describes the applicable compliance requirements applicable to Example Entity's] [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] for the year ended June 30, 20X1.

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that are applicable to [indicate the reporting level pursuant to governmental audit requirement] for the year ended June 30, 20X1.

#### **Basis for Opinion**

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America (GAAS); the standards applicable to financial audits contained in Government Auditing Standards (GAS) issued by the Comptroller General of the United States; and [insert the name of the governmental audit requirement or program-specific audit guide]. Our responsibilities under those standards and [insert the name of the governmental audit requirement or program-specific audit guide] are further described in the Auditor's Responsibilities for the Audit of Compliance section of our report.

We are required to be independent of Example Entity and to meet our other ethical responsibilities, in accordance with relevant ethical requirements relating to our audit. We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with the compliance requirements referred to above.

#### **Responsibilities of Management for Compliance**

Management is responsible for compliance with the requirements referred to above and for the design, implementation, and maintenance of effective internal control over compliance with the requirements of laws, statutes, regulations, rules, and provisions of contracts or grant agreements applicable to the Example Entity's government programs.

#### **Auditor's Responsibilities for the Audit of Compliance**

Our objectives are to obtain reasonable assurance about whether material noncompliance with the compliance requirements referred to occurred, whether due to fraud or error, and express an opinion on Example Entity's compliance based on our audit. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS, Government Auditing Standards, and [insert the name of the governmental audit requirement or program-specific audit guide] will always detect material noncompliance when it exists. The risk of not detecting material noncompliance resulting from fraud is higher than for that resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Noncompliance with the compliance requirements referred to above is considered material if there is a substantial likelihood that, individually or in the aggregate, it would influence the judgment made by a reasonable user of the report on compliance about Example Entity's compliance with the requirements of the government program as a whole.

In performing an audit in accordance with GAAS, Government Auditing Standards, and [insert the name of the governmental audit requirement or program-specific audit guide], we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material noncompliance, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding Example Entity's compliance with the compliance requirements referred to above and performing such other procedures as we considered necessary in the circumstances.
- Obtain an understanding of Example Entity's internal control over compliance relevant to the audit in order to design audit procedures that are appropriate in the circumstances and to test and report on internal control over compliance in accordance with [insert the name of the governmental audit requirement or program-specific audit guide], but not for the purpose of expressing an opinion on the effectiveness of Example Entity's internal control over compliance. Accordingly, no such opinion is expressed.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and any significant deficiencies and material weaknesses in internal control over compliance that we identified during the audit.

#### **Report on Internal Control Over Compliance**

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the Auditor's Responsibilities for the Audit of Compliance section above and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies in internal control over compliance. Given these limitations, during our audit we did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, material weaknesses or significant deficiencies in internal control over compliance may exist that have not been identified.

Our audit was not designed for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, no such opinion is expressed.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the [insert the name of the governmental audit requirement or program-specific audit guide]. Accordingly, this report is not suitable for any other purpose.

*[Signature of the auditor's firm]*

*[City and state where the auditor's report is issued]*

*[Date of the auditor's report]*

## **SAS 141, AMENDMENT TO THE EFFECTIVE DATES OF SASs 134–140**

### ***Objective***

Delaying the effective dates of SASs 134 to 140 provides relief to audit firms amid the challenges created by the coronavirus pandemic. The delay is designed to ensure that firms will be able to implement the audit standards in the highest quality manner possible when distractions due to the pandemic subside.

### ***Provisions***

SASs 134–140 now have effective dates for the audits of financial statements for periods ending on or after December 15, 2021.

## **SAS 142, AUDIT EVIDENCE**

### ***Objective***

SAS 142 addresses the evolving nature of business and audit services and issues that have arisen since AU-C Section 500, *Audit Evidence*, was originally issued. The issues arising include the use of emerging technologies by both preparers and auditors, the application of professional skepticism, the expanding sources of information to be used as audit evidence, and more broadly, the accuracy, completeness, relevance, and reliability of audit evidence. SAS 142 brings audit evidence into a more current perspective, modernizing the guidance for today's and tomorrow's audits.

Prior audit evidence guidance was very focused on paper-based documents and audit evidence that auditors would obtain directly from their clients. Today, there are many different forms of evidence that are available, including third-party sources and other external information sources.

The objective of the auditor is to evaluate information to be used as audit evidence, including the results of audit procedures to inform the auditor's overall conclusion about whether sufficient appropriate audit evidence was obtained.

### ***Provisions***

**Audit evidence** is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. It is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements. Audit evidence is the result of performing audit procedures as follows:

- Tests of controls
- Risk assessment procedures
- Substantive audit procedures

**Sufficiency of audit evidence** is the measure of the quantity of audit evidence. The quantity of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement and the quality of audit evidence obtained.

**Appropriateness of audit evidence** is the measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based.

SAS 142 is a documentation standard rather than a performance standard. For example, SAS 142 expands the objective of prior guidance to be more broadly focused on considering the attributes of information to be used as audit evidence in assessing whether sufficient appropriate audit evidence has been obtained. Prior audit evidence guidance focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence rather than evaluating the sufficiency and appropriateness of the audit evidence obtained.

This change is accomplished by establishing attributes of information to be used as audit evidence when evaluating whether sufficient and appropriate audit evidence has been obtained by the auditor. The reliability of information to be used as audit evidence is affected to varying degrees by the following attributes, individually or in combination:

- Accuracy
- Completeness
- Authenticity
- Susceptibility to bias

When evaluating information to be used as audit evidence:

1. The auditor should evaluate information to be used as audit evidence by taking into account
  - the relevance and reliability of the information, including its source; and
  - whether such information corroborates or contradicts assertions in the financial statements.
2. The auditor's evaluation of the information to be used as audit evidence in accordance with the earlier information should include
  - evaluating whether the information is sufficiently precise and detailed for the auditor's purposes; and
  - obtaining audit evidence about the accuracy and completeness of the information, as necessary.

Finally, SAS 142 states that an auditor may use automated tools and techniques to perform both a risk assessment procedure and a substantive procedure concurrently if the objectives of both types of

procedures are achieved. The following exhibit, taken directly from SAS 142, illustrates this approach.

## **Exhibit A—Using ADAs to Simultaneously Accomplish Multiple Audit Procedures (Ref: par. A46 and par. A61)**

A69.

### **Exhibit A — Using ADAs to Simultaneously Accomplish Multiple Audit Procedures (Ref: par. A46 and par. A61)**

This exhibit illustrates the use of an audit data analytic (ADA) that simultaneously accomplishes the objectives of both risk assessment and substantive audit procedures.

#### **Background**

The fact pattern in this example, in which the auditor uses a revenue transaction scoring model, will focus on the audit of an entity that recognizes revenue when control of the product (or satisfaction of the performance obligation) transfers at a specific point in time,<sup>1</sup> such as a manufacturer of external data storage devices.

For purposes of this example, assume the following:

- Revenue was determined to be a material account during initial planning and scoping with the occurrence (including cut-off) and accuracy assertions being more susceptible to misstatement.
- The ADA was performed after initial planning and scoping as part of the ongoing and iterative risk assessment process.
- All transactions within the account were subject to the same processes and controls.
- The purpose of the ADA was to design the nature, timing, and extent of the audit procedures and to obtain audit evidence.
- Based on the understanding of controls, the auditor has concluded that the controls over revenue were effectively designed and have been implemented, the auditor has tested certain relevant controls and determined they are operating effectively, and the auditor is otherwise satisfied the entity has appropriately applied the requirements of the applicable financial reporting framework (for example, FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*).
- Data used in the ADA are relevant and reliable and have been tested for accuracy and completeness.
- Customers tend to purchase consistent quantities throughout the year, with the exception of purchases just prior to major retail holidays, such as Memorial Day, Black

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<sup>1</sup> FASB *Accounting Standards Codification* 606-10-25-30.

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<sup>1</sup> FASB *Accounting Standards Codification* 606-10-25-30.

Friday, and Christmas.

- Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
- The customer base does not fluctuate significantly from period to period.
- Revenue is recognized when control transfers at a free-on-board (FOB) shipping point.
- Invoicing occurs the day the product ships from the entity's warehouse.
- Warehouse personnel typically do not work weekends.
- The company does not sell product to any related parties.

All items that are determined to be individually material were excluded from the ADA and substantively tested separately. The remaining population that was subject to the ADA comprised routine, non-complex transactions with third parties. The processing and recording of transactions are highly automated and less likely to be susceptible to management override.

#### **Description of the ADA**

ADA Scoring Model — A complete population of transactions (at the individual item level) for one material account (excluding individually significant items) was subjected to an ADA designed to identify and assess risk and obtain audit evidence specific to a relevant assertion using different routines. The scoring of each routine is based on the evidence expected to be provided by that routine in relation to the auditor's assessment of the risks of material misstatement.

The routines were as follows:

Routine	Description	Characteristic	Transaction Scoring Model	Risk Score	Relevant Fact Pattern
1	Identify customers with infrequent revenue activity (less than X transactions)	Volume	Less than 6 transactions 6-12 transactions More than 12 transactions	2 1 0	Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month. Some customers only purchase in bulk a few times a year, whereas others purchase smaller quantities one to two times a month.
2	Identify customers with a significant fluctuation in volume of products purchased (item level) on a period-over-period basis	Volume	Greater than 70% variance 30% to 70% variance Less than 30% variance	2 1 0	Customers tend to purchase consistent quantities throughout the year, with the exception of purchases just prior to major retail holidays, such as Memorial Day, Black Friday, and Christmas. Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
3	Identify activity for new customers	Volume	Customer for 6 months or less Customer for greater than 6 months	1 0	The customer base does not fluctuate significantly from period to period.
4	Identify all transactions recorded within X days of quarter-end.	Timing	Within 3 days of quarter end Greater than 3 days of quarter end	1 0	Revenue is recognized when control transfers at FOB shipping point.
5	Identify revenue transactions with an invoice date on	Timing	Transaction on <sup>a</sup>	2	Invoicing occurs the day the product ships from the company's warehouse.

Routine	Description	Characteristic	Transaction Scoring Model	Risk Score	Relevant Fact Pattern
	an unusual date (for example, weekend or holiday)		weekend/holiday		Warehouse personnel typically do not work weekends.
			Transaction on a weekday	0	
			Invoice and shipping document do not match, and invoice date is before shipping date.	4	Revenue is recognized when control transfers at FOB shipping point.
6	Identify instances in which the shipping document date and invoice date do not match.	Timing	Invoice and shipping document do not match, and shipping date is before invoice date.	2	Invoicing occurs the day the product ships from the company's warehouse.
			Invoice and shipping document match.	0	

Running the revenue transaction level detail through the ADA routines produces a total score for each transaction. The auditor then groups each transaction into a sub-population based on the individual transaction score. The number of sub-populations may differ depending upon the type of ADA developed, the scores produced by the ADA, and the auditor's assessment of those scores. For purposes of this example, the auditor grouped the population of the account into sub-populations as follows:

Assessed Risk	Total Risk Score	Group
High risk	8-12	A
Moderate risk	4-7	B
Low risk	0-3	C

- Group A – High risk - Comprises items with characteristics deemed to present a higher risk of material misstatement.

Approach - The auditor would perform additional substantive procedures to provide more persuasive audit evidence for the items identified by the ADA. For example, the nature of the substantive procedure may be confirmation as opposed to inspection; the extent of testing may be greater (larger proportionate sample size); or the timing of the procedure may be at or near the financial statement date as opposed to earlier in the period.

- Group B – Moderate risk - Comprises items that warrant further procedures but do not have characteristics of those in the higher risk group.

Approach - The auditor would perform substantive procedures appropriate for the items identified by the ADA in less depth relative to the higher risk population. For example, the nature of the substantive procedure may be limited to inspection of documents and records; the extent of testing may be less (smaller proportionate sample size); and the timing of the procedure may be earlier in the period.

- Group C – Low risk - Comprises items that demonstrate no unusual characteristics based on the procedure performed using the ADA.

Approach - The results of other audit procedures performed throughout the audit would be evaluated for contradictory information regarding the assessed risk of material misstatement.

In the absence of contradictory information, as the routines of the ADA are sufficiently precise for the auditor to conclude that the risks of material misstatement have been addressed, no additional substantive procedures may be warranted for any reason other than to incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year.

As a result of the previous procedures, the auditor concluded

- Groups A, B, and C comprise a material account in the aggregate for which each group has differing risks.
- for Group C, the audit evidence provided over the transactions (within the population analyzed by the ADA in combination with the audit evidence provided by testing of certain key controls over revenue as determined by the auditor and the absence of contradictory audit evidence from the testing of related accounts) was sufficiently persuasive for the auditor to conclude that the risk of material misstatement was addressed.
- for Groups A and B, the audit evidence provided by the ADA was not sufficiently persuasive, and further substantive procedures were required to address the risk of material misstatement.

## **SAS 143, AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES**

### **Objective**

SAS 143 is intended to enable auditors to appropriately address the increasingly complex scenarios that arise today from new accounting standards that include estimates and related disclosures, and to enhance the auditor's focus on factors driving estimation uncertainty and potential management bias. In the current environment, management's estimates related to asset impairments are particularly important and SAS 143 will aid auditors in assessing management's estimates during a period of economic uncertainty and volatility.

The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable, in the context of the applicable financial reporting framework.

SAS 143 supersedes AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

### **Definitions**

- *Accounting estimate*. A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty
- *Auditor's point estimate or auditor's range*. An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate
- *Estimation uncertainty*. Susceptibility to an inherent lack of precision in measurement
- *Management bias*. A lack of neutrality by management in the preparation of information

### **Provisions**

SAS 143 requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated. For the purposes of SAs 143, *reasonable*—in the context of the applicable financial reporting framework—means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address the following:

- The development of the accounting estimate, including the selection of the method, assumptions, and data in view of the nature of the accounting estimate and the facts and circumstances of the reporting entity
- The selection of management's point estimate

- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

### ***Examples of Accounting Estimates***

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of infrastructure assets, such as buildings and roadways
- Valuation of financial instruments
- Outcome of pending litigation
- Provision for expected credit losses
- Valuation of insurance contract liabilities
- Warranty obligations
- Employee retirement benefits liabilities
- Share-based payments
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Nonmonetary exchanges of assets or liabilities between independent parties
- Revenue recognized for long-term contracts

### ***Requirements***

- Explains the nature of accounting estimates and the concept of estimation uncertainty
- Provides information about scalability of the SAS for all types of accounting estimates, from those that are relatively simple to those that are complex
- Requires a separate assessment of inherent risk and control risk at the assertion level
- Includes an enhanced risk assessment model intended to address the challenges auditors face when auditing accounting estimates by providing risk assessment requirements that are more specific to estimates and addresses the increasingly complex business environment and complexity in financial reporting frameworks

- Emphasizes that the auditor’s further audit procedures need to be responsive to the reasons for the assessed risks of material misstatement at the relevant assertion level
- Refers to relevant requirements in other AU-C sections and provides related guidance to emphasize the importance of the auditor’s decisions about internal controls relating to accounting estimates
- Addresses the exercise of professional skepticism when auditing accounting estimates
- Requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework

### ***Documentation***

- Key elements of the auditor’s understanding of the entity and its environment, including the entity’s internal control, related to the entity’s accounting estimates
- The linkage of the auditor’s further audit procedures with the assessed risks of material misstatement at the relevant assertion level, taking into account the reasons given to the assessment of those risks
- The auditor’s responses when management has not taken appropriate steps to understand and address estimation uncertainty
- Indicators of possible management bias related to accounting estimates, if any, and the auditor’s evaluation of the implications for the audit, as required by paragraph
- Significant judgments relating to the auditor’s determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated

## **PROPOSED NEW AUDITING STANDARD**

### ***Objective***

February 25, 2021, the ASB issued an exposure draft titled *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations (NOCLAR)* to amend SAS No. 122, as amended section 210, *Terms of Engagement* to inquire of the predecessor auditor regarding identified or suspected fraud or noncompliance with laws or regulations (NOCLAR), assuming management authorizes the predecessor auditor to respond to inquiries from the auditor.

### ***Background***

Due to certain changes in the International Ethics Standards Board for Accountants (IESBA) and ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* related to inquiries

of the predecessor auditor by the successor auditor, the ASB has elected to make narrow revisions to auditing standards in the United States.

### ***Proposed Provisions***

Currently, before engagement acceptance, an auditor must request management to authorize the predecessor auditor to respond fully to the auditor's inquiries. Assuming management authorizes the predecessor auditor to respond, the proposed ASB adds the following:

- Auditor is required to inquire of the predecessor regarding identified or suspected fraud and matters involving noncompliance with laws and regulations
- Predecessor auditor is required to respond fully and timely and to indicate if the response is limited

As with previous guidance, the auditor should evaluate the predecessor auditor's response and consider the implication if there is no or limited response in determining whether to accept the engagement.

The exact language used in amending Section 210, *Terms of Engagement*, new paragraph 12 added is:

*If pursuant to paragraph 11, management authorizes the predecessor auditor to respond to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement, the auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including:*

- a. *Identified or suspected fraud involving:*
  - i. *Management*
  - ii. *Employees who have significant roles in internal control, or*
  - iii. *Others, when the fraud resulted in a material misstatement in the financial statements*
- b. *Matters involving non-compliance or suspected non-compliance with laws and regulations that came to the predecessor auditor's attention during the audit, other than when matters are clearly inconsequential.*

The auditor should document its inquiries and the results of those inquiries with the predecessor auditor.

**NOTE:** If management does not authorize the predecessor auditor to respond fully to the auditor's inquiries, then the auditor must inquire about the reasons and consider the implications of refusal in deciding whether to accept the engagement.

The comment period ends on June 30, 2021.

## ***Proposed Effective Date***

The proposed ASU would have to be effective for audits of financial statements for the periods ending on or after December 15, 2022, if issued as final. Practically, any auditor changes during the calendar year 2022 and thereafter would be subject to the proposed revisions to AU-C section 210.

Early implementation would be permitted.

# **ATTESTATION STANDARDS UPDATE**

## **INTRODUCTION**

An attestation engagement is an examination, review, or agreed-upon procedures engagement performed under the attestation standards related to subject matter or an assertion that is the responsibility of another party. The following are the three types of attestation engagements:

- **Examination Engagement.** An attestation engagement in which the practitioner obtains reasonable assurance by obtaining sufficient appropriate evidence about the measurement or evaluation of subject matter against criteria in order to be able to draw reasonable conclusions on which to base the practitioner's opinion about whether the subject matter is in accordance with (or based on) the criteria or the assertion in order for it to be fairly stated, in all material respects.
- **Review Engagement.** An attestation engagement in which the practitioner obtains limited assurance by obtaining sufficient appropriate review evidence about the measurement or evaluation of subject matter against criteria in order to express a conclusion about whether any material modification should be made to the subject matter in order for it to be in accordance with (or based on) the criteria or the assertion in order for it to be fairly stated.
- **Agreed-Upon Procedures Engagement.** An attestation engagement in which a practitioner performs specific procedures on subject matter or an assertion and reports the findings without providing an opinion or a conclusion.

The **objectives** of the practitioner when performing attestation engagements includes:

- Apply the requirements relevant to the attestation engagement
- In an examination engagement, report on the subject matter or conclusion with an opinion
- In a review engagement, report on the subject matter or assertion with a conclusion
- In an agreed-upon procedures engagement, report on the procedures performed and related findings without providing an opinion or conclusion on the subject matter
- Communicate as required by the applicable AT-C section, in accordance with the results of the practitioner's procedures

- Implement quality control procedures at the engagement level that provide the practitioner with reasonable assurance that the attestation engagement complies with professional standards and applicable legal and regulatory requirements

In 2019 and 2020, the ASB issued the following attestation standards:

- SSAE 19, *Agreed-Upon Procedures Engagements*—Effective for agreed-upon procedures reports dated on or after July 15, 2021.
- SSAE 20, *Amendments to the Description of the Concept of Materiality*—Effective for periods ending, or for practitioners’ examination or review reports dated, on or after December 15, 2020.
- SSAE 21, *Direct Examination Engagements*—Effective for reports dated on or after June 15, 2022.
- SSAE 22, *Review Engagements*—Effective for practitioners’ review reports dated on or after June 15, 2022.

## **SSAE 19—AGREED-UPON PROCEDURES ENGAGEMENTS**

### ***Objective***

SSAE 19 provides flexibility to a practitioner by performing an agreed-upon procedures engagement by:

- Removing the requirement that the practitioner request an assertion from the responsible party
- Permitting the practitioner to issue a general-use report
- No longer requiring intended users to take responsibility for the sufficiency of the procedures
- Allowing procedures to be developed over the course of the engagement and allowing the practitioner to develop or assist in developing the procedures with a requirement that the engaging party acknowledge the appropriateness of the procedures prior to the issuance of the practitioner’s report

### ***Provisions***

SSAE 19 provides much needed relief to practitioners by giving more flexibility in performing agreed-upon procedures engagements. Many requesting agreed-upon procedures did not have the ability or, in many cases, the willingness to perform the measurement or evaluation of the **subject matter**; therefore, the required assertion could not be provided by the responsible party. The legacy requirement for the practitioner was to request an assertion or disclose in the accountant’s report if the responsible party could not or would not provide the assertion. The practitioner was in a difficult position, but SSAE removes the requirement to obtain an assertion. The standard will affect the current guidance as follows:

- Supersedes SSAE 18, AT-C Section 215, *Agreed-Upon Procedures*
  - SSAE 19 provides guidance in performance and reporting requirements and application guidance for all agreed-upon procedures engagements.
- Amends SSAE 18, AT-C Section 105, Concepts Common to All Attestation Engagements
  - SSAE 19 provides requirements and guidance that supplements the requirements in SSAE 18.

Agreed-upon procedures engagements involve three parties:

- Engaging party—The party engaging the practitioner to perform the engagement (client)
- Responsible party—The party responsible for the subject matter
- Specified party—The intended user(s) of the practitioner’s written report

SSAE 19 provides flexibility to the practitioner performing agreed-upon procedures in several ways:

- Removes the requirement for an assertion from the responsible party
- General-purpose report can now be issued
- Intended users no longer are required to take responsibility for the sufficiency of the procedures
- Allows for procedures to be developed during the engagement
- Allows the practitioner to assist in developing procedures; however, providing that the engaging party must acknowledge the appropriateness of the procedures prior to the report being issued.

Extant AT-C Section 215 requires the practitioner report letter to be restricted to the use of specified parties that accept responsibility for the sufficiency of the procedures. SSAE 19 permits the practitioner to issue a general-use report, which may be restricted when the practitioner deems such a restriction appropriate. Language will be added to the report letter that the procedures performed and the result of the procedures may not be appropriate for their purposes.

**NOTE:** This guidance does not apply to engagements to issue letters (comfort letters) to underwriters and other requesting parties. For that guidance, refer to AU-C Section 920, *Letters for Underwriters and Certain Other Requesting Parties*, which can be found in the AICPA Professional Standards.

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## **EXAMPLE**

### **Independent Accountant's Report**

*[Appropriate Addressee]*

We have performed the procedures enumerated below on [identify the subject matter, for example, the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1]. [The responsible party, for example, XYZ Fund] is responsible for [the subject matter].

[The engaging party, for example, XYZ Fund] has agreed to and acknowledged that the procedures performed are appropriate to meet the intended purpose of [identify the intended purpose of the engagement, for example, assisting users in understanding the Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1]. This report may not be suitable for any other purpose. The procedures performed may not address all the items of interest to a user of this report and may not meet the needs of all users of this report and, as such, users are responsible for determining whether the procedures performed are appropriate for their purposes.

The procedures and the associated findings are as follows:

[Include paragraphs to describe the procedures performed detailing the nature and extent, and if applicable, the timing, of each procedure and to describe the findings from each procedure performed, including sufficient details on exceptions found.]

We were engaged by [the engaging party, for example, XYZ Fund] to perform this agreed-upon procedures engagement and conducted our engagement in accordance with attestation standards established by the AICPA. We were not engaged to and did not conduct an examination or review engagement, the objective of which would be the expression of an opinion or conclusion, respectively, on [identify the subject matter, for example, the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1].

Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. We are required to be independent of XYZ Fund and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our agreed-upon procedures engagement.

*[Additional paragraphs may be added to describe other matters.]*

*[Signature of the practitioner's firm]*

*[City and state where the practitioner's report is issued]*

*[Date of the practitioner's report]*

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## **EXAMPLE**

### **Independent Accountant's Report**

*[Appropriate Addressee]*

We have performed the procedures enumerated below on [identify the subject matter, for example, the cash and accounts receivable of XYZ Company as of December 31, 20XX, included in the accompanying information provided to us by management of XYZ Company]. [The responsible party, for example, XYZ Company] is responsible for [the subject matter].

[The engaging party, for example, ABC Company] has agreed to and acknowledged that the procedures performed are appropriate to meet the intended purpose of [identify the intended purpose of the engagement, for example, assisting users in understanding cash and accounts receivable of XYZ Company as of December 31, 20XX, included in the accompanying information provided to us by management of ABC Company]. This report may not be suitable for any other purpose. The procedures performed may not address all the items of interest to a user of this report and may not meet the needs of all users of this report and, as such, users are responsible for determining whether the procedures performed are appropriate for their purposes. The procedures and the associated findings are as follows:

### Cash

1. For the following four bank accounts, we obtained from XYZ Company management
  - the December 31, 20XX, bank reconciliations and
  - the December 31, 20XX, general ledger.
2. We performed the following procedures:
  - Obtained a bank confirmation directly from each bank of the cash on deposit as of December 31, 20XX
  - Compared the balance confirmed by the bank to the amount shown on the respective bank reconciliations
  - Mathematically recomputed the bank reconciliations
  - Compared the cash balances per book listed in the reconciliations as follows to the respective general ledger account balances

<i>Cash, December 31, 20XX</i>	
<i>Bank</i>	<i>Cash Balance per Book</i>
DEF National Bank, general ledger account 123	\$ 5,000
LMN State Bank, general ledger account 124	3,776
RST Trust Company regular account, general ledger account 125	86,912
RST Trust Company payroll account, general ledger account 126	5,000
	\$ 110,688

We found no exceptions as a result of the procedures.

### Accounts Receivable

1. We obtained the accounts receivable aged trial balance as of December 31, 20XX, from XYZ Company (attached as Exhibit A). We mathematically checked that the individual customer account balance subtotals in the aged trial balance of accounts receivable agreed to the total accounts receivable per the aged trial balance. We compared the total accounts receivable per the accounts receivable aged trial balance to the total accounts receivable per general ledger account 250.

We found no exceptions as a result of the procedures.

2. We obtained the accounts receivable subsidiary ledger as of December 31, 20XX, from XYZ Company. We compared the individual customer account balance subtotals shown in the accounts receivable aged trial balance (Exhibit A) as of December 31, 20XX, to the balances shown in the accounts receivable subsidiary ledger.

We found no exceptions as a result of the procedures.

3. We selected 50 customer account balances from Exhibit A by starting at the 8th item and selecting every 15th item thereafter until 50 were selected. The sample size selected represents 9.8% of the aggregate amount of the customer account balances. We obtained the corresponding invoices from XYZ Company and traced the aging (according to invoice dates) for the 50 customer account balances shown in Exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger.

We found no exceptions as a result of the procedures.

4. We mailed confirmations directly to the customers representing the 150 largest customer account balance subtotals selected from the accounts receivable aged trial balance, and we received responses as indicated as follows. As agreed, any individual differences in a customer account balance of less than \$300 were to be considered minor, and no further procedures were performed.

Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply.

No exceptions were identified in 120 of the confirmations received. The differences in the remaining 20 confirmation replies were less than \$300.

For the 10 customers that did not reply, we traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents.

A summary of the confirmation results according to the respective aging categories is as follows.

<i>Aging Categories</i>	<i>Accounts Receivable December 31, 20XX</i>		
	<i>Customer Account Balances</i>	<i>Confirmations Requested</i>	<i>Confirmations Received</i>
<b>Current</b>	<b>\$ 156,000</b>	<b>\$ 76,000</b>	<b>\$65,000</b>
<b>Past due:</b>			
<b>Less than 1 month</b>	<b>60,000</b>	<b>30,000</b>	<b>19,000</b>
<b>1–3 months</b>	<b>36,000</b>	<b>18,000</b>	<b>10,000</b>
<b>Over 3 months</b>	<b>48,000</b>	<b>48,000</b>	<b>8,000</b>
	<b>\$300,000</b>	<b>\$172,000</b>	<b>\$102,000</b>

We were engaged by [the engaging party, for example, ABC Company] to perform this agreed-upon procedures engagement and conducted our engagement in accordance with attestation standards established by the AICPA. We were not engaged to and did not conduct an examination or review engagement, the objective of which would be the expression of an opinion or conclusion, respectively, on [identify the subject matter]. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our agreed-upon procedures engagement.

*[Additional paragraphs may be added to describe other matters.]*

*[Signature of the practitioner's firm]*

*[City and state where the practitioner's report is issued]*

*[Date of the practitioner's report]*

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**NOTE:** Additional examples are in SSAE 19

## **SSAE 20—AMENDMENT TO THE DESCRIPTION OF THE CONCEPT OF MATERIALITY**

### ***Objective***

SSAE 20 aligns the materiality definition with the description of materiality used in the U.S. judicial system, the auditing standards of the PCAOB, the SEC, and the FASB. The ASB believes it is in the public interest to eliminate inconsistencies between the AICPA *Professional Standards* and the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators.

### ***Provisions***

The ASB issued SSAE No. 20, *Amendments to the Description of the Concept of Materiality* in December 2019. While the concept of materiality is not new, the standard clarifies and provides additional guidance related to the consideration of materiality in attestation engagements.

Specifically, SSAE No. 20 amends Statement on Standards for Attestation Engagements (SSAE) No. 18 in two areas:

- AT-C Section 205—Examination Engagements
- AT-C Section 210—Review Engagements

**Materiality** is defined in SSAE 20 as:

Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

AT-C Section 205 for Examinations Engagements is amended to consider misstatements (including omissions) are to be material if there is a substantial likelihood that either individually, or in the aggregate, the misstatement would influence the judgment of the user.

For purposes of determining materiality, the accountant may assume that intended users

- have reasonable knowledge and use reasonable diligence about the subject matter,
- understand that the concept of appropriate levels of materiality has been applied about the subject matter,
- understand that there are inherent uncertainties in measuring or evaluating the subject matter, and
- make reasonable judgments based on the subject matter.

AT-C Section 210 for *Review Engagements* has been amended for the same terminology of *substantial likelihood, judgment, and for purposes of determining materiality* as AT-C Section 205 for *Examination Engagements*.

## **SSAE 21—DIRECT EXAMINATION ENGAGEMENTS**

### ***Objective***

SSAE 21 enables practitioners to perform an examination engagement in which the practitioner obtains reasonable assurance by measuring or evaluating underlying subject matter against criteria and expressing an opinion that conveys the results of that measurement or evaluation.

### ***Definitions***

- *Assertion-Based Examination Engagement.* An attestation engagement in which the practitioner obtains reasonable assurance by obtaining sufficient appropriate evidence about the responsible party's measurement or evaluation of the underlying subject matter against criteria in order to be able to draw reasonable conclusions on which to base the practitioner's opinion about whether the subject matter is in accordance with (or based on) the criteria or the responsible party's assertion is fairly stated, in all material respects.
- *Direct Examination Engagement.* An attestation engagement in which the practitioner obtains reasonable assurance by measuring or evaluating the underlying subject matter against the criteria and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of that measurement or evaluation. In a direct examination engagement, the responsible party does not provide an assertion.
- *Underlying Subject Matter.* In an examination engagement, the phenomenon that is measured or evaluated by applying criteria.
- *Subject Matter Information.* The outcome of the measurement or evaluation of the underlying subject matter against criteria. An assertion about whether the underlying subject matter is in accordance with the criteria is a form of subject matter information.
- *Responsible Party.* The party(ies) responsible for the underlying subject matter, which is a party other than the practitioner. In an assertion-based examination if the nature of the underlying

subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the underlying subject matter may be deemed to be the responsible party.

## ***Provisions***

SSAE 21 is organized in two sections:

- Section 205, Assertion-Based Examination Engagements
- Section 206, Direct Examination Engagements

### *Section 205—Assertion-Based Examination Engagement*

When performing an assertion-based examination engagement, the engagement provides reasonable assurance about whether the subject matter or an assertion about the subject matter is free from material misstatement, whether due to error or fraud. To obtain reasonable assurance, the practitioner should

- obtain an assertion from the responsible party;
- plan the work and properly supervise other members of the engagement team;
- identify and assess the risks of material misstatement, whether due to error or fraud, based on an understanding of the subject matter, its measurement or evaluation, the criteria, and other engagement circumstances; and
- obtain sufficient appropriate evidence about whether material misstatements exists by designing and implementing appropriate responses to the assessed risks.

Examination procedures may involve inspection, observation, analysis, inquiry, reperformance, recalculation, or confirmation with outside parties.

### *Section 206—Direct Examination Engagement*

When performing a direct examination engagement, the practitioner would evaluate whether the underlying subject matter meets the stated criteria and perform other procedures to obtain sufficient appropriate evidence to provide an opinion on the results of that evaluation. In this engagement, the responsible party would make no assertions. To obtain reasonable assurance, the practitioner would perform applicable procedures

- such as planning, risk assessment, materiality considerations, tests of controls, analytical procedures, test of estimates, sampling, evaluation of fraud risk, evaluation of compliance with laws and regulations, using specialist and the work of internal auditors, and considering subsequent events; and
- involving the terms of engagement, written representations, and the content of the report

The responsible party must acknowledge its responsibility for the underlying subject matter.

The practitioner must be independent of the underlying subject matter.

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## **EXAMPLE 1 – ASSERTION-BASED EXAMINATION REPORT**

*Practitioner’s Assertion-Based Examination Report on Subject Matter; Unmodified Opinion*

The following is an illustrative practitioner’s report for an assertion-based examination engagement in which the practitioner has examined the subject matter and is reporting on the subject matter.

### **Independent Accountant’s Report**

*[Appropriate Addressee]*

We have examined [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company’s management is responsible for *[identify the subject matter, for example, presenting the schedule of investment returns]* in accordance with (or based on) *[identify the criteria, for example, the ABC criteria set forth in Note 1]*.

Our responsibility is to express an opinion on *[identify the subject matter, for example, the schedule of investment returns]* based on our examination. Our examination was conducted in accordance with attestation standards established by the AICPA. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether *[identify the subject matter, for example, the schedule of investment returns]* is in accordance with (or based on) the criteria, in all material respects. An examination involves performing procedures to obtain evidence about *[identify the subject matter, for example, the schedule of investment returns]*. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of *[identify the subject matter, for example, the schedule of investment returns]*, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

We are required to be independent and to meet our other ethical responsibilities in accordance with relevant ethical requirements relating to the engagement.

*[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]*

*[Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]*

In our opinion, *[identify the subject matter, for example, the schedule of investment returns of XYZ Company for the year ended December 31, 20XX, or the schedule of investment returns referred to above]*, is presented in accordance with (or based on) *[identify the criteria, for example, the ABC criteria set forth in Note 1]*, in all material respects.

*[Practitioner’s signature]*

*[Practitioner’s city and state]*

*[Date of practitioner’s report]*

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## EXAMPLE 2 – DIRECT EXAMINATION REPORT

Circumstances include the following:

The practitioner was engaged to

- measure the rates of return (subject matter information) on XYZ Company’s investment transactions during the year ended December 31, 20XX (the underlying subject matter) based on specified criteria and
- present the rates of return on the investment transactions in a schedule of investment returns (subject matter information).

### Independent Accountant’s Report

*[Appropriate Addressee]*

We have examined *[identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX]*. XYZ Company’s management is responsible for *[identify the underlying subject matter, for example, its investment transactions during the year ended December 31, 20XX]* and maintaining a record of those transactions. Our responsibility is to obtain reasonable assurance by measuring (or evaluating) *[identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX]* against *[identify the criteria, for example, the ABC criteria set forth in Note 1 of the accompanying schedule of investment returns]* to determine *[identify the subject matter information, for example, the rates of return on those investment transactions]* and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of our measurement (or evaluation) based on our examination. We have presented the results of our measurement in the accompanying schedule of investment returns.

Our examination was conducted in accordance with the attestation standards for a direct examination engagement established by the AICPA. Those standards require that we obtain reasonable assurance by measuring (or evaluating) *[identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX]* against *[identify the criteria, for example, the ABC criteria set forth in Note 1 of the accompanying schedule of investment returns]* and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of our measurement or evaluation of *[identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX]*. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of *[identify the subject matter information, for example, the rates of return on those investment transactions for the year ended December 31, 20XX, as presented in the schedule of investment returns]*, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

We are required to be independent of *[identify the responsible party, for example, XYZ Company]* and to meet our other ethical responsibilities, in accordance with relevant ethical requirements relating to our examination engagement.

*[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the underlying subject matter against the criteria.]*

*[Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement, the underlying subject matter, or the subject matter information.]*

In our opinion, *[identify the subject matter information, for example, the rates of return on the investment transactions of XYZ Company during the year ended December 31, 20XX included in the accompanying*

*schedule of investment returns of XYZ Company for the year ended December 31, 20XX], are fairly presented in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.*

*[Signature of the practitioner's firm]*

*[City and state where the practitioner's report is issued]*

*[Date of the practitioner's report]*

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## **SSAE 22—REVIEW ENGAGEMENTS**

### ***Objective***

SSAE 22 describes the types of procedures a practitioner may perform in a review engagement. SSAE 22 also

- clarifies for practitioners that the objective of a review engagement is to obtain limited assurance,
- results in more transparent reporting by requiring that the practitioner disclose in a review report the procedures performed to obtain limited assurance, and
- allows the practitioner to issue a report containing an adverse review conclusion when the subject matter is materially and pervasively misstated.

### ***Provisions***

Based on the practitioner's understanding of the subject matter and other engagement circumstances, the practitioner must identify areas in which a material misstatement of the subject matter is likely to arise and design and perform procedures to address such areas to obtain limited assurance to support the conclusion in the practitioner's report.

While review evidence obtained through the performance of inquiry and analytical procedures will ordinarily provide the practitioner with a reasonable basis for obtaining limited assurance, analytical procedures may not be possible when the subject matter is qualitative, rather than quantitative. Additionally, analytical procedures may not provide sufficient appropriate review evidence if an expectation cannot be developed. Therefore, the practitioner may determine that other procedures are more effective or efficient to obtain limited assurance. While inquiry procedures are required, in addition to inquiry, SSAE No. 22 provides the following examples of procedures to obtain review evidence:

- Analytical procedures
- Inspection
- Observation
- Confirmation

- Recalculation
- Reperformance

SSAE No. 22 includes a requirement that the practitioner’s review report include a description of the work performed as a basis for the practitioner’s conclusion. Such description helps the users of the practitioner’s report understand the basis for the practitioner’s conclusion. The description may be as brief as “the procedures we performed were based on or professional judgment and consisted primarily of analytical procedures and inquiries,” or may be more detailed.

SSAE No. 22 requires the practitioner to express an adverse conclusion when the practitioner, having obtained sufficient appropriate review evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the subject matter.

In a review engagement, the practitioner provides a conclusion about whether the practitioner was aware of any material modification that should be made to the subject matter in order for the subject matter to be in accordance with (or based on) the criteria or to an assertion about the subject matter in order for it to be fairly stated. To obtain limited assurance in a review engagement, the practitioner should do the following:

- Obtain an assertion from the responsible party
- Plan the work and properly supervise other members of the engagement team
- Focus procedures in areas where the practitioner believes increased risks of misstatements exist, whether due to error or fraud, based on the practitioner’s understanding of the subject matter, its measurement or evaluation, the criteria, and other engagement circumstances
- Obtain review evidence, through the application of inquiry and analytical procedures or other appropriate procedures to obtain limited assurance that no material modifications should be made to the subject matter in order for it to be in accordance with) or based on) the criteria
- A review engagement would normally test fewer transactions or subject matter than that in an assertion-based or direct examination engagement

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### **EXAMPLE 1: PRACTITIONER’S REVIEW REPORT ON SUBJECT MATTER; UNMODIFIED CONCLUSION**

The following is an illustrative practitioner’s review report in which the practitioner has reviewed the subject matter and is reporting on the subject matter.

#### **Independent Accountant’s Report**

[Appropriate Addressee]

We have reviewed [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company’s management is responsible for [identify the subject matter, for example, presenting the schedule of investment returns] in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1]. Our

responsibility is to express a conclusion on [identify the subject matter, for example, the schedule of investment returns] based on our review.

Our review was conducted in accordance with attestation standards established by the AICPA. Those standards require that we plan and perform the review to obtain limited assurance about whether any material modifications should be made to [identify the subject matter, for example, the schedule of investment returns] in order for it to be in accordance with (or based on) the criteria. The procedures performed in a review vary in nature and timing from and are substantially less in extent than, an examination, the objective of which is to obtain reasonable assurance about whether [identify the subject matter, for example, the schedule of investment returns] is in accordance with (or based on) the criteria, in all material respects, in order to express an opinion. Accordingly, we do not express such an opinion. Because of the limited nature of the engagement, the level of assurance obtained in a review is substantially lower than the assurance that would have been obtained had an examination been performed. We believe Page 44 that the review evidence obtained is sufficient and appropriate to provide a reasonable basis for our conclusion.

We are required to be independent and to meet our other ethical responsibilities in accordance with relevant ethical requirements related to the engagement.

*[Include a description of the work performed as a basis for the practitioner's conclusion.]*

*[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]*

*[Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]*

Based on our review, we are not aware of any material modifications that should be made to [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], in order for it be in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1].

*[Practitioner's signature]*

*[Practitioner's city and state]*

*[Date of practitioner's report]*

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## NOTES

# Unit

# 4

## AICPA Update – SSARS

### LEARNING OBJECTIVES

*After completing this unit, participants will be able to:*

- › Apply SSARS requirements found in recently issued SSARS 25, Materiality in a Review of Financial Statements and Adverse Conclusions, to accounting and review service issues such as engagement terms, independence, reporting, and documentation.

### INTRODUCTION

The Accounting and Review Services Committee (ARSC) of the AICPA issues Standards for Accounting and Review Services (SSARS). In 2014, ARSC made significant changes to the SSARS literature with the issuance of SSARS 21, *Clarification and Recodification*. SSARS 21 provided guidance in four areas:

- AR-C Section 60, General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services
- AR-C Section 70, Preparation of Financial Statements
- AR-C Section 80, Compilation Engagements
- AR-C Section 90, Review of Financial Statements

The major changes to SSARS engagements made by SSARS 21 include:

- Incorporates the AICPA **Clarity Drafting Conventions**, similar to those previously applied to auditing standards
- Introduces a new level of service called **preparation**. This is a nonattest service where the accountant prepares, but does not report or provide any assurance on the financial statements

- Includes revisions to the **compilation and review standards**, mostly affecting reports and engagement letters
- **Management-use-only** compilation engagement has been eliminated, so that all compilation engagements will include a report
- **Revises guidance on the circumstances that determine the type of service provided.** The type of service is dependent on what the accountant was engaged to do
- **Requires a signed engagement letter** for all engagements covered by SSARS 21, including preparation engagements

Subsequent to the issuance of SSARS 21, the ARSC continued with additional clarifications as amendments to the SSARS literature with the issuance of:

- SSARS 22, *Compilation of Pro Forma Financial Information effective for compilation reports on pro forma financial information dated on or after May 1, 2017*
- SSARS 23, *Omnibus Statement on Standards for Accounting and Review Services—2016, generally effective upon issuance*
- SSARS 24, *Omnibus Statement on Standards for Accounting and Review Services—2018, generally effective for compilations and reviews of financial statements for periods ending on or after June 15, 2019*

SSARS 21 through SSARS 24 have been covered in previous Kaplan FASB and AICPA Update programs, but due to the amendments to SSARS 21 by SSARS 25 in February 2020, we thought it would be useful to identify all the SSARS statements issued as part of this clarification and recodification initiative.

## **SSARS 25—MATERIALITY IN A REVIEW OF FINANCIAL STATEMENTS AND ADVERSE CONCLUSIONS**

### ***Introduction***

SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, was issued February 2020, by the ARSC.

SSARS 25 aligns ARSC engagements closer to the International Standards for Review Engagements (ISRE 2400—Engagements to Review Historical Financial Statements). The ARSC’s objective is to converge as closely as possible with the ISRE to allow engagements to be performed and reported on in accordance with both sets of standards. It is anticipated that less confusion about the level of assurance being given will result.

SSARS concepts, such as materiality, will also align with generally accepted auditing standards (GAAS).

**NOTE:** There should not be significant change in practice for those practitioners that have been performing ARSC engagements appropriately using current standards, but should result in less diversity in practice.

### ***Effective Date***

Effective date will be for financial statements with periods ending on or after December 15, 2021. Early implementation will be allowed.

The standard will amend SSARS 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, as amended in the following sections:

- Section 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services* [AICPA, Professional Standards, AR-C Section 60]
- Section 70, *Preparation of Financial Statements* [AICPA, Professional Standards, AR-C Section 70]
- Section 80, *Compilation Engagements* [AICPA, Professional Standards, AR-C Section 80]
- Section 90, *Review of Financial Statements* [AICPA, Professional Standards, AR-C Section 90]

## **CHANGES IN DEFINITIONS WITHIN SSARS**

- **Financial Reporting Framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.
- **Applicable Financial Reporting Framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.
- **Fair Presentation Framework.** Refers to the financial reporting framework that requires compliance with the requirements of the framework and does one of the following:
  - Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework.
  - Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements.

A financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgment in the two previous bullets is not a fair presentation framework.

- **Reasonable Period of Time.** The period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable).
- **Review Evidence.** Information used by the accountant to provide a reasonable basis for obtaining limited assurance. Review evidence includes both information contained in the accounting records underlying the financial statements and other information, which primarily consists of the results of analytical procedures and inquiries. Sufficiency of review evidence is the measure of the quantity of review evidence. Appropriateness of review evidence is the measure of the quality of review evidence, that is, its relevance and reliability in providing support for the conclusions on which the accountant's review report is based.
- **Inquiry.** Inquiry consists of seeking information of knowledgeable persons within or outside the entity.
- **Limited Assurance.** A level of assurance that is less than the reasonable assurance obtained in an audit engagement but is at an acceptable level as the basis for the conclusion expressed in the accountant's review report.
- **Unmodified Conclusion.** The accountant should express an unmodified conclusion in the accountant's review report on the financial statements as a whole when the accountant has obtained limited assurance to be able to conclude that nothing has come to the accountant's attention that causes the accountant to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.
- When the accountant expresses an unmodified conclusion, the accountant should, unless required by law or regulation, use the following language:

*Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements for them to be in accordance with [the applicable financial reporting framework].*

- **Modified Conclusion.** The accountant should express a modified conclusion in the accountant's review report on the financial statements as a whole when the accountant determines, based on the procedures performed and the review evidence obtained, that the financial statements are materially misstated resulting in a qualified conclusion or an adverse conclusion.
- **Pervasive.** A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements. Pervasive effects on the financial statements are those that, in the accountant's judgment
  - are not confined to specific elements, accounts, or items of the financial statements,
  - if so confined, represent or could represent a substantial portion of the financial statements,
  - or

- with regard to disclosures, are fundamental to users’ understanding of the financial statements.
- **Qualified Conclusion.** When the accountant concludes that the effects of the matter or matters giving rise to the modification are material but not pervasive to the financial statements.
- **Adverse Conclusion.** When the effects of the matter or matters giving rise to the modification are both material and pervasive to the financial statements.

## SSARS 25 CHANGES

### General Principles—AR-C Section 60

- Principle changes in Section 60 are in definitions related to the **applicable financial reporting framework** used by a client to prepare its financial statements.
- These changed definitions are designed to emphasize the requirements for an acceptable financial reporting framework when an accountant provides accounting and review services to clients.

### Preparation of Financial Statements—AR-C Section 70

- The primary change in Section 70 addresses financial statements that **omit substantially all the disclosures** required by the applicable financial reporting framework, requiring that the accountant disclose the omission of disclosures either in the financial statements or in an accompanying disclaimer.
- Additionally, it emphasizes that financial statements may be misleading if the applicable financial reporting framework includes the premise that the financial statements are prepared on the **going concern basis** and undisclosed uncertainties exist regarding the reporting entity’s ability to continue as a going concern.

### Compilation Engagements—AR-C Section 80

- Additional **compilation report guidance** is provided for regulatory or the contractual basis of accounting and for alerting users in the accountant’s compilation report when special purpose framework financial statements are presented, that these financial statements are prepared in accordance with a special purpose framework, and that the basis of accounting is a basis other than generally accepted accounting principles (GAAP).

### Review of Financial Statements—AR-C Section 90

- The review definition is modified from the accountant providing “limited assurance” that the financial statements are free from material misstatement to now **expressing a conclusion** that the reporting entity’s financial statements are free from material misstatement.
- The accountant now obtains **limited assurance** to express a conclusion in the review report.

- Related to expressing a conclusion, the accountant may reach a **modified conclusion**, which is a qualified conclusion or an adverse conclusion.
- A **qualified conclusion** is reached when the accountant concludes that the effects of the matter or matters, giving rise to this modification, are material but not pervasive to the financial statements.
- An **adverse conclusion** is reached when the effects of the matter or matters, giving rise to this modification, are both material and pervasive to the financial statements.
- As a result of *expressing a conclusion*, the review **report language** changes to reflect the conclusion reached.
- The accountant must determine **materiality** for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.
- Furthermore, the accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.
- Consistent with the increased emphasis on materiality, the accountant, when **designing and performing analytical procedures and inquiries**, should address 1) all material items in the financial statements, including disclosures, and 2) areas in the financial statements where the accountant believes there are increased risks of material misstatement.
- **Additional review guidance** is included in SSARS 25 in the areas of related parties, fraud and noncompliance with laws and regulations, and going concern.
- **Examples of transactions, events, or matters** the accountant should inquire about are included in SSARS 25.

The primary changes resulting from the issuance of SSARS 25 are in AR-C Section 90, *Review of Financial Statements*. The following provides more explanatory information related to the changes made by SSARS 25 to review engagements.

## **SSARS 25—Review Engagements**

In a review of financial statements, the accountant expresses a conclusion regarding the entity's financial statements in accordance with an applicable financial reporting framework. The accountant's conclusion is based on the accountant obtaining limited assurance. The accountant's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion.

The accountant performs primarily analytical procedures and inquiries to obtain sufficient appropriate review evidence as the basis for a conclusion on the financial statements as a whole, expressed in accordance with the requirements of this section.

If the accountant becomes aware of a matter that causes the accountant to believe the financial statements may be materially misstated, the accountant designs and performs additional procedures, as the accountant considers necessary in the circumstances, to be able to conclude on the financial statements in accordance with this section.

In conducting a review of financial statements, the **objectives of the accountant** are to

- obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework; and
- report on the financial statements as a whole and communicate, as required by AR-C 90.

The accountant should **inquire** of members of management who have responsibility for financial and accounting matters concerning the financial statements, and **others within the reporting entity**, as appropriate, related to whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied, including how management determined that significant accounting estimates are reasonable in the circumstances.

- The identification of related parties and related party transactions, including the purpose of those transactions
- Whether there are significant, unusual, or complex transactions, events, or matters that have affected or may affect the entity's financial statements, including the following:
  - Significant changes in the entity's business activities or operations
  - Significant changes to the terms of contracts that materially affect the entity's financial statements, including terms of finance and debt contracts or covenants
  - Significant journal entries or other adjustments to the financial statements
  - Significant transactions occurring or recognized during the period, particularly those in the last several days of the reporting period
- The status of any uncorrected misstatements identified during the previous review (that is, whether adjustments were recorded subsequent to the periods covered by the prior review and, if adjustments were recorded, the amounts recorded and period in which such adjustments were recorded)
- Effects or possible implications for the entity of transactions or relationships with related parties
- Matters about which questions have arisen in the course of applying the review procedures
- The existence of any actual, suspected, or alleged fraud or noncompliance with laws and regulations

- Noncompliance with provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations
- Whether management has identified and addressed events subsequent to the date of the financial statements that require adjustment of, or disclosure in, the financial statements
  - The basis for management’s assessment of the entity’s ability to continue as a going concern
  - Whether there are events or conditions that appear to cast doubt on the entity’s ability to continue as a going concern
  - Material commitments, contractual obligations, or contingencies that have affected or may affect the entity’s financial statements, including disclosures
  - Material nonmonetary transactions or transactions for no consideration in the financial reporting period under consideration
  - Communications from regulatory agencies, if applicable
  - Any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management’s response to the accountant’s inquiry
  - Actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements
  - Any other matters that the accountant may consider necessary

## **Materiality in a Review of Financial Statements**

The accountant should **determine materiality** for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.

The accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.

In obtaining **sufficient appropriate review evidence** as the basis for a conclusion on the financial statements as a whole, the accountant should design and perform the analytical procedures and inquiries to address the following:

- **All material items** in the financial statements, including disclosures
- Areas in the financial statements where the accountant believes there are **increased risks** of material misstatements

## Evaluating Review Evidence Obtained from the Procedures Performed

If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant's attention is incorrect, incomplete, or otherwise unsatisfactory, the accountant should

- request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and
- consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be materially misstated.

The accountant should evaluate whether sufficient appropriate review evidence has been obtained from the procedures performed and, if **sufficient appropriate review evidence has not been obtained from the procedures performed**, the accountant should perform other procedures that are necessary in the circumstances to be able to form a conclusion on the financial statements.

If the accountant is not able to obtain sufficient appropriate review evidence to form a conclusion, the accountant should withdraw from the engagement.

When the accountant expresses a **qualified conclusion** on the financial statements because of a material misstatement, the accountant should, unless otherwise required by law or regulation, use the following language:

*Based on my (our) review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with [the applicable financial reporting framework].*

When the accountant expresses an **adverse conclusion** on the financial statements, the accountant should, unless otherwise required by law or regulation, use the following language:

*Based on my (our) review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with [the applicable financial reporting framework].*

In the **basis for conclusion paragraph**, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the accountant should do the following:

Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures) and the effects of the departure on the financial statements have been determined by management or are known to the accountant as a result of the accountant's procedures.

- If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to determine

the effects of the departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.

- Explain how disclosures are misstated if the material misstatement relates to narrative disclosures.
- Describe the nature of omitted information if the material misstatement relates to the nondisclosure of information required to be disclosed. The accountant should include the omitted disclosures when practicable to do so.

**NOTE:** An adverse conclusion relating to a specific matter described in the basis for modification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the accountant's conclusion. In instances in which other identified matters would have otherwise required a modification of the accountant's conclusion, the disclosure of such other matters of which the accountant is aware may be relevant to users of the financial statements.

## **Consideration of the Applicable Financial Reporting Framework in Relation to the Financial Statements**

In forming the conclusion on the financial statements, the accountant should do the following:

- Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.
- Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:
  - The terminology used in the financial statements, including the title of each financial statement, is appropriate
  - The financial statements adequately disclose the significant accounting policies selected and applied;
  - The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate
  - Accounting estimates made by management appear reasonable
  - The information presented in the financial statements appears relevant, reliable, comparable, and understandable
  - The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements.

The accountant should consider the impact of the following:

- Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole
- Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments
- The accountant's consideration should also include the following:
  - The overall presentation, structure, and content of the financial statements
  - Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation

## **Review Documentation**

The extent and type of documentation in a review file is a matter of professional judgment. However, verbal explanations in and of themselves are not sufficient to support the work performed or the conclusions reached. The documentation should be sufficient to demonstrate the work performed. Documentation provides evidence that their review was performed in accordance with professional standards and supports the accountant's conclusion. This should include (review) evidence of

- the nature, timing, extent, and results of the work performed such as inquiry, analytical, or other procedures;
- the review evidence obtained from the review procedures performed and the accountant's conclusion formed on the basis of that review evidence;
- the source of the review evidence; and
- significant matters arising during the review, the accountant's conclusions reached, and significant professional judgments made in reaching those conclusions.

An accountant can include any additional documentation that the accountant believes is appropriate. AR-C Section 90 states the accountant's documentation should include the following:

- An engagement letter
- A copy of the review report issued and the financial statements
- Analytical procedures performed, including documentation of
  - the expectation, if not self-evident, and the factors considered in their development;
  - the results of comparing the results of the procedure performed to the general ledger. For example, calculating a gross margin would not be sufficient unless it was compared to prior periods or an industry standard; and
  - management's explanations if the procedures differ significantly from expectations.

- Any additional review procedures performed in response to significant unexpected differences and the results of these procedures
- The results of significant inquiries
- Any significant findings or issues
- Significant unusual matters
- Any verbal or written communication of fraud or illegal acts
- Communications with management regarding the accountant's expectation to include emphasis-of-matter or other-matter paragraph(s) in the accountant's review report
- Communication with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters
- If, in the course of the engagement, the accountant identified information that is inconsistent with the accountant's findings regarding significant matters affecting the financial statements, how the inconsistency was addressed
- Communications with other accountants that have audited or reviewed the financial statements of significant components
- A signed representation letter

**NOTE:** While SSARS 25 does not explicitly state that **materiality** should be documented in a review, there is now an explicit requirement for the accountant to determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. When determining and using materiality in a review engagement, the accountant must document materiality to reach a review conclusion. The accountant's conclusion states the following:

*Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the applicable financial reporting framework.*

In documenting the nature, timing, and extent of procedures performed, the accountant should document the following:

- Who performed the work and the date such work was completed
- Who reviewed the work performed for the purpose of quality control for the engagement and the date and extent of the review

In addition to the earlier content, the following additional documentation should be included:

- That the accountant has knowledge of the client's business and industry
- A trial balance that bridges the general ledger to the financial statements
- Indication that there are no material modifications required to the financial statements
- A work program, if required by firm policy
- A disclosure checklist, if required by firm policy
- Any consultation performed. Consultation would include discussion with firm personnel, technical research, and so on.

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## **EXAMPLE**

### **Independent Accountant's Review Report**

*[Appropriate Addressee]*

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

#### **Management's Responsibility for the Financial Statements**

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

#### **Accountant's Responsibility**

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be **independent** of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

#### **Accountant's Conclusion**

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

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## **EXAMPLE**

### **Independent Accountant's Review Report**

*[Appropriate Addressee]*

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

### **Management's Responsibility for the Financial Statements**

Management (Owners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

### **Accountant's Responsibility**

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

### **Basis for Adverse Conclusion**

As disclosed in Note X to these financial statements, the Company has not consolidated the financial statements of subsidiary ABC Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

### **Adverse Conclusion**

Based on my (our) review, due to the significance of the matter described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

*[Signature of accounting firm or accountant, as appropriate]*

*[Accountant's city and state]*

*[Date of the accountant's review report]*

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**NOTE:** Additional examples are in SSARS 25.

## NOTES

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