Accounting and Auditing Update

(AAU4)

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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 section, participants will be able to:

- Apply recently issued Accounting Standard Updates (ASUs)

INTRODUCTION

This section reviews ASUs issued in 2022 as of 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. We also include at the beginning of this section FASB's Technical Agenda to enable you to anticipate the new ASU topics that will be issued in 2023 and beyond.

FASB'S TECHNICAL AGENDA

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

1. Recognition and Measurements
2. Presentation and Disclosure Projects
3. Framework Projects
4. Research Projects
5. Post-Implementation Projects

As of the time of writing this course, the following are topics included in each of the five project areas.

Recognition and Measurement

- Accounting for and Disclosure of Crypto Assets
- Accounting for and Disclosure of Software Costs
- Accounting for Environmental Credit Programs
- Codification Improvements (next phase)
- Codification Improvements-Amendments to Remove References to the Concepts Statements
- EITF 21-A, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method
- Financial Instruments-Credit Losses (Topic 326)-Acquired Financial Assets
- Joint Venture Formations
- Leases (Topic 842)-Common Control Arrangements
- Scope Application of Profits Interest Awards: Compensation-Stock Compensation (Topic 718)
- Topic 815 – Hedge Accounting Improvements

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*

- Disaggregation-Income Statement Expenses
- Disclosure Improvements in Response to the SEC's Release on Disclosure Update and Simplification
- Improvements to Income Tax Disclosures
- Interim Reporting-Narrow Scope Improvements
- Segment Reporting

Framework Projects

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

- Conceptual Framework: Measurement
- Conceptual Framework: The Reporting Entity
- Conceptual Framework: Recognition and Derecognition

Research Projects

The following research projects are in various stages of completion.

- Accounting for and the Disclosure of Intangibles
- Accounting for Exchange-Traded Commodities
- Accounting for Government Grants
- Consolidation for Business Entities
- Definition of a Derivative
- Financial Key Performance Indicators for Business Entities
- Statement of Cash Flows

Post-Implementation Projects

- Credit Losses
- Leases
- Revenue Recognition

FASB EFFECTIVE DATES

Public Companies

- ASU 2016-13, *Measurement of Credit Losses on Financial Instruments,* (Topic 326). Effective for fiscal years beginning after December 15, 2022 (Smaller Reporting Entities (SRCs)
- ASU 2017-04, *Goodwill and Other* (Topic 350). Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts* (Topic 944). Effective for fiscal years beginning after December 15, 2022 – For SRCs, effective for fiscal years beginning after December 15, 2024

- ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*. Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*. Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2019-05, *Targeted Transition Relief* (Topic 326). Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2019-09, *Insurance Effective Date* (Topic 944). Effective for fiscal years beginning after December 15, 2022 – For SRCs, effective for fiscal years beginning after December 15, 2024

- ASU 2019-10, *Financial Instruments-Credit Losses (Topic 326), Derivatives and Hedging (Topic 815, and Leases (Topic 842): Effective Dates*. Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*. Effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2020-03, *Codification Improvements to Financial Instruments*. Issues 6 and 7 - effective for fiscal years beginning after December 15, 2022 (SRCs)

- ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* (Topics 470, and 815. Effective for fiscal years beginning after December 15, 2023 (SRCs)

- ASU 2020-11, *Financial Services-Insurance (Topic 944: Effective Date and Early Application)*. Effective for fiscal years beginning after December 15, 2022 – For SRCs, effective for fiscal years beginning after December 15, 2024

- ASU 2021-08, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers* (Topic 805). Effective for fiscal years beginning after December 15, 2022

- ASU 2022-01, *Fair Value Hedging-Portfolio Layer Method* (Topic 815). Effective for fiscal years after December 15, 2022

- ASU 2022-02, *Troubled Debt Restructurings and Vintage Disclosures* (Topic 326). Effective for fiscal years beginning after December 15, 2022

- ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* (Topic 820). Effective for fiscal years beginning after December 15, 2023

- ASU 2022-04, *Disclosure of Supplier Finance Program Obligations* (Subtopic 405-50). The amendments in ASU 2022-04 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, except for the amendment on rollforward information, which should be effective for fiscal years beginning after December 15, 2023

- ASU 2022-05, *Transition for Sold Contracts* (Topic 944 – Financial Services – Insurance). Effective for fiscal years beginning after December 15, 2022 – For SRCs, effective for fiscal years beginning after December 15, 2024

- ASU 2022-06, *Reference Rate Reform* (Topic 848): Deferral of the Sunset Date of Topic 848. Effective for all entities upon issuance of this Amendment

Non-Public Companies

- ASU 2016-13, *Measurement of Credit Losses on Financial Instruments,* (Topic 326). Effective for fiscal years beginning after December 15, 2022

- ASU 2017-04, *Intangibles-Goodwill and Other*. Effective for annual and interim goodwill impairment tests for fiscal years beginning after December 15, 2022

- ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts* (Topic 944). Effective for fiscal years beginning after December 15, 2024

- ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*. Effective for fiscal years beginning after December 15, 2022

- ASU 22019-04, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses, Topic 815, Derivatives and Hedging and Topic 825, Financial Instruments*. Effective for fiscal years beginning after December 15, 2022

- ASU 2019-05, *Financial Instruments-Credit Losses (Topic 326) Targeted Transition Relief*. Effective for fiscal years beginning after December 15, 2022

- ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*. Effective for fiscal years beginning after December 15, 2022

- ASU 2020-03, *Codification Improvements to Financial Instruments*. Effective for fiscal years beginning after December 15, 2022

- ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity (*Subtopics 470-20 and 815-40). Effective for fiscal years beginning after December 15, 2023

- ASU 2020-11, *Financial Services-Insurance (Topic 944: Effective Date and Early Application)*. Effective for fiscal years beginning after December 15, 2024 and interim periods within fiscal years beginning after December 15, 2025

- ASU 2021-08, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers* (Topic 805). Effective for fiscal years beginning after December 15, 2023

- ASU 2022-01, *Fair Value Hedging-Portfolio Layer Method* (Topic 815). Effective for fiscal years beginning after December 15, 2023

- ASU 2022-02, *Troubled Debt Restructurings and Vintage Disclosures* (Topic 326). Effective for fiscal years beginning after December 15, 2022

- ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* (Topic 820). Effective for fiscal years beginning after December 15, 2024

- ASU 2022-04, *Disclosure of Supplier Finance Program Obligations* (Subtopic 405-50). The amendments in ASU 2022-04 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, except for the amendment on rollforward information, which should be effective for fiscal years beginning after December 15, 2023

- ASU 2022-05, *Financial Services-Insurance (Topic 944: Transition for Sold Contracts).* Effective for fiscal years beginning after December 15, 2024 and interim periods within fiscal years beginning after December 15, 2025

- ASU 2022-06, *Reference Rate Reform* (Topic 848): Deferral of the Sunset Date of Topic 848. Effective for all entities upon issuance of this Amendment

FASB UPDATE - 2023

NOTE: ASU 2016-13, is included in this year's FASB Update because its effective date for non-public entities has been extended to fiscal years beginning after December 15, 2022.

ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

Introduction

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.

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.

Provisions

- 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.
- **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.

ASU 2022-01, Fair Value Hedging-Portfolio Layer Method: Derivatives and Hedging (Topic 815)

Objective

ASU 2022-01 updates ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities* (Topic 815) by providing expanded optional hedge accounting guidance to better reflect the effects of risk management activities in the financial statements and ultimately provide investors and other allocators of capital with more transparent, decision-useful information around a reporting entity's use of derivatives.

Definitions

- Fair Value Hedge - A fair value hedge is a type of financial strategy that involves using a financial product, usually a derivative, to hedge against risk from price changes in an asset.

- Last-of-Layer Method – The last-of-layer method allows an entity to fair value hedge any asset (or portfolio of similar assets) by using the last dollar amount within that portfolio of "prepayable" assets as the hedged item.

  For a closed portfolio (new assets cannot be added) of fixed-rate prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, such as mortgages or mortgaged-backed securities, the last-of-layer method allows an entity to hedge its exposure to fair value changes due to changes in interest rates for a portion of the portfolio that is not expected to be affected by prepayments, defaults, and other events affecting the timing and amount of cash flows.

- Portfolio Layer – Term replaces last-of-layer method in ASU 2022-01.

- Hedged Layer – The hedged item designated in a portfolio layer method hedging relationship, representing a stated amount or stated amounts of a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments that is not expected to be affected by prepayments, defaults, or other factors affecting the timing and amount of cash flows for the designated hedge period.

- Prepayable Risk - Prepayment risk is the risk involved with the premature return of principal on a fixed-income security. When principal is returned early, future interest payments will not be paid on that part of the principal, meaning investors in associated fixed-income securities will not receive interest paid on the principal.

Background

As noted in ASU 2022-01, before the issuance of ASU 2017-12, reporting entities had difficulty achieving fair value hedge accounting for interest rate risk hedges of portfolios of prepayable financial assets. ASU 2017-12 added the last-of-layer method to make portfolio fair value hedge accounting for hedges of those types of assets more accessible.

For a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, the last-of-layer method allows a reporting entity to hedge a stated amount of the asset or assets in the closed portfolio that is anticipated to be outstanding for the designated hedge period. If the requirements for the last-of-layer method are met, prepayment risk or credit risk is not incorporated into the measurement of the hedged item.

Since the issuance of ASU 2017-12, users have told the FASB that the ability to elect hedge accounting for a single layer (last-of-layer method) is useful, but hedge accounting could better reflect risk management activities if expanded to allow multiple layers of a single closed portfolio to be hedged under the method.

NOTE: Interest rate hedges utilized by non-public reporting entities are almost exclusively cash flow hedges rather than fair value hedges as addressed by ASU 2017-12.

Provisions

ASU 2022-01 expands the scope of ASU 2017-12 to allow reporting entities to apply the portfolio layer method (referred to previously as last-of-layer) to portfolios of all financial assets, including both prepayable and non-prepayable financial assets. ASU 2022-01 allows reporting entities to designate multiple layers in a single portfolio as individual hedged items. This permits reporting entities to designate multiple hedging relationships with a single closed portfolio enabling a larger portion of the interest rate risk associated with the portfolio to be hedged.

Also, the hedged item (layer) in a portfolio layer method hedge is related to multiple assets within a closed portfolio but it is not necessarily related to all of the assets within that portfolio. ASU 2022-01 clarifies that a reporting entity should adjust the basis at the portfolio level and not allocate the amount to individual assets within the portfolio.

ASU 2022-01 specifies that eligible hedging instruments in a single-layer hedge may include spot-starting or forward-starting constant-notional swaps, or spot or forward-starting amortizing-notional swaps and that the number of hedged layers (single or multiple) corresponds with the number of hedges designated.

In addition, if multiple hedged layers are designated, ASU 2022-01 requires that a reporting entity perform an analysis (documentation) to support its expectation that the aggregate amount of the hedged layers is anticipated to be outstanding for the designated hedge periods.

While only closed portfolios may be hedged under the portfolio method, a reporting entity is permitted to designate new hedging relationships and de-designate existing hedging relationships with the closed portfolio any time after the closed portfolio is established and designated in a portfolio layer method hedge. This allows the accounting too better reflect changes in a reporting entity's risk management activities in a dynamic interest rate environment.

ASU 2022-01 also indicates that if the aggregate amount of the hedged layers is no longer anticipated to be outstanding in future hedged periods (a breach is anticipated), a reporting entity is required to partially or fully de-designate a hedged layer or layers until a breach is no longer anticipated. If the aggregate amount of the hedged layers currently exceeds the amount of the closed portfolio (a breach has occurred), a reporting entity is similarly required to partially or fully de-designate a hedged layer or layers until the aggregate amount of the hedged layers no longer exceeds the closed portfolio. If there are multiple hedged layers, a reporting entity should determine which hedges to de-designate or partially de-designate in accordance with an accounting policy election that specifies a systematic and rational approach to determining which hedge or hedges to de-designate (or partially de-designate). That policy should be consistently applied when a breach is anticipated and when a breach has occurred.

ASU 2022-01 also provides **accounting guidance** for hedge basis adjustments under the portfolio layer method. This guidance includes the following:

- A reporting entity is required to maintain basis adjustments in an existing hedge in a closed portfolio – not allocated to individual assets
- A reporting entity is required to immediately recognize and present the basis adjustment associated with the amount of the de-designated layer that was breached in interest income. In addition, the reporting entity is required to disclose the amount and the circumstances that led to the breach
- A reporting entity is required to disclose the total amount of the basis adjustments in existing hedges as a reconciling amount if other areas of GAAP require the disaggregation disclosure of the amortized cost basis of assets included in the closed portfolio
- A reporting entity is prohibited from considering basis adjustments in an existing hedge when determining credit losses

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EXAMPLE

Last-of-Layer Method

FMA Corporation has a $100,000,000 of closed portfolio, fixed rate prepayable loans. FMA considers historical prepayments and defaults and it expects the following amounts to be outstanding:

- 4 years - $80,000,000
- 6 years - $50,000,000
- 10 years - $10,000,000 (this would be the last-of-layer)

According to ASU 2017-12, this last of layer can be hedged.

Portfolio Layer Method

FMA Corporation has a $100,000,000 of closed portfolio, fixed rate prepayable loans. FMA considers historical prepayments and defaults and it expects the following amounts to be outstanding:

- 4 years - $80,000,000
- 6 years - $50,000,000
- 10 years - $10,000,000

According to ASU 2022-01, multiple layers can be hedged in addition to the last-of-layer. For example:

- $30,000,000 4-year layer could be hedged ($80,000,000 - $50,000,000)
- $40,000,000 6-year layer could be hedged ($50,000,000 - $10,000,000)
- $10,000,000 10-year layer (last-of-layer) could be hedged

Effective Date

- For public business entities, ASU 2022-01 is effective for fiscal years beginning after December 15, 2022 and interim periods within those fiscal years.
- For all other reporting entities, ASU 2022-01 is effective for fiscal years beginning after December 15, 2023 and interim periods within those fiscal years.

ASU 2022-02, Troubled Debt Restructurings and Vintage Disclosures: Financial Instruments-Credit Losses (Topic 326)

Objective

ASU 2022-02 is intended to improve the decision usefulness of information provided to investors about certain loan re-financings, restructurings, and write-offs. ASU 2022-02 creates a single model for loan modification accounting by creditors while providing improved loan modification and write-off disclosures.

Background

Legacy GAAP includes guidance for troubled debt restructurings (TDRs) in Subtopic 310-40, *Receivables-Troubled Debt Restructurings by Creditors.* This guidance provides an exception to the general recognition and measurement guidance for loan restructurings and re-financings (modifications) that a reporting entity determines meet the criteria for be considered a troubled debt restructuring. Modifications are TDRs and thus subject to different accounting guidance, if they are made to borrowers experiencing financial difficulty and if the creditor grants a concession to the borrower.

If a modification is a TDR, an incremental expected loss, if any, is recorded in the allowance for credit losses upon modification. Certain concessions can be captured only through a discounted cash flow (DCF) method and therefore discounts cash flow models are required for measurement of some TDRs. There are also additional disclosures required for TDRs. Related and updated guidance for current expected credit losses (CECL) can also be found in Topic 326, *Financial Instruments-Credit Losses.*

Also, FASB noted an inconsistency in the requirements for a public business entity to disclose gross write-offs and gross recoveries by class of financing receivables and major security type in the disclosures required in Subtopic 326-20-50 and the Example 15 in Subtopic 326-20-55

Provisions

ASU 2022-02 eliminates the accounting guidance for troubled debt restructurings in Subtopic 310-40 by creditors that have adopted CECL (Topic 326, *Financial Instruments-Credit Losses)* while enhancing disclosure requirements for certain loan re-financings and restructurings by creditors made to borrowers experiencing financial difficulty. Rather than applying the recognition and measurement

guidance for TDRs, a reporting entity must apply the loan refinancing and restructuring guidance in Subtopics 310-20-35-9 through 11 to determine whether a modification results in a new loan or a continuation of an existing loan.

Under ASU 2022-02, a reporting entity is no longer required to use a DCF method to measure the allowance for credit losses as a result of a modification or restructuring with a borrower experiencing financial difficulty.

Also, ASU 2022-02 requires that a public business entity disclose current period write-offs by year of origination for financing receivables and net investment in leases. This disclosure should include each of the previous five annual fiscal periods starting with the date of the financial statements and for the annual periods before that. Upon adoption of ASU 2022-02, a reporting entity would not provide the previous five annual fiscal periods of gross write-offs but instead be provided on a prospective basis allowing the reporting entity to build the five annual fiscal period disclosure over time.

Disclosures

Modification to Debtors Experiencing Financial Difficulty

These disclosures should be provided for modifications of receivables to borrowers experiencing financial difficulty in the form of principal forgiveness, an interest rate reduction, an other than insignificant payment delay, or a term extension made within the scope of Topic 310.

The objectives of these disclosures are to provide financial statement users with information about:

- The type and magnitude of certain modifications of receivables made to borrowers experiencing financial difficulty
- The financial effect of those modifications and
- The degree of success of the modifications in mitigating potential credit losses

In addition to these objectives, a reporting entity should consider providing information that helps financial statement users understand significant changes in the types or magnitude of modifications, including those modifications that, for example, were caused by a major credit event, even if the modifications otherwise would not require the disclosures required below.

For each period for which a statement of income is presented, an reporting entity should disclose the following information related to **modifications of receivables** that are in the form of principal forgiveness, an interest rate reduction, an other than-insignificant payment delay, or a term extension (or a combination thereof) made to debtors experiencing financial difficulty during the reporting period:

1. By class of financing receivable, qualitative and quantitative information about:

   – The types of modifications utilized by an entity, including the total period-end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to debtors experiencing financial difficulty relative to the total period-end amortized cost basis of receivables in the class of financing receivable

   – The financial effect of the modification by type of modification, which should provide information about the changes to the contractual terms as a result of the modification and

should include the incremental effect of principal forgiveness on the amortized cost basis of the modified receivables, as applicable, or the reduction in weighted-average interest rates (versus a range) for interest rate reductions

  - Receivable performance in the 12 months after a modification of a receivable made to a debtor experiencing financial difficulty

2. By portfolio segment, qualitative information about how those modifications and the debtors' subsequent performance are factored into determining the allowance for credit losses

For each period for which a statement of income is presented, a reporting entity should disclose the following information about **financing receivables** that had a payment default during the period and had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or a combination thereof) within the previous 12 months preceding the payment default when the debtor was experiencing financial difficulty at the time of the modification:

1. By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the following:

   - The type of contractual change that the modification provided

   - The amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted

2. By portfolio segment, qualitative information about how those defaults are factored into determining the allowance for credit losses

Vintage Disclosures-Gross Write-offs

Topic 326 requires that a reporting entity should provide quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets including all of the following:

1. A description of the credit quality indicator

2. For amortized cost basis, by credit quality indicator

3. For each credit quality indicator, the date or range of dates in which the information was last updated for the credit quality indicator

ASU 2022-02 requires that a public business entity disclose current-period gross write-offs by year of origination for financial receivables and net investment in leases. As noted in ASU 2022-02, a public business entity should present:

- The gross write-offs recorded in the current period, on a current year-to-date basis, for financing receivables and net investments in leases by origination year

- For origination years before the fifth annual period, a public business entity may present the gross write-offs in the current period for financing receivables and net investments in leases in the aggregate

- By class of financing receivable, the amount of line-of-credit arrangements that are converted to term loans in each reporting period and the total of these financing receivables that were written off in the current reporting period

EXAMPLE

Disclosing Credit Quality Indicators of Financing Receivables by Amortized Cost Basis

	Term Loans Amortized Cost Basis by Origination Year								
As of December 31, 20X5	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term Loans Amortized Cost Basis	Total
Residential mortgage:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total residential mortgage loans	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~									
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~
Consumer:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total consumer	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~									
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~
Commercial business:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial business	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial business loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~									
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~
Commercial mortgage:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
~~Current-period recoveries~~									
~~**Current-period net writeoffs**~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~	~~$~~

Effective Date

- For all reporting entities, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022 including interim periods within those fiscal years.

ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sales Restrictions (Topic 820)

Objective

To clarify the guidance in Topic 820, *Fair Value Measurement,* when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of the equity security, to amend a related illustrative example, and to introduce new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value.

Background

As noted in the background information and basis for conclusions of ASU 2022-03:

> *Topic 820 states that when measuring the fair value of an asset or a liability, a reporting entity should consider the characteristics of the asset or liability, including restrictions on the sale of the asset or liability, if a market participant also would take those characteristics into account. Key to that determination is the unit of account for the asset or liability being measured at fair value; in other words, the specific asset or liability (or group of assets and/or liabilities) being sold and whether the restriction should be included as part of the sale. Generally, the unit of account is determined by the relevant Topic or Subtopic that requires or permits fair value measurement, but in certain instances the unit of account is determined by Topic 820.*
>
> *Stakeholders asserted that Topic 820 contains conflicting guidance on what the unit of account is when measuring the fair value of an equity security. In certain paragraphs, the guidance indicates that the unit of account is an individual equity security (that is, exclusive of the contractual sale restriction and, therefore, the contractual sale restriction is specific to the entity holding the security). As a result, some stakeholders concluded that adjusting the fair value of an equity security to reflect the effect of a separate contractual restriction is not appropriate. However, before the amendments in this Update became finalized, an illustrative example within Topic 820 that addressed the consideration of the effects of a restriction on the ability to sell an equity security indicated that a contractual sale restriction would be considered a characteristic of that equity security and, therefore, included within the unit of account. Stakeholders that concluded that a contractual sale restriction was considered in the unit of account measured the fair value of the equity security as the price of an otherwise identical equity security that was not subject to a contractual sale restriction adjusted to reflect the effect of the restriction. Stakeholders asked the Board to clarify the guidance within Topic 820 to resolve the diversity in practice.*

Note: **Unit of account** is defined by FASB as "The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes." As compared to **unit of measure** which is defined by FASB as "The currency in which assets, liabilities, revenues, expenses, gains, and losses are measured."

Provisions

ASU 2022-03 clarifies that a contractual restriction on the sale of an equity security is **not considered** part of the unit of account of the equity security and, therefore, is not considered in measuring fair

value. ASU 2022-03 also clarifies that a reporting entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction.

The related example has been updated and amended.

Disclosures

For equity securities subject to contractual sales restrictions:

1. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet

2. The nature and remaining duration of the restriction(s)

3. The circumstances that could cause a lapse in the restriction(s)

Effective Date

- For public business entities, ASU 2022-03 are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

- For all other reporting entities, ASU 2022-03 is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

- Early adoption is permitted.

ASU 2022-04, Disclosure of Supplier Finance Program Obligations (Subtopic 405-50)

Objective

- The objective of ASU 2022-04 is for a reporting entity to disclose sufficient information to enable users of financial statements to understand the nature, activity during the period, changes from period to period, and potential magnitude of the entity's supplier finance programs

- To achieve that objective, a reporting entity should disclose qualitative and quantitative information about its supplier finance programs

Background

ASU 2022-04 addresses investor and other financial statement user requests for additional information about the use of supplier finance programs by the buyer party to understand the effect of those programs on the reporting entity's working capital, liquidity, and cash flows. Supplier finance programs allow a buyer to offer its suppliers the option to be paid by a third party in advance of an invoice due date, based on invoices that the buyer has confirmed as valid.

As noted in ASU 2022-04, a buyer in a supplier finance program enters into an agreement with a finance provider or an intermediary to establish the program then purchases goods or services from suppliers with a promise to pay at a later date. The buyer notifies the finance provider or intermediary

of the supplier invoices that it has confirmed as valid. Suppliers may then request early payment from the finance provider or intermediary for those confirmed invoices.

Provisions

In each annual reporting period, the buyer should disclose the following information:

- The key terms of the program, including a description of the payment terms (including payment timing and basis for its determination) and assets pledged as security or other forms of guarantees provided fore the committed payment to the finance provider or intermediary

- For the obligations that the buyer has confirmed as valid to the finance provider or intermediary:

    1. The amount outstanding that remains unpaid by the buyer as of the end of the annual period (the outstanding confirmed amount)

    2. A description of where those obligations are presented in the balance sheet

    3. A rollforward of those obligations during the annual period, including the amount of obligations confirmed and the amount of obligations subsequently paid

Effective Date

- The amendments in ASU 2022-04 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, except for the amendment on rollforward information, which should be effective for fiscal years beginning after December 15, 2023.

- Early application is permitted.

ASU 2022-05, Transition for Sold Contracts (Topic 944-Financial Services-Insurance)

Objective

Reduce implementation costs and complexity associated with the adoption of ASU 2018-12, *Financial Services-Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI), for contracts that have been derecognized before the LDTI effective date. As noted in ASU 2022-05, without the amendments in this Update, an insurance entity would be required to reclassify a portion of the previously recognized gains or losses to the LDTI transition adjustment because of the adoption of a new accounting standard. Because there is no effect on an insurance entity's future cash flows, such a reclassification may not be decision useful to investors and other allocators of capital.

Provisions

ASU 2022-05 amend the LDTI transition guidance to allow an insurance entity to make an accounting policy election on a transaction-by-transaction basis. An insurance entity may elect to exclude contracts that meet certain criteria from applying ASU 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts*. To qualify for the accounting policy election, as of the LDTI effective date both of the following conditions must be met:

1. The insurance contracts must have been derecognized because of a sale or disposal of individual or a group of contracts or legal entities

2. The entity has no significant continuing involvement with the derecognized contracts

Effective Date

- For public business entities that meet the definition of a U.S. Securities and Exchange Commission (SEC) filer and are not smaller reporting companies, LDTI is effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. Early application is permitted.

- For all other entities, LDTI is effective for fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early application is permitted.

ASU 2022-06, Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848

Objective

The objective of the guidance in Topic 848 is to provide temporary relief associated with reference rate reform as a result of transiting from LIBOR to The Secured Overnight Financing Rate (SOFR) in 2023.

Provision

In March 2021, the UK Financial Conduct Authority (FCA) announced that the intended cessation date of the overnight 1-, 3-, 6-, and 12-month tenors of USD LIBOR would be June 30, 2023, which is beyond the current sunset date of Topic 848.

Because the current relief in Topic 848 may not cover a period of time during which a significant number of modifications may take place, the amendments in ASU 2022-06 defer the sunset date of Topic 848 from December 31, 2022, to December 31, 2024, after which entities will no longer be permitted to apply the relief in Topic 848.

Effective Date

ASU 2022-06 is effective for all reporting entities upon issuance of this ASU.

AICPA TECHNICAL QUESTIONS AND ANSWERS (TQAS) IN ACCOUNTING

The AICPA in May of 2022 updated its TQA in the areas of accounting, auditing, compilations, reviews and ethics. This Update program includes those TQAs most relevant to practitioners based on questions from attendees at our seminars. Accounting TQAs are included in this section and the other TQAs are included in the appropriate related sections.

Consolidated Versus Combined Financial Statements

Inquiry — S Corporation has 2000 common shares and 1000 preferred shares outstanding. The preferred shareholders have the same rights as the common shareholders, except the right to vote. Of the 2000 common shares outstanding, 1000 shares are owned by P Corporation and 1000 shares are owned by I (an individual) who also owns all of the outstanding common shares of P Corporation. The preferred shares of S Corporation are owned by an outside party. Should P Corporation consolidate S Corporation for financial reporting purposes?

Reply — FASB ASC 810-10-55-1B states that to "justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation." In this situation P does not control S directly or indirectly and therefore consolidation is not appropriate. Combined financial statements could be presented if the circumstances are such that combined financial statements of S Corporation and P Corporation are more meaningful than separate financial statements.

Inquiry — If a reporting entity is the primary beneficiary of a variable interest entity (VIE) under FASB ASC 810, would it be appropriate to issue combined financial statements rather than consolidated financial statements?

Reply — No. FASB ASC 810 acknowledges that combined financial statements may be permitted in certain situations in which consolidated financial statements are not required.

Disclosure Concerning Subsequent Events in Special Purpose Financial Statements

Inquiry — FASB Accounting Standards Codification (ASC) 855, Subsequent Events, sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date on which the financial statements were issued or were available to be issued. Should full disclosure financial statements prepared in accordance with a special purpose framework contain the disclosures set forth in FASB ASC 855?

Reply — Paragraph .A33 of AR-C section 80 and paragraph .A128 of AR-C section 90 state “financial statements prepared when applying a special purpose framework [fn 3] are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or are similar to, those in financial statements prepared in accordance with GAAP.” Paragraph .A26 of AU-C section 800 states, in part, “when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.” Therefore, the date through which an entity has evaluated subsequent events and the basis for that date should be disclosed. Furthermore, some non-recognized subsequent events are of such a nature that disclosure is required to keep the financial statements prepared from being misleading. Such events should be disclosed following the guidance in FASB ASC 855.

Applicability of Fair Value Disclosure Requirements and Measurement Principles in FASB Accounting Standards Codification (ASC) 820, Fair Value Measurement, to Certain Financial Instruments

Inquiry— Do the fair value measurement principles and disclosure requirements in FASB Accounting

Standards Codification (ASC) 820, Fair Value Measurement, apply to financial instruments that are not recognized at fair value in the statement of financial position, but for which fair value is required to be disclosed in the notes to financial statements in accordance with paragraphs 10– 15 of FASB ASC 825-10-50?

Reply — The measurement principles of FASB ASC 820 apply when determining for disclosure purposes the fair value of financial instruments that are not recognized at fair value in the statement of financial position. FASB ASC 820-10-15-1, which establishes the scope of FASB ASC 820, provides that "Except as noted below, this Topic applies when another Topic requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements)." The exceptions listed in FASB ASC 820-10-15-2 relate to (1) share-based payment transactions, (2) FASB ASC sections, subtopics, or topics that require or permit measurements that are similar to fair value but that are not intended to measure fair value, (3) the recognition and measurement of revenue from contracts with customers in accordance with FASB ASC 606, and (4) the recognition and measurement of gains and losses upon the derecognition of non-financial assets in accordance with FASB ASC 610-20.

In addition, certain disclosure requirements of FASB ASC 820 apply to financial instruments for which fair value is only disclosed. Specifically, FASB ASC 820-10-50-2E provides that for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed,

> *a reporting entity shall disclose the information required by paragraph 820-10-50-2(b) and (h). However, a reporting entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2(bbb)(2). For such assets and liabilities, a reporting entity does not need to provide the other disclosures required by this Topic.*

Accounting for Certain Liquidated Damages

Inquiry — "Liquidated damages" represent contractual payments to a buyer of property, plant, and equipment (PP&E) for the non-delivery or noncompletion of construction of PP&E by a stated completion date. The amount is specified in advance by contract — for example, a stated amount per day of delay — rather than a computation of actual losses of the buyer caused by the delay. Liquidated damages are negotiated to represent compensation for a reasonable estimate of the buyer's costs associated with a delay. Liquidated damages are specified in advance in order to eliminate the need for possibly contentious after-the-fact negotiations about actual costs incurred. How should a buyer of PP&E account for liquidated damages, as defined above?

Reply — Because the buyer does not provide the payer of the damages with an identifiable benefit in

exchange for the payment, a buyer typically records liquidated damages as a reduction of the payments it has made to the vendor for the PP&E (that is, a reduction of the cost of the PP&E). Amounts of liquidated damages in excess of the total cost of PP&E would be recognized by the buyer as income. The basis for this reply is FASB ASC 705-20. As stated in FASB ASC 705-20-25-1:

> *The entity shall account for consideration from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration from the vendor is one of the following:*
>
> a. *In exchange for a distinct good or service (as described in paragraphs 606-10-25-19 through 25-22) that the entity transfers to the vendor*
> b. *A reimbursement of costs incurred by the entity to sell the vendor's products*
> c. *Consideration for sales incentives offered to customers by manufacturers.*

Contracts between a buyer and provider of PP&E could be drafted in two ways — with a realistic completion date and contract price with liquidated damages for late delivery, or with a pessimistic completion date and a bargain contract price with a bonus for early delivery. The accounting for liquidated damages, as noted in this reply, results in the same accounting for the buyer regardless of how the contract is drafted.

FASB Project – Accounting for and Disclosure of Crypto Assets

PWC in their Crypto Asset Guide from August of 2021 defines crypto assets as:

> *Transferable digital representations that are designed in a way that prohibits their copying or duplication. The technology that facilitates the transfer of crypto assets is referred to as blockchain or distributed ledger technology. Blockchain is a digital, decentralized ledger that keeps a record of all transactions that take place across a peer to peer network and enables the encryption of information.*
>
> *Crypto assets come in a variety of forms, and new crypto assets (sometimes referred to as digital tokens or digital assets) continue to be created. These assets may function as a medium of exchange, provide a right to use a product or service, provide rights to an underlying asset, provide voting rights, or provide rights to profits and losses among others*

The AICPA defines a crypto asset as:

> *A type of digital asset that functions as a medium of exchange, and is not any of the following:*
>
> - *Issued by a governmental authority*
> - *A contract between the asset holder and another entity or*
> - *A security under either the Securities Act of 1933 or the Securities Exchange Act of 1934*

Crypto assets are considered to be intangible assets for accounting purposes because they lack physical substance and meet the asset recognition criteria in Topic 350, Intangibles-Goodwill and Other.

The SEC has recently issued SAB 121, Accounting for Obligations to Safeguard Crypto-Assets (See Section 3 of this program) and in May of 2022 FASB added a project to its Technical Agenda Accounting for And Disclosure of Crypto Assets.

SAB 121 requires a reporting entity within the scope of the SAB that operates a platform that allows its users (customers) to transact in crypto-assets and that also performs custodial activities, to record (recognize) a safeguarding liability with a corresponding asset, regardless of the reporting entities assessment as to who controls the crypto-asset. In addition, the SEC staff believes that it would be appropriate to measure this safeguarding liability at initial recognition and for each reporting period at its fair value based on Topic 820, Fair Value Measurement (measure) of the crypto-asset that the reporting entity is responsible for holding for its platform users.

The purpose of this FASB project is to establish accounting guidance for companies and NFPs that hold crypto currencies. Currently, FASB's guidance treats crypto currencies as indefinite-lived intangible assets recorded at their cost to acquire them with subsequent measurement at their impaired value (if any) with no provisions to recognize market gains on these currencies.

It is expected that as a result of this project, FASB will apply fair value accounting for crypto currencies considering them to be financial assets. The following is the status of the project as of December 14, 2022 as described in a FASB Board meeting:

FASB decided that crypto assets that are held by an entity must meet the following criteria to be within the project's scope:

- Meet the definition of an intangible asset as defined in the FASB Codification
- Do not provide the asset holder with enforceable rights to, or claims on, underlying goods, services, or other assets
- Are created or reside on a distributed ledger or blockchain
- Are secured through cryptography
- Are fungible (something (such as money or a commodity) of such a nature that one part or quantity may be replaced by another equal part or quantity in paying a debt or settling an account (Merriam-Webster)

The Board decided to require an entity to:

1. At a minimum, present the aggregate amount of crypto assets (within the scope of this project) separately from other intangible assets that are measured using other measurement bases.
2. Present gains and losses on crypto assets (within the scope of this project) in net income and present those gains and losses separately from the income statement effects of other intangible assets, such as amortization or impairments.
3. Classify crypto assets received as noncash consideration during the ordinary course of business that are converted nearly immediately into cash as operating cash flows.
4. These presentation requirements would be applicable to all entities, including public and private entities. The Board also decided that investment companies and not-for-profit entities should present their financial statements in accordance with the presentation requirements in Topic 946, *Financial Services—Investment Companies*, and Topic 958, *Not-for-Profit Entities*, respectively, subject to minor amendments that would clarify the inclusion of crypto assets.

5. The Board affirmed that disclosures in Topic 820, *Fair Value Measurement*, would be required for crypto assets within the scope of this project. Those disclosures would be required in annual and interim periods, consistent with the existing requirements in Topic 820.

The Board also decided to require an entity to **disclose** the following:

1. At both annual and interim periods, the following information about each significant crypto asset holding (as determined by the fair value of that holding): the name of the crypto asset, fair value, units held, and cost basis.

2. At both annual and interim periods, the fair value and cost basis of other crypto asset holdings, which may be aggregated into a single line item.

3. At annual periods, a reconciliation of activity between the beginning and end of the period for total crypto asset holdings. This disclosure would require that an entity disaggregate information by additions, dispositions, gains, and losses during the period and include a description of the additions and dispositions.

4. At annual periods, for disposition of crypto assets during the period, the difference between the sale price and the cost basis of those assets.

5. At both interim and annual periods, the fair value of the crypto assets that are restricted from sale, the nature and remaining duration of the restriction, and circumstances that could cause a lapse in the restriction(s).

The disclosure requirements would be required for all entities, including public and private entities, as well as entities that apply industry-specific guidance (to the extent that the requirements would not duplicate existing industry-specific disclosure requirements).

FASB Staff Educational Paper – Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards

Introduction

In 1983, the United Nations commissioned a report to be issued on global strategies for sustainable development. This report is titled, *Report of the World Commission on Environment and Development.* In 1991, a sub-group of the United Nations, the Business Council for Sustainable Development (BCSD), was created - Its primary objective was to identify forward-thinking business people to lead sustainable development around the world and that this independent, non-commercial organization could help with this objective.

In 1995, evolving from this UN initiative, the World Business Council for Sustainable Development (WBCSD) was created to accelerate the transition to a sustainable world. The Sustainability Accounting Standards Board (SASB) was Founded in 2011 to develop sustainability accounting standards (SASB). The International Integrated Reporting Council (IIRC) – a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia, and non-governmental organizations was founded in 2010 - Its purpose is to communicate about value creation as the next step in the evolution of corporate reporting.

The UN World Commission on Environment and Development defines sustainability as development that meets the needs of the present without compromising the ability of future generations to meet

their own needs. The Commission's focus is about promoting prosperity and economic growth (profit) while protecting the planet and people across three interconnected core elements (ESGs):

1. Environmental

2. Social

3. Governance

Environmental

Considers how an organization performs as a steward of nature. This factor includes the nature and extent of non-renewable resources used in production, as well as the release of potentially harmful elements in the air, land, and water.

Metrics can include:

- Percent of reduction in energy used
- Amounts of toxic waste generated
- Amount of carbon emissions

Social

Examines how an organization manages relationships with employees, suppliers, customers, and the communities where it operates.

Metrics can include:

- Median hourly gender pay gaps
- Percent of employee retention
- Number of suppliers identified with high-risk labor conditions and actions taken by the organization
- Employee health and safety

Governance

Deals with an organization's leadership and effective management of the business. In addition to overseeing strategy execution, performance, and management of risks, effective governance ensures maintenance of the social license to operate. Specific governance considerations include executive pay, regulatory compliance, and shareholder rights, as well as internal controls and internal and external audits.

Metrics can include:

- Board oversite of high-risk issues such as climate

- Executive compensation
- Number of minority directors
- Anti-corruption programs and activities
- Tax transparency

The United States Securities and Exchange Commission (SEC)

The SEC's Investor Advisory Committee, in May 2020, voted to make recommendations to the SEC on ESG disclosure in annual 10k filings. As part of its recommendations it stated, "ESG related disclosures have gone from a fringe concept to a mainstream, global investment and geopolitical priority", It supported its recommendation as follows:

1. Investors require reliable, material ESG information upon which to base investment and voting decisions
2. Issuers should directly provide material information to the market relating to ESG issues used by investors to make investment and voting decisions
3. Requiring material ESG disclosures will level the playing field among issuers
4. Ensure the flow of capital to U.S. markets and to U.S. issuers of all sizes
5. The U.S. should take the lead on disclosure of material ESG disclosures

FASB Staff Educational Paper – March 21, 2021

Purpose

ESG reporting is an area of growing focus for a wide range of interested parties including investors, credit rating agencies, lenders, preparers, regulators, and policy makers. ESG reporting includes a broad spectrum of quantitative and qualitative information. Interested parties seek to understand the effects of relevant ESG matters on a reporting entity's business strategy, cash flows, financial position, and financial performance. In other cases, parties seek that information from a public policy perspective or to influence corporate behavior.

The FASB staff developed this educational paper to provide investors and other interested parties with an overview of where ESG matters may have relevance with current accounting standards. Below identify the accounting standards the FASB staff believe may be relevant disclosure areas for ESG matters:

- Subtopic 205-40, *Presentation of Financial Statements-Going Concern*-For example, compliance cost related to enacted emissions regulations that may impact the entity's going concern evaluation
- Topic 275, *Risks and Uncertainties*-Entity may determine that the effects of environmental matters (estimates) are material to the entity in the near term

- Topic 330, *Inventory*-Estimates of net realizable value could be materially affected by a regulatory change that renders inventories obsolete, or a significant weather event could cause physical damage to inventories, or a decrease in demand for an entity's goods resulting from changes in consumer behavior or an increase in completion costs because of disruptions in the supply chain

- Topic 360, *Property, Plant & Equipment*-Environmental matters could give rise to impairment indicators. For example, A material decline in market demand for products or a change in regulation that adversely affects an entity could cause an asset impairment

- Topic 450, *Contingencies*-Loss contingencies could result from environmental or asset retirement obligations that may need to be accrued or recognized

- Topic 740, *Income Taxes*-ESG matters may affect future taxable income resulting in a recognized valuation allowance needed for deferred tax assets

- Topic 820, *Fair Value Measurement*-Fair value is used in accounting for business combinations, financial instruments, asset impairments, goodwill impairments, and lease classification. Based on the recognition of ESG matters by an organization, an asset's highest and best use may be affected causing an impact of the asset's fair value measurement

While much of the focus on climate-change and ESG matters is taking place at the public company level (SEC), private companies are also paying attention and are expected to take actions to reduce their impact on climate-change and improve their ESG practices in the future. Private Company Director magazine in their March 2022 issue makes the point that if ESG issues are integrated into business strategy they can create significant competitive advantages for the private company. The article identifies five reasons private companies are taking ESG issues seriously:

1. Strengthens and secures relationships with business partners – strengthens supply chain relationships

2. Captures new business opportunities and spurs innovation

3. Connects with consumers by demonstrating the company's ESG credentials

4. Retain and attract employees

5. Ensure access to markets and capital on favorable terms

Unit 2

SEC Update

LEARNING OBJECTIVE

After completing this section, participants will be able to:

- Describe the SEC accounting and disclosure issues identified as priorities by the SEC
- Identify the recent statements by Paul Munter, Acting Chief Accountant of the SEC, concerning independent audits and auditor independence
- *Identify the specific areas that the SEC staff have issued comment letters for companies filing 10-Ks and 10-Qs.*

INTRODUCTION

In this year's SEC Update, we cover six specific topics designed to provide insight into the accounting and financial reporting areas of most concern to the SEC. These topics are:

1. SAB 121, *Accounting for Obligations to Safeguard Crypto-Assets*
2. SEC Considerations for Special Purpose Acquisition Companies (SPACs)
3. SEC's Pay vs. Performance Disclosure Rules
4. SEC Proposals Related to Climate Change Disclosures
5. Auditor Independence
6. SEC Comment Letter Topics

SAB 121, ACCOUNTING FOR OBLIGATIONS TO SAFERGUARD CRYPTO-ASSETS

Objective

SAB 121 adds interpretative guidance for reporting entities to consider when they have obligations to safeguard crypto-assets held for their platform users.

SAB 121 is applicable to reporting entities that file reports pursuant to the Securities Exchange Act of 1934 and reporting entities that have submitted or filed a registration statement under the Securities Act of 1933 or the 1934 Act that is not yet effective. SAB 121 is also applicable to reporting entities submitting or filing an offering statement or post-qualification amendment under Regulation A (exemption from registration for public offerings), reporting entities subject to the periodic and current reporting requirements of Regulation A, and private operating companies whose financial statements are included in filings with the SEC in connection with a business combination involving a shell company, including a special purpose acquisition company (SPAC).

Definitions

- Crypto-Assets – Assets which can only and exclusively be transmitted by means of block-chain technology, including but not limited to digital coins and digital tokens and any other type of digital mediums of exchange.
- Crypto-Currency Exchange - A cryptocurrency exchange (crypto exchange) is a platform that promotes the trade of cryptocurrencies using digital money, fiat money or other assets. These exchanges are the intermediaries between parties and make money from transaction fees and commissions.

Background

SAB 121 addresses the accounting for reporting entities that have obligations to safeguard crypto-assets held for their platform users. In recent years the SEC staff have observed an increase in the number of reporting entities that provide platform users with the ability to transact in crypto-assets. These reporting entities and/or their agents may safeguard the platform user's crypto-assets and also maintain the cryptographic key information necessary to access the crypto-asset. The obligations associated with these arrangements involve unique risks and uncertainties not present in other arrangements to safeguard assets that are not crypto-assets.

These risks include technological, legal and regulatory risks and uncertainties due to the custody of these crypto-assets on the reporting entities platform. These risks can have a significant impact on the reporting entities operations and financial condition. The SEC staff believe that the recognition, measurement, and disclosure guidance in SAB 121 will enhance the information received by investors and other users of financial statements about these risks, thereby assisting these investors and users in making investment and other capital allocation decisions.

Provisions

SAB 121 requires a reporting entity within the scope of the SAB that operates a platform that allows its users (customers) to transact in crypto-assets and that also performs custodial activities, to record

(recognize) a safeguarding liability with a corresponding asset, regardless of the reporting entities assessment as to who controls the crypto-asset.

In addition, the SEC staff believes that it would be appropriate to measure this safeguarding liability at initial recognition and for each reporting period at its fair value based on Topic 820, *Fair Value Measurement* (measure) of the crypto-asset that the reporting entity is responsible for holding for its platform users. The SEC staff also believe that the reporting entity should recognize an asset at the same time it recognizes the safeguarding liability, measured at initial recognition and for each reporting date at the fair value of the crypto-assets held for platform users.

NOTE: There is the potential for double reporting of these crypto-assets where a bitcoin could be reported on multiple companies' balance sheets when a reporting entity holds this bitcoin for one of its customers, but also safeguards that bitcoin with another third-party custodian.

Disclosures

- The nature and amount of crypto-assets that the reporting entity is responsible for safeguarding for its platform users
- Each significant crypto-asset held and the vulnerabilities the reporting entity has due to any concentration in these activities
- Significant risks and uncertainties associated with the reporting entity's safeguarding of crypto-assets for others
- Fair value measurement disclosures required by Topic 820

These disclosures should include information about who (the company, its agent, or another third party) holds the cryptographic key information, maintains the internal record keeping of those assets, and is obligated to secure the assets and protect them from loss or theft.

Effective Date

Existing registrants must apply SAB 121 to financial statements for interim and annual reporting periods ending after June 15, 2022 with retrospective application, at a minimum, to the beginning of the fiscal year.

Other reporting entities subject to SAB 121 apply SAB 121 in their next submission or filing. Retrospective application is required for either:

- The beginning of the most recent annual reporting period ending before June 15, 2022 when a subsequent interim period is presented or
- The beginning of the two most recent annual reporting periods ending before June 15, 2022 when a subsequent interim period is not presented

SEC CONSIDERATIONS FOR SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)

In recent years, there has been a significant increase in the use of special purpose acquisition companies (SPACs) to raise capital and take a private companies public. The SPAC is created with capital from initial investors, participates in an IPO to raise additional capital, and identifies a private company target to merge with that then becomes a public company.

According to the SEC:

> *Certain market participants believe that, through a SPAC transaction, a private company can become a publicly traded company with more certainty as to pricing and control over deal terms as compared to traditional initial public offerings, or IPOs.*

A SPAC transaction can include the following steps:

1. SPAC formation
2. Raise capital through an IPO
3. Perform search for a target company to acquire
4. Negotiate with the target company
5. SEC S-1 Filing
6. Shareholder votes
7. 8K filing takes place
8. Acquisition (business combination) takes place

SEC Considerations

Formation of the SPAC:

- Initial IPO process requires the preparation and filing of Form S-1 with the SEC
- Form S-1 is an initial registration statement under the Securities Act of 1933 necessary to register the securities of a company wishing to go public
- Once approved by the SEC, the SPAC's securities can be traded on an exchange

Once an acquisition company is identified, the SPAC is required to file one of the following schedule or form:

- Proxy statement (Schedule 14A) pursuant to Section 14A of the Securities Act of 1934 to obtain voting approval from the SPAC shareholders to approve the transaction, or

- Form S-4 Registration Statement Under the Securities Act of 1933 - a combined proxy and registration statement when the SPAC is going to register additional securities as part of the acquisition transaction

In addition, an 8K must be filed within four business days of the transaction approval - this 8K must include disclosure of:

- Amendments to Articles of Incorporation or Bylaws
- Change in Shell Company Status
- Financial Statements and Exhibits including proforma financial information

Following the business combination (merger) of the SPAC and the operating company, the new public company will be required to file:

- 10Qs quarterly
- 10Ks annually
- Including internal control over financial reporting

On January 11, 2022, the SEC warned that SPACs can't put disclaimers in their financial statements that their financial reporting could run afoul of the U.S. accounting rules. Some SPACs have been issuing broad disclaimers that long-standing SPAC accounting practices could change and lead to future errors. In other words, "accepted practice" may not the same as U.S. GAAP. Some companies are trying to limit their liability associated with the use of SPACs for acquisition purposes but the SEC believes this practice is inappropriate and may violate existing U.S. GAAP. The SEC is saying "you are either following GAAP or you are not."

On March 30, 2022, the SEC issued a proposal titled *Special Purpose Acquisition Companies, Shell Companies and Projections*, including proposed rules intended to enhance investor protections in initial public offerings by special purpose acquisition companies ("SPACs") and in subsequent business combination transactions between SPACs and private operating companies. Specifically, the SEC is proposing specialized disclosure requirements with respect to, among other things, compensation paid to sponsors, conflicts of interest, dilution, and the fairness of these business combination transactions.

The proposed new rules and amendments to certain rules and forms under the Securities Act of 1933 and the Securities Exchange Act of 1934 would address the application of disclosure, underwriter liability, and other provisions in the context of, and specifically address concerns associated with, business combination transactions involving SPACs as well as the scope of the Private Securities Litigation Reform Act of 1995.

Further, the SEC is proposing a rule that would deem any business combination transaction involving a reporting shell company, including a SPAC, to involve a sale of securities to the reporting shell company's shareholders and are proposing to amend a number of financial statement requirements applicable to transactions involving shell companies.

In addition, The SEC is proposing to update guidance regarding the use of projections in Commission filings as well as to require additional disclosure regarding projections when used in connection with business combination transactions involving SPACs.

SEC PAY VS. PERFORMANCE RULES

Executive Compensation - Pay vs. Performance Disclosure Rules

The Securities and Exchange Commission adopted on August 25th 2022 amendments to its rules to require registrants to disclose information reflecting the relationship between executive compensation actually paid by a registrant and the registrant's financial performance.

The rules implement a requirement mandated by the Dodd-Frank Act in Section 953(a) of the Act. The amendments add new Item 402(v) of Regulation S-K.

The amendments require registrants to provide a **table** disclosing specified executive compensation and financial performance measures for their five most recently completed fiscal years. With respect to the measures of performance, a registrant will be required to report its total shareholder return (TSR), the TSR of companies in the registrant's peer group, its net income, and financial performance measures chosen by the registrant.

This **table** will include the following:

- Principal executive officer's (PEO) actual compensation and the average actual compensation paid to other named executive officers (NEO)
- Total executive compensation reported in the summary compensation table for the principal PEO and an average for the other NEOs
- Total shareholder return (TSR) of the registrant and its peer group
- The registrant's net income or loss
- Financial performance measures chosen by the registrant for the most recent fiscal year

Using the information presented in the table, registrants will be required to describe the relationships between the executive compensation actually paid and each of the performance measures, as well as the relationship between the registrant's TSR and the TSR of its selected peer group. A registrant will also be required to provide a list of three to seven financial performance measures that it determines are its most important performance measures for linking executive compensation actually paid to company performance.

Smaller reporting companies will be subject to scaled disclosure requirements under the rules.

Registrants must begin to comply with these pay vs. performance disclosures in proxy and information statements that are required to include Item 402 executive compensation disclosure for fiscal years ending on or after December 16, 2022. For example, Item 11. Executive Compensation in Part 3 of Form 10-k.

SEC PROPOSALS RELATED TO CLIMATE CHANGE DISCLOSURES

All Registrants

The Securities and Exchange Commission in March of 2022 proposed rule changes that would require registrants to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements. The required information about climate-related risks also would include disclosure of a registrant's greenhouse gas emissions, which have become a commonly used metric to assess a registrant's exposure to such risks.

"I am pleased to support today's proposal because, if adopted, it would provide investors with consistent, comparable, and decision-useful information for making their investment decisions, and it would provide consistent and clear reporting obligations for issuers," said SEC Chair Gary Gensler. "Our core bargain from the 1930s is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures. Today, investors representing literally tens of trillions of dollars support climate-related disclosures because they recognize that climate risks can pose significant financial risks to companies, and investors need reliable information about climate risks to make informed investment decisions. Today's proposal would help issuers more efficiently and effectively disclose these risks and meet investor demand, as many issuers already seek to do. Companies and investors alike would benefit from the clear rules of the road proposed in this release. I believe the SEC has a role to play when there's this level of demand for consistent and comparable information that may affect financial performance. Today's proposal thus is driven by the needs of investors and issuers."

The proposed rule changes would require a registrant to disclose information about:

1. The registrant's governance of climate-related risks and relevant risk management processes

2. How any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term

3. How any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook

4. The impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements.

For registrants that already conduct scenario analysis, have developed transition plans, or publicly set climate-related targets or goals, the proposed amendments would require certain disclosures to enable investors to understand those aspects of the registrants' climate risk management.

The proposed rules also would require a registrant to disclose information about its direct greenhouse gas (GHG) emissions (Scope 1) and indirect emissions from purchased electricity or other forms of energy (Scope 2). In addition, a registrant would be required to disclose GHG emissions from upstream and downstream activities in its value chain (Scope 3), if material or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions.

These proposals for GHG emissions disclosures would provide investors with decision-useful information to assess a registrant's exposure to, and management of, climate-related risks, and in particular transition risks. The proposed rules would provide a safe harbor for liability from Scope 3 emissions disclosure and an exemption from the Scope 3 emissions disclosure requirement for smaller reporting companies. The proposed disclosures are similar to those that many companies already provide based on broadly accepted disclosure frameworks, such as the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol.

Under the proposed rule changes, accelerated filers and large accelerated filers would be required to include an attestation report from an independent attestation service provider covering Scopes 1 and 2 emissions disclosures, with a phase-in over time, to promote the reliability of GHG emissions disclosures for investors.

The proposed rules would include a phase-in period for all registrants, with the compliance date dependent on the registrant's filer status, and an additional phase-in period for Scope 3 emissions disclosure.

Investment Advisors and Investment Companies

According to the SEC, while ESG strategies have existed for decades, investor interest in these strategies has rapidly increased in recent years, with significant inflows of capital to ESG-related investment products and advisory services. Asset managers have responded to increased demand by creating and marketing ESG products.

The ways that different funds and advisers define ESG can vary widely. Similarly, there are significant differences in the data, criteria, and strategies used as part of ESG strategies. The lack of disclosure requirements and a common disclosure framework tailored to ESG investing make it harder for investors who seek to understand which investments or investment policies are associated with a particular ESG strategy. In the absence of informative disclosures, a fund's or adviser's disclosure could exaggerate its actual consideration of ESG factors.

The proposed rule and form amendments issued in May of 2022 are designed to provide consistent standards for ESG disclosures, allowing investors to make more informed decisions as they compare various ESG investments. The proposal's framework for ESG-related strategy disclosure is designed to allow investors to determine whether a fund's or adviser's ESG marketing statements translate into concrete and specific measures taken to address ESG goals and portfolio allocation. The proposal also requires certain environmentally focused funds to disclose information regarding the GHG emissions associated with their portfolio.

ESG Strategy Disclosure for Funds and Advisers

The proposal would require funds that consider ESG factors in their investment process to disclose additional information regarding their strategy. The amount of required disclosure depends on how central ESG factors are to a fund's strategy and follows a "layered" framework, with a concise overview in the prospectus supplemented by more detailed information in other sections of the prospectus or in other disclosure documents, all of which would be reported in a structured data language. The proposal identifies the following three types of ESG funds:

1. Integration Funds. Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to describe how ESG factors are incorporated into their investment process.

2. ESG-Focused Funds. Funds for which ESG factors are a significant or main consideration would be required to provide detailed disclosure, including a standardized ESG strategy overview table.

3. Impact Funds. A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

Advisers that consider ESG factors would be required to make generally similar disclosures in their brochures with respect to their consideration of ESG factors in the significant investment strategies or methods of analysis they pursue and report certain ESG information in their annual filings with the Commission.

Additional Disclosure Regarding Impacts and Proxy Voting or Engagements

Certain ESG-Focused Funds would be required to provide additional information about their strategies, including information about the impacts they seek to achieve and key metrics to assess their progress. The proposal would require funds that use proxy voting or engagement with issuers as a significant means of implementing their ESG strategy to provide additional information about their proxy voting or ESG engagements, as applicable.

GHG Emissions Reporting

The proposal generally would require ESG-Focused Funds that consider environmental factors in their investment strategies to disclose additional information regarding the GHG emissions associated with their investments. These funds would be required to disclose the carbon footprint and the weighted average carbon intensity of their portfolio. The requirements are designed to meet demand from investors seeking environmentally focused fund investments for consistent and comparable quantitative information regarding the GHG emissions associated with their portfolios and to allow investors to make decisions in line with their own ESG goals and expectations.

Funds that disclose that they do not consider GHG emissions as part of their ESG strategy would not be required to report this information. Integration funds that consider GHG emissions would be required to disclose additional information about how the fund considers GHG emissions, including the methodology and data sources the fund may use as part of its consideration of GHG emissions.

AUDITOR INDEPENDENCE

NOTE: The following are recent comments made by Paul Munter, Acting Chief Accountant of the SEC concerning auditor independence.

The Importance of Auditor Independence

"The independence of the auditor, in both fact and appearance, is foundational to the credibility of the financial statements. While sourcing a high-quality independent auditor is a key responsibility of the audit committee, compliance with auditor independence rules is a shared responsibility of the issuer, its audit committee, and the auditor.

As we near the twentieth anniversary of SOX, it is critical for all gatekeepers to continue to vigilantly maintain the independence of auditors, in both fact and appearance. In this regard, auditors and audit

clients must carefully consider the scope of their audit and any permissible non-audit engagements that have been pre-approved by the audit committee to guard against impairments of independence. As part of this responsibility, all gatekeepers in the financial reporting ecosystem should be especially mindful of the nature and the scope of any other services provided by the independent auditor. For instance, an auditor that provides extensive non-audit services to an entity that has an active mergers and acquisitions business model must continually monitor the impacts of all such transactions, and potential transactions, on its audit engagements to ensure that the auditor remains, in fact and appearance, independent of all of its audit clients.

The Auditor Independence Framework of Rule 2-01(b) of Regulation S-X

The general standard of Rule 2-01(b) is the heart of the Commission's auditor independence rule. This general standard is grounded in the auditor's objectivity and impartiality, and is measured by reference to the reasonable investor standard: "[t]he Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment of all issues encompassed within the accountant's engagement."

The general standard of auditor independence does not end there, however, but states that when determining whether an accountant is independent the Commission takes into consideration "all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission." As described in more detail in our recent statement*,* the text of Rule 2-01(b) of Regulation S-X, together with the four guiding principles that the Commission specified in the introductory text to Rule 2-01, provides a framework for considering whether an accountant is independent with respect to an audit client. Those four principles include a consideration as to whether all the relevant circumstances:

- Create a mutual or conflicting interest between the accountant and the audit client;
- Place the accountant in the position of auditing their own work;
- Result in the accountant acting as management or an employee of the audit client; or
- Place the accountant in a position of being an advocate for the audit client".

Firm's Ethical Culture

"It is of paramount importance that public accounting firms foster a culture of ethical behavior with respect to all aspects of their professional responsibilities, including auditor independence. As we noted at the outset, high-quality audits are critical to the process of disclosing financial information for the benefit of investors and serve an important gatekeeping function to help protect investors by ensuring that issues are promptly identified and addressed. The Commission has long-recognized that audits by professional, objective, and skilled accountants that are independent of their audit clients contribute to both investor protection and investor confidence. Any perceived erosion of auditor independence or the profession's ethics or integrity breaks down the critical gatekeeper role of public accountants and can, over time, lead to diminished investor confidence.

The examples of such erosion need not be as extreme as those instances that result in Commission enforcement action. As we mentioned earlier, OCA staff have seen situations of decreased vigilance when it comes to auditor independence—what we describe as a "checklist compliance" mentality. This has, in turn, led to a deterioration in the ethical culture in some firms. We caution leadership of accounting firms to remain focused on the trusted role that public accountants play in the disclosure of high-quality financial information to the investing public and to take compliance with all aspects of the Commission's auditor independence rule very seriously.

To preserve the critical role that accountants play in serving the public interest and fulfilling an investor protection mandate, audit firms should lead by example. They should, for example, prioritize auditor independence and a culture of ethical behavior in all professional activities, and where independence on an audit engagement is a close-to-the-line call, the firms must be willing to forego audit and review fees or potentially lucrative restructuring proposals to comply with their independence responsibilities. Further, firms should establish and maintain quality controls that adequately reckon with regulatory requirements and be vigilant about internal efforts to circumnavigate those requirements. Finally, firms should address auditor independence compliance with the seriousness and urgency it deserves.

Accountants serve a critical role in the integrity of our markets and the protection of investors, and audit professionals in particular have a difficult job—they are forced to sometimes make difficult determinations. But that is precisely how public accountants fulfill their gatekeeping function to help protect investors—by ensuring that issues are promptly identified and addressed. To maintain that function, and in training the next generations of public accountants, it is critical that our accounting firms foster and prioritize a culture of ethical behavior in all their professional activities, but especially with respect to auditor independence."

SEC COMMENT LETTER TOPICS

As noted on the SEC's website, comment letters between SEC staff and SEC filers are contained in the SEC's EDGAR database. The SEC began publicly releasing this correspondence in 2005 for filings made after August 1, 2004 that were reviewed by the SEC staff. SEC staff from the Divisions of Corporation Finance and Investment Management issues this type of comment letter in connection with their review of disclosure filings. The staff's comments are in response to a company's disclosure and other public information and are based on the staff's understanding of that company's facts and circumstances.

In issuing comments to a company, the staff may request that a company provide additional supplemental information so the staff can better understand the company's disclosure, revise disclosure in a document on file with the SEC, provide additional disclosure in a document on file with the SEC, or provide additional or different disclosure in a future filing with the SEC. There may be several rounds of letters from the SEC staff and responses from the filer until the issues identified in the review are resolved. These letters set forth staff positions and do not constitute an official expression of the SEC's views. The letters are limited to the specific facts of the filing in question and do not apply to other filings.

While SEC comment letters are impact public company reporting, the topics are frequently also applicable to non-public company financial statements.

The most frequent comment letters in 2021 and 2022 by topic are as follows:

1. Non-GAAP financial measures

2. Management's discussion and analysis (MD&A)

3. Segment reporting
4. Risk Factors-climate change matters
5. Revenue recognition
6. Fair value measurement
7. Form compliance and exhibits
8. Disclosure controls and internal control over financial reporting
9. Inventory and cost of sales
10. Debt, quasi-debt, warrants, and equity

Specific Areas of Focus

- Non-GAAP Performance Measurements – This topic was the most frequently commented on topic by the SEC during 2021 and 2022. The comments have addressed both 10-K and 10-Q filings as well as comment letters discussing company press releases on Form 8-K.

  1. Comments addressing 10-K and 10-Q filings:

     – Non-GAAP performance and liquidity measurements presented more prominently than GAAP measurements

     – Non-GAAP performance and liquidity measurements not quantitatively reconciled with the most comparable GAAP measurements (net income or cash flows) – this reconciliation should begin with the GAAP measurement

     – Lack of appropriate disclosures concerning the purpose and use of non-GAAP measurements

     – Not distinguishing between non-GAAP performance and liquidity measurements

     – Inconsistent presentations when including unusual gains in a non-GAAP presentation but excluding unusual losses or excluding cash operating expenses from non-GAAP performance measures

     – Certain performance indicators should be identified as non-GAAP measures

  2. Comments addressing press releases included in 8-K filings:

     – Adjustments to reported net income that eliminate normal recurring operating expenses in the non-GAAP measurement

     – Not properly describing the reasons for certain adjustments to a GAAP measurement when presenting a non-GAAP measurement

– Certain performance indicators should be identified as non-GAAP measures

NOTE: On December 13th, 2022 the SEC issued Non-GAAP Financial Measures a question and answer document with compliance and disclosure interpretations of the rules and regulations on the use of non-GAAP financial measures. This document ca n be accessed at https://www.sec.gov/corpfin/non-gaap-financial-measures

- Management's Discussion and Analysis (MD&A) – These comments are focused on explaining the results of operations more clearly, identifying the underlying drivers for each material factor that affected the company's earnings or is reasonably likely to have a material effect on future earnings. In addition, the comments focused on performance metrics, including whether the company has disclosed key metrics used by management that would be of interest to investors and other users and how those metrics correlate to material changes in the company's results of operations.

- The comments also addressed critical accounting estimates discussed in 10-K filings. SEC Financial Reporting Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations,* notes that MD&A rules require disclosure of critical accounting estimates and assumptions when both of the following conditions are met:

1. The nature of the estimates or assumptions is material because of the levels of subjectivity and judgment needed to account for matters that are highly uncertain and susceptible to change.

2. The effect of the estimates and assumptions is material to the financial statements.

- Segment Reporting – The comments for this topic address the compliance of companies when applying the guidance in FASB's Topic 280, *Segment Reporting*. Specific issues include the following:

– How companies identify operating segments

– How companies aggregate operating segments into reportable segments

– Whether companies have inappropriately included non-GAAP measures in their segment disclosures

– Whether companies provide appropriate entity-wide disclosures related to products or services, revenue attributable to individual foreign countries, and revenues from major external customers

- Risk-Factors-Climate Change Matters – During 2021 and 2022, the SEC implemented a new focus on the quality and adequacy of climate-related disclosures following existing SEC rules and regulations. Specifically, the SEC is addressing the following in comment letters:

– Any inconsistencies between a company's corporate social responsibility report and information in the company's SEC filings

– Any lack of disclosure in the company's SEC filings concerning the risks, trends, and impact (if any) of climate change for the company and its business

– Any lack of disclosure in a company's SEC filings related to pending or existing climate0related legislation and regulations that could have a material impact on the company's business

As noted in Section 2 of this program, the accounting standards the FASB staff believe may be relevant disclosure areas for climate-change matters include:

- Subtopic 205-40, *Presentation of Financial Statements-Going Concern*-For example, compliance cost related to enacted emissions regulations that may impact the entity's going concern evaluation

- Topic 275, *Risks and Uncertainties*-Entity may determine that the effects of environmental matters (estimates) are material to the entity in the near term

- Topic 330, *Inventory*-Estimates of net realizable value could be materially affected by a regulatory change that renders inventories obsolete, or a significant weather event could cause physical damage to inventories, or a decrease in demand for an entity's goods resulting from changes in consumer behavior or an increase in completion costs because of disruptions in the supply chain

- Topic 360, *Property, Plant & Equipment*-Environmental matters could give rise to impairment indicators. For example, A material decline in market demand for products or a change in regulation that adversely affects an entity could cause an asset impairment

- Topic 450, *Contingencies*-Loss contingencies could result from environmental or asset retirement obligations that may need to be accrued or recognized

- Topic 740, *Income Taxes*-ESG matters may affect future taxable income resulting in a recognized valuation allowance needed for deferred tax assets

- Topic 820, *Fair Value Measurement*-Fair value is used in accounting for business combinations, financial instruments, asset impairments, goodwill impairments, and lease classification. Based on the recognition of ESG matters by an organization, an asset's highest and best use may be affected causing an impact of the asset's fair value measurement

■ Revenue Recognition – While ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606)*,* has only been effective for a short period of time, the comments from the SEC that address issues associated with the new revenue ASU include the following:

- Identifying and the satisfaction of performance obligations (promises)

- Recognition of revenue over time versus at a point in time

- Considering variable consideration in the determination of the transaction price

- Determining the transaction price and allocating it to the performance obligations

- Determining when control has transferred to the customer, permitting the selling entity to recognize revenue

- Adequacy of revenue disclosures, including the disaggregation of revenue

- Gross vs. net presentation – judgments used

- Fair Value Measurement – The SEC primarily is focusing on the significant judgments and estimates made in developing fair value measurements. For example:

  - Valuation techniques and inputs used to determine fair value

  - Fair value measurements determined by management or a third-party pricing service

  - Quantitative information provided for significant unobservable inputs used to measure Level 3 fair values

NOTES

Unit

3

AICPA Update – Audit Engagements

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- Describe the AICPA's recently issued quality management standards
- Identify and describe recently issued SASs (audit standards)
- Describe current audit issues and how these issues are being addressed

INTRODUCTION

Auditing standards have gone through significant changes and updates during the past few years. Starting with SAS 134 through SAS 141 (May 2019 through April 2020), the Auditing Standards Board (ASB) has changed the nature of the auditor's report to reflect both management's and the auditor's responsibilities as well as the overall nature of the audit. This Update summarizes SASs 134 through 141 and also discusses recently issued audit standards, SASs 142 through SAS 147.

In addition, in June of 2022 the AICPA issued new quality management standards (SQMS 1 and SQMS 2) to incorporate a new risk-based approach, incorporating a risk assessment process driving firms to focus on quality management tailored to their individual circumstances. These new quality management standards are not effective until periods beginning after December 15th, 2025. As a result, this Update will provide only a summary overview of these two quality management standards.

Additionally, peer review issues continue to be identified in the conduct of audits and we will begin this section with an overview of current audit peer review issues.

PEER REVIEW ISSUES

For peer review, **risk-based auditing** is a continuing issue that needs to be reviewed by firms, especially in light of the significant changes made by the auditing standards issued in 2019/2020, and 2021 (SASs 134, 135, 136, 137, 138, 139, 140, 141, 142, 143, 144, 145). 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 Auditing Standards Board (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 (IASB), and the recommendations of the August 2000 report of the Panel on Audit Effectiveness of the Public Oversight Board. SAS 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* issued in October 2021 is another attempt to emphasize the importance of performing risk-based audits in today's complex audit environment.

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:

1. 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;

2. 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:

    a. 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

b. Performing both financial and non-financial 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

c. 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:

    a. Significant decisions reached in engagement team discussions, as well as timing of those discussions, and audit team members who participated in those discussions;

    b. 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;

    c. Identified and assessed risks of material misstatement at both the financial statement and relevant assertion levels; and

    d. 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 12 years, **deficiencies by engagement teams 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. Further, 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:

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 non-existent 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:

        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 non-routine 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

Other Peer Review Findings

- **Documentation.** Lack of adequate documentation, or non-existence of documentation, is a frequent finding in non-conforming engagements. The AICPA has responded by developing and making available a free toolkit on documentation which can be found at www.aicpa.org/documentation.
- **Must-select engagements**, i.e., single audit and employee benefit plan audits, resulted in unusually high levels of non-compliance. 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 non-conforming 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:

- 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 **2022-2023 peer reviews**, should focus on the following areas:

a. Firm's system of quality control

b. Independence potential impairments and documentation

c. Implementation of new standards; especially, revenue recognition

d. Recurring deficiencies in audits and review engagements

e. Other matters including cybersecurity, omitted procedures, and adequate documentation

QUALITY MANAGEMENT STANDARDS – SQMS NO.1 AND SQMS NO. 2

In June of 2022, the Auditing Standards Board (ASB) and the Accounting and Review Services Committee (ARSC) issued four interrelated standards on quality management (QM) designed to replace the existing Statement on Quality Control Standards (SQCS) 8, *A Firm's System of Quality Control* (QC section 10).

According to the AICPA, the new quality management (QM) standards do the following:

- Increase firm leadership responsibilities and accountability, and improve firm governance
- Introduce a risk-based approach focused on achieving quality objectives
- Address technology, networks and the use of external service providers
- Increase focus on the continual flow of information and appropriate communication, internally and externally
- Promote monitoring of quality-management systems and timely and effective remediation of deficiencies
- Clarify and strengthen requirements for a more robust engagement quality review (EQR)

- Enhance the engagement partner's (EP's) responsibility for audit engagement leadership and audit quality

These new QM standards represent a significant change in how CPA firms will approach audit and attestation quality in the future, moving from a policies-based approach to a risk-based approach. The four QM standards consist of the following:

Statement on Quality Management Standards (SQMS) 1, *A Firm's System of Quality Management* – requires the firm to design, implement, and operate a system of quality management that is customized for the nature and circumstances if its accounting and auditing practice.

The objective of SQMS 1 includes both the objective of the firm and the objective of the system of quality management. The objective of the firm in the context of the standard is to design, implement, and operate a system of quality management that provides the firm with reasonable assurance that the objectives of the system of quality management are achieved. The system of quality management is designed to achieve the following two objectives:

1. The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements and conduct engagements in accordance with such standards and requirements

2. Engagement reports issued by the firm are appropriate in the circumstances

An effective system of quality management provides the firm with reasonable assurance regarding the achievement of the two objectives. In this context, reasonable assurance is not intended to be obtained through independent assurance that the system is effective (peer review every year) but rather it is obtained through the operation of the system as a whole.

SQMS 1 consists of eight components that operate in an iterative and integrated manner:

1. The firm's risk assessment process (new)

2. Governance and leadership (adopted from the leadership responsibilities for quality within the firm component in QC section 10)

3. Relevant ethical requirements (QC section 10)

4. Acceptance and continuance of client relationships and specific engagements (QC section 10)

5. Engagement performance (QC section 10)

6. Resources (QC section 10)

7. Information and communication (new)

8. Monitoring and remediation process (QC section 10)

SQMS 1 introduces a new risk assessment process aimed at achieving quality objectives. The firm is required to establish prescribed quality objectives, assess quality risks, and design and implement responses. This risk assessment process is described as a three-step process as follows:

1. Establish Quality Objectives – SQMS 1 requires the firm to establish specific quality objectives based on the nature and circumstances of the firm and its engagements for each component except risk assessment and monitoring/remediation. The firm is required to establish additional quality objectives when necessary to achieve the objective of the system of quality management.

2. Identify and Assess Quality Risks to the Achievement of the Quality Objectives – Identifying and assessing quality risks involves:

   – Understanding the factors (that is, the conditions, events, circumstances, actions or inactions) that may adversely affect the achievement of quality objectives, and considering how and the degree to which the factors may adversely affect the achievement of the quality objectives

3. Design and Implement Responses to Address the Quality Risks – The nature, timing, and extent of the firm's responses to address the quality risks are based on, and responsive to, the reasons for the assessments given to the quality risks.

Statement on Quality Management Standards (SQMS) 2, *Engagement Quality Reviews* – SQMS 2 addresses the appointment and eligibility of the EQ reviewer and the performance of EQ reviews.

An engagement quality review (EQR) is a specified response the firm designs and implements to address quality risks. SQMS 1 requires the firm determine when an engagement quality review is an appropriate response to quality risks. SQMS 2 contains requirements for policies and procedures addressing the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews.

The objective of SQMS 2 reflects the intended outcome, which is the performance of an objective review of the engagement team's significant judgments and the conclusions reached (an EQR).

SQMS 2 is expected to provide a number of benefits:

- Clarifies that an engagement quality review (EQR) can be a response too quality risks doe any type of engagement – not only audit engagements

- Emphasizes the importance of the EQR

- Facilitates the enhancement of the robustness of the requirements for the eligibility of EQ reviewers and the performance and documentation of the EQR

- Provides a mechanism to more clearly differentiate the responsibilities of the firm and the EQ reviewer

- Increases the scalability of SQMS 1 by not including requirements that would be irrelevant in circumstances when a firm determines that there are no engagements for which an EQR is an appropriate response to address the quality risks

SAS 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* – SAS 146 updates and supersedes AU-C section 220, Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards, and addresses quality

management at the engagement level, focusing on the quality responsibilities of the engagement team and the engagement partner.

SAS 146 addresses public interest considerations by encouraging proactive management of quality at the engagement level, emphasizing the importance of the exercise of professional skepticism, enhancing the documentation of the auditor's judgments and reinforcing the need for robust communications during the audit.

SSARs 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services* – SSARs 26 amends SSARs statements to confirm with SQMS 1 and SQMS 2.

These amendments include:

- Section 60, General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services
- Section 80, Review Engagements
- Section 90, Review Engagements

These four new quality management standards require that systems of quality management to be in compliance with SQMS 1 and be designed and implemented by December 15, 2025, and the evaluation of such is required to be performed within one year following December 15, 2025.

OVERVIEW OF THE SUITE OF NEW AUDIT STANDARDS ISSUED IN 2019/2020 EFFECTIVE FOR AUDITS PERFORMED AFTER DECEMBER 15, 2021

INTRODUCTION

The U.S. Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (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 of 2019 and May of 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 to 140 are effective for audits of financial statements for periods ending on or after December 15, 2021.

The following is a summary overview of SASs 134 through 140.

Overview

SAS 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements

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.

SAS 134 also provides guidance for the communication of key audit matters found in the audit if the auditor is engaged by the client to do so.

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 is required to be independent of the reporting entity and to meet other ethical responsibility requirements
- 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:

- 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 event, considered in the aggregate, that raise substantial doubt about the reporting entity's ability to continue as a going concern for a reasonable period of time
- Stating that the auditor is 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 the auditor identified during the audit

SAS 135, Omnibus Statement on Auditing Standards-2019

SAS 135 primarily amends AU-C section 260, *Communication with Those Charged with* Governance and AU-C section 550, *Related Parties*. SAs 135 identifies significant unusual transactions and establishes new requirements for what the communication with those charged with governance must include. SAS 135 also adds and specifically expands procedures to focus on the transactions and relationships of related parties.

SAS 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA

SAS 136 improves ERISA audit quality and includes a revised auditor report consistent with the guidance in SAS 134 related to auditor and management responsibilities. An ERISA limited scope audit is now referred to an ERISA section 103(a)(3)(c) audit and the election to exclude certain investments is no longer considered a scope limitation.

SAS's 137 Through 140

These SASs provide clarifications, eliminate inconsistencies, include technical corrections and amend other standards to include changes from previously issued SASs 134 through 136.

UPDATED ENGAGEMENT LETTERS BASED ON THE NEW AUDIT STANDARDS

As a result of the changes to the auditor's report following the guidance in SASs 134 and 136, other changes are now necessary to audit engagement letters, communications with those charged with governance, and certain aspects of the management representation letter. The following identifies the changes in AU-C section 210, *Terms of Engagement,* and also includes an example engagement letter based on the changes.

Based on SASs 134 and 136, the agreement on audit engagement terms should be documented in an audit engagement letter or other suitable form of written agreement and should include the following:

- The objective and scope of the audit of financial statements
- The responsibilities of the auditor
- The responsibilities of management
- A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS
- Identification of the applicable financial reporting framework for the preparation of the financial statements
- Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content

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EXAMPLE

Engagement letter

To the appropriate representative of those charged with governance of Macklain Company:

The objective and scope of the audit

You have requested that we audit the financial statements of Macklain Company, which comprise the balance sheet as of December 31, 20XX, 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. We are pleased to confirm our acceptance and our understanding of this audit by means of this letter.

The objectives of our audit 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 and 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 auditing standards generally

accepted in the United States of America (GAAS) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and 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.

The responsibilities of the auditor

We will conduct our audit in accordance with GAAS. As part of an audit in accordance with GAAS, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than on resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control
- 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 entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies or material weaknesses in internal control relevant to the audit of the financial statements that we have identified during the audit
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant estimates made by management, as well as evaluate the overall presentation of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation
- Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Macklain Company's ability to continue as a going concern for a reasonable period of time.
- We are also 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

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk that some material misstatements may not be detected exists, even though the audit is properly planned and performed in accordance with GAAS.

The responsibilities of management and identification of the applicable financial reporting framework

Our audit will be conducted on the basis that management and if appropriate, those charged with governance, acknowledge and understand that they have responsibility:

- For the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America
- 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, and
- To provide us with:
  - Access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation, and other matters
  - Additional information that we may request from management for the purpose of the audit, and

- Unrestricted access to persons within Macklain Company from whom we determine it necessary to obtain audit evidence

As part of our audit process, we will request from management and if appropriate, from those charged with governance written confirmation concerning representations made to us, in connection with the audit.

Other relevant information

Such as fee arrangements, billings, and other specific items as appropriate

Reporting

We will issue a written report upon completion of our audit of Macklain Company's financial statements. Our report will be addressed to the board of directors of Macklain Company. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending on the nature of these circumstances, it may be necessary for us to modify our opinion, add an emphasis-of-matter paragraph or other-matter paragraph to our auditor's report, or if necessary, withdraw from the engagement.

Please sign and return the attached copy of this letter to indicate your acknowledgment of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

Finnigan & Company

Acknowledged and agreed on behalf of Macklain Company by

Signed

Name and Title

Date

AUDIT UPDATE - 2023

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 has been obtained.

Provisions

Audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. **Audit evidence** 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 above 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 considering:
   - 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 above 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:

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,[1] 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 theauditor 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 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.

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[1] FASB *Accounting Standards Codification* 606-10-25-30.

- 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	2	Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
			6–12 transactions	1	Some customers only purchase in bulk a few times a year, whereas others purchase smaller quantities one to two times a month.
			More than 12 transactions	0	
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	2	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.
			30% to 70% variance	1	Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
			Less than 30% variance	0	
3	Identify activity for new customers	Volume	Customer for 6 months or less	1	The customer base does not fluctuate significantly from period to period.
			Customer for greater than 6 months	0	
4	Identify all transactions recorded within X days of quarter-end.	Timing	Within 3 days of quarter end	1	Revenue is recognized when control transfers at FOB shipping point.
			Greater than 3 days of quarter end	0	
5	Identify revenue transactions with an invoice date on	Timing	Transaction on a	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	
6	Identify instances in which the shipping document date and invoice date do not match.	Timing	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.
			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

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 auditor's 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
- Non-monetary exchanges of assets or liabilities between independent parties
- Revenue recognized for long-term contracts

Guidance

- 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, considering 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

SAS 144, AMENDMENTS TO AU-C SECTIONS 501, 540, AND 620 RELATED TO THE USE OF SPECIALISTS AND THE USE OF PRICING INFORMATION OBTAINED FROM EXTERNAL SOURCES

Introduction

SAS 144 makes changes to three existing audit standards:

1. AU-C 501, *Audit Evidence-Specific Considerations for Selected items*
2. AU-C 540, *Auditing Accounting Estimates and Related Disclosures*
3. AU-C 620, *Using the Work of an Auditor's Specialist*

SAS 144 is effective for audits of financial statements for periods ending on or after December 15, 2023.

The following summary information is organized by each of the three SASs.

AU-C 501, Audit Evidence-Specific Considerations for Selected items

This section of AU-C 501 addresses specific consideration by the auditor, in obtaining sufficient appropriate audit evidence, regarding aspects of selected items, including use of management's specialist. The primary change in from SAS 144 is information related to the use of a management's specialist.

Management specialist is defined as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the reporting entity to assist the entity in preparing financial statements.

If information to be used as audit evidence has been prepared using the work of a management's specialist, the auditor should, to the extent necessary, considering the significance of the specialist's work for the auditor's purposes, perform the following:

- Evaluate the competence, capabilities, and objectivity of that specialist
- Obtain an understanding of the work performed by that specialist
- Evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion

AU-C 540, Auditing Accounting Estimates and Related Disclosures

SAS 144 adds a new appendix – *Use of Pricing Information from Third Parties as Audit Evidence.* This appendix provides guidance on using pricing information as audit evidence for estimates related to fair value of financial instruments obtained from external information sources.

AU-C 620, Using the Work of an Auditor's Specialist

SAS 144 makes minor changes to AU-C 620 to enhance the guidance related to using work of an auditor's specialist. Two specific additions are as follows:

1. Agreement on the respective roles and responsibilities of the auditor and the auditor's specialist may include the degree of responsibility of the auditor's specialist for the following:
   - Testing of source data, for example, testing data produced by the reporting entity, or evaluating the relevance and reliability of data from sources external to the entity
   - Evaluating the significant assumptions used by the reporting entity or management's specialist, or developing the auditor's specialist's own assumptions
   - Evaluating the methods used by the reporting entity or management's specialist, or using the auditor's specialist's own methods
2. Examples of situations in which the auditor may conclude that the work of the auditor's specialist is not adequate for the auditor's purposes include the following:
   - The specialist's use of data or significant assumptions was not based on consideration of relevant information available to the specialist

- The methods used by the specialist were not appropriate
- The specialist's work was not performed in accordance with the auditor's instructions
- The specialist's findings and conclusions are inconsistent with other information available to the auditor
- The specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work

SAS 145, UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Introduction

SAS 145 is an extensive audit standard over 200 pages in length. It is in response to peer review deficiencies identified in the risk assessment process performed by auditors.

SAS No. 145 enhances the requirements and guidance on identifying and assessing the risks of material misstatement, in particular the areas of understanding the entity's system of internal control and assessing control risk. The SAS also includes extensive guidance regarding the use of information technology (IT) and the consideration of IT general controls.

Finally, the SAS revises the definition of significant risks, includes new guidance on maintaining professional skepticism, and includes a new "stand-back" requirement intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor.

SAS 145 amends the following previously issued audit standards:

- SAS 122, Statements on Auditing Standards: Clarification and Recodification
- SAS 126, Using the Work of Internal Auditors
- SAS 130, An Audit of Internal Control Over Financial Reporting That Is Integrated with the Audit of Financial Statements
- SAS 134, Auditor's Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements
- SAS 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA
- SAS 137, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports
- SAS 142, Audit Evidence
- SAS 143, Auditing Accounting Estimates and Related Disclosures

The Auditing Standards Board's (ASB) project to enhance the auditing standards relating to the auditor's risk assessment through the issuance of SAS 145 is intended to enable auditors to appropriately address the following:

- Understanding the reporting entity's system of internal control, in particular, relating to the auditor's work effort to obtain the necessary understanding
- Modernizing the standard in relation to IT considerations, including addressing risks arising from a reporting entity's use of IT
- Determining risks of material misstatement, including significant risks

SAS 145 builds on the fundamental concepts relating to the audit of financial statements in AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Audit Standards,* (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of inherent and control risk).

Objective

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Assessing the Risks of Material Misstatement

Risk-based auditing is a continuing issue that needs to be reviewed by firms. The risk assessment model is not replaced in SAS 145, 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 Auditing Standards Board (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 (IASB), 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 **risk assessment process** 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:

   f. 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

   g. Performing both financial and non-financial 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

   h. 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, the applicable financial reporting framework, 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:

    a. Significant decisions reached in engagement team discussions, as well as timing of those discussions, and audit team members who participated in those discussions;

    b. 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;

    c. Identified and assessed risks of material misstatement at both the financial statement and relevant assertion levels; and

    d. 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.).

As stated above, SAS 145 builds on these fundamental concepts.

SAS 145 Definitions

- Assertions - Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework.

  Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement,

- Business risk - A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

- Controls - Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance -in this context:

  - Policies are statements of what should, or should not, be done within the entity to effect control - such statements may be documented, explicitly stated in communications, or implied through actions and decisions. ii. procedures are actions to implement policies.

  - Procedures are actions to implement policies.

- General information technology (IT) controls - Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system.

- Information-processing controls - Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information.

- Inherent risk factors - Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls.

  Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

- IT environment - The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.

- Relevant assertions - An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).

  The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the determination is based on inherent risk).

- Risks arising from the use of IT - Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

- Risk assessment procedures - The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

- Significant class of transactions, account balance, or disclosure - A class of transactions, account balance, or disclosure for which there is one or more relevant assertions.

- Significant risk - An identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur, or that is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

- System of internal control - The system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations (COSO).

Requirements

Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consists of two components: inherent risk and control risk.

1. **Inherent risk** is described as the susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

2. **Control risk** is described as the risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the reporting entity's system of internal control.

   – Auditors are required based in SAS 145 to separately assess inherent and control risk.

   – SAS 145 stresses the need for the auditor to obtain an **understanding** of the:

     ▪ Reporting entity

     ▪ The entity's environment

     ▪ The applicable financial reporting framework

     ▪ The entity's system of internal control

   – The auditor should perform risk assessment procedures to obtain an **understanding** of:

     ▪ The reporting entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT

     ▪ Industry, regulatory, and other external factors

     ▪ The measures used, internally and externally, to assess the reporting entity's financial performance

     ▪ The applicable financial reporting framework and the reporting entity's accounting policies and the reasons for any changes

     ▪ How inherent risk factors affect the susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework, based on the understanding obtained

     ▪ The auditor should also evaluate whether the reporting entity's accounting policies are appropriate and consistent with the applicable financial reporting framework

   – Further the auditor needs to understand the components of the reporting entity's **system of internal control.** This includes the reporting entity's control environment, risk assessment process, monitoring, and information and communication processes. In the area of **control activities**, the auditor is required to obtain an understanding of the control activities component and should identify the following controls that address risks of material misstatement at the assertion level:

     ▪ Controls that address a risk that is determined to be a significant risk

        - Controls over journal entries and other adjustments

        - Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

        - Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, and to design further audit procedures

        - Based on the controls identified above, the auditor should identify the IT applications and the other aspects of the reporting entity's IT environment that are subject to risks arising from the use of IT

        - For the IT applications and other aspects of the IT environment identified above, the auditor should identify the related risks arising from the use of IT and the reporting entity's general IT controls that address such risks

        - For each control identified by the auditor, the auditor should:

            - Evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other controls and

            - Determine whether the control has been implemented by performing procedures in addition to inquiry of the reporting entity's personnel

    - For identified risks of material misstatement at the assertion level, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should **assess control risk at the maximum level** such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

    - Documentation

- The discussion among the engagement team and the significant decisions reached

- Key elements of the auditor's understanding with the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed

- The evaluation of the design of identified controls, and determination whether such controls have been implemented

- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.

Effective Date

SAS 145 is effective for audits of financial statements for periods ending on or after December 15, 2023.

SAS 146, QUALITY MANAGEMENT FOR AN ENGAGEMENT CONDUCTED IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS

Objective

The objective of the auditor is to manage quality at the engagement level to obtain reasonable assurance that quality has been achieved such that:

- The auditor has fulfilled the auditor's responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements, and
- The auditor's report issued is appropriate in the circumstances

Scope

SAS 146 addresses the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements and the related responsibilities of the engagement partner. SAS 146 also applies to other engagements conducted in accordance with generally accepted auditing standards (GAAS). SAS 146 is also applicable to auditors in government audit organizations who perform financial audits in accordance with GAAS.

SAS 146 makes clear that the engagement partner has overall responsibility for managing and achieving quality

Requirements

The engagement team, led by the engagement partner, is responsible, within the context of the firm's system of quality management and through complying with the requirements of SAS 146, for the following:

- Implementing the firm's responses to quality risks (that is, the firm's policies and procedures) that are applicable to the audit engagement using information communicated by, or obtained from, the firm
- Given the nature and circumstances of the audit engagement, determining whether to design and implement responses at the engagement level beyond those in the firm's policies and procedures
- Communicating to the firm information from the audit engagement that is required by the firm's policies and procedures to be communicated to support the design, implementation, and operation of the firm's system of quality management

Documentation

- Significant issues identified, relevant discussions with personnel, and conclusions reached with respect to:
  - Fulfillment of responsibilities relating to relevant ethical requirements, including those related to independence
  - The acceptance and continuance of the client relationship and audit engagement
- The nature and scope of, and conclusions resulting from, consultations undertaken during the audit engagement and how such conclusions were implemented
- If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed before the release of the auditor's report

Effective Date

SAS 146 is effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2025.

SAS 147, INQUIRIES OF THE PREDECESSOR AUDITOR REGARDING FRAUD AND NONCOMPLIANCE WITH LAWS AND REGULATIONS

Objective

To require an auditor, once management authorizes the predecessor auditor to respond to inquiries from the auditor, to inquire of the predecessor auditor regarding identified or suspected fraud or noncompliance with laws or regulations.

SAS 147 amends SAS 122, *Clarification and Recodification,* as amended, section 210, *Terms of Engagement.*

Requirements

SAS 147 clarifies requirements and guidance related to the auditor's inquiries of a predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement. Once management authorizes the predecessor auditor to respond, these are the new requirements:

- The auditor is required to inquire of the predecessor auditor regarding identified or suspected fraud and matters involving noncompliance with laws or regulations
- Predecessor auditor has a responsibility to respond on a timely basis. Predecessor is required to clearly state if the response is limited due to unusual circumstances
- When an engagement is accepted the auditor is required to document the inquiries and the results of these inquiries

Effective Date

SAS 147 is effective for audits of financial statements for periods beginning on or after June 30, 2023.

SAS 148, AMENDMENT TO AU-C SECTION 935, COMPLIANCE AUDITS

Objective

SAS 148 amends AU-C section 935 to update the appendix and conform AU-C section 935 to reflect the issuance of the following SASs:

- SAS 142, Audit Evidence
- SAS 145, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Background

As noted in the Executive Summary of SAS 148:

> *AU-C section 935, Compliance Audits, addresses the application of generally accepted auditing standards (GAAS) to a compliance audit. AU-C sections 200–900 address audits of financial statements as well as other kinds of engagements. Generally, these AU-C sections can be adapted to the objectives of a compliance audit. However, certain AU-C sections, or portions thereof, are not applicable to a compliance audit because (a) they are not relevant to a compliance audit environment; (b) the procedures and guidance would not contribute to meeting the objectives of a compliance audit; or (c) the subject matter is specifically covered in AU-C section 935. These AU-C sections, or specified requirements thereof, are identified in the appendix to AU-C section 935, "AU-C Sections That Are Not Applicable to Compliance Audits" (the appendix).*

Provisions

AU-C Section 935 addresses the application of GAAS to a compliance audit. Compliance audits may be performed in conjunction with an audit of a complete set of financial statements, an audit of a single financial statement, or an audit of a specific element, account, or item. This Section does not apply to an audit of a complete set of financial statements, an audit of a single financial statement, or an audit of a specific element, account, or item of a financial statement, even when such audit is performed in conjunction with a compliance audit.

Compliance audit is defined in AU-C Section 935 as a program-specific audit of an organization-wide audit of an entity's compliance with applicable laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs with which the entity is required to comply.

AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* as updated by SAS 145 incorporates the following when adopting and applying the requirements of Section 315 to identify controls that address risks of material non-compliance, the auditor should perform risk assessment procedures, beyond inquiry, to evaluate whether the

following controls that address risks of material non-compliance are effectively designed and determine whether those controls have been implemented:

- Controls over journal entries and other adjustments as required by section 240, *Consideration of Fraud in a Financial Statement Audit*
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include:
    1. Controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, and
    2. Controls that are required to be tested for operating effectiveness by the governmental audit requirement
- Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to identify and assess risks of material noncompliance and design further audit procedures.

In addition, the auditor should identify the risks of material non-compliance whether due to fraud or error for each applicable compliance requirement and should consider whether any of those risks are pervasive to the entity's compliance because they may affect the entity's compliance with many compliance requirements.

For identified risks of material non-compliance for each applicable compliance requirement, the auditor should assess inherent risk by assessing the likelihood and magnitude of non-compliance. In doing so, the auditor should consider how, and the degree to which, inherent risk factors affect the susceptibility of compliance requirements to non-compliance. The auditor should determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material non-compliance.

For identified risks of material non-compliance for each applicable compliance requirement, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at the maximum level such that the assessment of the risk of material non-compliance is the same as the assessment of inherent risk.

Effective Date

- The amendment relating to AU-C section 501 in the appendix, "AU-C Sections That Are Not Applicable to Compliance Audits," is effective for compliance audits for fiscal periods ending on or after December 15, 2022, consistent with the effective date of SAS No. 142. All other amendments are effective for compliance audits for fiscal periods ending on or after December 15, 2023, consistent with the effective date of SAS No. 145.
- The effective date of the amendment to the appendix with regard to AU-C section 501 is aligned with the effective date of SAS No. 142 because, as explained previously, this amendment arises from SAS No. 142. This amendment is not intended to change current practice because there were no changes to the underlying requirement; only its placement within GAAS changed. All other amendments in SAS No. 148 arise from SAS No. 145 and, accordingly, their effective date is aligned with the effective date of SAS No. 145.

- Early implementation of SAS No. 148 is permitted. Because SAS No. 148 amends AU-C section 935 to reflect the issuance of SAS No. 142 and SAS No. 145, early implementation of SAS No. 148 is expected to occur in conjunction with early implementation of SAS No. 142 or SAS No. 145, as applicable, for compliance audits.

AICPA TECHNICAL QUESTIONS AND ANSWERS (TQAS) IN AUDITING

The AICPA in May of 2022 updated its TQA in the areas of accounting, auditing, compilations, reviews, and ethics. This Update program includes those TQAs most relevant to practitioners based on questions from attendees at our seminars. Auditing TQAs are included in this section and the other TQAs are included in the appropriate related sections.

Reporting Guidance Upon Initial Implementation of SAS 134, As Amended

Inquiry — SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as amended (hereinafter referred to as SAS No. 134 in this question and answer), addresses, among other things, the auditor's responsibility to form an opinion on the financial statements and the form and content of the auditor's report issued as a result of an audit of financial statements. The following AU-C sections from SAS No. 134, as amended, become effective for audits of financial statements for periods ending on or after December 15, 2021:

- 700, Forming an Opinion and Reporting on Financial Statements
- 701, Communicating Key Audit Matters in the Independent Auditor's Report
- 705, Modifications to the Opinion in the Independent Auditor's Report
- 706, Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report

Upon the effective date, the required form and content of the auditor's report will supersede the required form and content of the auditor's report that has been in effect in extant AU-C section 700B, AU-C section 705B, and AU-C section 706B of the same titles. Early implementation is permitted.

If a continuing auditor is engaged to perform an audit of comparative financial statements in the first year of implementation of SAS No. 134, is the auditor permitted to express an opinion on all periods presented in one report in accordance with SAS No. 134?

Reply — A continuing auditor performing an audit of comparative financial statements in the initial period of implementation of SAS No. 134, as amended by SAS No. 141, may issue one report in accordance with SAS No. 134 as amended that refers to each period for which financial statements are presented and on which the auditor is expressing an opinion (for example, for the year ended December 31, 2021, and 2020). Alternatively, the auditor may issue two separate reports: one in accordance with SAS No. 134 for the current year (year ended December 31, 2021) and one in accordance with extant AU-C section 700B for the prior year (year ended December 31, 2020).

Paragraph .47 of AU-C section 700 notes that comparative financial statements may be required by the applicable financial reporting framework, or management may elect to provide such information. When comparative financial statements are presented, the auditor's report should refer to each period for which financial statements are presented and on which an audit opinion is expressed.

Paragraph .48 of AU-C section 700 is specific to a continuing auditor and the updating of the auditor's report and states the following:

> *When expressing an opinion on all periods presented, a continuing auditor should update the report on the financial statements of one or more prior periods presented on a comparative basis with those of the current period. The auditor's report on comparative financial statements should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit.*

Paragraph .A68 of AU-C section 700 explains that an updated report on prior period financial statements is distinguished from a reissuance of a previous report. An updated report is issued in conjunction with the auditor's report on the current period financial statements. When issuing an updated report, the information considered by the continuing auditor is that which the auditor has become aware of during the audit of the current period financial statements.

Examining Journal Entries

Inquiry — Paragraph .21 of AU-C section 330 states, in part:

The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as:

- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers, and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Does the phrase "adjustments made during the course of preparing the financial statements" refer to journal entries and other adjustments prepared by the client during the process of drafting the financial statements, or does it refer to journal entries recorded during the year?

Reply — The requirement to examine material journal entries and other adjustments made during the course of preparing the financial statements in paragraph .21 of AU-C section 330 refers to those journal entries and adjustments prepared by the entity during the process of preparing its financial statements (for example, consolidating entries or elimination entries between divisions). It does not refer to the journal entries recorded by the entity in the general ledger during the year. However, paragraph .32a of AU-C section 240, Consideration of Fraud in a Financial Statement Audit, requires auditors to design and perform audit procedures to test the appropriateness of journal entries recorded by the entity in the general ledger during the year.

The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report

Inquiry — AU-C section 580, Written Representations, establishes a requirement that the auditor request written representations from management as part of an audit of financial statements performed in accordance with generally accepted auditing standards. Additionally, paragraph .43 of AU-C section 700 states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Among other things, sufficient appropriate audit evidence includes that all the entity's financial statements, including the related disclosures, have been prepared and that management has asserted that it has taken responsibility for them. Is the auditor required to have the signed management representation in hand as of the date of the auditor's report?

Reply — Paragraph .A27 of AU-C section 580 addresses this issue and states that occasionally, circumstances may prevent management from signing the representation letter and returning it to the auditor on the date of the auditor's report. In those circumstances, the auditor may accept management's oral confirmation, on or before the date of the auditor's report, that management has reviewed the final representation letter and will sign the representation letter without exception as of the date of the auditor's report thereby providing sufficient appropriate audit evidence for the auditor to date the report.

However, possession of the signed management representation letter prior to releasing the auditor's report is necessary because paragraph .21 of AU-C section 580 requires that the representations be in the form of a written letter from management. Furthermore, when there are delays in releasing the report, a fact may become known to the auditor that, had it been known to the auditor at the date of the auditor's report, might affect the auditor's report and result in the need for updated representations. AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, addresses the auditor's responsibilities in such circumstances.

Statutory Basis Financial Statements Differ from GAAP

Inquiry — Financial statements filed with a state regulatory agency are prepared on a statutory basis which differs from generally accepted accounting principles (GAAP). How should the accountant report on the financial statements if the accountant knows they will be distributed to third parties other than the regulatory agency?

Reply — Paragraph .22 of AU-C section 800, Special Considerations-Audits of Financial Statements addresses this situation and indicates that the auditor should express a qualified or adverse opinion regarding the application of GAAP and, in a separate paragraph, express an opinion about whether the financial statements are presented in accordance with the prescribed basis of accounting mandated by the state regulatory agency. In accordance with paragraph .21 of AU-C section 705, Modifications to the Opinion in the Independent Auditor's Report, the auditor's report would include a basis for opinion section that includes a description of the matter giving rise to the modification. This would include a description of the differences between GAAP and the state mandated policies, as required by paragraph .16 of AU-C section 800.

Restriction on Use of Report on Financial statements Prepared on a Basis of Accounting Prescribed in an Agreement

Inquiry — An auditor was asked to report on special purpose financial statements of a corporation prepared in accordance with a contractual basis of accounting. Certain assets, such as receivables, inventories, and other properties, have been valued on a basis specified in the agreement (fair market value). Is the auditor required to issue a report containing a paragraph that restricts the use of the report?

Reply — Yes. Paragraph .21 of AU-C section 800 indicates that in such circumstances, the auditor's report on special purpose financial statements should include an other-matter paragraph, under an appropriate heading, that restricts the use of the auditor's report when the special purpose financial statements are prepared in accordance with

a. A contractual basis of accounting,

b. A regulatory basis of accounting, or

c. An other basis of accounting when required pursuant to paragraph .06a–b of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.

Auditor Reporting When the Entity Issues Its Annual Report Subsequent to Its Financial Statements

Inquiry — AU-C section 720, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports, addresses the auditor's responsibilities relating to other information included in the entity's annual report. The auditor is required to perform procedures on other information that comprise the annual report, including reading the other information and considering whether a material inconsistency exists between the other information and the financial statements or whether a material misstatement of the other information exists. If, at the date of the auditor's report, the auditor has obtained all the other information, the auditor should include a separate section in the auditor's report on the financial statements with the heading "Other Information".

In the circumstance in which all the other information was not obtained at the date of the auditor's report, what are the auditor's reporting responsibilities with respect to the other information when the entity subsequently issues its annual report?

Reply — The auditor has no reporting requirement for other information obtained after the date of the auditor's report on the financial statements.

Condensed Financial Statements of a Non-Public Entity

Inquiry — A client prepares condensed financial statements that name the auditor and state that they have been derived from audited financial statements. The condensed statements incorporate the audited financial statements by reference and indicate such statements and auditor's report thereon may be obtained. Is the auditor required to report on the condensed financial statements?

Reply — Paragraph .29 of AU-C section 810, Engagements to Report on Summary Financial Statements, states that if the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor should be satisfied that:

a. The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and
b. The statement does not give the impression that the auditor has reported on the summary financial statements.

If these conditions are met, the auditor need not do anything further. If either a or b is not met, the auditor should request management to change the statement to meet both of the criteria in a and b or not refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor should advise management that the auditor disagrees with the reference to the auditor, and the auditor should determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

Going Concern Problem-Financial Statements Prepared on the Income Tax Basis of Accounting

Inquiry — A client prepares its financial statements on the income tax basis of accounting. The client is experiencing financial difficulties the auditor concludes that substantial doubt exists about the client's ability to continue as a going concern. Since the financial statements are prepared on a special purpose framework, is the CPA required to include a separate section in the auditor's report with the title "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" that refers to this substantial doubt?

Reply — Yes. AU-C section 570, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, applies to audits of special purpose financial statements. Paragraph .14 of AU-C section 800, Special Considerations — Audits of Financial Statements Prepared in Accordance With

Special Purpose Frameworks, states that irrespective of whether the going concern basis of accounting is relevant to the preparation of the special purpose financial statements, the requirements of AU-C 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 of time.

- When such substantial doubt exists, evaluate the adequacy of the financial statement disclosures.

Therefore, if, after considering identified conditions or events and management's plans, the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework, the auditor is required to perform the following procedures:

- Evaluate the possible financial statement effects, including the adequacy of disclosure regarding the entity's ability to continue as a going concern for a reasonable period of time.

- Include a separate section in the auditor's report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern."

NOTES

Unit

4

AICPA Update – Attestation, Compilation and Review Issues

LEARNING OBJECTIVE

After completing this section, participants will be able to:

- Identify and describe recently issued SSAEs (attestation standards)
- 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
- Apply SSARS 26, Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services, which enhances certain concepts related to quality management for engagements performed in accordance with SSARS

INTRODUCTION

Both attestation standards and review standards have had significant changes take place during the past couple of years. SSAEs have become more relevant to the needs of companies and their auditors and review engagements have been updated and reporting outcomes changed more significantly than at any time since review engagements were initially developed in 1978. SSARS 26 has been issued to improve the quality controls standards for accounting firms, now quality management standards. This section identifies these changes and discusses the use of these newly updated standards.

SSAE UPDATES

ATTESTATION ENGAGEMENTS

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:

1. **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.

2. **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.

3. **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

SSAE 20, AMENDMENTS 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 Auditing Standards Board issued Statement on Standards for Attestation Engagements 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:

1. AT-C Section 205 – Examination Engagements

2. 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 judgement 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.
- 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," "judgement," 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:

1. Section 205, *Assertion-Based Examination Engagements*

2. 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

- 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:

- Ensure that the responsible party acknowledges its responsibility for the underlying subject matter
- 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
- Also perform applicable procedures involving the terms of engagement, written representations, and the content of the report

The practitioner must be independent of the underling subject matter.

Effective Date

Effective for reports dated on or after June 15, 2022.

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]

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]

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
- 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 is required to 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 providers 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

Effective Date

Effective for reports dated on or after June 15, 2022.

EXAMPLE

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 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]

AICPA TECHNICAL QUESTIONS AND ANSWERS (TQAS) IN ATTESTATION ENAGEMENTS

The AICPA in May of 2022 updated its TQA in the areas of accounting, auditing, compilations, reviews and ethics. This Update program includes those TQAs most relevant to practitioners based on questions from attendees at our seminars. Attestation engagement TQAs are included in this section and the other TQAs are included in the appropriate related sections.

Testing Prospective Financial Information as Part of Performing Auditing Procedures

Inquiry — Generally accepted accounting principles require that certain accounts be carried at or adjusted to fair value. Many fair value models are based on the present value of future cash flows or earnings. In making those fair value calculations, management may seek the auditor's assistance in developing what may be considered either a full or partial financial forecast. In testing an entity's fair value calculation, an auditor might test management's assumptions including, for example future cash flows for the next five years. Similarly, the auditor may make an independent estimate of fair value, for example, by using a cash flow model developed and prepared by the auditor.

Does the auditor's assistance in developing or preparing prospective cash flows require the auditor to examine such information in accordance with Statements on Standards for Attest Engagements (SSAEs) or perform a compilation on such information in accordance with Statements on Standards for Accounting and Review Services (SSARSs)?

Reply — No. Paragraph .01 of AT-C section 105, Concepts Common to All Attestation Engagements, indicates that the attestation standards apply when a practitioner is "engaged to issue or does issue a practitioner's examination, review, or agreed-upon procedures report…." Paragraph .01 of AR-C section 80, Compilation Engagements, indicates that AR Section 80 applies when the accountant is "engaged to perform a compilation of financial statements, prospective financial information, pro forma

financial information, or other historical financial information." Accordingly, the auditor would not be required to follow:

- The SSAEs unless the auditor has also been engaged to examine or apply agreed upon procedures to prospective financial information or the auditor issues an examination or agreed upon report on prospective financial information
- The SSARSs unless the auditor has also been engaged to perform a compilation of such information

Availability of Criteria for a Fee

Inquiry — A practitioner may perform an attestation engagement only if the subject matter is capable of evaluation against criteria that are suitable and available to the intended users. Paragraph .A53 of AT-C section 105 indicates that criteria are made available to the intended users in one or more of a number of ways, including available publicly. Paragraph .A54 of AT-C section 105 indicates that "when criteria are available only to specified parties, Paragraph.64b of AT-C section 205, Assertion-Based Examination Engagements, and Paragraph .47b of AT-C section 210, Review Engagements, require a statement in the practitioner's report restricting the use of the report." If criteria is only available for a fee, is it considered available publicly for the purpose of Paragraphs .A53-.A54 of AT-C section 105?

Reply — Yes, as long as the criteria is available to any person in the normal course of business, it is considered available publicly. This would include certain industry associations and other organizations that make criteria available free of charge to their members but charge a fee to nonmembers.

SSARS UPDATES

SSARS 25, Materiality in a Review of Financial Statements and Adverse Conclusions

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 non-attest 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

SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, was issued February 2020, by the Accounting and Review Services Committee (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 amends 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:

    1. 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.
    2. 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 bullets above 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** in order 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 is required 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.

- Further, 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 non-compliance 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.

- 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.

1. The identification of related parties and related party transactions, including the purpose of those transactions.

2. 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 non-compliance with laws and regulations

   – Non-compliance 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

3. The basis for management's assessment of the entity's ability to continue as a going concern

4. Whether there are events or conditions that appear to cast doubt on the entity's ability to continue as a going concern

5. Material commitments, contractual obligations, or contingencies that have affected or may affect the entity's financial statements, including disclosures

6. Material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration

7. Communications from regulatory agencies, if applicable

8. 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

9. 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

10. 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:

a. **All material items** in the financial statements, including disclosures

b. 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:

a. Request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and

b. 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.

1. 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.

2. Explain how disclosures are misstated if the material misstatement relates to narrative disclosures.

3. Describe the nature of omitted information if the material misstatement relates to the non-disclosure 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; and
- 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 in order 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 above, Kaplan suggests the following additional documentation 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, etc.

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]

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.

NOTE: Additional examples are in SSARS 25

SSARS 26, QUALITY MANAGEMENT FOR AN ENGAGEMENT CONDUCTED IN ACCORDANCE WITH STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES

Introduction

As noted in Section 5, in June of 2022, the Auditing Standards Board (ASB) and the Accounting and Review Services Committee (ARSC) issued four interrelated standards on quality management (QM) designed to replace the existing Statement on Quality Control Standards (SQCS) 8, *A Firm's System of Quality Control* (QC section 10). SSARS 26 is one of these four standards. SQMS 1 addresses the system of quality management, which forms the foundation for the management quality. SSARS 26 primarily addresses how the engagement partner leverages the firm's system and manages quality at the engagement level.

SSARS 26

SSARS 26 addresses public interest consideration by encouraging proactive management of quality at the engagement level, emphasizing the importance of the exercise of professional skepticism, enhancing the documentation of the auditor's judgments, and reinforcing the need for robust communications during the engagement.

SSARS 26 makes it clear that the engagement partner has overall responsibility for managing and achieving quality. This includes creating an environment that emphasizes the firm's culture and expected behavior of engagement team members. To achieve the above, the engagement partner needs to be sufficiently and appropriately involved throughout the engagement because this is fundamental to providing the engagement leadership required to achieve high quality engagements and therefore, to meeting the objective of SSARS 26. This overall responsibility includes the following:

- Fulfilling leadership responsibilities – including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks, or actions to other members of the engagement team

- Supporting engagement performance – including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed

- Understanding of the relevant ethical and independence requirements – including whether other members of the engagement team are aware of those requirements and the firm's related policies and procedures

- Monitoring and remediation – the engagement partner should take responsibility for the following:

  - Obtaining an understanding of the information from the firm's monitoring and remediation process, as communicated by the firm, including, as applicable, the information from the monitoring and remediation process of the network and across the network firms

  - Determining the relevance and effect on the engagement of the information above and taking appropriate action

– Remaining alert throughout the engagement for information that may be relevant to the firm's monitoring and remediation process and communicating such information to those responsible for the process

AICPA TECHNICAL QUESTIONS AND ANSWERS (TQAS) IN SSARS ENGAGEMENTS

The AICPA in May of 2022 updated its TQA in the areas of accounting, auditing, compilations, reviews and ethics. This Update program includes those TQAs most relevant to practitioners based on questions from attendees at our seminars. Compilation and review TQAs are included in this section and the other TQAs are included in the appropriate related sections.

Issuing a Compilation Report on Financial Statements That Omit Substantially All Disclosures Required by an Applicable Financial Reporting Framework After Issuing a Report on Financial statements for the Same Period That Include Substantially All Disclosures Required by the Same Financial Reporting Framework

Inquiry — May an accountant accept a compilation engagement on financial statements that omit substantially all disclosures required by an applicable financial reporting framework, if the accountant previously issued an audit, review, or compilation report on financial statements for the same reporting period with substantially all disclosures required by the same financial reporting framework presented?

Reply — Yes. The financial statements that omit substantially all disclosures are separate and distinct from the financial statements that include substantially all disclosures. Paragraph.26 of AR-C section 80 states that an accountant should not issue an accountant's compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework if, in the accountant's professional judgment, such financial statements would be misleading to users of the financial statements.

Disclosure of Independence Impairment in the Accountant's Compilation Report on Comparative Financial Statements When the Accountant's Independence Is Impaired in Only One Period

Inquiry — When the accountant is not independent with respect to the entity, in accordance with Paragraph.22 of AR-C section 80, the accountant is required to indicate that accountant's lack of independence in a final paragraph of the accountant's compilation report. How may an accountant modify the accountant's compilation report on comparative financial statements for an entity with respect to which the accountant was not independent as of and for the earlier period ended, but such impairment was subsequently cured?

Reply — The accountant may indicate the independence impairment as of and for the earlier period ended that was subsequently cured by including language such as the following as the final paragraph of the accountant's compilation report: "As of and for the year ended December 31, 20X1, I was not independent with respect to XYZ Company." The accountant is not precluded from disclosing a description about the reason(s) that the accountant's independence is impaired. However, pursuant

to Paragraph .23 of AR-C section 80, if the accountant elects to disclose a description about the reasons the accountant's independence is impaired, the accountant is required to include all such reasons in the description.

NOTES

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