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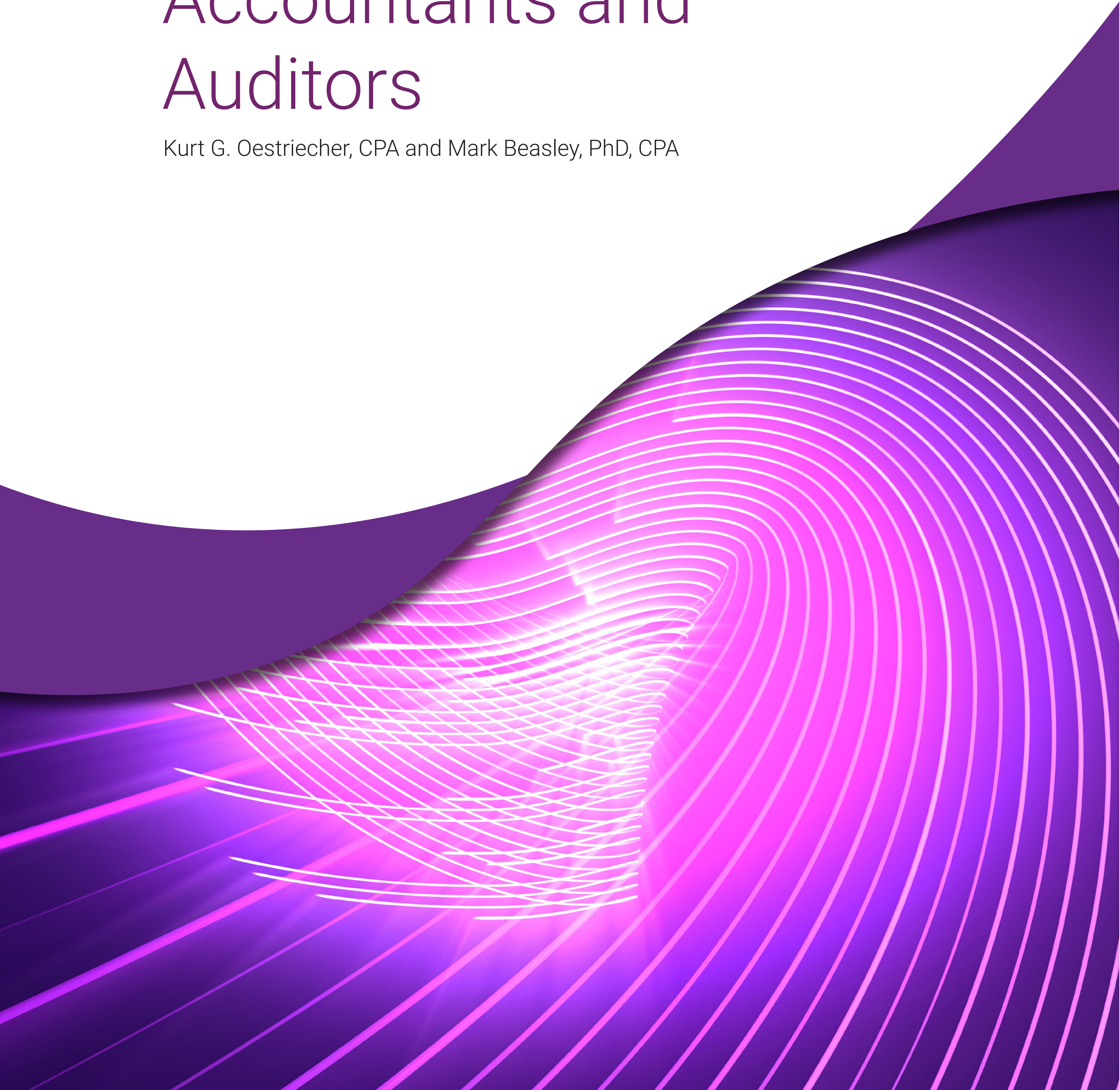
Annual Update for Accountants and Auditors

Kurt G. Oestriecher, CPA and Mark Beasley, PhD, CPA



Annual Update for Accountants and Auditors

By
Kurt G. Oestriecher, CPA
& Mark Beasley, PhD, CPA

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Use of materials

This course manual accompanies all formats in which the course is offered, including self-study text, self-study online, group study, in-firm, and other formats, as applicable. Specific instructions for users of the various formats are included in this section.

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Professional standards for CPE programs are issued jointly by the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA) to provide a framework for the development, presentation, measurement, and reporting of CPE programs. The Statement on Standards for CPE Programs (CPE standards)
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Review questions and exercises for self-study participants
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- For group and independent study programs, a certificate or other verification supplied by the CPE program sponsor
- For self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination

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When you participate in self-study, you must complete the exam within one year of the date of course purchase to receive a certificate indicating satisfactory completion of the CPE program.

- The exam for self-study in print format is located in the "Examination" section at the end of the course manual.
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Program evaluations
The information accumulated from participant evaluation forms is important in our continual efforts to provide high quality continuing education for the profession. When you participate in group study and other live presentations, please return your evaluation forms prior to departing your program sessions. When you participate in self-study, please complete the course evaluation online. Your comments are very important to us.

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For help and support, including information on refund claims and complaint resolutions, please call the Global Engagement Center at 1.888.777.7077, or visit the online help page at https://www.aicpa.org/cpe-learning.

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FASB Accounting Standards Updates — Broad Issues

Learning objective

- Identify recently issued FASB Accounting Standards Updates (ASUs) that cover broad issues, other than those related to financial instruments and leases.

These course materials present ASUs that are general in nature and typically originated with the input of the full board. The ASUs covered in this material are those that have effective dates in 2019 or later; therefore, several ASUs issued in prior years are included. Effective dates for public business entities are frequently different than those for other entities.

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FASB ASU No. 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*

Why was this ASU issued?

FASB issued this standard as part of its Simplification Initiative designed to reduce the overall complexity of GAAP.

Who is affected by this ASU?

Any entity that is required to account for income tax expense within the scope of FASB ASC 740.

What are the main provisions of this ASU?

The following exceptions were eliminated from FASB ASC 740:

- The exception to the incremental approach for intraperiod tax allocation when there is a loss from continuing operations and income or gain from other items such as discontinued operations or other comprehensive income. Apply on a prospective basis.
- The exception to the requirement to recognize a deferred tax liability for equity-method investments when a foreign subsidiary becomes an equity-method investment. Apply on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.
- The exception to the ability not to recognize a deferred tax liability for a foreign subsidiary when a foreign equity-method investment becomes a subsidiary. Apply on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.
- The exception to the general methodology for calculating income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year. Apply on a prospective basis.

The following provisions were added:

- An entity is required to recognize a franchise or similar tax that is partially based on income as an income-based tax and account for any incremental amount incurred as a non-income-based tax. Apply on either a retrospective basis for all periods presented or a modified retrospective basis as of the beginning of the fiscal year of adoption.
- An entity is required to evaluate when a step-up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction. Apply on a prospective basis.
- Specifies that an entity is not required to allocate the consolidated amount of current and deferred tax expense to a legal entity that is not subject to tax in its separate financial statements. However,

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an entity may elect to do so for a legal entity that is both not subject to tax and disregarded by the taxing authority. This election is on an entity-by-entity basis. Apply on a retrospective basis for all periods presented.

- An entity is required to reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date. Apply on a prospective basis.
- Minor codification changes in
  - employee stock ownership plans and
  - investments in qualified affordable housing projects under the equity method.

What is the effective date of this ASU?

For public business entities:

- For fiscal years beginning after December 15, 2020
- For interim periods within fiscal years beginning after December 15, 2020

For all other entities:

- For fiscal years beginning after December 15, 2021
- For interim periods within fiscal years beginning after December 15, 2022

Early adoption is permitted, including within an interim period. All amendments must be adopted within the same period.

Knowledge check

1. Which type of tax is required to be accounted for under FASB ASC 740, *Income Taxes*?

    a. Sales tax.
    b. Property tax.
    c. Franchise tax based on income elements.
    d. Excise tax.

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FASB ASU No. 2020-01, *Investments — Equity Securities (Topic 321), Investments — Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) — Clarifying the Interactions between Topic 321, Topic 323, and Topic 815 (a consensus of the FASB Emerging Issues Task Force)*

Why was this ASU issued?

There were many amendments to FASB ASC related to the financial instruments project, one of which allowed certain companies to account for marketable securities without a readily determinable value to account for the investment at cost, less impairment (FASB ASC 321), if any. However, several issues have arisen related to this accounting treatment as it relates to equity investments accounted for under the equity method (FASB ASC 323) and certain guidance in derivatives and hedging (FASB ASC 815).

Who is affected by this ASU?

Entities that

- have investments in marketable equity securities,
- account for some investments using the equity method of accounting, and
- apply derivative and hedging guidance for certain forward contracts or purchase options for securities that upon settlement or exercise, would be accounted for under the equity method.

What are the main provisions of this ASU?

This ASU provides clarity for two specific issues in which stakeholders believed that there could be diversity in practice based on interpretations of existing standards.

Issue No. 1

In certain circumstances, an entity may either begin applying or discontinue applying the equity method of accounting for an investment in a marketable equity security. FASB ASC 321 allows for a

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measurement alternative of cost less impairment for a marketable equity security if there are no observable inputs.

This ASU clarifies that an entity should consider observable transactions that require it to either apply or discontinue the equity method of accounting for purposes of applying the measurement alternative immediately before applying or discontinuing the equity method.

Issue No. 2

An entity may enter into a contract that will either require or provide an option for the entity to purchase equity securities in the future that, upon settlement, would be accounted for using the equity method.

This ASU clarifies that, in applying FASB ASC 815 (derivatives and hedging), an entity should not consider whether, upon settlement, the underlying securities would be accounted for under the equity method (FASB ASC 323) or the fair value option in accordance with FASB ASC 825.

What is the effective date of this ASU?

For public business entities:

- For fiscal years beginning after December 15, 2020
- For interim periods within those fiscal years

For all other entities:

- For fiscal years beginning after December 15, 2021
- For interim periods within those fiscal years

Early adoption is permitted, including within an interim period for financial statements that have not been issued or been made available for issuance.

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FASB ASU No. 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*

Why was this ASU issued?

Not-for-profit entities (NFPs) sometimes receive nonfinancial assets as a means of support. This ASU is designed to increase transparency on such transactions through improvements to presentation and disclosure requirements related to such transactions.

Who is affected by this ASU?

Any NFP that receives contributed nonfinancial assets

What are the main provisions of this ASU?

An NFP is required to present contributed nonfinancial assets as a separate line item in the statement of activities, apart from contributions of cash and other financial assets.

An NFP is required to disclose the following:

- A disaggregation of the amount of contributed nonfinancial assets recognized within the statement of activities by category that depicts the type of contributed nonfinancial assets
- For each category of contributed nonfinancial assets
  - Qualitative information about whether the nonfinancial assets were either monetized or utilized during the reporting period; if utilized, a description of the programs or activities in which those assets were used
  - The policy, if any, about monetizing rather than using contributed nonfinancial assets
  - A description of any donor-imposed restrictions associated with the contributed nonfinancial assets
  - A description of the valuation techniques and inputs used to arrive at a fair value measure at initial recognition
  - The principal market used to arrive at a fair value measure if it is a market in which the recipient NFP is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets

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What is the effective date of this ASU?

This ASU is effective for annual periods beginning after June 15, 2021, and interim periods within annual periods beginning after June 15, 2022.

Early adoption is permitted.

Knowledge check

2. What is required to be disclosed for a not-for-profit entity under ASU No. 2020-07?

    a. Total contributed assets for the period.
    b. Disaggregation of the amount of contributed nonfinancial assets.
    c. Remaining pledged nonfinancial assets.
    d. Income taxes paid.

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FASB ASU No. 2021-03, *Intangibles-Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events*

Why was this ASU issued?

In a word, the COVID-19 pandemic was the catalyst for this standard. Reporting entities are required to monitor and evaluate goodwill impairment triggering events throughout the reporting period and use that information to determine whether or not a goodwill impairment test must be performed. The uncertainty caused by COVID-19, and the rapidly changing environment, quarter over quarter, raised concerns that some entities may write down goodwill during an interim period, even though by the end of the year the triggering event may have stabilized. Once goodwill is considered impaired, the impairment cannot be restored. There was concern about diversity in practice with some entities writing down goodwill during an interim period and other entities not taking an impairment write-down in an interim period. The FASB issued this ASU to address those potential inconsistencies. The requirements in this standard relate to any goodwill triggering event, not just the COVID-19 pandemic.

Who is affected by this ASU?

Private companies and not-for-profit entities that elect the accounting alternative to evaluate goodwill triggering events to determine the proper carrying amount of goodwill.

What are the main provisions of this ASU?

Private and not-for-profit entities may perform the goodwill impairment triggering event evaluation at the end of a reporting period. An entity that elects this alternative is not required to monitor for goodwill triggering events during the reporting period (including interim financial statements), but instead shall evaluate facts and circumstances at the end of the annual reporting period to determine if a goodwill impairment test should be performed.

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What is the effective date of this ASU?

The standard is effective for fiscal years beginning after December 15, 2019, and should be applied prospectively.

An entity may not retroactively adopt this standard for interim financial statements already issued in the year of adoption.

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FASB ASU No. 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities From Contracts With Customers*

Why was this ASU issued?

An entity that acquires a business in a business combination is required to record the assets and liabilities of the acquired entity at fair value. Subsequent to the effective date of ASC 606, *Revenues From Contracts With Customers*, entities began recording contract assets and contract liabilities in accordance with ASC 606. Diversity in practice and inconsistency in recording these assets and liabilities has resulted in the issuance of the ASU. The primary issue is the recognition of deferred revenues (contract liability) of the acquired company. Prior to the effective date of ASC 606, deferred revenues were recognized only if a legal obligation existed. Under the guidance of ASC 606, deferred revenues may be recognized even though a legal obligation does not exist. This ASU provides guidance for recognizing a contract liability by the acquirer in a business combination and other guidance related to contract assets and contract liabilities recognized under ASC 606.

Who is affected by this ASU?

All entities that enter into business combinations that are accounted for under ASC 850-10 where the acquired company has adopted ASC 606. From a practical standpoint, most businesses must use ASC 850-10, and most companies have adopted ASC 606; therefore, this standard will likely affect any entity that acquires another entity.

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What are the main provisions of this ASU?

1. The acquiring entity must recognize and measure contract assets and contract liabilities of the contracts with customers of the acquired entity in accordance with ASC 606.
   a. The acquiring entity should account for contracts with customers of the acquired entity as if the acquiring company had originated the contracts.
   b. The acquiring entity may assess how the acquired company applied ASC 606 when accounting for the contracts with customers.
   c. In many, if not most cases, it is likely that the acquiring entity will determine that the acquired company properly applied ASC 606.
   d. There may be instances where the acquiring company determines that the acquired company did not measure contract assets and contract liabilities in accordance with ASC 606. The cause may be that the acquired company did not use U.S. GAAP, the acquired company may not have properly applied ASC 606, or there were changes necessary to conform with the acquiring entity's accounting policies.
   e. When the acquiring entity determines that an adjustment is necessary, the following steps should be taken:
      i. Consider the terms of the acquired contracts
      ii. Identify each performance obligation in the contracts
      iii. Allocate the total transaction price to each identified performance obligation on a relative stand-alone selling price basis as of contract inception (the date the acquiree obtained the contract) or the contract modification date (if any) to determine what should be recorded at the acquisition date.
2. The amendments in this update also provide certain practical expedients for acquirers when recognizing and measuring acquired contract assets and liabilities from revenue contracts in business combinations. These practical expedients basically permit measurement of the contract assets and contract liabilities at the amounts reported by the acquired entity.
3. The provisions of this update also apply to contracts to which the provisions of ASC 606 apply, even if those contracts are not contracts with customers. An example of such a contract is a contract liability from the sale of nonfinancial assets within the scope of ASC 610-20.
4. The provisions of this standard effectively override the basic requirement of ASC 805 that requires the assets and liabilities of the acquired company to be recorded at fair value. Instead of recording contract assets and contract liabilities at fair value, these assets and liabilities will be recorded in accordance with ASC 606 as if the acquiring entity had entered into the contract. In most cases, this amount will be the same amount that was recorded as a contract asset or a contract liability on the books of the acquired company.

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What is the effective date of this ASU?

For public business entities, this ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those years.

For all other entities, this ASU is effective for fiscal years beginning after December 15, 2023, including interim periods within those years.

The provisions should be applied prospectively to business combinations occurring on or after the effective dates of these amendments.

Early adoption is permitted, including in an interim period. If an entity elects to adopt in an interim period, the entity should apply the amendments

a. retrospectively to all business combinations for which the acquisition date occurs on or after the beginning of the fiscal year that includes the interim period of early adoption, and
b. prospectively to all business combinations that occur on or after the date of initial application.

Exercise: Group discussion

With a partner or in a small group, consider the following question.

How do you believe the provisions of ASU No. 2021-08 will affect accounting for contract assets and contract liabilities in business combinations?

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FASB ASU No. 2021-10, *Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance*

Why was this ASU issued?

The deliberations for this standard began in 2016 and the release of the standard coincides with the recent COVID-19-related programs that will be subject to ASU No. 2021-10. The guidance in this standard does not address measurement issues, but instead focuses on disclosures so that the user of the financial statements can determine the impact of government assistance on the financial position and results of operations. This standard creates a new topic (Topic 832) within the Accounting Standards Codification.

Who is affected by this ASU?

The amendments in this update apply to business entities (all entities except for not-for-profit [NFP] entities within the scope of Topic 958, *Not-for-Profit Entities*, and employee benefit plans within the scope of Topic 960, *Plan Accounting — Defined Benefit Pension Plans*, Topic 962, *Plan Accounting — Defined Contribution Pension Plans*, and Topic 965, *Plan Accounting — Health and Welfare Benefit Plans*) that account for a transaction with a government by applying a grant or contribution accounting model by analogy to other accounting guidance (for example, a grant model within IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, or Subtopic 958-605, *Not-For-Profit Entities — Revenue Recognition*).

What are the main provisions of this ASU?

An entity that has transactions with a government that are accounted for by applying a grant or contribution accounting model by analogy:

- Information about the nature of the transaction and the related accounting policy used to account for the transaction
- The line items on the balance sheet and income statement that are affected by the transactions, and the amounts applicable to each financial statement line item
- Significant terms and conditions of the transactions, including commitments and contingencies

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ASC 832-10-05-1 defines the following transactions as government assistance:

- Tax credits
- Cash grants
- Grants of other assets
- Project grants

The transactions listed previously are not intended to be all-inclusive. It is the opinion of the author that Paycheck Protection Program (PPP) loans would be considered transactions with the government that would be covered by this guidance. In addition, an entity should consider state and local grants related to the COVID-19 pandemic in determining compliance with the disclosure requirements of ASC 832.

What is the effective date of this ASU?

This standard is effective for financial statements issued for annual periods beginning after December 15, 2021. Early application is permitted.

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FASB ASU No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

Why was this ASU issued?

Equity securities are generally required to be measured at fair value. Existing guidance on the fair value measurement for equity securities that had contractual restrictions prohibiting the sale of an equity security contained examples that led to diversity in practice in measuring such securities. Some stakeholders discounted the value of the security due to the contractual restrictions, but others did not. This ASU was issued to clarify the guidance so that diversity in practice would not exist.

Who is affected by this ASU?

Any entity that owns an investment in an equity security that is both measured at fair value and is subject to a contractual sale restriction will apply the guidance in this update.

What are the main provisions of this ASU?

An entity is ***not permitted*** to consider a contractual sale restriction in determining the fair value of an equity security. Therefore, no discount should be provided for such a restriction.

The following disclosures are required when an entity owns an interest in an equity security that is subject to a contractual sales restriction:

- The fair value of equity securities subject to contractual sales restrictions reflected in the balance sheet
- The nature and remaining duration of the restriction(s)
- The circumstances that could cause a lapse in the restriction(s)

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What are the transistion requirements of this ASU?

For all entities except investment companies defined in Topic 946, the amendments to this update should be applied prospectively with any adjustments form the adoption of the amendments recognized in earnings and disclosed on the date of the adoption.

An entity that qualifies as an investment company as defined in Topic 946 should apply the amendments in this update to an investment in an equity security subject to a contractual sales restriction that is executed or modified on or after the date of the adoption. Equity securities subject to a contractual sales restriction that was executed before the date of adoption should continue to account for the equity security until the contractual restrictions expire or are modified using the accounting policy applied before the adoption of the amendments.

Entities that have previously accounted for investments in marketable equity securities with contractual sales restrictions that did not discount the fair value of such securities have no transition accounting requirements because those entities will have no change in how they measure such securities.

What is the effective date of this ASU?

For public business entities, the effective date is fiscal years beginning after December 15, 2023, and interim periods within those years.

For all other entities, the effective date is fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

Early adoption is permitted for those periods for financial statements that have not been issued or made available for issuance.

Knowledge check

3. An entity that accounts for an equity security at fair value that is subject to a contractual sales restriction should account for the restriction in what manner?

    a. Discount the security for the estimated decrease in value due to the sales restriction.
    b. Amortize the discount related to the restriction over the time period the restriction is in place.
    c. Ignore the sales restriction in determining the fair value.
    d. Record a premium to account for the value of the restriction.

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FASB ASU No. 2022-04, *Liabilities — Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*

Why was this ASU issued?

Diversity in practice in presenting and disclosing liabilities related to supplier finance programs resulted in FASB issuing this standard. This standard will provide more transparency and information to stakeholders when a reporting entity is a buyer party in a supplier finance program.

Who is affected by this ASU?

Any entity that is a buyer party in a supplier finance program will be subject to the disclosure requirements of this ASU.

A buyer party is an entity that has entered into an agreement with a third party that allows the supplier to receive payment for products or services rendered prior to the due date. Such arrangements are sometimes referred to as "reverse factoring arrangements," "payables financing," or "structured payables arrangement." The effect of such arrangements is that the supplier can be paid before the due date; but, instead of the supplier arranging for factoring or some other financing of their receivables, the purchases will establish those financing arrangements. This can allow the purchaser to be more competitive in bargaining for the purchase price.

What are the main provisions of this ASU?

When a buyer party enters into a supplier finance program, the liability is due to the third party instead of the original supplier or vendor. To provide transparency, this update requires the following qualitative and quantitative disclosures related to the program:

- The key terms of the program
  - Description of payment terms (timing and basis for determination)
  - Assets pledged as security
  - Other guarantees provided to the finance provider or intermediary

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- For obligations that have been confirmed as valid to the finance provider or intermediary
  - The amount outstanding that remains unpaid by the buyer (the amount due from the buyer to the finance provider or intermediary)
  - A description of where those obligations are presented in the balance sheet
  - A roll-forward of those obligations during the annual period, including the totals of the amounts confirmed (paid by the finance provider or intermediary) and amounts subsequently paid to the finance provider or intermediary by the buyer.

What is the effective date of this ASU?

The effective date is for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

There is an exception for the disclosures related to the roll-forward information. The roll-forward information is effective for fiscal years beginning after December 15, 2023.

Early adoption is permitted.

The amendments should be applied retrospectively for all disclosures, with the exception of the roll-forward information, which should be applied prospectively.

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Summary

The FASB continues the recent trend in the standard-setting process of simplifying GAAP where appropriate and responding to changes in the financial reporting environment. Financial statement preparation in accordance with U.S. GAAP will continue to evolve and those responsible for preparing financial statements should be aware of the changes and effective dates of the new standards.

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Solutions

FASB Accounting Standards Updates — Broad Issues

Exercise: Group discussion

- The standard should simplify accounting for business combinations.
- It was difficult to determine the fair value of contract assets and contract liabilities.
- In most cases, it is likely that contract assets and contract liabilities will be measured at the value that was carried on the books of the acquired company.

Knowledge check solutions

1.

a. Incorrect. Sales tax is not based on income.
b. Incorrect. Property tax is not based on income.
c. Correct. Franchise and similar taxes based on income are within the scope of ASU No. 2019-12.
d. Incorrect. Excise tax is not based on income.

2.

a. Incorrect. Total contributed assets are not required to be disclosed.
b. Correct. ASU No. 2020-07 requires disclosure of disaggregated amount of contributed nonfinancial assets.
c. Incorrect. Remaining pledged nonfinancial assets are not required to be disclosed.
d. Incorrect. Income taxes paid are not required to be disclosed under ASU No. 2020-07.

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3.

a. Incorrect. ASU No. 2022-03 specifically prohibits this treatment. Some entities applied this theory causing diversity in practice, and the FASB clarified that this treatment is not appropriate.
b. Incorrect. Because no discount is allowed to be recorded, there can be no amortization of a discount
c. Correct. ASU No. 2023 specifically provides that any contractual restriction shall be ignored when determining fair value.
d. Incorrect. ASU No. 2023 prohibits the consideration of a contractual restriction in determining fair value.

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FASB Accounting Standards Updates — Narrow Issues

Learning objective

- Identify recently issued FASB Accounting Standards Updates (ASUs) that cover narrow issues.

These course materials present ASUs that are very specific in nature, many of which originated with the Emerging Issues Task Force. These ASUs typically deal with very specific transactions or industry-specific issues.

The ASUs covered in this course are those that have effective dates in 2022 or later; therefore, several ASUs issued in prior years are included. Effective dates for public business entities are frequently different than those for other entities.[1] [2]

[1] Reference parts of this course are taken directly from FASB *Accounting Standards Update* (ASU) No. 2018-14, *Compensations – Retirement Benefits – Defined Benefit Plans –General (Subtopic 715-20).*

[2] Some information in this course was previously presented by the course author, Kurt Oestriecher, CPA, on June 20, 2019, as part of the Accounting and Auditing Update at the Annual Meeting of the West Virginia Society of CPAs.

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FASB ASU No. 2018-14, Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20): Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans

Why was this ASU issued?

This standard is the result of FASB finalizing the *Conceptual Framework for Financial Reporting — Chapter 8: Notes to Financial Statements* on August 28, 2018. Using this framework, FASB issued *Accounting Standards Update* (ASU) No. 2018-14 to improve the effectiveness of the disclosures for defined benefit plans.

Who is affected by this ASU?

This update affects all employers that sponsor defined benefit pension or other postretirement plans. Note that these requirements are for the sponsors of plans, not the plans themselves.

What are the main provisions of this ASU?

Disclosure requirements that were *added* as a result of this update:

- The weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates
- An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period
- Nonpublic entities required to disclose the amounts of transfers in and out of level 3 fair value measurements and purchases of level 3 plan assets

Disclosure requirements that are *clarified* as a result of this update:

- The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets
- The accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets

Disclosure requirements that were *removed* as a result of this update:

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- The amounts in accumulated comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year
- The amount and timing of plan assets expected to be returned to the employer
- The disclosures related to the June 2001 amendments to the Japanese Welfare Pension Insurance Law
- Related party disclosures about the amount of future annual benefits covered by insurance and annuity contracts
- Significant transactions between the employer or related parties and the plan
- For nonpublic entities, the reconciliation of opening and closing balances of plan assets measured using level 3 recurring fair value measurements
- For public entities, the effects of a one-percentage-point change in the assumed health care cost trend rates

When will this ASU be effective?

The following are the effective dates for ASU No. 2018-14:

- Public business entities — Fiscal years ending after December 15, 2020
- All other business entities — Fiscal years ending after December 15, 2021

The amendments should be adopted on a retrospective basis.

Knowledge check

1. Which disclosure was added for sponsors of defined benefit plans as a result of the issuance of ASU No. 2018-14?

    a. The amount and timing of plan assets expected to be returned to the employer.
    b. Significant transactions between the employer or related parties and the plan.
    c. An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.
    d. For public entities, the effects of a one-percentage-point change in the assumed health care cost trend rates.

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FASB ASU No. 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting — Amended by FASB ASU No. 2022-06

Why was this ASU issued?

Stakeholders were concerned that the movement to benchmarks other than the London Inter-Bank Offered Rate (LIBOR) would cause unintended consequences. Current guidance for transactions, particularly contracts accounted for as hedges, requires an entity to re-evaluate the accounting for the contract if substantial modifications are made to the contract. Many entities will have contract modifications as a result of regulator action that will require entities to move to reference rates other than LIBOR or other benchmarks that are susceptible to manipulation. This ASU was issued to offer practical expedients to entities that have contract modifications due to these issues.

Who is affected by this ASU?

This update will apply to all entities that meet certain criteria and that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform.

What are the main provisions of this ASU?

This ASU provides practical expedients and exceptions for applying GAAP to contracts, hedging relationships, and other transactions affected by reference rate reform if the following criteria are met:

- The contract must reference LIBOR or another reference rate expected to be discontinued.
- The expedients and exceptions do not apply to contract modifications made and hedging relationships entered into or revalued after December 31, 2024, except for hedging relationships existing as of December 31, 2024, that an entity has elected certain practical expedients for and that are retained through the end of the hedging relationship.

The expedients, in effect, allow an entity to continue to account for the transaction as originally intended because the modification of the contract was not initiated by the entity but instead required by a regulatory authority. The ultimate outcome of the contract or the hedging relationship should retain the original intended economic impact, therefore an entity should not apply the provisions that would normally occur when a contract is modified. The practical expedients are provided for the following areas:

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- Expedients for contract modifications
- Exceptions to FASB ASC 815, *Derivatives and Hedging*, related to changes in critical terms of a hedging relationship
- Expedients for excluded components
- Expedients for fair value hedges
- Expedients for cash flow hedges
- One-time election to sell or transfer debt securities classified as held to maturity

When will this ASU be effective?

This update is effective for all entities as of March 12, 2020, through December 31, 2024.

An entity may elect to apply the amendments for contract modifications by topic or industry subtopic as of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020, or prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date that the financial statements are available to be issued. Once elected for a topic or an industry subtopic, the amendments in this update must be applied prospectively for all eligible contract modifications for that topic or industry subtopic.

An entity may elect to apply the amendments in this update to eligible hedging relationships existing as of the beginning of the interim period that includes March 12, 2020, and to new eligible hedging relationships entered into after the beginning of the interim period that includes March 12, 2020.

If an entity elects to apply any of the amendments for an eligible hedging relationship existing as of the beginning of the interim period that includes March 12, 2020, any adjustments as a result of those elections must be reflected as of the beginning of that interim period and recognized in accordance with the guidance in Reference Rate Reform in FASB ASC 848-30, FASB ASC 848-40, and FASB ASC 848-50 (as applicable). If an entity elects to apply any of the amendments for a new hedging relationship entered into between the beginning of the interim period that includes March 12, 2020, and March 12, 2020, any adjustments as a result of those elections must be reflected as of the beginning of the hedging relationship and recognized in accordance with the guidance in Reference Rate Reform in FASB ASC 848-30, FASB ASC 848-40, and FASB ASC 848-50 (as applicable).

For private companies that are not financial institutions as described in FASB ASC 942-320-50-1 and not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market), an entity must update its hedge documentation noting the changes made before the next interim (if applicable) or annual financial statements are available to be issued. For all other entities, an entity must update its hedge documentation noting the changes made no later than when the entity performs its first quarterly assessment of effectiveness after the election.

The amendments in this update do not apply to contract modifications made after December 31, 2024, new hedging relationships entered into after December 31, 2024, and hedging relationships evaluated for periods after December 31, 2024, except for hedging relationships existing as of December 31, 2024, that apply the following optional expedients that are retained through the end of the hedging relationship (including for periods evaluated after December 31, 2024):

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- An optional expedient to the systematic and rational method used to recognize in earnings the components excluded from the assessment of effectiveness
- An optional expedient to the rate to discount cash flows associated with the hedged item and any adjustment to the cash flows for the designated term or the partial term of the designated hedged item in a fair value hedge
- An optional expedient to not periodically evaluate certain conditions when using the shortcut method for a fair value hedge

If an entity has not adopted the amendments in FASB ASU No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, the entity may elect only the following optional expedients for hedge accounting:

- An optional expedient allowing changes in critical terms of a hedging relationship
- An optional expedient allowing a change in the method designated for use in assessing hedge effectiveness in a cash flow hedge, if the optional expedient method being elected is the simplified hedge accounting approach for eligible private companies for initial hedge effectiveness or for subsequent hedge effectiveness
- An optional expedient allowing the entity to assume that the hedged forecasted transaction in a cash flow hedge is probable of occurring
- An optional expedient allowing the entity to assume that the reference rate will not be replaced for the remainder of the hedging relationships for initial and subsequent hedge effectiveness when the entity is using any of the methods for assessing and measuring hedge effectiveness in a cash flow hedge on a quantitative basis and if both the hedged forecasted transaction and the hedging instrument have an eligible reference rate
- An optional expedient allowing the entity to disregard certain requirements of the simplified hedge accounting approach for eligible private companies for initial hedge effectiveness or for subsequent hedge effectiveness in a cash flow hedge

The one-time election to sell, transfer, or both sell and transfer debt securities classified as held to maturity may be made at any time after March 12, 2020, but no later than December 31, 2024.

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FASB ASU No. 2020-06, Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity

Why was this ASU issued?

This update was issued as a result of the FASB project related to financial instruments that have characteristics of both debt and equity. FASB has reduced the number of accounting models for both convertible debt and convertible preferred stock. This change will result in fewer instruments being separately recognized.

Who is affected by this ASU?

Any entity that issues convertible instruments and/or contracts in an entity's own equity. The types of instruments that will have measurement impacts are those that have beneficial conversion features or cash conversion features as those models will no longer require separate recognition. The disclosure requirements will apply to all entities that have convertible instruments.

What are the main provisions of this ASU?

Current GAAP requires separate accounting for four different models of convertible instruments. This update reduces this requirement to only two models. This ASU will no longer require separate presentation for convertible instruments that have the following characteristics:

- Conversion features that are not required to be accounted for as derivatives under FASB ASC 815
- Conversion features that do not result in substantial premiums accounted for as paid-in capital

Debt instruments that have at least one of these characteristics will now be accounted for as a single debt instrument measured at its amortized cost, and a convertible preferred stock will be accounted for as a single equity instrument measured at its historical cost.

This ASU also requires disclosure of the following for convertible instruments:

- Objective of the issuance of the instrument

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- Information related to events or conditions that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed
- Information related to which party controls conversion rights
- Align disclosure for contingently convertible instruments with disclosure requirements for other convertible instruments
- Existing fair value disclosures be provided at the individual convertible instrument level rather than in the aggregate
- For convertible debt instruments with substantial premiums accounted for as paid-in capital, disclose the following:
  - The fair value amount and hierarchy of the entire instrument for public business entities
  - The premium recorded as paid-in capital

When will this ASU be effective?

The following are the effective dates for ASU No. 2020-06:

- For public companies, fiscal years beginning after December 15, 2021, and interim periods within those fiscal years
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years

The guidance should be adopted at the beginning of an entity's fiscal year.

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FASB ASU No. 2021-01, Reference Rate Reform (Topic 848): Scope — Amended by ASU No. 2022-06

Why was this ASU issued?

This ASU contains follow-up guidance to ASU No. 2020-04, which was also titled *Reference Rate Reform*. For the same reasons as outlined in the earlier discussion on ASU No. 2020-04, the benchmarks used in many derivative financial instruments will be or have been changed as a result of reference rate reform. Stakeholders were concerned that the guidance in FASB ASC 848, *Reference Rate Reform*, did not clearly allow some practical expedients for some contracts, therefore resulting in unintended accounting consequences. This update was issued to provide clarity to this issue and allow adoption of practical expedients so that financial statements are not affected by reference rate reform in a manner that does not reflect the underlying economic realities.

Who is affected by this ASU?

The update will apply to all entities that have derivative financial instruments that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform. The amendments can also be used by entities that designate receive-variable-rate, pay-variable-rate cross-currency interest rate swaps as hedging instruments in net investment hedges that are modified as a result of reference rate reform.

What are the main provisions of this ASU?

This update clarifies that certain optional expedients and exceptions in FASB ASC 848, *Reference Rate Reform*, for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. By allowing the practical expedients in FASB ASC 848 for derivative contracts that are described in the scope of this update, entities will not have an unintended impact on its financial statements as a result of reference rate reform. The following paragraphs in FASB ASC 848 are amended:

- Reference rate reform — Overall (FASB ASC 848-10): Specifically includes derivative instruments that undergo a modification of the underlying interest rates due to reference rate reform to be included within the scope of FASB ASC 848
- Contract modifications (FASB ASC 848-20): Specifically includes the derivative instruments referred to in this ASU and modifications to such contracts are eligible for the practical expedients
- Hedging — General (FASB ASC 848-30): Provides specific relief to derivative instruments that are classified as hedges
- Fair value hedges (FASB ASC 848-40): Specifically includes certain fair value hedges and clarified optional expedients
- Cash flow hedges (FASB ASC 848-50): Specifically includes certain cash flow hedges

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What is the effective date of this ASU?

The amendments in this update were effective immediately for all entities as of January 2021.

This update will not apply to contract modifications made after December 31, 2024; new hedging relationships entered into after December 31, 2024; and existing hedging relationships evaluated for effectiveness in periods after December 31, 2024, with certain exceptions.

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FASB ASU No. 2021-07, Compensation — Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards

Why was this ASU issued?

All entities, including private companies, are required to determine the value of share-based awards granted to employees and others. Because private companies are not publicly traded, determining the value of the underlying shares at grant date or modification date is costly and complex. Stakeholders reached out to the FASB and the Private Company Council (PCC) to obtain relief from this requirement.

The PCC determined that the information provided by recording the value of the share-based awards was necessary for fair financial reporting. Rather than eliminate the recording of the transaction, the PCC determined that a practical expedient was necessary. By issuing a practical expedient, stakeholders will continue to be provided with relevant information, but management will have less complex and costly procedures to determine the value of the underlying shares.

Who is affected by this ASU?

Any nonpublic entity that issues equity-classified share-based awards and elects to use the practical expedient provided in this update is affected.

What are the main provisions of this ASU?

A nonpublic entity is allowed to determine the current price input of equity classified, share based awards issued to both employees and non-employees using the reasonable application of a reasonable valuation method.

The characteristics of a reasonable application of a reasonable valuation model include the following:

- The date on which a valuation's reasonableness is evaluated
- The factors to be considered in a reasonable valuation
- The scope of information to be considered in a reasonable valuation
- The criteria that should be met for the use of a previously calculated value to be considered reasonable

The update notes that a reasonable valuation performed in accordance with Treasury regulations related to IRC Section 409A is an example of a way to achieve the practical expedient.

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It is important to note that this practical expedient applies only to equity-classified awards. If the award is required to be classified as a liability, this practical expedient is not allowed. The basis for this decision is that liability-classified awards, by definition, expect to have a cash outflow. The PCC and FASB determined that this practical expedient is not appropriate for such awards.

What is the effective date of this ASU?

This standard is effective, on a prospective basis, for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application, including application in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

Knowledge Check

2. ASU No. 2021-07 provides a practical expedient in determining the value of the underlying shares for share-based awards classified as

    a. Liabilities.
    b. Equity.
    c. Assets.
    d. Deferred outflows of resources.

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

Why was this ASU issued?

ASU 2017-12 provided improvements to the optional hedge accounting model. It also provided relief to entities that incurred difficulties in achieving fair value hedge accounting for interest rate risk hedges of portfolios of prepayable financial assets. Additionally, 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. ASU 2022-01 clarifies issues that were brought to the board by stakeholders.

Who is affected by this ASU?

The amendments in this ASU apply to all entities that elect to apply the portfolio layer method of hedge accounting in accordance with Topic 815.

What are the main provisions of this ASU?

Current GAAP permits only prepayable financial assets and one or more beneficial interests secured by a portfolio of prepayable financial instruments to be included in a last of layer closed portfolio. The amendments in this Update allow nonprepayable financial assets also to be included in a closed portfolio hedged using the portfolio layer method. That expanded scope permits an entity to apply the same portfolio hedging method to both prepayable and nonprepayable financial assets, thereby allowing consistent accounting for similar hedges.

This update will also allow multiple layer hedging relationships to be designated for a single closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments.

Ultimately, the amendments in this update will allow for hedge accounting to be applied so that financial instruments that are entered into for hedging purposes will be allowed to off-set gains and losses on those hedges against the gains and losses of the hedged asset. Without these amendments, more financial instruments that management intended to be hedges will have the unrealized gains and losses recognized in earnings as they occur, rather than off-setting the gains and losses of the hedged asset.

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What is the effective date of this ASU?

The following are the effective dates for ASU No. 2022-01:

- Public business entities — Fiscal years beginning after December 15, 2022, and interim periods within those years
- All other entities — Fiscal years beginning after December 15, 2023, and interim periods within those years

Early adoption is permitted.

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Summary

It is important to keep abreast of the narrow scope standards as they could affect the entity for whom you are responsible for issuing, auditing, reviewing, compiling, or preparing financial statements. The implementation dates for many of these standards are often much sooner than broad standards, and many times early implementation is permitted.

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Solutions

FASB Accounting Standards Updates — Narrow Issues

Knowledge check solutions

1.

   a. Incorrect. The disclosure requirement for the amount and timing of plan assets expected to be returned to the employer was removed as a result of the issuance of FASB ASU No. 2018-14.
   b. Incorrect. The disclosure requirement for significant transactions between the employer or related parties and the plan was removed as a result of the FASB ASU No. 2018-14 update.
   c. Correct. This disclosure was added because of the issuance of FASB ASU No. 2018-14.
   d. Incorrect. The disclosure requirement for public entities regarding the effects of a one-percentage-point change in the assumed health care cost trend rates was removed as a result of the issuance of FASB ASU No. 2018-14.

2.

   a. Incorrect. Liability-based awards are specifically excluded from this practical expedient.
   b. Correct. Because no cash settlement is anticipated with equity-based awards, FASB determined that the practical expedient is appropriate.
   c. Incorrect. Share-based awards are never classified as assets.
   d. Incorrect. Deferred outflows of resources are not presented in financial statements of nongovernmental entities.

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Financial Instruments and Leases

Learning objectives

- Recall the requirements of the current expected credit loss (CECL) model for measuring the impairment of financial instruments.
- Calculate the right-of-use (ROU) asset and corresponding lease obligation for lease agreements.

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Introduction

FASB and the International Accounting Standards Board (IASB) have been working on three joint projects since 2007 to provide guidance on areas they felt needed improvement: revenue recognition, financial instruments, and leases. The revenue recognition standard and accounting for marketable debt and equity securities are now effective for all entities, and the CECL and lease standards have had their effective dates extended. Regardless of when the lease or CECL standard will be effective for your entity or clients, it is imperative that implementation processes begin now so that an entity will have the resources and information available when the standards are adopted.

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FASB ASU No. 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

Why was this ASU issued?

Current GAAP requires an "incurred loss" methodology for recognizing credit losses that delays recognition of the loss until it is probable that a loss has been incurred. Both financial institutions and users of their financial statements expressed concern that current GAAP restricts the ability to record credit losses that are expected but do not yet meet the "probable" threshold.

The main objective of this update is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

The new model is referred to as the "current expected credit loss" (CECL) model.

Who is affected by this ASU?

The amendments of this update affect entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. Obviously, financial institutions will be impacted more than any other industry due to the size of their receivable portfolios, but it also affects any company that has trade receivables, loans, debt securities, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. The amendments in this update affect an entity to varying degrees depending on the credit quality of the assets held by the entity, their duration, and how the entity applies current GAAP. There is significant diversity in practice in applying the incurred loss methodology, which means that before transition, some entities may be more aligned, under current GAAP, than others to the new measure of expected credit losses.

What are the main provisions of this ASU?

Assets measured at amortized cost

The amendments of this update will require financial assets measured at amortized cost basis to be presented on the balance sheet at the net amount expected to be collected. The allowance for credit

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losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. The income statement will reflect the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period (FASB ASC 326-20-30-1).

When calculating the valuation allowance, the measurement is based on relevant information about past events (including historical loss experience), current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. Entities will be required to use a great deal of judgment in determining the relevant information and estimation methods that are appropriate in their circumstances. Note that, although historical loss ratios are the appropriate place to start the analysis, current events and conditions at the balance sheet date must also be considered. Management must also evaluate how conditions that existed during the historical charge-off period might differ from their current expectations and must revise loss ratios appropriately. Although management must estimate losses expected to be incurred during the entire life of the contract, they are not required to forecast conditions over that contractual life. Forecasts should only be made for the period for which the entity can make reasonable and supportable forecasts. For periods beyond that time frame, the entity reverts to historical credit loss experience (paragraphs 7–10 of FASB ASC 326-20-30).

Implementation guidance in FASB ASC 326-20-55 provides a discussion of methods and information to be considered in estimating the allowance for credit losses.

Available-for-sale debt securities

The CECL model does not apply to available-for-sale debt securities and measurement has not changed from current GAAP. However, the amendments in this update require that credit losses be presented as an allowance rather than as a write-down. This approach is an improvement of current GAAP because an entity will be able to record reversals of credit losses in current-period net income. Therefore, it allows for a recovery of the charge when conditions improve. The allowance is limited to the amount at which the security's fair value is less than its amortized cost.

Unit of account

The CECL model does not prescribe a unit of account. However, an entity is required to evaluate financial assets on a collective (that is, pool) basis when assets share similar risk characteristics (FASB ASC 326-20-30-2). Otherwise, the financial assets are to be evaluated individually. If an individual asset is evaluated for credit losses, available external information such as credit ratings and other credit loss statistics must be considered.

For many entities, this will not require a change in methodology because most companies evaluate credit losses on a pool method now. However, entities will need to consider whether their current data-capturing processes comply with the requirements of the CECL model.

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Collateral-dependent financial assets

An entity will continue to be permitted to measure its estimate of the expected credit loss on collateral-dependent financial assets as the difference between the asset's amortized cost and the collateral's fair value, adjusted for selling costs (FASB ASC 326-20-35-4).

Disclosures

Financial institutions (and others with significant lending portfolios) will have extensive disclosures to make regarding the allowance and the methodology used in developing that allowance. However, most companies that have only trade accounts receivable (with a term of less than one year) will not see a significant increase from the disclosures currently required under GAAP.

The objective of required disclosures is to enable a user of the financial statements to understand

- the credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio,
- management's estimate of expected credit losses, and
- changes in the estimate of expected credit losses that have taken place during the period.

It is likely that companies will need to provide a more robust policy discussion in the summary of significant accounting policies than is currently disclosed.

What is the effective date of this ASU?

For public business entities that are SEC filers, excluding entities eligible to be smaller reporting companies as defined by the SEC, the amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Early application of the amendments is permitted.

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FASB ASU No. 2019-05, *Financial Instruments — Credit Losses (Topic 326) Targeted Transition Relief*

Why was this ASU issued?

Several entities informed FASB that they were planning to elect the fair value option on newly originated or purchased financial assets, a deviation from their historical treatment of measuring these financial assets at cost. Without any transition relief, these entities would be required to maintain dual measurement methodologies for identical or similar financial instruments that are managed in the same manner.

Who is affected by this ASU?

Any entity that reports financial instruments in accordance with FASB ASC 326.

What are the main provisions of this ASU?

This standard provides an irrevocable election to use the fair value option for certain assets previously reported at amortized cost basis.

What is the effective date of this ASU?

For entities that have not adopted ASU No. 2016-13, the effective date and transition methodology will be the same as in FASB ASU No. 2016-13.

For entities that have adopted ASU No. 2016-13, this standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those years.

Early adoption is permitted in any interim period after the issuance of ASU No. 2019-05, as long as an entity has adopted the amendments in ASU No. 2016-13.

The standard shall be applied on a modified retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings.

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FASB ASU No. 2019-11, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses*

Why was this ASU issued?

FASB issued this standard to address minor changes to FASB ASC 326 that stakeholders have brought to the attention of the board as they were assessing implementation plans for the current expected credit loss model.

Who is affected by this ASU?

Any entity that is required to account for credit losses of financial instruments.

What are the main provisions of this ASU?

The following issues, and the amendments to address those issues are as follows:

Area of improvement	Summary of amendments
Issue 1: Expected Recoveries for Purchased Financial Assets with Credit Deterioration The guidance in paragraph 326-20-30-1 states that expected recoveries of amounts previously written off or expected to be written off should be included in the allowance for credit losses valuation account. Stakeholders questioned whether this guidance applies to purchased financial assets with credit deterioration (PCD assets) measured at amortized cost basis in FASB ASC 326-20, *Financial Instruments — Credit Losses — Measured at Amortized Cost*. Specifically, stakeholders questioned whether negative allowances were permitted on PCD assets. The phrase *negative allowance* is used to describe situations for which an entity determines that it will recover the amortized cost basis, or a portion of that basis, after a write-off and that "basis recovery" is included in the allowance for credit losses through a	The amendments clarify that the allowance for credit losses for PCD assets should include in the allowance for credit losses expected recoveries of amounts previously written off and expected to be written off by the entity and should not exceed the aggregate of amounts of the amortized cost basis previously written off and expected to be written off by an entity. In addition, the amendments clarify that when a method other than a discounted cash flow method is used to estimate expected credit losses, expected recoveries should not include any amounts that result in an acceleration of the noncredit discount. An entity may include increases in expected cash flows after acquisition.

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Area of improvement	Summary of amendments
negative allowance. Those situations often are a result of an entity applying regulatory charge-off policies that are generally based on delinquency status.	
Issue 2: Transition Relief for Troubled Debt Restructuring At the June 2017 Transition Resource Group for Credit Losses (TRG) meeting, stakeholders noted the operational complexities of calculating a prepayment-adjusted effective interest rate on troubled debt restructurings (TDRs) that exist as of the adoption date by using the prepayment assumptions in effect immediately before the restructuring. They requested transition relief when adjusting the effective interest rate for those arrangements.	The amendments provide transition relief by permitting entities an accounting policy election to adjust the effective interest rate on existing TDRs using prepayment assumptions on the date of adoption of topic 326 rather than the prepayment assumptions in effect immediately before the restructuring.
Issue 3: Disclosures Related to Accrued Interest Receivables Accounting Standards Update No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, amended the guidance in FASB ASC 326-20 and 326-30, *Financial Instruments — Credit Losses — Available-for-Sale Debt Securities*, to allow an entity to elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements. Stakeholders noted that an entity would still be required to include accrued interest in other disclosure requirements of its amortized cost basis for financial assets under other topics. Stakeholders requested that the disclosure relief for accrued interest receivable balances be extended to all relevant disclosures involving amortized cost basis.	The amendments extend the disclosure relief for accrued interest receivable balances to additional relevant disclosures involving amortized cost basis.
Issue 4: Financial Assets Secured by Collateral Maintenance Provisions The guidance in paragraph 326-20-35-6 for financial assets secured by collateral	The amendments clarify that an entity should assess whether it reasonably expects the borrower will be able to continually replenish collateral securing the financial asset to apply the practical expedient.

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Area of improvement	Summary of amendments
maintenance provisions provides a practical expedient to measure the estimate of expected credit losses by comparing the amortized cost basis of a financial asset and the fair value of collateral securing the financial asset as of the reporting date. Stakeholders questioned whether an entity is required to evaluate whether a borrower has the ability to continually replenish collateral securing the financial asset to apply the practical expedient. Additionally, stakeholders questioned how an entity should determine its estimate of expected credit losses if the fair value of the collateral securing the financial asset is less than its amortized cost basis.	The amendments clarify that an entity applying the practical expedient should estimate expected credit losses for any difference between the amount of the amortized cost basis that is greater than the fair value of the collateral securing the financial asset (that is, the unsecured portion of the amortized cost basis). An entity may determine that the expectation of nonpayment for the amount of the amortized cost basis equal to the fair value of the collateral securing the financial asset is zero.
Issue 5: Conforming Amendment to FASB ASC 805-20 Stakeholders noted that paragraph 805-20-50-1 references FASB ASC 310-30, *Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality*, which was superseded by the amendments in ASU No. 2016-13.	The amendment to FASB ASC 805-20, *Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest*, clarifies the guidance by removing the cross-reference to FASB ASC 310-30 in paragraph 805-20-50-1 and replacing it with a cross-reference to the guidance on PCD assets in FASB ASC 326-20.

What is the effective date for this ASU?

For entities that have not yet adopted the amendments in FASB ASU No. 2016-13 as of the issuance date of this update, the effective dates and transition requirements for the amendments are the same as the effective dates and transition requirements in FASB ASU No. 2016-13.

For entities that have adopted the amendments in FASB ASU No. 2016-13, the amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of this update as long as an entity has adopted the amendments in FASB ASU No. 2016-13.

For entities that have adopted the amendments in FASB ASU No. 2016-13, the amendments in this update should be applied on a modified retrospective basis by means of a cumulative-effect adjustment to the opening retained earnings balance in the statement of financial position as of the date that an entity adopted the amendments in FASB ASU No. 2016-13.

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FASB ASU No. 2022-02, *Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*

Why was this ASU issued?

The provisions within this ASU are the result of outreach efforts of the FASB, particularly from the Transition Resource Group for Credit Losses, related to the implementation of ASU No. 2016-13, *Financial Instruments — Credit Losses: Measurement of Credit Losses on Financial Instruments.*

This ASU provides guidance on two issues related to accounting for credit losses on financial instruments:

- Troubled Debt Restructurings by Creditors
- Vintage Disclosures — Gross Write-offs

Who is affected by the ASU?

Any entity that has adopted the guidance in ASU No. 2016-13 and has a entered into a troubled debt restructuring with a debtor and public business entities that have adopted ASU No. 2016-13 with investments in financing receivables.

What are the main provisions of this ASU?

An entity that enters into a troubled debt restructuring should apply the loan refinancing and restructuring guidance in ASC 310-20-35-9 through 35-11 to determine whether the modification results in a new loan or a continuation of an existing loan.

Public business entities are required to disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of ASC 326-20.

What is the effective date of this ASU?

For any entity that has adopted ASU No. 2016-13, the ASU is effective for fiscal years beginning after December 15, 2022, and interim periods within those years.

For entities that have not adopted ASU No. 2016-13, the effective dates for the amendments are the same as the effective dates in ASU No. 2016-13.

FASB ASU No. 2016-02, *Leases (Topic 842)*

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Why was this ASU issued?

Issued in February 2016, FASB ASU No. 2016-02 is intended to increase transparency and comparability in financial reporting by requiring balance sheet recognition of leases and note disclosure of certain information about lease arrangements.

Leasing is utilized by many entities and is a means of gaining access to assets, of obtaining financing, or of reducing an entity's exposure to the full risks of asset ownership. The prevalence of leasing, therefore, means that it is important that users of financial statements have a complete and understandable picture of an entity's leasing activities. Previous leases accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there were long-standing requests from many users of financial statements and others to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities. In addition, many of the criticisms associated with previous leases guidance related to the accounting for operating leases in the financial statements of lessees. Addressing those concerns with lessee accounting was the main focus of the boards.

In addition, some changes have been made to lessor accounting to conform and align that guidance with the lessee guidance and other areas within GAAP, such as FASB ASC 606.

This update codifies the new FASB ASC 842, *Leases*, and makes conforming amendments to other FASB ASC topics.

The new FASB ASC topic on leases includes the following subtopics:

- Overall
- Lessee
- Lessor
- Sale and leaseback transactions
- Leveraged lease arrangements

Who is affected by this ASU?

This update affects all entities that enter into leases and subleases. The requirements do not apply to leases of the following nondepreciable assets accounted for under other FASB ASC topics:

- Intangible assets
- Exploration for or use of nonregenerative resources such as minerals, oil, and natural gas
- Biological assets, such as timber
- Inventory
- Assets under construction

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Election to exclude certain easements accounted for under current lease guidance (FASB ASU No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*)

- An entity may elect to exclude land easements that exist or expired before an entity's adoption of FASB ASC 842, provided that the entity does not account for those land easements as leases under current guidance (FASB ASC 640).
- The election must apply to all land easements.
- The provisions of this update will remove the requirement that the underlying contracts be evaluated to determine if they are leases.
- The election, if made, shall be disclosed.
- The effective date is the same as that of FASB ASU No. 2016-02.

What are the main provisions of this ASU?

Identifying a lease

Key changes in the guidance are illustrated by comparing the definition of a lease in FASB ASC 840 (previous GAAP) and FASB ASC 842.

FASB ASC 840	FASB ASC 842
An agreement conveying the right to use property, plant, or equipment (land or depreciable assets) usually for a stated period of time	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration

The identification of a lease under FASB ASC 842 is based on the presence of key elements in the definition.

Separating components of a lease contract

Under FASB ASC 842, a contract that contains a lease is separated into lease components. Separation is based on the right to use; each underlying asset is considered to be separate from other lease components when both of the following criteria are met:

- The lessee can benefit from the ROU of the asset (either alone or with other readily available resources), and
- The ROU is neither highly dependent on nor highly interrelated with other underlying assets in the contract

The consideration in the contract is allocated to the separate lease and nonlease components in accordance with provisions of FASB ASC 842.

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Lease classification

When a lease meets any of certain specified criteria at commencement, the lease is classified by the lessee as a finance lease and by the lessor as a sales-type lease. These criteria can be summarized as follows:

- Transfers of ownership to lessee
- Purchase option reasonably certain to be exercised
- Lease term for major portion of asset's economic life
- Present value of lease payments and residual value equals or exceeds substantially all of the fair value of the underlying asset
- Specialized nature of underlying asset results in no expectation of alternative use after the lease term

If none of the preceding criteria are met, the lease is classified by the lessee as an operating lease and by the lessor as either a direct financing lease or an operating lease, based on certain specified criteria.

Lease term and measurement

The lease term is the noncancelable period of the lease together with applicable options summarized as follows:

- Period covered by option for lessee to extend the lease if reasonably certain to be exercised
- Period covered by option for lessee to terminate the lease if reasonably certain not to be exercised
- Period covered by option for lessor to extend or not terminate the lease if option is controlled by lessor

Lease payments relating to use of the underlying asset during the lease term include the following at the commencement date:

- Fixed payments less incentives payable to lessee
- Variable lease payments based on an index or other rate
- Exercise price of an option if reasonably certain to be exercised
- Payments for penalties for terminating a lease if the lease term reflects exercise of lessee option
- Certain fees paid by the lessee to the owners of a special purpose entity for structuring the lease
- For lessee only, amounts probable of being owed under residual value guarantees

Lease payments specifically exclude the following:

- Certain other variable lease payments
- Any guarantee by the lessee of the lessor's debt
- Certain amounts allocated to nonlease components

Reassessment of the lease term and purchase options, and subsequent remeasurement by either the lessee or lessor, is limited to certain specified conditions.

Lessee accounting

Recognition and measurement

At the commencement date of the lease, a lessee recognizes an ROU asset and a lease liability. The lease liability is measured at the present value of the unpaid lease payments. The ROU asset consists of

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the initial lease liability, any lease payments made to lessor at or before the commencement date minus any incentives received, and initial direct costs. For short-term leases (those for which the lease term is less than 12 months), an alternative accounting policy election is available.

After the commencement date, the lessee recognizes in profit or loss (unless costs are included in the carrying amount of another asset) the following:

- Finance leases
  - Amortization of the ROU asset and interest on the lease liability
  - Variable lease payments not included in the lease liability in the period obligation incurred
  - Any impairment
- Operating leases
  - A single lease cost calculated such that the remaining cost is allocated on a straight-line basis over the remaining term (unless another allocation is more representative of the benefit from use of the asset)
  - Variable lease payments not included in the lease liability in the period obligation incurred
  - Any impairment

Presentation and disclosure

Key presentation matters include the following:

- Statement of financial position
  - Separate presentation of ROU assets and lease liabilities from finance leases and operating leases
- Statement of comprehensive income
  - Finance leases — interest expense of lease liability and amortization of ROU asset
  - Operating leases — expense to be included in the lessee's income from continuing operations
- Statement of cash flows
  - Presentation with financing activities — the repayment of the principal portion of the lease liability arising from finance leases
  - Presentation with operating activities — payments from operating leases; variable lease payments and short-term lease payments not included in lease liability

Disclosure requirements include qualitative and quantitative information for leases, significant judgments, and amounts recognized in the financial statements, including certain specified information and amounts.

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Practical expedient for common control arrangements

Accounting for common control leasing arrangements

FASB is expected to issue an ASU in early 2023 that will provide additional guidance for lessor accounting for arrangements between entities under common control. It is very common for such arrangements to not be in writing; therefore, a question exists regarding whether or not the payments under such arrangements should be accounted for under FASB ASC 842.

It has been the opinion of some practitioners that such arrangements would not fall under the scope of FASB ASC 842 as there were no legally enforceable obligations to make the payments. The objective of FASB ASC 842 is to present the present value of legally enforceable payments and legally enforceable options as a liability on the balance sheet. If no such legally enforceable obligation exits, then not all the elements of a contract that are required to be accounted for under FASB ASC 842 were present; therefore, any payments under an unenforceable arrangement should be accounted for as rent or some type of similar expense.

Because of diversity in practice, FASB placed an item on its agenda to address the issue. The decisions reached at the FASB meeting on February 15, 2023, (which are expected to be included in the ASU) are as follows:

- The provisions will apply to entities that are not public business entities, non-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the SEC.
- The practical expedient may be applied on an arrangement-by-arrangement basis.
- The entity applying the practical expedient is not required to determine whether any written terms are legally enforceable.
- If no written terms and conditions exist, an entity is required to apply FASB ASC 842 on the basis of the legally enforceable terms of the arrangement. [Note: Whether an oral agreement is legally enforceable will depend on the jurisdiction of the parties subject to the unwritten agreement. Legal counsel may be necessary to assist the entity in determining the legally enforceable provisions. Many jurisdictions may not recognize oral contracts to have future legally enforceable provisions.]

An entity that adopts the practical expedient concurrently with its adoption of FASB ASC 842 is required to adopt the practical expedient using the same transition method elected to adopt FASB ASC 842. For all other entities, the practical expedient may be adopted either

- prospectively to all leases that commence on or after the date of the adoption of the final ASU or
- retrospectively to the beginning of the earliest period presented in accordance with FASB ASC 842 if the arrangements existed at the date of adoption of the final ASU. The amendments would not be applicable to any arrangement no longer in place at the adoption of the final ASU.

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FASB affirmed its decision that an entity is permitted to document any existing unwritten terms and conditions of a common control arrangement before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the practical expedient. FASB decided that an entity electing the transition practical expedients in FASB ASC 842-10-65-1(f) and (g) is not required to apply those transition expedients to common control arrangements for which the practical expedient for Issue 1 is being applied.

Accounting for leasehold improvements associated with common control leases

Leasehold improvements associated with common control leasing arrangements should be

- amortized by the lessee over the useful life of the leasehold improvements to the common control group as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the underlying asset through a lease with another entity not within the same common control group, the amortization period may not exceed the lease term associated with the lessor's lease with the other entity.
- If and when the lessee no longer controls the use of the underlying asset, the leasehold improvements should be accounted for as a transfer between the entities under common control through an adjustment to equity (net assets for not-for-profit entities).

Entities that adopt this ASU concurrently with the adoption of FASB ASC 842 may follow the same transition method elected to adopt ASU No. 842, or may elect to use either of the two prospective transition methods available for entities that adopt this ASU after adopting FASB ASC 842. The three methods available for such entities are as follows:

- Prospectively to all new leasehold improvements recognized on or after the date an entity first applies these amendments.
- Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the amendments. The unamortized balance of existing leasehold improvements is required to be amortized over their remaining useful life to the common control group at that date.
- Retrospectively to the beginning of the period in which the entity first applied FASB ASC 842 for leasehold improvements that exist at the date the amendments are adopted. Any leasehold improvements that otherwise would not have been amortized or impaired are required to be recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the fiscal year of adoption of FASB ASC 842.

Lessor accounting

Recognition and measurement

FASB ASC 842 provides recognition guidance for sales-type leases, direct financing leases, and operating leases. The following table summarizes the guidance:

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Sales-type leases	
At the commencement date	After the commencement date
Lessor derecognizes the underlying asset and recognizes the following: • Net investment in the lease (lease receivable and unguaranteed residual asset) • Selling profit or loss arising from the lease • Initial direct costs as an expense	Lessor recognizes the following: • Interest income on the net investment in the lease • Certain variable lease payments • Impairment
Direct financing leases	
At the commencement date	After the commencement date
Lessor derecognizes the underlying asset and recognizes the following: • Net investment in the lease (lease receivable and unguaranteed residual asset reduced by selling profit) • Selling loss arising from the lease, if applicable • Impairment	Lessor recognizes the following: • Interest income on the net investment in the lease • Certain variable lease payments
Operating leases	
At the commencement date	After the commencement date
Lessor defers initial direct costs.	Lessor recognizes the following: • The lease payments as income in profit or loss over the lease term on a straight-line basis (unless another method in more representative of the benefit received) • Certain variable lease payments as income in profit or loss • Indirect costs as an expense over the lease term on the same basis as lease income

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Presentation and disclosure

Key presentation matters include the following:

For sales-type and direct financing leases

- Statement of financial position
  - Separate presentation of lease assets (that is, aggregate of lessor's net investment in sales-type leases and direct financing leases) from other assets
  - Classified as current or noncurrent based on the same considerations as other assets
- Statement of comprehensive income
  - Presentation of income from leases in the statement of comprehensive income or disclosure of income from leases in the notes with a reference to the corresponding line in the statement of comprehensive income
  - Presentation of profit or loss recognized at the commencement date in a manner appropriate to lessor's business model
- Statement of cash flows
  - Presentation with operating activities — cash receipts from leases

For operating leases

- Statement of financial position
  - Presentation of an underlying asset subject to an operating lease in accordance with other FASB ASC topics
- Statement of Comprehensive Income
  - Separate presentation or disclosure of lease income
- Statement of cash flows
  - Presentation with operating activities — cash receipts from leases

Disclosure requirements include qualitative and quantitative information for leases, significant judgments, and amounts recognized in the financial statements, including certain specified information and amounts.

Sale and leaseback transactions

FASB ASC 842 provides guidance for both the transfer contract and the lease in a sale and leaseback transaction (a transaction in which a seller-lessee transfers an asset to a buyer-lessor and leases that asset back). Determination of whether the transfer is a sale should be based on provisions of FASB ASC 606. FASB ASC 842-40-25 provides measurement guidance for a transfer that is either determined to be a sale or determined not to be a sale.

FASB ASC 842-40 provides guidance for subsequent measurement, financial statement presentation, and disclosures.

Leveraged lease arrangements

The legacy accounting model for leveraged leases continues to apply to those leveraged leases that commenced before the effective date of FASB ASC 842. There is no separate accounting model for leveraged leases that commence after the effective date of FASB ASC 842.

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Exhibit: Lease example — Finance lease

Facts

ABC Company (a nonpublic company) leases a fleet of trucks for a three-year term. The trucks have a fair value of $30,000 each at inception of the lease, with an expected 20% residual value at the end of the lease term. The expected economic life of the trucks is five years. There is no purchase option or transfer of ownership at the termination of the lease. The payments are $3,868 per month, of which $286 is a use tax. The first month is paid at the inception of the lease.

The dealer does not disclose the interest rate in the lease. The last three borrowings the company made include a credit card with a 19% rate, a 5% rate on a three-year secured loan, and 7% on a working line of credit.

Conclusions

- The transaction is a lease because control of the asset has been transferred to ABC Company, based on the fact that ABC has the right to direct the use of the asset and to obtain substantially all of the economic benefits from the use of the asset.
- Under the new standard (FASB ASC 842), the lease should be categorized as a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset.
- The lease term is three years. There are no renewal options to consider.
- The appropriate discount rate is 5% because this is the borrowing rate of the lessee on a recent, similar transaction.
- There are no variable payments to consider.
- The present value of the lease liability is $120,000. This is the present value of 35 payments of $3,582 (do not include the sales tax) discounted at .05 ÷ 12, plus one payment of $3,582. This is also the amount to be recorded as the ROU asset.

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Entries

The following entries are made at lease inception by the lessee:

ROU asset — Leased trucks	120,000	
Lease obligation		120,000
Use tax expense	286	
Lease obligation	3,582	
Cash (first month payment)		3,868

In the first year, the following entries are made (these are annual amounts; the monthly amounts for the interest expense will be based on the amortization schedule).

Interest expense on lease obligation	4,617	
Use tax expense	3,146	
Lease obligation	34,780	
Cash		42,543
Amortization expense	40,000	
ROU asset — accumulated amortization		$40,000

The following table shows the annual amounts for the entire lease term:

Period	Lease liability	Interest expense	Amortization expense	Total lease expense
0	120,000			
1	81,638	$ 4,617	$ 40,000	$44,617
2	41,837	3,178	40,000	43,178
3	-0-	1,142	40,000	41,142
Total		$ 8,937	$120,000	$128,937

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Exhibit: Lease example — Operating lease

Facts

ABC Company (a nonpublic company) leases an office building (including the land). This is new construction, but ABC Company was not involved in the design or construction of the building. The building has an estimated useful life of 40 years. The land obviously has an indefinite life.

The initial term of the lease is for five years, with an annual rent of $60,000 payable monthly. There is one renewal option with a term of five years, with annual rent of $66,000 payable monthly (negotiated down from the initial offer of $72,000 per year). The payments are all fixed.

The lessor does not disclose the interest rate in the lease. The last three borrowings the company made include a credit card with a 19% rate, a 5% rate on a three-year secured loan, and 7% on a working line of credit. None of these transactions are considered comparable to the current transaction.

The company paid costs of $15,000 directly relating to the acquisition of the lease.

Conclusions

- The transaction is a lease because control of the asset has been transferred to ABC Company, based on the fact that ABC has the right to direct the use of the asset and to obtain substantially all of the economic benefits from the use of the asset.
- Under the new standard (FASB ASC 842), the lease should be categorized as an operating lease because none of the criteria for a finance lease are met. Under FASB ASC 840 (existing standard), this lease would also have been classified as an operating lease.
- The lease term is 10 years. Because the company negotiated the renewal rate down from the initial offer, and based on management discussions, the current plan is to exercise the renewal.
- The appropriate discount rate is 6%, based on a study of market rates for similar transactions for a company with the credit profile of ABC Company. Management determined this based on discussions with their banker.
- There are no variable payments to consider.
- The company determines that the lease includes both a building and land component and that each would be classified as an operating lease, and therefore accounting for the two lease components together is reasonable because the overall impact of accounting for them separately would be insignificant.
- The present value of the lease liability is $471,889 (inclusive of the initial payment).
- The ROU asset is recorded as the amount of the lease liability plus the $15,000 in professional fees relating directly to the origination of the lease.

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Entries

The following entries are made at lease inception by the lessee:

ROU asset — Real estate	486,889	
Cash (first month payment)		5,000
Cash (payments to attorneys)		15,000
Lease obligation		466,889

In the first year, the following entries are made (these are the 11 payments that are made after the initial payment recorded previously and are based on payments of $5,000 per month).

Lease expense	64,500	
Lease liability	30,065	
Cash		55,000
ROU asset — Accumulated amortization		39,565

The lease expense is calculated as the amount paid over the initial and renewal periods totaled, plus the professional fees, and then divided by 120 months for a straight-line expense. The lease liability is decreased by the principal from the amortization schedule, with amortization of the asset being the "plug" figure.

Calculation of annual lease expense

Upfront costs	$ 15,000
First five years (60 × $5,000)	300,000
Last five years (60 × $5,500)	330,000
Total cash paid	645,000
Divided by term (years)	10
Annual operating expense	64,500

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The following table shows the annual amounts for the entire lease term:

Period	Lease liability	Accumulated amortization	Lease expense
0	$471,889		
1	436,824	$ 39,565	$ 64,500
2	402,088	78,801	64,500
3	365,210	120,179	64,500
4	326,058	163,831	64,500
5	284,481	209,898	64,500
6	234,192	258,697	64,500
7	180,791	310,598	64,500
8	124,096	365,793	64,500
9	63,904	424,485	64,500
10	-0-	486,889	64,500
Total			$645,000

What is the effective date of this ASU?

The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:

- A public business entity
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files financial statements with the SEC

For all other entities, the amendments in this update are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

Early application of the amendments in this update is permitted for all entities.

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Transition

Modified retrospective approach

Record ROU asset and lease liability as of the beginning of the earliest period presented.

Practical expedients

- No reassessment of the following:
  - Whether any expired or existing contracts contain leases
  - The lease classification for any expired or existing leases
  - Initial direct costs for any existing leases
- An entity may use hindsight in determining the remaining lease term and in assessing impairment of the ROU asset

Lessee accounting

Leases previously accounted for as an operating lease

1. Recognize an ROU asset and a lease liability upon adoption date.
   a. ROU asset measurement at transition
      i. The amount of the lease liability defined in item b.
      ii. Adjust for the following items:
         (1) Prepaid or accrued lease payments
         (2) Remaining balance of lease incentives received
         (3) Unamortized initial direct costs
         (4) Impairment of the ROU asset
   b. Lease liability measurement at transition
      i. Sum of the present value of the remaining minimum lease payments
      ii. Any amounts probable of being owed under a residual value guarantee

Leases previously accounted for as a capital lease and subsequently accounted for as a finance lease upon adoption

1. Recognize an ROU asset and a lease liability at the carrying amount of the lease asset and capital lease obligation in accordance with the guidance used prior to the adoption of this standard.
2. Include any unamortized initial direct costs that meet the definition of initial direct costs.
3. If the practical expedient is elected, continue to account for the ROU asset and lease liability in the current manner prior to implementing this standard.
4. Classify the assets and liabilities held under capital leases as ROU assets and lease liabilities for presentation and disclosure issues.

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Leases previously accounted for as a capital lease and subsequently accounted for as an operating lease upon adoption

1. Derecognize the carrying amount of any capital lease asset and lease obligation.
   a. Any difference should be accounted for in the same manner as prepaid or accrued rent.
2. Recognize an ROU asset and a lease liability in accordance with the new lease standard (this will vary depending upon which practical expedients are elected).
3. Account for the lease as an operating lease subsequent to transition.
   a. Write off any unamortized initial direct costs that do not meet the definition of an initial direct cost within the new standard as an adjustment to equity.

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FASB ASU No. 2018-11, *Lease Accounting, Targeted Improvements*

Why was this ASU issued?

FASB issued ASU No. 2018-11 in July 2018 to provide transition guidance to the lease accounting standard for the following issues:

- Comparative reporting requirements for initial adoption
- Lessor accounting for contracts that have both lease and nonlease components

Transition — Comparative reporting at adoption

FASB has added another transition method by allowing entities to initially apply the lease standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or equivalent) in the period of adoption.

Separating components of a contract — Lessor accounting

A practical expedient is provided to lessors that will allow a lessor to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if the nonlease components otherwise would be accounted for under the new revenue recognition guidance and both of the following conditions are met:

- The timing and pattern of transfer of the nonlease component(s) and associate lease component are the same
- The lease component, if accounted for separately, would be classified as an operating lease

If the nonlease components are the predominate components of the contract, account for the contract under the new revenue recognition guidance (FASB ASC 606).

If the lease components are the predominate component of the contract, account for the contract as an operating lease in accordance with FASB ASC 842.

What is the effective date of this ASU?

The amendments in this ASU related to separating components of a contract affect the amendments in ASU No. 2016-02, which are not yet effective but can be adopted early.

For entities that have not adopted FASB ASC 842 before the issuance of this update, the effective date and transition requirements for the amendments in this ASU related to separating components of a contract are the same as the effective date and transition requirements in ASU No. 2016-02.

For entities that have adopted FASB ASC 842 before the issuance of this update, the transition and

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effective date of the amendments related to separating components of a contract in this update are as follows:

1. The practical expedient may be elected either in the first reporting period following the issuance of this ASU or at the original effective date of FASB ASC 842 for that entity.
2. The practical expedient may be applied either retrospectively or prospectively.

All entities, including early adopters, that elect the practical expedient related to separating components of a contract in this ASU must apply the expedient, by class of underlying asset, to all existing lease transactions that qualify for the expedient at the date elected.

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FASB ASU No. 2018-20, *Leases (Topic 842) Narrow-Scope Improvements for Lessors*

Why was this ASU issued?

Stakeholders have informed FASB about certain issues related to lessor accounting that needed clarification. This standard addresses those issues.

Who is affected by this ASU?

Any lessor that collects sales or similar taxes from lessees, any lessor that has a lease that requires a lessee to pay lessor costs directly to a third party or requires a lessee to reimburse a lessor for costs paid by the lessor directly to a third party, and any lessor contract with variable lease and nonlease components.

What are the main provisions of this ASU?

Sales taxes and other similar taxes collected from lessees

Lessors may make an accounting policy election to not evaluate whether certain sales taxes and other similar taxes are lessor costs or lessee costs. Instead, those lessors will account for those costs as if they are lessee costs. Therefore, a lessor making this election will exclude from the consideration and from variable payments not included in the consideration in the contract all collections from lessees of taxes within the scope of the election. Any sales tax or similar tax collected will be accounted for as an agency type transaction. The accounting policy shall be disclosed.

Certain lessor costs

Any lessor costs paid by lessees directly to third parties shall not be accounted for by the lessor. Any costs paid by the lessor and reimbursed directly to the lessor by the lessee shall be accounted for as variable payments and will be considered revenue by the lessor.

Recognition of variable payments for contracts with lease and nonlease components

Lessors will be required to allocate certain variable payments to the lease and nonlease components of a contract when the changes in facts and circumstances related to the variable payments occur. After the allocation, the amount of variable payments allocated to the lease components will be recognized as income in profit or loss in accordance with FASB ASC 842 (Leases), and the nonlease components will be recognized in other topics, such as FASB ASC 606 (Revenue Recognition).

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What is the effective date for this ASU?

For entities that have not adopted the new lease standard (ASU No. 2016-02), this standard will be adopted at the time of the adoption of ASU No. 2016-02.

For entities that have early adopted the new lease standard, this standard should be applied as of the effective date of the adoption of ASU No. 2016-02. An entity can elect to apply the amendments in either the first reporting period ending after the issuance of ASU No. 2018-20, or in the first reporting period beginning after the issuance of ASU No. 2018-20.

An entity may apply the amendments either retrospectively or prospectively.

All entities, including early adopters, must apply this standard to all new and existing leases.

Knowledge check

1. FASB ASU No. 2016-02 applies to leases of

    a. Office property.
    b. Biological assets.
    c. Rights to explore for minerals, oils, or natural gases.
    d. Inventory.

2. Lessors will defer initial direct costs in accounting for which of the following types of leases?

    a. Sales-type lease.
    b. Direct-financing-type lease.
    c. Operating lease.
    d. Capital lease.

3. A lessee shall derecognize assets and liabilities from which type of lease accounted for under existing guidance?

    a. Capital lease.
    b. Operating lease.
    c. Finance lease.
    d. Sales-type lease.

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FASB ASU No. 2021-05, *Leases (Topic 842): Lessors-Certain Leases With Variable Lease Payments*

Why was this ASU issued?

This update was issued as a result of the FASB outreach during the implementation phase of ASU No. 2016-02. An issue was noted for lessors when the underlying lease contract contains variable payments that are not based on a reference index or a rate and would have resulted in the recognition of a selling loss at lease commencement if classified as a sales-type lease or a direct financing lease.

Who is affected by this ASU?

Lessors that classify a lease as a sales-type lease or a direct financing lease when the underlying lease agreement has variable payments that are not based on a reference index or a rate and the classification would have resulted in the recognition of a selling loss at the commencement date.

What are the main provisions of this ASU?

Under existing guidance, a lessor is not permitted to estimate most variable payments and therefore must exclude those payments when determining the lease payments receivable that will be recorded for a sales-type lease or a direct financing lease. If the variable lease payments are based on a reference index or a rate, those variable payments may be included, thus increasing the lease receivable recorded at lease inception. However, if the variable lease payments are not based on a reference index or a rate and are excluded, the resulting lease receivable is less than the carrying value of the underlying asset, therefore causing a loss to be recorded at lease inception.

In order to address this issue, the FASB has reintroduced a concept that was allowed under the old lease guidance (FASB ASC 840). If a lease contains variable payments that are not dependent upon a reference rate index or a rate, that lease should be accounted for by the lessor as an operating lease. When a lease is classified as an operating lease, the lessor neither derecognizes the underlying asset nor recognizes a net investment in the lease.

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What is the effective date of this ASU?

For public entities, this update is effective for fiscal years beginning after December 15, 2021, and interim periods within those years.

For all other entities, this update is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

Entities that have not adopted FASB ASC 842 should implement this update concurrently with the adoption of FASB ASC 842.

Early application is permitted.

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FASB ASU No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

Why was this ASU issued?

The FASB has conducted outreach during the implementation phase of FASB ASC 842 (the new lease standard) in order to facilitate the adoption of the new lease accounting model. As part of this outreach, stakeholders have suggested improvements to the practical expedient that allows nonpublic business entities and not-for-profit entities to use the risk-free discount rate as an accounting policy election when discounting future lease payments to present value. This ASU was issued in response to the concerns of stakeholders.

Who is affected by this ASU?

All nonpublic business entities including not-for-profit entities and employee benefit plans.

What are the main provisions of this ASU?

Under current guidance, an entity that elects to use the risk-free discount rate must use the rate for all lease arrangements. This update will allow qualifying entities more flexibility by applying the practical expedient at the asset class level rather than at the entity-wide level.

This update also requires that when the rate implicit in the lease is readily available for any individual lease, the lessee must use that rate rather than the risk-free rate or the incremental borrowing rate of the lessee. This requirement supersedes the risk-free election.

An entity that elects to use this practical expedient should disclose this accounting policy and to which asset classes it has elected to apply the risk-free rate.

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What is the effective date of this ASU?

Entities that have not yet adopted FASB ASC 842 as of November 11, 2021, are required to adopt the amendments in this ASU at the same time that they adopt FASB ASC 842, using the existing transition provisions. For entities that have adopted FASB ASC 842 as of November 11, 2021, the amendments in this ASU are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application is permitted.

Entities that have already adopted FASB ASC 842 should apply this update on a modified prospective basis to leases that exist at the beginning of the fiscal year of adoption of a final update.

Knowledge check

4. A nonpublic entity or not-for-profit entity may use which rate, instead of the implicit rate or incremental borrowing rate, when discounting future payments under a lease contract to present value?

    a. Fed discount rate.
    b. LIBOR.
    c. Inflation rate.
    d. Risk-free rate.

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Summary

Entities are now in the process of implementing the standards resulting from the joint efforts of the FASB and IASB. Entities should use all of the resources available at the FASB and AICPA website to assist in implementation. Nonpublic companies can use the published financial statements of public companies as a resource in determining compliance with disclosure and measurement requirements.

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Solutions

Financial Instruments and Leases

Knowledge check solutions

1.

   a. Correct. Property leases are included in the scope of FASB ASU No. 2016-02.
   b. Incorrect. Leases of biological assets are scoped out of FASB ASU No. 2016-02.
   c. Incorrect. Leases for rights to explore for minerals, oils, or natural gases are scoped out of FASB ASU No. 2016-02.
   d. Incorrect. Leases of inventory are scoped out of FASB ASU No. 2016-02.

2.

   a. Incorrect. The initial direct costs are expensed in a sales-type lease.
   b. Incorrect. The initial direct costs are expensed in a direct-financing-type lease.
   c. Correct. The initial direct costs are deferred in an operating lease.
   d. Incorrect. Capital lease is no longer a classification that lessors use.

3.

   a. Correct. Capital leases under current guidance will be derecognized.
   b. Incorrect. Operating leases are not recognized as an asset or liability under current guidance.
   c. Incorrect. Finance leases do not exist under current guidance.
   d. Incorrect. Sales-type lease is a lessor accounting issue, not a lessee accounting issue.

4.

   a. Incorrect. The Fed discount rate is not a substitute for the implicit or incremental borrowing rate.
   b. Incorrect. LIBOR may not be used in place of the implicit or incremental borrowing rate.
   c. Incorrect. The inflation rate is not considered a benchmark rate.
   d. Correct. FASB ASU No. 2021-09 allows the risk-free rate to be elected at the account-class level.

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Private Company Financial Reporting

Learning objectives

- Identify the objectives and working plan of the Private Company Council (PCC).
- Determine the updates issued by FASB at the recommendation of the PCC.

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Introduction

Both the Financial Accounting Foundation (FAF) and the International Accounting Standards Board (IASB®) have recognized the need for improvements in financial reporting for private companies, and both have taken steps to introduce standards exclusively for private companies. The FAF has taken a supplemental approach by providing options for private companies for accounting treatment in generally accepted accounting principles (GAAP) for certain accounting issues.

Private Company Council

Introduction

The FAF established the Private Company Council (PCC) on May 30, 2012, to address the concerns of constituents related to the development of financial reporting standards for private companies in the United States. Though the PCC is not the autonomous standard-setting body that many requested, it is the most significant step taken by the FAF related to standards specifically for private companies.

Predecessors to the PCC

Private Company Financial Reporting Committee

The FAF and AICPA jointly formed the Private Company Financial Reporting Committee (PCFRC) in June 2006; Judy O'Dell was the first chair. This committee's objective was to monitor FASB projects and make recommendations regarding the impact, if any, new standards could have on private companies and to propose different standards when deemed appropriate. FASB agreed to consider the recommendations of the PCFRC but was not bound by their recommendations.

Private Company Standards Improvement Council

The Private Company Standards Improvement Council (PCSIC) was proposed by the FAF in response to a report from the blue-ribbon panel on standard setting for private companies. This report urged the FAF to create an independent standard-setting body that would issue financial reporting standards for private companies without ratification by FASB. This council was never formed, however, because of strong opposition from the AICPA, which included a referendum passed at the October 2011 meeting of the AICPA Council. The referendum called for the FAF to create an independent standard-setting body, as had been recommended by the blue-ribbon panel on private company financial reporting. The formation of the PCC was the FAF's response to the referendum.

Formation of the PCC

The FAF issued a final report on May 30, 2012, that established the PCC. The PCC is overseen by the FAF trustees and replaces the PCFRC. The trustees appointed both a FASB member as liaison and a FAF

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observer to monitor the activities of the PCC and to provide support in the achievement of the PCC's objectives.

The PCC has two primary objectives:

- Study the existing FASB *Accounting Standards Codification®* (ASC) to determine if any changes are necessary to enhance financial reporting for private companies.
- Serve as an advisory board to FASB as new ASUs are being deliberated by considering the effects of those updates on private companies.

Knowledge check

1. What is the objective of the PCC?

    a. To provide oversight to the development of Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs framework).
    b. To serve in an advisory capacity to FASB.
    c. To establish a separate set of standards for private companies in the United States.
    d. To provide input to the continued development of *IFRS for SMEs*.

Highlights of 2022 PCC meetings

In this section, you will find a summary of the topics discussed at the 2022 PCC meetings. Meeting materials, including full meeting minutes, can be found at http://www.fasb.org/pcc.

April 21–22, 2022, meeting

Profits interests and their interrelationship with partnership accounting

FASB staff summarized past research (including outreach) and provided its analysis and recommendations on the issue of determining the appropriate scope of guidance for profits interests awards (that is, Topic 710, Compensation — General, or Topic 718, Compensation — Stock Compensation). The staff also highlighted how certain potential solutions might affect public business entities. PCC members recommended that FASB add a project to its technical agenda to address the issue of determining the appropriate scope of guidance for profits interests awards. They noted that diversity in practice and cost and complexity result from the lack of authoritative guidance that explicitly addresses profits interests and that the issue potentially affects both public business entities and private companies. Overall, PCC members supported developing illustrative examples to include in the IRC and potentially providing additional educational materials.

Leases implementation issues

PCC members discussed challenges private companies are facing when adopting Topic 842, *Leases*, including evaluating individually immaterial lease agreements that may or may not be material in the aggregate, allocating costs to lease and nonlease components, and addressing diversity in practice in the accounting for contingent lease incentives. FASB staff and PCC members also discussed (*a*) whether

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private companies are expected to elect the practical expedient that allows lessees to combine lease and nonlease components and account for the combined component as a single lease component, (*b*) the use of capitalization thresholds, and (*c*) the use of leasing software by private companies.

Credit losses

FASB staff provided an overview of Accounting Standards Update (ASU) No. 2022-02, Financial Instruments — Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures, which was issued on March 31, 2022. PCC members noted that the disclosure requirements provide decision-useful information to investors. The staff also provided background on FASB's decision not to further defer the effective date for nonpublic entities to apply Topic 326, *Financial Instruments — Credit Losses*. PCC members shared their observations on nonpublic entities' readiness to adopt the current expected credit losses guidance.

Current issues in financial reporting

PCC members discussed practice issues arising from the current business environment. Topics discussed included disclosures about the Paycheck Protection Program and the accounting and reporting for employee retention credits included in the Coronavirus, Aid, Relief, and Economic Security (CARES) Act and subsequent COVID-19-related legislation.

FASB agenda consultation: FASB staff summarized FASB's discussions and decisions made so far resulting from stakeholder feedback received in response to the June 2021 FASB Invitation to Comment (ITC), *Agenda Consultation* (the Agenda Consultation ITC). FASB staff updated the PCC on changes made to the research agenda and the technical agenda and updated the PCC on next steps. PCC members asked about FASB's recent removal of the Distinguishing Liabilities from Equity Phase 2 project from the technical agenda, citing continued challenges for private companies in applying the liabilities and equity guidance.

Accounting for government grants, invitation to comment: FASB staff summarized the feedback received on the Agenda Consultation ITC on the accounting for government grants and the objective of the recently added FASB research project. The staff plans to issue an ITC to solicit feedback on whether certain requirements in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, represent a workable solution for improving the accounting for government grants under U.S. GAAP. PCC members provided feedback on potential areas for FASB staff to research, including investor preferability for gross versus net presentation, clarifying the scope of government grants, and the recognition and measurement of government grants.

Accounting for and disclosure of intangibles: FASB staff summarized this FASB research project (which includes software costs, internally developed intangibles, and research and development), existing guidance, feedback received on the Agenda Consultation ITC, and next steps. PCC members expressed support for this research project, citing the increased prevalence of intangible assets in private companies and the differences in the accounting treatment of internally generated intangibles and of acquired intangibles. PCC members also noted the complexity and undue costs associated with the accounting for software costs because of the evolving nature of software.

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Accounting for financial instruments with environmental, social, and governance (ESG)-linked features and regulatory credits: FASB staff summarized the background, feedback received on the Agenda Consultation ITC, and next steps of the recently added FASB research project. PCC members discussed their experience with financial instruments with ESG-linked features, noting that it is an emerging area that could become more prevalent for private companies. PCC members encouraged FASB to monitor how ESG-related activities could affect financial reporting.

Reference rate reform — Deferral of the sunset date of Topic 848

FASB staff provided an update on the amendments in the proposed ASU, Reference Rate Reform (Topic 848) and Derivatives and Hedging (Topic 815): Deferral of the Sunset Date of Topic 848 and Amendments to the Definition of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate. The PCC Chair noted that some of her private company clients are starting to transition away from LIBOR and expressed support for the amendments in the proposed ASU.

June 23–24, 2022, meeting

Accounting for and disclosure of digital assets

Staff summarized FASB's recent decision to add a project on digital assets to its technical agenda, the project's background and scope, and issues related to current practices for digital asset accounting. PCC members noted that this is a growing area of interest for private company preparers and practitioners. Specifically, PCC members discussed the need for guidance on the recognition, measurement, and balance sheet classification of digital assets. PCC members also discussed the enhanced internal controls needed to audit digital assets, the volatility inherent in using the impairment model, and the accounting for digital assets used to settle receivables.

Emerging Issues Task Force (EITF) Issue No. 21-A, "Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method"

FASB staff provided the PCC with an overview of the project, the consensus-for-exposure reached by the EITF, and next steps. The PCC member who observes EITF meetings provided additional details about certain aspects of the project (for example, transition method). In response to PCC member questions, FASB staff clarified that the project focuses on investments in certain tax credit structures by tax equity investors and not on the accounting by project sponsors. PCC members expressed support for the consensus-for-exposure reached by the EITF.

Identifiable intangible assets and subsequent accounting for goodwill

Staff highlighted FASB's recent decision to deprioritize and remove the project from its technical agenda and noted FASB's continued interest in monitoring the IASB's Goodwill and Impairment project.

Disaggregation — Income statement expenses

FASB staff provided an overview of the feedback on income statement expense disaggregation received in response to the 2021 FASB ITC, *Agenda Consultation* (the Agenda Consultation ITC); the background

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on the agenda project; and the feedback on income statement expense disaggregation received during prior PCC meetings. FASB staff solicited feedback from PCC members on private company practices on income statement presentation; the need for further disaggregation of cost of sales and selling, general, and administrative expenses in private company financial statements; and potential disaggregation principles and approaches. PCC members were generally supportive of exploring further expense disaggregation but expressed varying views on the most appropriate approach and factors to consider. PCC members who are users discussed the benefits of incremental disaggregation, including the ability to better understand an entity's operating leverage, predict future cash flows, and distinguish between an entity's periodic expenses and costs incurred as an investment in the business. PCC members who are preparers and those who are practitioners raised concerns about a disaggregation principle that may be costly to implement and whether the benefits to users would exceed those costs.

Agenda consultation

FASB staff updated the PCC on FASB's recent discussions and decisions in response to stakeholder feedback received on the Agenda Consultation ITC, the resulting changes to the research and technical agendas, and next steps. The FASB Chair explained the objective of the newly added research project, Financial Key Performance Indicators for Business Entities, and its interdependency with the Disaggregation — Income Statement Expenses project. PCC members asked about FASB's recent removal of the Leases (Topic 842): *Lease Modifications* project from the technical agenda. FASB staff explained that stakeholder feedback had indicated that there was not a pervasive need to amend the guidance at this time. Additionally, because Topic 842 is currently being implemented by nonpublic entities, FASB did not want to propose amendments at this time. FASB staff also noted that outreach will continue in this area in connection with post-implementation review activities.

Leases — Implementation issues

A PCC member who is a preparer highlighted the topics discussed at the Leases Implementation Best Practices session of the June 2022 AICPA ENGAGE conference. Those topics included embedded leases, capitalization thresholds, discount rates, lease and nonlease components, and related party leases. That member also discussed the effect of applying Topic 842, Leases, on internal controls and the use of software to comply with that topic. PCC members highlighted related party leases as an area that received significant attention during both the Leases Implementation Best Practices session and the PCC Town Hall meeting at the same conference. PCC members noted that many related party leases are between entities under common control, some of which have written terms that may not be at arm's length and others that are unwritten. PCC members emphasized that those factors make it difficult for private companies to determine the legally enforceable terms of a related party arrangement for purposes of applying Topic 842. PCC members discussed ways in which they (or FASB) could assist private company stakeholders in applying the related party leases requirements in Topic 842 through either educational materials (such as an FASB Staff Q&A) or IRC improvements. The PCC also discussed performing outreach with private company stakeholders to determine whether the issue with applying the Topic 842 related party leases requirements is limited to common control arrangements or includes other related party arrangements.

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Accounting for environmental credit programs

FASB staff summarized this FASB technical agenda project, feedback received on the Agenda Consultation ITC, recent FASB decisions made, and next steps. PCC members noted that while private companies enter into certain ESG-related transactions, PCC members have limited experience to date with environmental credit programs.

Stock compensation disclosures

FASB staff provided the PCC with an update on the formation of a working group and noted that the initial working group meeting is scheduled for the end of June. The staff noted that the initial objective of the working group is to determine whether a problem exists in the area of stock compensation disclosures for private companies. The working group comprises three PCC members and a member of the AICPA's Private Companies Practices Section Technical Issues Committee. The PCC Chair acknowledged recent feedback received from some private company stakeholders that stock compensation is not an area that broadly affects all private companies and indicated that the PCC will be cognizant of balancing its resources in this area with other broader issues facing private companies.

Other business

The PCC Chair highlighted an issue on the accounting for increasing freight costs related to inventory and whether those freight costs should be expensed or capitalized. The PCC Chair referenced guidance that exists in Topic 330, Inventory, to assist private company stakeholders in accounting for such freight costs.

September 22–23, 2022, meeting

Targeted improvements to income tax disclosures

PCC members discussed the two areas of income tax disclosures that FASB is considering for potential improvements (specifically, income taxes paid and rate reconciliation). PCC members who are users noted that disaggregated income tax information would help them better understand a company's tax risks and opportunities, assess trends, highlight persistence of taxes across jurisdictions, and highlight areas in which to ask management for more information. Some PCC members who are preparers noted that although information about income taxes paid by jurisdiction is readily available, they question the relevance of disclosing such information. Those PCC members also expressed concern that although a quantitative rate reconciliation could be provided, it would create undue costs compared to the narrative disclosures currently required for private companies.

Leases (Topic 842): Common control arrangements

Staff highlighted FASB's recent decision to add a project to its technical agenda to address the following issues related to arrangements between entities under common control: (1) what terms and conditions an entity should consider for determining whether a lease exists and, if a lease does exist, the classification and accounting for that lease, and (2) accounting for leasehold improvements associated with leases between entities under common control. Most PCC members were supportive of the practical expedient that would allow private companies and not-for-profit entities that are not conduit

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bond obligors, on an arrangement-by-arrangement basis, to use written terms and conditions to (1) determine whether an arrangement is a lease, and, if so, (2) classify and account for that lease. Under the practical expedient, an entity would not have to determine whether the written terms and conditions are legally enforceable. However, if no written terms and conditions exist, an entity would continue to use enforceable rights and obligations to apply Topic 842, which is consistent with the requirements for all other arrangements. One PCC member expressed concern that written terms alone may not reflect the economic substance of the lease. PCC members also discussed specific challenges when accounting for leasehold improvements in arrangements between entities under common control, including the determination of an appropriate lease term, and the need for sufficient disclosures to provide decision-useful information to financial statement users.

Accounting for and disclosure of software costs

Staff summarized FASB's recent decision to add a project on software costs to its technical agenda and potential alternatives being explored by the staff. Some PCC members expressed concerns that significant judgment may be required to identify capitalizable software costs, such as labor costs. PCC members also noted that additional disclosures about software costs may be decision useful. PCC members expressed mixed views on whether a principles-based model for capitalization or an alternative to expense all software costs would be operable or more relevant. Some PCC members asserted that software costs are not a prevalent issue for private companies and that it may be difficult for preparers to determine a useful life for certain software assets.

Profits interests

FASB staff provided input about (1) potential illustrative examples to clarify how an entity would apply the existing scoping guidance in Topic 718, Compensation — Stock Compensation, to various profits interest awards and (2) potential transition guidance for those examples. Overall, PCC members were supportive of the illustrative examples and the staff's approach to align those examples with the current scoping guidance in Topic 718. Some PCC members suggested that FASB staff consider whether additional fact patterns should be incorporated into the examples. Overall, PCC members were supportive of a prospective transition method with qualitative disclosures. A few PCC members indicated that retrospective application should be a permitted transition method.

Accounting for and disclosure of crypto assets

Staff summarized FASB's decisions to add a project on crypto assets to its technical agenda and to establish the scope of the project. FASB staff provided an overview of current practices for accounting for crypto assets under Topic 350, Intangibles — Goodwill and Other. Some PCC members questioned whether the scope of the project, which excludes nonfungible assets, will sufficiently address the need for standard setting in this area. FASB staff and members noted that the project's scope would represent a significant portion of crypto asset market capitalization. PCC members were generally supportive of including public and nonpublic entities within the project's scope.

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Conceptual Framework: The reporting entity

FASB staff provided an overview of the Conceptual Framework and its role in standard setting. The discussion focused on the definition of a reporting entity, the criteria for recognition and derecognition, and the importance of removal of the term "sufficient reliability" from the measurement criteria. It was noted that the Conceptual Framework is nonauthoritative and does not establish or change GAAP.

Stock compensation disclosures

FASB staff and members of the stock compensation disclosures working group provided the PCC with an update on the working group's progress. The working group has met twice since the June 2022 PCC meeting to analyze the user relevance of the current disclosure requirements and the cost and complexity to prepare and audit those disclosures. The working group will conduct outreach with various types of private company financial statement users to solicit feedback on an illustrative example.

Other business

A PCC liaison meeting was held with members of the Risk Management Association (RMA) on October 13, 2022. RMA members who participated in the liaison meeting represent lenders and creditors to private companies.

December 16, 2022 Meeting

Summary of December 16, 2022, meeting with the AICPA Private Companies Practice Section, Technical Issues Committee (TIC)

PCC members reported on the issues discussed with the TIC during their annual PCC-TIC Liaison meeting. PCC members shared observations on a variety of topics including the implementation of Topic 842, Leases, accounting for common control arrangements, stock compensation disclosures, accounting for and disclosure of software costs, joint venture formations, and taxes paid by pass-through entities.

Leases (Topic 842): Common control arrangements

The PCC discussed the post-implementation review activities related to Topic 842, Leases, including the proposed ASU to improve accounting guidance for arrangements between entities under common control. PCC members were supportive of the proposed practical expedient that would allow nonpublic entities to use written terms and conditions of an arrangement between entities under common control to determine whether a lease exists, and, if so, the accounting for that lease. Some members discussed the degree of formality required in documenting agreed upon terms and conditions, with those members observing that entities have latitude to use reasonable judgment when deciding how the terms and conditions of the arrangement are conveyed in writing. The proposed ASU also, allows leasehold improvements associated with arrangements between entities under common control to be amortized by the lessee over the economic life of the leasehold improvements as long as the lessee controls the use of the leased asset. PCC members discussed the judgment required under current GAAP to determine the owner of improvements made by a lessee to the leased asset in a common control lease

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for purposes of determining whether the lessee capitalizes those improvements as leasehold improvements. Those PCC members acknowledged that the issue with that determination is not unique to common control arrangements or the adoption of Topic 842 (that is, that same determination also was being made under Topic 840, Leases).

Accounting for government grants, ITC

The PCC reviewed a summary of the feedback received in response to the ITC — *Accounting for Government Grants by Business Entities: Potential Incorporation of IAS 20, Accounting for Government Grants and Disclosure of Government Assistance*, *into Generally Accepted Accounting Principles*. Overall, PCC members were supportive of a project that would result in the development of accounting guidance for recognition, measurement, and presentation of government grants using IAS 20 as a starting point. Given the pervasiveness of government grants, some PCC members noted that IAS 20 permits different recognition, measurement, and presentation based on the type of grant, which could result in a workable solution to account for based on the types of grants. Some PCC members stated that there are challenges with certain aspects of IAS 20, such as applying the reasonable assurance threshold for recognition. PCC members discussed how additional examples could be helpful when accounting for various types of government grants. PCC members who are users emphasized the need for conservatism and consistency in the accounting, in addition to understanding the predictability and risk related to future cash flows.

Revenue: Implementation issues

The PCC discussed the post-implementation review activities completed to date for Topic 606, Revenue from Contracts with Customers. PCC members were generally supportive of the revenue standard. PCC members also observed some ongoing implementation challenges for private companies in the following areas:

- Insufficient familiarity with Topic 606, especially by smaller companies/firms
- Disclosures about opening contract balances
- Principal versus agent determination in service transactions

Scope application of profits interests awards: Compensation — Stock compensation (Topic 718)

The PCC reviewed FASB's recent decision to add a project to its technical agenda that would add illustrative examples to the IRC to demonstrate how an entity would apply the scope guidance in Subtopic 718-10, Compensation — Stock Compensation — Overall, to determine whether a profits interest or similar award should be accounted for by applying Topic 718. A proposed ASU is expected to be issued in early 2023 with a 60-day comment period. PCC members expressed support for the project and related FASB decisions on the illustrative examples and transition. Some PCC members suggested that FASB increase communication about the project with smaller entities who may not be aware of the proposed guidance.

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Accounting for and disclosure of software costs

The PCC reviewed and discussed recent outreach and the alternatives being explored by the staff for future consideration by FASB. Many PCC members supported the initial development cost model. One PCC member supported a model that would expense all software development costs, while other PCC members acknowledged the lack of a conceptual basis in that model. PCC members discussed the challenges with distinguishing between maintenance and enhancements, tracking software development activities, and determining a useful life for software with continued enhancements under a capitalization model. PCC members who are users supported increased transparency about software costs and highlighted that their focus is to predict future cash flows.

Accounting for and disclosure of crypto assets

The PCC reviewed FASB's recent decisions on scope, measurement, presentation, and disclosure. One PCC member commented on FASB's decision to exclude a disclosure about the nature and purpose of crypto asset holdings. In contrast, another PCC member observed that users of private company financial statements have access to management that allows them the opportunity to ask questions about the nature and purpose of crypto asset holdings.

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FASB ASU No. 2013-12, Definition of a Public Business Entity — An Addition to the Master Glossary

Why was this ASU issued?

This ASU is designed to minimize the inconsistency and complexity of having multiple definitions of, or diversity in practice regarding what constitutes, a nonpublic entity and a public entity within GAAP on a going-forward basis. This project is related to the development of the *Private Company Decision-Making Framework* (the Guide).

Who is affected by this ASU?

The definition of a public business entity will be used in considering the scope of *new* financial reporting guidance issued through FASB ASUs going forward and will identify whether such new guidance does or does not apply to public business entities. The definition excludes a not-for-profit entity within the scope of FASB ASC 958, *Not-for-Profit Entities*, or an employee benefit plan within the scope of FASB ASC 960 through 965 on plan accounting. Business entities that are within the scope of the Guide are those for which FASB and the PCC will consider potential financial accounting and reporting alternatives within GAAP.

Note: This new definition of a public business entity does not supersede any existing definitions in the FASB ASC Master Glossary and does not affect the scope of any existing topics in FASB ASC. All existing topics will continue to use previously existing definitions to determine scope.

What are the main provisions of this ASU?

The definition of *public business entity* differs from some of the existing definitions of public entity in FASB ASC. The amendment specifies the following:

- An entity that is required by the SEC to file or furnish financial statements with the SEC or does file or furnish financial statements with the SEC is considered a public business entity. Some of the existing definitions of public entity in FASB ASC do not include this criterion to define public entity.
- A consolidated subsidiary of a public company is not considered a public business entity for purposes of its stand-alone financial statements other than those included in an SEC filing by its parent or by other registrants or those that are issuers and are required to file or furnish financial statements with the SEC. Some of the existing definitions of public entity in FASB ASC consider a consolidated subsidiary of a public company to be public.
- A business entity that has securities that are not subject to contractual restrictions on transfer and that is by law, contract, or regulation required to prepare GAAP financial statements (including footnotes) and make them publicly available on a periodic basis is considered a public business entity. The existing definitions of public entity in FASB ASC do not include this criterion and do not consider an entity to be public unless it meets one of the other criteria included in the definition

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(for example, if it has debt or equity securities that trade either on a stock exchange or an over-the-counter market).

What is the effective date of this ASU?

There is no actual effective date for the amendment in this ASU. However, the term *public business entity* will be used in future ASUs to establish scope and applicability of new guidance.

Knowledge check

2. Which does FASB ASU No. 2013-12 include within the definition of a public business entity?

    a. An entity that is required by the SEC to file financial statements with the SEC.
    b. An entity that has issued securities using a private placement memorandum.
    c. Governmental organizations.
    d. A foreign company that does business in the United States.

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FASB ASU No. 2016-03, Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (a consensus of the Private Company Council)

Why was this ASU issued?

When FASB began issuing updates that were a consensus of the PCC and provided an alternative accounting treatment available to private companies, a "grace period" was provided that allowed private companies to adopt these updates without doing the required assessment of preferability. The grace period was the time from the issuance of the update to the effective date. If an entity adopted these updates after the effective dates, then they would have to justify adoption by assessing the preferability of the update.

The PCC received feedback from private company stakeholders who said that this requirement would deter private companies from adopting some or all of the updates at a future date and would create an unnecessary obstacle for future adoption. There was also concern that favorable transition guidance would not be available for entities that elected to adopt these updates after their effective dates.

Who is affected by this ASU?

The amendments in this update could affect all private companies within the scope of FASB ASU No. 2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill;* FASB ASU No. 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach*; FASB ASU No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*; and FASB ASU No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination*. In other words, this applies to any entity that had not elected the provisions of these updates by the initial effective date.

What are the main provisions of this ASU?

The amendments in this ASU make the guidance in FASB ASU Nos. 2014-02, 2014-03, 2014-07, and 2014-18 effective immediately by removing their effective dates. The amendments also include transition

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provisions that provide that private companies are able to forgo a preferability assessment the first time they elect the accounting alternatives within the scope of this ASU. Any subsequent change to an accounting policy election requires justification that the change is preferable under FASB ASC 250, *Accounting Changes and Error Corrections*.

The amendments in this ASU also extend the transition guidance in FASB ASU Nos. 2014-02, 2014-03, 2014-07, and 2014-18 indefinitely. Although this ASU extends transition guidance for FASB ASU Nos. 2014-07 and 2014-18, there is no intention to change how transition is applied for those two ASUs.

What is the effective date of this ASU?

This ASU became effective upon issuance.

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FASB ASU No. 2014-02, Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)

Why was this ASU issued?

Accounting for goodwill became more complex in 2002, with the requirement of an annual impairment test for goodwill. Despite a later ASU that allowed for a qualitative assessment of goodwill that could preempt the need for the quantitative impairment test, many private companies found compliance costly and complex due to the difficulty in determining the fair value of reporting units and, in some cases, allocating goodwill to reporting units. This ASU was issued to provide private companies with an alternative method of accounting for goodwill that would require fewer resources to implement.

Who is affected by this ASU?

This ASU applies to all entities except

- public business entities and not-for-profit entities as defined in the Master Glossary of FASB ASC.
- employee benefit plans within the scope of FASB ASC 960 through 965.
- financial institutions as described in FASB ASC 942-320-50-1.

What are the main provisions of this ASU?

An entity that elects to apply the provisions of this ASU can amortize goodwill on a straight-line basis over 10 years, or fewer than 10 years if the entity demonstrates that a shorter life is more appropriate.

An entity will also be required to make an accounting policy election to test goodwill for impairment at either the entity level or the reporting unit level when a triggering event occurs that indicates that the fair value of the entity or the reporting unit may be less than the carrying amount. The entity also has the option to perform a qualitative assessment to determine whether the quantitative impairment test is necessary.

When an impairment test is deemed necessary, the ASU allows for a one-step test to be conducted and eliminates step two of the current impairment test in FASB ASC 350-20 (which requires the hypothetical application of the acquisition method to calculate the goodwill impairment amount). Under the one-step test, the goodwill impairment amount, if any, represents the excess of the entity's (or the reporting unit's) carrying amount over its fair value (limited to the carrying amount of goodwill of the entity [or reporting unit]).

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What is the effective date of this ASU?

FASB issued ASU No. 2016-03 in March 2016, stating that the guidance in ASU No. 2014-02 is effective immediately upon issuance of ASU No. 2016-03 for new goodwill. For existing goodwill, the guidance is effective as of the beginning of the first fiscal year in which the accounting alternative is adopted.

The following example illustrates disclosure when adopting the accounting alternative for goodwill in FASB ASU No. 2014-02.

Example: Goodwill — Accounting alternative

Facts

A company that is not publicly traded has carried the asset goodwill in the amount of $3,000,000 since a business combination was recorded in 2007. Management of the company has spent considerable resources each year in obtaining a valuation of the reporting unit that contains the goodwill.

Management has not yet issued the December 31, 2013, financial statements as of January 29, 2014, and they have become aware of FASB ASU No. 2014-02 that will allow an election by management to amortize goodwill. Management determines that it is appropriate to make the election to amortize goodwill, and now records amortization expense of $300,000 ($3,000,000 ÷ 10). Management has determined that it is not appropriate to amortize the goodwill for a period shorter than 10 years.

In addition, the following disclosures are made in the summary of significant accounting policies and goodwill footnotes:

Summary of significant accounting policies (excerpt)

Goodwill

Prior to the year ended December 31, 2013, ABC Company accounted for goodwill in accordance with FASB ASC 350, *Intangibles–Goodwill and Other*. Those standards required an annual impairment test for goodwill. Goodwill was not amortized under FASB ASC 350.

The company has elected to apply the provisions of FASB ASU No. 2014-02 for the year ended December 31, 2013, which allows private companies the option of amortizing goodwill using the straight-line method over a period of 10 years, or a period of less than 10 years if the shorter period is more appropriate.

Change in accounting policies

ABC Company has elected to apply the provisions of FASB ASU No. 2014-02 for the year ended December 31, 2013, as described in the subsection titled “Goodwill” in this summary of significant accounting policies.

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Example: Goodwill — Accounting alternative (continued)

Goodwill (excerpt)

ABC Company has elected to apply the provisions of FASB ASU No. 2014-02 for the year ending December 31, 2013. Prior to the adoption of this standard, ABC Company has not amortized goodwill. Amortization of goodwill over a 10-year period using the straight-line method reflects an amortization expense for the year in the amount of $300,000. Goodwill is presented on the balance sheet as follows:

Goodwill	$ 3,000,000
Accumulated amortization	300,000
Goodwill, net of amortization	$ 2,700,000

Knowledge check

3. In which manner does FASB ASU No. 2014-02 allow private companies the option to account for goodwill?

   a. Amortize over the same period as the company uses for income tax purposes.
   b. Perform the annual impairment test only at year-end.
   c. Amortize over a 10-year period in any systematic manner.
   d. Amortize over a 10-year period using the straight-line method.

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FASB ASU No. 2014-03, Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach (a consensus of the Private Company Council) — Amended by ASU No. 2016-03

Why was this ASU issued?

Many private companies found accounting for plain vanilla interest rate swaps to be very time-consuming and expensive under existing GAAP. Most private companies that entered into plain vanilla interest rate swaps did so concurrently with the issuance of the variable interest debt instrument and were not subject to many of the risks that accompany an investment in a derivative financial instrument. Also, in some cases, management of the private company did not even understand that they had two separate financial instruments; they thought they had a fixed-rate loan.

In order to implement hedge accounting for the interest rate swaps, a company had to test the effectiveness of the hedge and also had to comply with many other provisions of FASB ASC 815, *Derivatives and Hedging*. Because of the complexities involved, many private companies did not elect to implement hedge accounting, and therefore reported the fair value of the hedging instrument as either an asset or a liability at each balance sheet date, with a resulting gain or loss in earnings. The resulting volatility to earnings concerned many users and preparers of financial statements for private companies.

This ASU was issued by FASB at the recommendation of the PCC in order to ease the burden of accounting for plain vanilla interest rate swaps for private companies by allowing companies to elect the simplified hedge accounting approach.

Who is affected by this ASU?

This ASU applies to all entities except the following:

- Public business entities and not-for-profit entities as defined in the Master Glossary of FASB ASC.
- Employee benefit plans within the scope of FASB ASC 960 through 965.
- Financial institutions as described in FASB ASC 942-320-50-1.

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What are the main provisions of this ASU?

This ASU allows eligible private companies the option to elect the simplified hedge accounting approach for plain vanilla interest rate swaps. This approach allows an entity to record interest expense at the effective fixed rate that is achieved through the use of the hedging instrument (that is, the interest rate swap). In order to apply the provisions of this ASU, an entity must ensure that the following criteria are met when the debt instrument and the interest rate swap are consummated:

- Both the variable rate on the swap (instrument 1) and borrowing (instrument 2) are based on the same index and reset period.
- The terms of the swap are typical of a plain vanilla interest rate swap, and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a similar floor or cap.
- The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- The swap's fair value at inception is at or near zero.
- The notional amount of the swap matches the principal amount of the borrowing being hedged. The amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- All interest payments occurring on the borrowing during the term of the swap are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

Entities that elect the simplified hedging accounting approach have the option to measure the designated swap at settlement value instead of fair value. Electing to measure at the settlement value will eliminate the need to consider non-performance risk, thus allowing a company to estimate the settlement value by performing a present value calculation of the swap's remaining cash flows using a valuation technique that is not adjusted for non-performance risk. Typically, settlement value will be provided by the bank that issued the variable debt instrument and the interest rate swap.

The documentation, disclosure, and all other requirements of FASB ASC 815 continue to apply for the swap accounted for under the simplified hedge accounting approach.

What is the effective date of this ASU?

FASB issued ASU No. 2016-03 in March 2016, stating that guidance in ASU No. 2014-03 should be applied as of the beginning of the first fiscal year in which the approach is elected.

A company that adopts the provisions of this ASU will have the option of using the modified retrospective approach or the full retrospective approach.

Modified retrospective approach

Under this approach, adjustments are made to the assets, liabilities, and appropriate equity accounts of the current period presented to reflect application of hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered into by the entity.

Full retrospective approach

Under this approach, the financial statements will be adjusted to reflect the period-specific effects of applying hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered

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into by the entity and the corresponding adjustments should be made to the assets, liabilities, and appropriate equity accounts of the earliest period presented to reflect application of hedge accounting from the date the receive-variable, pay-fixed interest rate swap was entered into by the entity.

Knowledge check

4. If a private entity elects the provisions of ASU No. 2014-03 for the treatment of plain vanilla interest rate swaps, the entity should measure the interest rate swap at each balance sheet date at

    a. Fair value.
    b. Historical cost.
    c. Settlement value.
    d. Impaired value.

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FASB ASU No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* (a consensus of the Private Company Council) — Amended by ASU No. 2016-03

Why was this ASU issued?

Private companies sometimes lack the resources to both identify and value certain intangible assets acquired in a business combination. As a result, the benefits from current accounting required for identifiable intangible assets acquired in a business combination may not justify the related costs. This ASU is meant to reduce the cost and complexity associated with the measurement of certain identifiable intangible assets without significantly diminishing decision-useful information to users of private company financial statements.

Who is affected by this ASU?

The amendments in this ASU, at an entity's election, apply to all entities except public business entities and not-for-profit entities as defined in the Master Glossary of FASB ASC.

What are the main provisions of this ASU?

A private company can elect an accounting alternative to not recognize separately from goodwill the following intangible assets:

- Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of the business. Examples of customer-related intangible assets that may meet this criteria are
  - mortgage servicing rights,
  - commodity supply contracts,
  - core deposits, and
  - customer information (mailing lists, email addresses).
- Noncompetition agreements.

As a result of this ASU, some intangible assets that, under current guidance, would be separately identified and thus measured at fair value in a qualifying transaction (typically a business combination), would now be subsumed into goodwill. It is important to note that the accounting alternative would affect initial and subsequent measurement for these assets.

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A qualifying or in-scope transaction to which the alternative applies is a transaction accounted for by

- applying the acquisition method of accounting in FASB ASC 805, *Business Combinations*,
- assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method under FASB ASC 323, *Investments — Equity Method and Joint Ventures*, and
- adopting fresh-start reporting under FASB ASC 852, *Reorganizations*.

An entity that elects treatment of the accounting alternative in this ASU is required to also adopt the accounting alternative to amortize goodwill under ASU No. 2014-02. However, an entity that elects the accounting alternative in ASU No. 2014-02 is not required to adopt the amendments in this update.

What is the effective date of this ASU?

FASB issued ASU No. 2016-03, which states that upon adoption of ASU No. 2014-18, the guidance is effective prospectively to the first transaction that is identified within the scope of the accounting alternative.

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FASB ASU No. 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities

Why was this ASU issued?

The PCC identified potential improvements to financial reporting by further reducing the requirement that certain entities consolidate variable interest entities (VIEs). Currently, entities that have certain common control leasing arrangements are exempt from consolidation. The PCC believed that this exemption should apply to all VIEs if both the primary beneficiary and the VIE are not public companies.

Who is affected by this ASU?

This amendment affects all entities that must evaluate whether they should consolidate a legal entity as a VIE except for public entities, non-for-profit entities, as defined in the Master Glossary of FASB ASC, and employee benefit plans, within the scope of FASB ASC 960 through 965.

What are the main provisions of this ASU?

Election to not recognize certain VIEs (Private Company Council Alternative)

A private entity may elect to not apply VIE guidance to legal entities under common control if both the parent and the legal entity being evaluated for consolidation are not public business entities.

This alternative allows for an election to be made that will apply to all current and future legal entities under common control that meet the criteria for applying this alternative.

Note: This election applies only to the VIE guidance. Other factors may still cause an entity to consolidate a subsidiary such as the voting interest criteria.

An entity that elects this guidance will be required to provide detailed disclosures about its involvement with the legal entity under common control, and exposure to liabilities as follows:

1. The nature and risks associated with a reporting entity's involvement with the legal entity under common control
2. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows
3. The carrying amounts a classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control
4. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the amount cannot be quantified, that fact shall be disclosed

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a. If the maximum exposure to loss exceeds the net carrying amount of assets and liabilities reported in the third item, the disclosures shall include information that will allow users to understand the excess exposure. This information shall include, but is not limited to, the following:
    i. Terms of arrangements, both implicit and explicit, that could require the reporting entity to provide financial support
    ii. Events and circumstances that could expose the reporting entity to a loss

FASB ASC 810-10-50-2AI explicitly states that the disclosures required under this guidance should not be included with other disclosures such as related party or guarantees or cross-referenced to such disclosures. Therefore, an entity shall be required to have separate disclosure of all required items.

What is the effective date of this ASU?

For private companies, this ASU is effective for fiscal years beginning after December 15, 2020, and interim periods for fiscal years beginning after December 15, 2021.

Transition

All entities are required to apply the amendments in this ASU retrospectively with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented.

Knowledge check

5. Entities that elect **not** to consolidate variable interest entities under ASU No. 2018-17 must disclose certain information related to the VIE in which manner?

    a. In the summary of significant accounting policies.
    b. In a related party footnote.
    c. Separate disclosures are not required.
    d. In a separate, discrete footnote.

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FASB ASU No. 2019-06: Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities

Why was this ASU issued?

When FASB issued ASU No. 2014-18 that provided relief to private companies in accounting for goodwill, FASB acknowledged that the relief could be appropriate for not-for-profit entities as well as public companies. Therefore, FASB added a project to its agenda to explore the possibility of extending the relief to not-for-profit entities. FASB has concluded that the cost of using an impairment-only model for not-for-profit entities does not exceed the benefit and issued this standard in response.

Who is affected by this ASU?

Any entity that meets the definition of a not-for-profit entity is defined as an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- Contributions of significant amounts of resources from resource providers that do not expect commensurate or proportionate pecuniary return
- Operating purposes other than to provide goods or services at a profit
- Absence of ownership interests like those of business enities

What are the main provisions of this standard?

The amendments in this ASU extend the private company alternatives from FASB ASC 350 (ASU No. 2014-02) and FASB ASC 805 (ASU No. 2014-18) to not-for-profit entities.

A not-for-profit entity that elects the alternative in FASB ASC 350 will amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the entity can establish that a shorter life is more appropriate.

The entity is also required to make an accounting policy election to test for goodwill impairment at either the entity level or the reporting unit level when a triggering event occurs that indicates the fair value of the entity (or a reporting unit) may be below its carrying amount.

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For acquisition transactions occurring after adoption of the alternative in FASB ASC 805, a not-for-profit entity should subsume into goodwill and amortize customer-related intangible assets that are not capable of being sold or licensed independently, including all noncompetition agreements acquired.

A not-for-profit entity that elects treatment of the accounting alternative in FASB ASC 805 is required to also adopt the accounting alternative in FASB ASC 350 to amortize goodwill. However, a not-for-profit entity that elects the accounting alternative in FASB ASC 350 is not required to adopt the accounting alternative in FASB ASC 805.

What is the effective date of this ASU?

This standard was effective upon issuance, May 2019.

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Summary

As U.S. GAAP becomes more complex, especially with the implementation of revenue recognition, lease accounting, and credit losses, many nonpublic companies are searching for alternative financial reporting frameworks. Though the PCC is not the autonomous standard-setting body that many requested, it is the most significant step taken by the FAF related to standards specifically for private companies. We have covered the objectives and working plan of the PCC, along with the ASUs issued by FASB at the recommendation of the PCC.

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Solutions

Private Company Financial Reporting

Knowledge check solutions

1.

   a. Incorrect. The AICPA, not the PCC, developed the FRF for SMEs accounting framework.
   b. Correct. The PCC serves as an advisory body to FASB, keeping in mind the needs of private companies.
   c. Incorrect. The PCC does not establish a separate set of standards. The PCC helps develop accounting alternatives that may be used by private companies.
   d. Incorrect. The PCC does not provide input to *IFRS for SMEs* because the PCC does not have authority over IFRS standards.

2.

   a. Correct. This type of entity is defined as a public business entity in the FASB ASC Master Glossary.
   b. Incorrect. An entity that has issued a private placement memorandum does not have to file with the SEC; therefore, it is not a public business entity.
   c. Incorrect. Governmental organizations are subject to GASB standards, not FASB standards.
   d. Incorrect. Foreign companies that do business in the United States are not, by definition, public business entities.

3.

   a. Incorrect. Tax methods are not mentioned in FASB ASU No. 2014-02.
   b. Incorrect. The annual impairment test may still be used by private companies but does not have to be performed at year-end as long as it is performed annually.
   c. Incorrect. The period is 10 years, but the ASU requires a particular method of amortization.
   d. Correct. FASB ASU No. 2014-02 requires a maximum amortization of 10 years straight-line for entities that adopt this accounting alternative.

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4.

a. Incorrect. Fair value is used if the provisions of this ASU are *not* applied.
b. Incorrect. Most swaps have a historical cost of zero. The concept of measurement would be to provide the user with the asset due or liability owed at each balance sheet date, not historical cost.
c. Correct. Settlement value is the applicable value in this ASU.
d. Incorrect. The "impaired" value is not used as credit risk and is not involved in the calculation.

5.

a. Incorrect. The detailed information required is not an accounting policy.
b. Incorrect. ASU No. 2018-17 explicitly states that the disclosures required under this guidance should not be included with related party disclosures.
c. Incorrect. Disclosures are required.
d. Correct. ASU No. 2018-17 requires separate, discrete disclosure.

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FASB Exposure Drafts and Projects

Learning objective

- Recognize ongoing FASB projects.

Introduction

FASB has updated its website to make it easier to track and understand their current technical agenda by categorizing current projects into the following areas:

- Framework
- Recognition and measurement
- Presentation and disclosure

The recognition and measurement and presentation and disclosure areas are considered standard-setting areas. These projects are intended to result in the issuance of an Accounting Standards Update (ASU). FASB uses the following timeline to designate the status of each project:

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Framework projects

The objective of the conceptual framework project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the FASB's goal of developing standards that are principles-based, internally consistent, and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. The new FASB framework will build on the existing framework.

Conceptual framework: Measurement

This project was added to the agenda on June 18, 2014, and is still in the initial stage of deliberations. Currently FASB staff is developing the underlying concepts that they will use in adopting this framework. Once adopted, FASB will use the framework as a reference for all new updates that affect both initial and subsequent measurement issues in financial reporting.

FASB decisions as of November 30, 2016, include the following:

- There are three categories of initial measurement:
  - Entry price
  - Exit price
  - Estimated future cash flows
- Exit price is appropriate as an initial carrying amount of an asset when the subsequent measure of that asset will be at exit price.
- For noncash transactions, initial measure of an asset may be based on the exit price for the asset transferred.
- The overall objective in identifying costs to be included in the initial carrying amount of an asset at entry price is to capture the costs incurred to bring the asset to the location and condition necessary for it to be capable of operation.
- The following categories help identify the types of costs that should be included in an initial carrying amount consistent with the objectives described previously:
  - Government-imposed charges
  - Costs of services related to the acquisition of the asset and readying the asset for use
  - Costs to participate in the market for the asset
- Gains and losses on cash flow hedges are neither part of the entry price of assets nor a cost to be included in initial carrying amounts of assets based on the objective and categories described in the previous two items.

The board discussed an approach for developing a proposed measurement chapter of FASB Concepts Statement No. 8 on June 19, 2019, and provided its views on the issuance on the Invitation to Comment on the measurement chapter of the conceptual framework at the November 13, 2019, meeting. On October 13, 2021, the board discussed the staff's approach on developing a proposed Chapter 6 on measurement for FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*. The board discussed the content and level of specialty contained within the chapter. No board decisions were made at this meeting.

There were no documents issued or decisions reached on this project during 2022.

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Proposed Statement of Financial Accounting Concepts: Conceptual Framework for Financial Reporting

The FASB issued this exposure draft on October 18, 2022, to include a chapter in Concepts Statement No. 8 in order to establish concepts that the Board will use in developing standards related to financial reporting. The exposure draft requested comments from respondents to questions posed for the following broad areas:

- Definition of the reporting entity
    - — Consolidated financial statements
    - — Parent-only financial statement
    - — Portion of an entity
    - — Combined financial statements

The feedback received by the Board will provide a further understanding of the thought process of stakeholders in defining and determining the definition of a reporting entity and what should be reported within those financial statements.

Proposed Statement of Financial Accounting Concepts: Recognition and Derecognition

The Board issued an exposure draft on November 22, 2022, to request feedback on several questions related to recognition and derecognition of elements of financial statements.

The specific topics include:

- The criteria to recognize elements of a financial statement. The criteria in the exposure draft includes:
    - — *Definitions*. The item meets the definition of an element of financial statements
    - — *Measurability*. The item is measurable and had a relevant measurement attribute
    - — *Faithful representation*. The item can be depicted and measured with faithful representation
- Guidance related to when an element of the financial statements should be derecognized. The exposure draft suggests that an element should be derecognized when it no longer meets any one of the three criteria listed for recognition.

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Knowledge check

1. In relation to the conceptual framework measurement project, which category of initial measurement has FASB identified?

    a. Fair market value.
    b. Amortized cost.
    c. Estimated future cash flows.
    d. Historical cost.

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Recognition and measurement projects

Broad topics

Identifiable intangible assets and subsequent accounting for goodwill

The objective of this project is to revisit the subsequent accounting for goodwill and identifiable intangible assets broadly for all entities.

The Private Company Council (PCC) project on goodwill resulted in FASB issuing guidance that allowed private companies the option to elect to amortize goodwill over 10 years instead of testing for impairment on an annual basis. Other updates have simplified the annual impairment test, but this project is designed to explore the possibility of extending the private company election to not-for-profit entities.

The board issued an exposure draft in July 2019 with comments due in October 2019. The board held formal discussion on the comments during the December 11, 2019, board meeting. The board affirmed the following decisions during the meeting:

- To account for convertible instruments as a single unit of account, except in circumstances in which the conversion features are required to be bifurcated under FASB ASC 815, *Derivatives and Hedging*.
- To remove an entity's ability to overcome the presumption about share settlement when calculating diluted earnings per share for a contract that may be settled in either cash or shares.
- To remove the following settlement criteria from FASB ASC 815-40-25:
  - Condition regarding settlement in unregistered shares in paragraph 10(a) of FASB ASC 815-40-25.
  - Collateral condition in paragraph 10(g) of FASB ASC 815-40-25.
  - Shareholder rights condition in paragraph 10(f) of FASB ASC 815-40-25.

The board directed the staff not to conduct any further research on the following:

- Fair value disclosures for all equity-classified instruments.
- The effect of antidilutive instruments on the diluted earnings per share (EPS) calculation.
- EPS improvements included in the comment letter response that are beyond the scope of the amendments included in the proposed update.

At the March 2, 2022, meeting, the board discussed issues relating to the development of a proposed ASU addressing identifiable intangible assets in a business combination and "provided its leaning to require that an entity subsume contractual and noncontractual customer relationships into goodwill if they are not separable." The goodwill balances should be included within the scope of the subsequent accounting guidance for goodwill, which included

- goodwill arising from a reorganization,
- goodwill at a subsidiary, and
- goodwill arising from applying the equity method of accounting.

There were no decisions reached on this project by March 2022.

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Scope of Application of Profits Interests Awards: Compensation — Stock Compensation (Topic 718)

An exposure draft was issued in Q2 2023 to obtain feedback on this project. The objective of this project is to clarify generally accepted accounting procedures (GAAP) by adding illustrative examples to the ASC that would demonstrate how an entity would apply the guidance in ASC 718-10, Stock Compensation.

Proposed Accounting Standards Update: Business Combinations — Joint Venture Formations (Subtopic 805-60)

An exposure draft was issued on October 27, 2022, to obtain feedback on this topic. Current GAAP does not provide guidance on how a joint venture, at its formation, should recognize and initially measure assets and liabilities that are contributed and assumed to a joint venture.

The exposure draft requires that a joint venture apply a new basis of accounting upon formation. By applying a new basis of accounting, a joint venture, upon formation, would recognize and initially measure its assets and liabilities at fair value.

The exposure draft requested comments from respondents to questions posed for the following broad areas:

- New basis of accounting
- Determining the formation date
- Goodwill
- In-process research and development
- Measurement period
- Determining what is part of the joint venture formation
- Definition of a joint venture
- Transition and effective dates

Accounting for and disclosure of crypto assets

The Board has not issued an exposure draft on this topic as of the publication date, but it is expected to be released in 2023. This project explores the accounting for and disclosure of a subset of exchange-traded digital assets and exchange-traded commodities. The FASB has prioritized this project based on feedback from a June 2021 Invitation to Comment.

Other agenda topics: Narrow scope

- Hedge accounting improvements
- Accounting for investments in tax credit structures using the proportional amortization method
- Accounting for environmental credit programs
- Accounting for and disclosure of software costs

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Presentation and disclosure projects

FASB's website had five projects listed as presentation and disclosure projects as of March 2023. It will be important to monitor this website during 2023–2024 for updates on these projects at the FASB technical agenda link: [TECHNICAL AGENDA (fasb.org)]

The following projects are on the technical agenda:

Topic	Status
Targeted Improvements to Income Tax Disclosures	Exposure draft
Disclosure Framework: Disclosures — Interim reporting	Exposure draft
Disclosure improvements in response to the SEC's release on disclosure update and simplification	Final ASU
Segment reporting	Final ASU
Disaggregation – Income Statement Expenses	Exposure draft

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Summary

We have covered the current FASB exposure drafts and projects. It is important to monitor FASB projects so that an entity can prepare for changes to standards in a timely manner. It is also important for the accounting community to respond to exposure drafts and be a part of the process of developing accounting standards.

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Solutions

FASB Exposure Drafts and Projects

Knowledge check solutions

1.
   a. Incorrect. Fair market value is not a category of initial measurement in relation to the conceptual framework measurement project.
   b. Incorrect. Amortized cost is not a category of initial measurement in relation to the conceptual framework measurement project.
   c. Correct. There are three categories of initial measurement: entry price, exit price, and estimated future cash flows.
   d. Incorrect. Historical cost is not a category of initial measurement in relation to the conceptual framework measurement project.

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The Current Environment and Implications for Audit Planning

Learning objectives

- Determine the importance of obtaining a sufficient understanding of the client and the client's environment to effectively plan the audit in response to the risk of material misstatement.
- Determine how the key economic trends currently affecting U.S. businesses impact the auditor in assessing the risk of material misstatements.
- Identiy the key risk issues identified by executives for 2023.
- Identify unique audit challenges for audit and attest engagments for 2023–2024.

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Before we look at new standards related to audit and other attest services, we will first take a look at broader macro-level issues that may affect all service offerings. This course begins with a reminder of the key elements for auditors to consider when obtaining an understanding of the entity and its environment as a part of audit planning, including the broader business environment and a number of economic and industry factors, to assess how they might affect the risk of material misstatement.

You will then review some of the recent trends in economic conditions that should be considered by practitioners as they plan audit and attest engagements for 2023–2024. Practitioners should be alert for implications that recent economic developments may have on a client's overall business risk and the resulting impact that might have on the risk of material misstatement in financial reporting, including the risk of fraud. Furthermore, the course includes a brief reminder of key audit issues that auditors will want to be aware of as they plan and supervise their engagements for the upcoming year.

Understanding the entity and its environment

The auditor's core planning responsibility is to assess the risk of material misstatement in the financial statements being audited. As the performance principle in generally accepted auditing standards (GAAS) states

> [t]he auditor identifies and assesses the risk of material misstatements, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.[1]

The importance of obtaining a sufficient understanding of the entity and its environment could not be more significant than it is today. The COVID-19 pandemic drastically affected the operations and strategies of virtually all organizations, and its effects, along with other events such as the Russia-Ukraine war, continue to affect the global economy. Although the impact of the pandemic is subsiding, uncertainties tied to inflation, increasing interest rates, and layoffs in the technology sectors continue to be concerns that may affect businesses seeking audit and attest services.

The underlying economic and political environment introduces tremendous volatility and uncertainty that may create significant risks to the business, including risks related to material misstatements in financial statements. Businesses, not-for-profits, and government entities may struggle to respond to the uncertainties surrounding the economic and political climate not only in the United States but abroad as well. This is especially important for 2023 as the world continues to address tremendous uncertainties triggered by the Russia-Ukraine war and as the world keeps a watchful eye on China. Ongoing global sanctions against Russia and the continued disruption of supplies of key commodities (i.e., oil, natural

[1] See paragraph .05 of the AU-C preface, *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*.

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gas, wheat, and others) may be affecting the global marketplace for unknown periods of time. That, coupled with high inflation, means the overall risk environment for businesses is in a state of flux.

Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with GAAS. The entity and its environment consist of the following:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives, strategies, and related business risks
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

GAAS emphasizes that there is no "one size fits all" approach to obtaining an understanding of the entity and its environment. Circumstances surrounding the engagement, such as the size and complexity of the entity and the auditor's experience with that entity, can have an impact on how the auditor might approach obtaining this understanding. Additionally, the approach taken in one year may vary in subsequent years as the entity's business evolves and the overall economic, regulatory, and other external factors change.

In light of the aforementioned changes, we will briefly focus on the first three aspects related to the entity and its environment that are emphasized in GAAS:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives, strategies, and related business risks that might result in a material misstatement of the financial statements

This review will also help set the context for the importance of considering the broader economic and business trends that are discussed later in this course.

Industry, regulatory, and other external factors

Part of the auditor's understanding of the entity and its environment includes consideration of relevant industry, regulatory, and other external factors. These factors include consideration of industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments affecting the life cycles of products and services generally offered within that industry. The industry in which the entity operates might be subject to specific risks arising from the nature of the business, the degree of regulation, the impact of political or economic forces, and competition. All of these may lead to an increased risk of material misstatement.

Several industry issues could affect the client's overall business and its financial statement reporting. For example, the commercial construction industry involves the creation of significant long-term contracts that may span multiple fiscal years. Certain terms and conditions in those contracts might affect the ability to record revenues and could create potential liabilities and uncertainties that need to be disclosed. Additionally, changes in the economy and advances in technologies (such as new environmentally friendly building products) and changes in regulations (such as new building codes and environmental impact assessments) may affect key provisions within these long-term contracts.

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Therefore, auditors may need to assess how changes in the industry might affect the construction firm's ability to recognize revenue under these contracts and the need to accrue for unexpected construction costs and expenses.

Examples of matters the auditor may consider include the following:

- Industry conditions
  - The market and competition, including demand, capacity, and price completion
  - Cyclical or seasonal activity
  - Product technology related to the entity's products
  - Supply availability and costs
- Economic conditions
  - General level of economic activity (for example, recession, growth)
  - Interest rates and availability of financing
  - Inflation and currency revaluation
- Regulatory environment
  - Accounting principles, environmental requirements, and industry-specific practices
  - Regulatory framework for a regulated industry
  - Legislation and regulation that significantly affect the entity's operations
  - Taxation and other government policies, such as monetary and fiscal policy, tariffs, trade restrictions, and financial assistance programs

Nature of the entity

The *nature of the entity* refers to the entity's operations, ownership, governance, investments, structure, and financing. The entity may have a complex structure with subsidiaries or other operating components in multiple locations. The ownership structure might involve various types of equity positions. The equity structure, in turn, frequently influences the nature and composition of the board of directors, operating structure, and financing. Acquiring an understanding of issues related to the nature of the entity can help the auditor assess risks of material misstatements specific to classes of transactions, account balances, and disclosures.

Factors the auditor may want to consider include the following:

- Business operations
  - Nature of revenue sources
  - Products or services and markets
  - Geographic dispersion and industry segmentation
  - Location of production facilities, warehouses, and offices
  - Key customers
  - Important suppliers
  - Employee base and key outsourced functions
- Investments
  - Acquisitions, mergers, or disposals of business activities
  - Investments and dispositions of securities and loans
  - Capital investment activities
  - Life cycle stage of entity (startup, growth company, mature)
- Financing
  - Organizational structure — major subsidiaries and associated entities

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- — Debt structure, including debt covenants and restrictions
- — Leasing of property, plant, or equipment
- — Beneficial owners
- — Related parties

Objectives, strategies, and related business risks

An entity conducts its business in the context of industry, regulatory, and other internal and external factors. Management defines the objectives it seeks to achieve considering those factors for the benefit of the entity's key stakeholders, such as owners, investors, employees, and so on. Based on those objectives, management develops and executes strategies to achieve those objectives. However, because entities operate in an uncertain and ever-changing world, there are risks that the business faces as it deploys strategies over time.

Significant events, circumstances, actions, and inactions can introduce business risks that require the entity to change over time. Those risks may lead to risks of material misstatements in the financial statements. For example, a manufacturer may discover that a new competitor has entered the marketplace that has a competitive advantage of brand recognition and economies of scale. That may create business risks for the manufacturer related to its revenue objectives due to a reduction in the demand for the manufacturer's products. In turn, that may lead to increased risks of material misstatements in inventory because of inadequate inventory obsolescence reserves as well as in revenue recognition as revenue pressures increase.

Factors the auditor may want to consider as part of understanding the entity's objectives, strategies, and related business risks include objectives and strategies surrounding the following:

- New industry developments
- New products or services launched or in development
- Plans to expand the business
- Use of information technologies to capture efficiencies or to enter new markets
- Challenges in attracting and retaining knowledgeable personnel

Though not all business risks will affect financial statements, a greater awareness of the entity's broader business risks helps the auditor assess the potential risks of financial statements misstatement.

Knowledge check

1. What is the purpose of obtaining an understanding of the entity and its environment?

    a. To provide assurance about specific business risks.
    b. To assess the risk that material misstatements might exist in the financial statements.
    c. To assess the performance of management in light of current economic conditions.
    d. To provide assurance that internal controls are operating effectively and can be relied upon by the auditor to mitigate risks.

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Considering economic conditions to lower audit engagement risk

Businesses face all kinds of risks as they seek to achieve objectives that management and those charged with governance establish. Similarly, auditors face their own "business risks" as they manage their operations and engagements. On high-risk engagements, auditors face the audit risk that material misstatements exist in a client's financial statements and are undetected by the auditor, who subsequently issues an unmodified opinion on those financial statements. Therefore, risk exists in many forms.

Throughout the audit process, auditors should consider the overall risk associated with engagement — often thought of as "engagement risk." Engagement risk consists of the following three components:

1. *Client's business risk.* The risk associated with the entity's survival, profitability, integrity, fraud, poor internal control, and so on
2. *Audit risk.* The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated
3. *Auditor's business risk.* The risk of potential litigation costs from an alleged audit failure and the risk of other costs (whether an audit failure is alleged or not) such as fee realization and the effect on the auditor's reputation resulting from association with the client

Although the previous terms are not all explicitly defined in auditing standards, thinking about these three elements of engagement risk can help auditors manage the major drivers that affect the risks associated with an audit engagement.

Assessing risks of material misstatement

Auditing standards require the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement level and relevant assertion levels. Peer reviewers have noted that in the past, some auditors have bypassed the performance of risk assessment procedures by going directly to the design and performance of substantive procedures. Auditing standards require auditors to perform risk assessment procedures in every audit in order to assess the risk of material misstatement. Omitting steps that involve the auditor's identifying the client's risks of material misstatement by understanding the entity and its environment, including understanding internal control, is not in compliance with auditing standards. Auditors are required to identify risks, assess the risks, and design audit procedures to respond to those risks. Failure to perform risk assessment procedures is not compliant with the profession's standards.

Risks may be present at the overall financial statement level or at the relevant assertion level. As a result, auditing standards require auditors to assess the risk of material misstatement at both the financial statement level and assertion level and to design audit procedures responsive to those risks. Risks are likely to vary across different entities at the overall financial statement level and across different account balances and classes of transactions, including disclosures. Therefore, documenting that the same risks are present across the entire set of financial statements and across different account balances, classes of transactions, and disclosures suggests an insufficient risk assessment process.

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Statement on Auditing Standards No. 145

Statement on Auditing Standards (SAS) No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AU-C sec. 315), issued in October 2021, is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

SAS No. 145 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, and AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Additionally, SAS No. 145 amends various AU-C sections in AICPA *Professional Standards*.

SAS No. 145 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements. The SAS is principles-based and audit-methodology neutral. It does not fundamentally change the key concepts underpinning audit risk, but it does clarify and enhance certain aspects of the identification and assessment of the risks of material misstatement in an effort to drive better risk assessments and therefore enhance audit quality. The degree to which SAS No. 145 might affect an audit methodology may vary based on the particular audit approach and related audit methods, tools, or techniques.

SAS No. 145 enhances the following:

- Requirements and guidance related to the auditor's risk assessment, in particular, obtaining an understanding of the entity's system of internal control and assessing control risk
- Guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

SAS No. 145 also includes, among other things, the following:

- Revised requirements to evaluate the design of certain controls within the control activities component, including general IT controls, and to determine whether such controls have been implemented
- A new requirement to separately assess inherent risk and control risk
- A new requirement to assess control risk at the maximum level such that, if the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement is the same as the assessment of inherent risk
- A revised definition of *significant risk*
- New guidance on scalability
- New guidance on maintaining professional skepticism
- A new "stand-back" requirement intended to drive an evaluation of the completeness of the auditor's identification of significant classes of transactions, account balances, and disclosures
- Revised requirements relating to audit documentation
- A conforming amendment to perform substantive procedures for each relevant assertion of each significant class of transactions, account balance, and disclosure,

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regardless of the assessed level of control risk (rather than for all relevant assertions related to each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required)

Until the effective date of SAS No. 145, extant AU-C section 315 is designated with an "A" suffix (that is, "AU-C section 315A") to denote content that does not reflect the codification of SAS No. 145. Upon implementation of SAS No. 145, auditors and firms should no longer use content from AU-C section 315A and should follow the standard as codified.

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Current economic factors

Economic conditions can lead to significant pressures for executives and other stakeholders that may affect the auditor's assessment of engagement risk. Therefore, it is important for auditors to maintain an awareness of key economic indicators as they plan current-year engagements.

Prior to the emergence of the COVID-19 pandemic in the United States in early March 2020, the U.S. economic recession that began in 2008 seemed to be largely behind us. Equity markets enjoyed one of their strongest years in 2019 with the S&P 500 gaining over 28% for the year, with markets continuing to be strong in early 2020. However, the coronavirus pandemic changed everything in a matter of days by wreaking havoc on the economy. The passage of the $2 trillion stimulus package (the Coronavirus Aid, Relief, and Economic Security [CARES] Act) and subsequent legislation to stimulate the economy in 2020 and 2021 helped stabilize markets. Unfortunately, the Russia-Ukraine war in February 2022 introduced new uncertainties in the global marketplace, and with that conflict ongoing, there continues to be uncertainties affecting the marketplace in 2023. Additionally, over the past several months, growing concerns about inflation have triggered a number of increases in interest rates. That, in turn, is leading to economic concerns about the potential for even higher or sustained periods of inflation. Although unemployment remains quite low, layoffs in the technology and consulting services sectors suggest there may be pockets of sluggishness in the global business environment.

The materials presented in this course have been updated to reflect conditions as of the end of February 2023; however, given various ongoing challenges that continue to unfold daily, participants will want to stay abreast of how these factors are affecting their attest engagements throughout the year. Participants should visit the AICPA's Small Business Resiliency page (https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center) for updated information.

Although changes take time to unfold, pressures may exist that have a direct impact on the quality of financial reporting, including the risk of material misstatement. Understanding current leading key economic indicators is discussed in the following sections. These indicators are important to the auditor in identifying financial pressures and assessing their impact on the risk of material misstatement.

The following is a more detailed look at some of the important economic indicators for 2023.

Stock markets

Although investor optimism continued to push the Dow Jones Industrial Average (DJIA) to record highs throughout 2021 and early 2022, after experiencing a significant fall of over 11,000 points in the early days of the pandemic in March 2020, the DJIA has ebbed and flowed throughout 2022 and 2023. Despite dipping below 30,000 in June and October 2022, the DJIA has stayed relatively steady, around 32,500 in the early months of 2023, whereas the NASDAQ index was at 11,400 at the end of February 2023, down from highs over 14,000 about a year earlier. Growing concerns about inflation, higher interest rates, and geopolitical uncertainties have triggered some unsteadiness in the global marketplace. This is creating concerns that equity markets may fall and increase in volatility, particularly for entities in industries affected by oil and natural gas, agriculture (especially wheat), and technologies dependent on semiconductor components manufactured in the Ukraine.

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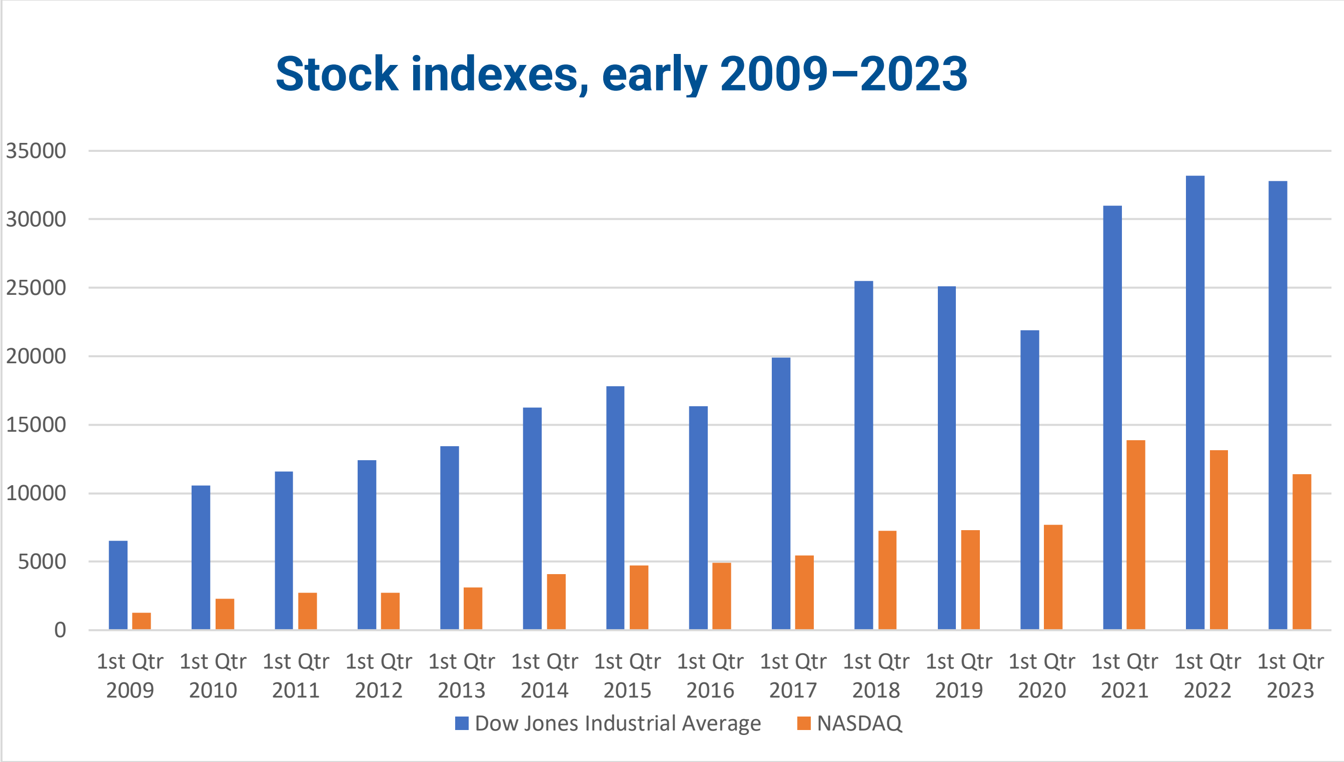
The following chart shows the trend for the DJIA and NASDAQ indexes from shortly after the financial crisis began in late 2008 through the end of February 2023.



Overall confidence in U.S. economy

The Conference Board's Consumer Confidence Index© (Confidence Index) reflects prevailing business conditions and likely developments for months ahead. The monthly report details consumer attitudes, buying intentions, vacation plans, and consumer expectations for inflation, stock prices, and interest rates.

Just prior to the pandemic's onset in March 2020, the Conference Board was reporting that consumer assessments of current conditions remained strong, with the Confidence Index tracking at 131.6 in January 2020.[2] However, the COVID-19 pandemic dramatically affected consumer confidence and by December 2020, the Confidence Index had fallen to 87.1.[3] Thankfully, consumer confidence has been relatively strong throughout 2022 and early 2023, with the Confidence Index at 107.1 as of the end of January 2023, where it remains relatively steady at levels noted in 2022.[4] There are some signals that consumers may have some concerns about the economy over the next 6 months of 2023 and they appear less optimistic about short-term job possibilities. According to the Conference Board, the

[2] "The Conference Board Consumer Confidence Index Increased in January," January 28, 2020, The Conference Board (www.conference-board.org).

[3] "The Conference Board Consumer Confidence Index Increased in January," January 26, 2021, The Conference Board (www.conference-board.org).

[4] The Conference Board's "The Conference Board Consumer Confidence Index Declined in January," January 31, 2023, The Conference Board (www.conference-board.org).

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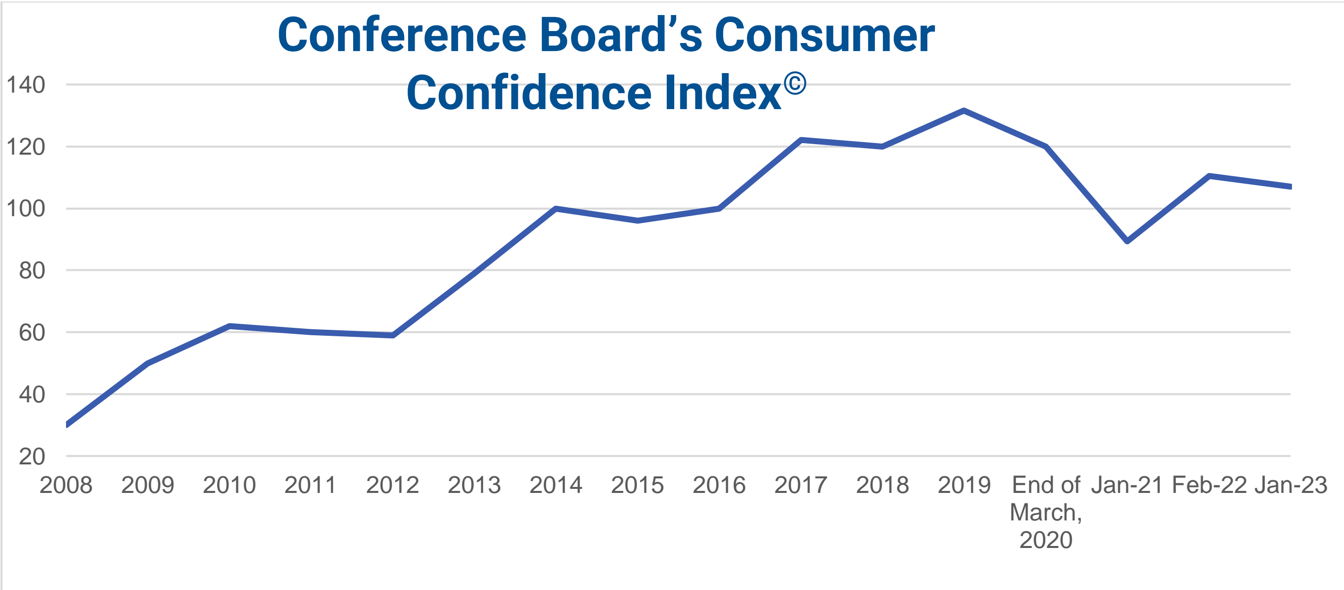
percentage of consumers appraising business conditions as “good” were at 20.2%, whereas 19.2% believed business conditions were “bad” in January 2023.[5]



CEOs surveyed by the Conference Board appeared to be cautious in early 2023 as they dealt with concerns about inflation, labor shortages, and supply chain challenges. The Conference Board’s Measure of CEO confidence was in negative territory at 43 at the start of 2023. That is up from 32 in quarter 4 of 2022, which reflected levels similar to what was observed in the depths of the recession caused by the COVID-19 pandemic (a score above 50 reflects more positive than negative responses).[6] Over 90% of CEOs surveyed report that they are anticipating a U.S. recession over the next 12–18 months, but they indicate the recession will be short-lived.

Unemployment[7]

Prior to March 2020, unemployment was at record lows, but that changed as the COVID-19 pandemic quickly shuttered operations, and many entities began to lay off or furlough their workforces. The number of unemployed persons rose by 1.4 million to 7.1 million in March 2020. In the four-week period ending in mid-April 2020, over 22 million Americans filed for unemployment.

Thankfully, throughout 2021 and 2022, labor markets drastically improved. Shifts to remote and hybrid work environments allowed workers to pursue employment opportunities in geographies far from where they reside. That has created huge talent wars for certain types of workers. Adding to this demand, the supply of workers has also been dampened by those deciding to exit the workforce. By January 2023, unemployment levels had returned to pre-pandemic levels, with unemployment at 3.4% and 5.7 million unemployed individuals. This is in line with pre-pandemic conditions in February 2020, when

[5] See footnote 4.
[6] The Conference Board’s “CEO Confidence Picked Up in Q1, but CEOs Remain Pessimistic,” February 9, 2023 (www.conference.board.org).
[7] The data in this section come primarily from data reported by the U.S. Bureau of Labor Statistics (www.bls.gov).

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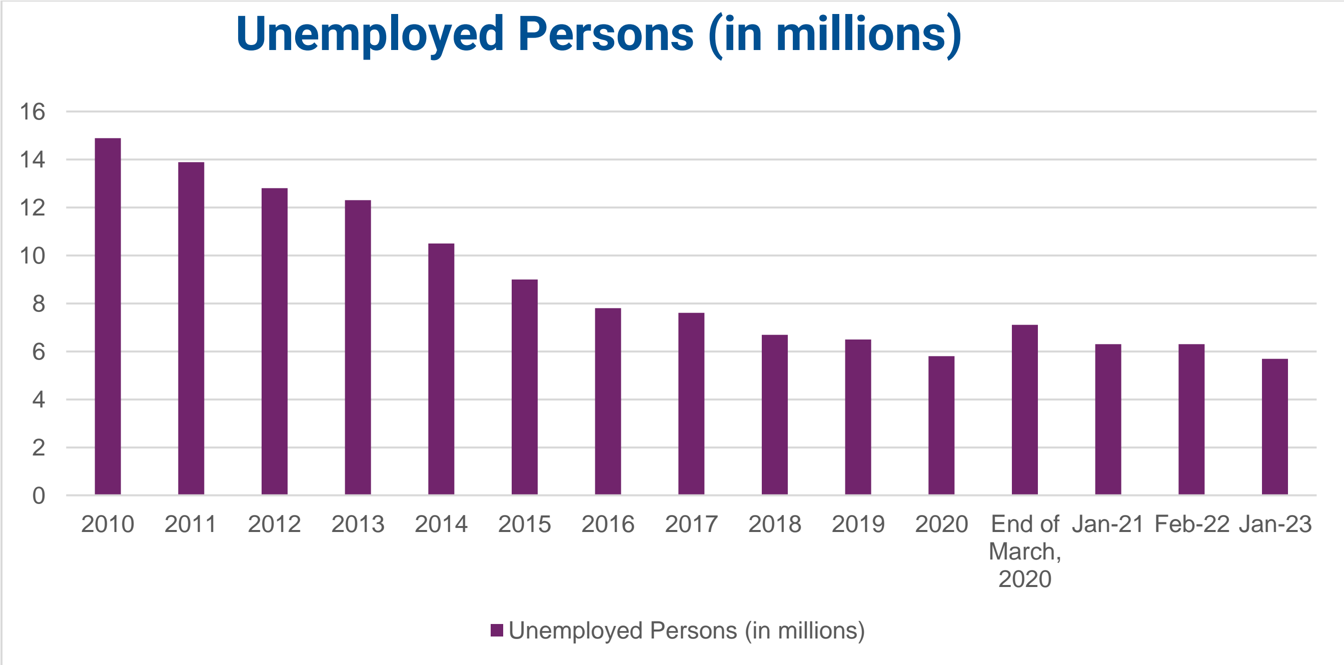
unemployment was at 3.5% with 5.7 million unemployed persons. Strong job growth was led by the leisure and hospitality industry, professional and business services, and health care industries.



The number of long-term unemployed (those jobless for 27 weeks or more) was at 1.1 million in January 2023, which is lower than the 1.7 million a year earlier and the 4.0 million as of the end of January 2021. This group accounts for 19.4% of the total unemployed.

The Conference Board's Employment Trends Index (ETI) provides an aggregate of eight labor-market indicators that reflect underlying trends in employment conditions. The ETI consists of the following eight components:

1. Percentage of respondents who say they find jobs "hard to get"
2. Initial claims for unemployment insurance
3. Percentage of firms with positions not able to fill right now
4. Number of employees hired by the temporary-help industry
5. Ratio of involuntary part-time to all part-time workers
6. Job openings
7. Industrial production
8. Real manufacturing and trade sales

Just prior to the pandemic in early 2020, the ETI was at 109.68,[8] which was where it had been for most of 2019. But, by April 2020, the ETI had dropped unprecedentedly to about half of the level at the start of 2020. However, throughout 2022 and into early 2023, the ETI was remaining fairly stable, ending at

[8] News Release, "The Conference Board Employment Trends Index (ETI) Declined in December" (January 13, 2020), The Conference Board (www.conference-board.org).

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118.74 as of January 2023.[9] As noted by the Conference Board, the economy is not observing widespread layoffs, despite the interest rate hikes over the past year. Strong hiring trends continue, except for pockets of layoffs announced in certain technology-centric businesses.

Interest rates[10]

The federal funds rate represents the interest rate at which depository institutions actively trade balances held at the Federal Reserve. Although the Federal Reserve kept its target for the federal funds rate low for a prolonged period of time, it began to raise rates in December 2015, and it slowly raised rates over the next three years, reaching 2.5 by early 2019. However, as news of the pandemic began to drastically affect the economy in early March 2020, the Federal Reserve announced on March 15, 2020, that it would drop interest rates to zero and buy at least $700 billion in government and mortgage-related bonds as part of a wide-ranging emergency action. The benchmark U.S. interest rate dropped to 0% to 0.25%.[11] The federal funds rate continued to be effectively at zero until early 2022. Then, in response to increased concerns about inflation, the Federal Reserve began raising rates in March 2022 and has steadily done so throughout 2022 and into 2023. At the end of February 2023, the target rate for federal funds was at 4.58%.

The Federal Open Market Committee (FOMC) seeks to foster maximum employment and price stability. In February 2023, the Committee decided to raise the target rate for federal funds to be in the range of 4.50%–4.75%.[12] This move is mostly attributed to concerns about elevated inflation, robust job growth and low unemployment, and the Russia-Ukraine war. This move will continue to increase financing costs for many forms of consumer borrowing and credit. The FOMC’s assessments take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.[13] Most expect rate increases to continue in 2023.

The AICPA’s Center for Plain English Accounting issued a November 2022 report, “Rising Interest Rate A&A Considerations,” highlighting accounting and auditing considerations triggered by rising interest rates that may reflect audit risks.[14] Practitioners may benefit from considering these impacts and risks during engagement planning and risk assessment procedures:

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[9] News Release, “The Conference Board Employment Trends Index (ETI) Increased in January” (February 6, 2023), The Conference Board (www.conference-board.org).

[10] The data in this section come primarily from the Federal Reserve (www.federalreserve.gov) or the U.S. Department of the Treasury (www.treasury.gov).

[11] Press Release, “Federal Reserve Issues FOMC Statement” (March 15, 2020), The Federal Reserve, (www.federalreserve.gov).

[12] Press Release, “Federal Reserve Issues FOMC Statement” (February 1, 2023), The Federal Reserve (www.federalreserve.gov).

[13] Press Release, “Federal Reserve Issues FOMC Statement” (January 27, 2021), The Federal Reserve, (www.federalreserve.gov).

[14] AICPA Center for Plain English Accounting, “Rising Interest Rate A&A Considerations,” (November 16, 2022), (aicpa.org).

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- Debt – Entities with floating debt may be challenged to service the debt, and entities seeking new financing will face a rising cost of capital.
- Valuations and impairments – Rising interest rates may affect the valuation of investments and derivatives. Auditors should consider discount rates used by clients to value investments in light of the current rate environment.
- Revenue contracts – Revenues may be affected by contracts based on significant financing, which may affect their accounting treatments.
- Defined benefit plans – Interest rates will affect several calculations and amounts related to accounting for defined benefit plans.
- Leases – Discount rates used to measure a lease may need to be revised.
- Overall accounting estimates – Rising interest rates may affect several assumptions for a number of accounting estimates.
- Fraud – Higher interest rates may trigger greater incentives and pressures to engage in fraud.
- Going concern – Higher rates may negatively affect customer demand for an entity's products or services, and at extreme levels, threaten an entity's ability to continue as a going concern.

The future action of the Federal Reserve is important; any volatility in interest rates may increase the inherent risks for the valuation of investments and derivatives because their value is significantly affected by interest rates.

The 10-year U.S. Treasury note yield was around 3.95% in late February 2023. The following chart shows the daily Treasury yield curve rates for the 10-year U.S. Treasury note since just prior to the financial crisis in 2007 (measured in January of each year, with an update for the end of March 2020 and again as of February 1, 2021, March 21, 2022, and February 24, 2023).[15]

[15] U.S. Treasury "Daily Treasury Par Yield Curve Rates" (February 24, 2023) (www.treasury.gov).

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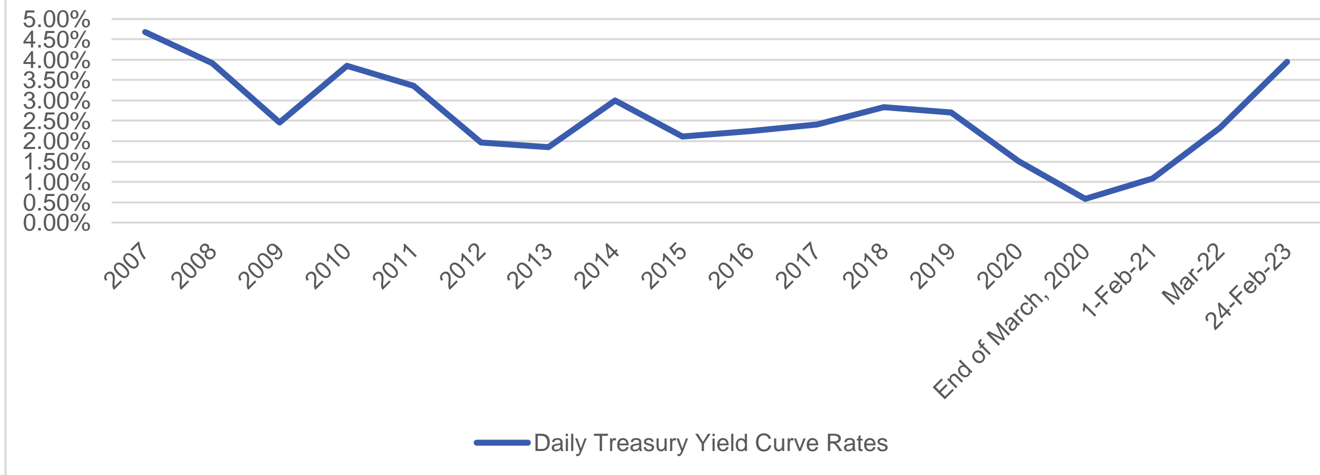
Daily Treasury Yield Curve Rates — 10-Year Notes



Production

Real gross domestic product (GDP) is the output of goods and services produced by labor and property located in the United States. Real GDP increased at an annual rate of 2.7% in the fourth quarter of 2022, according to the "second" estimate released by the U.S. Bureau of Economic Analysis on February 23, 2023.[16] According to the U.S. Bureau of Economic Analysis, the increases in the fourth quarter GDP reflect increases in private inventory investment, consumer spending, nonresidential fixed investment, federal government spending, and state and local government spending that are partly offset by decreases in residential fixed investments and exports. The following chart indicates the trend in average annual U.S. GDP growth rate (in percentages) for each year beginning with 2007.

[16] Gross Domestic Product, Fourth Quarter and Year 2022 (Second Estimate), U.S. Bureau of Economic Analysis (https://www.bea.gov/news/2023/gross-domestic-product-4th-quarter-and-year-2022-second-estimate).

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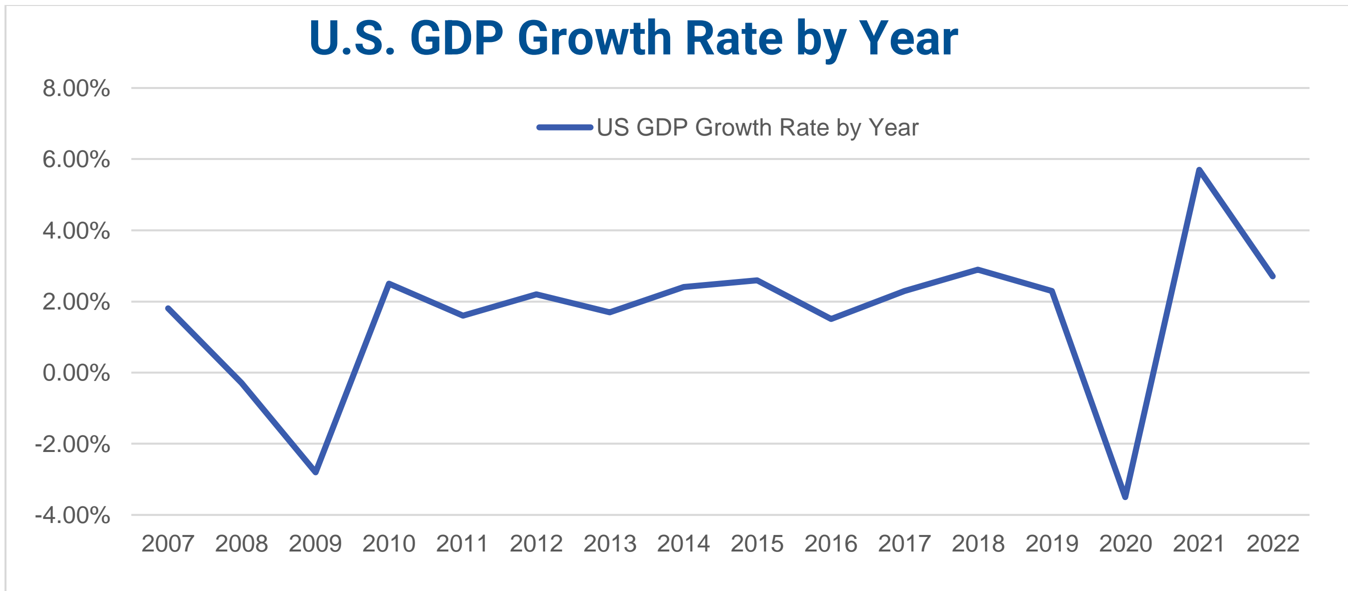

Personal income increased $131.1 billion (0.6%) in January 2023, led by increases in compensation reflecting private wages and salaries in both service-producing industries and goods-producing industries. This increase was offset by a decrease in government social benefits. The personal savings rate (which reflects personal saving as a percentage of disposable personal income) was 4.7% in January 2023.[17]

Economic growth and inflation outlook[18]

Although inflation peaked just above 9.0% in mid-2022, it has gradually decreased throughout the rest of 2022 and as of the end of February 2023, where it was at 6.0%.

In February 2023, the Congressional Budget Office (CBO) released its latest updated budget and economic outlook for the 10-year period 2023–2033. In that report, the CBO projects a federal budget deficit of $1.4 trillion for 2023. Debt held by the public is projected to rise in relation to the size of the economy each year, reaching 118% of GDP in 2033. The CBO expects weaker growth of real GDP for 2023, but stronger growth for 2024–2026, and gradual slowing of inflation in 2023 as pressures ease with expected rises in unemployment for 2023. Participants will want to monitor the CBO for updates in the analysis later in 2023.

Although oil prices per barrel fell to $20.5 per barrel at the beginning of the pandemic in March 2020, the price per barrel skyrocketed to just over $120.00 per barrel in early 2022, but those prices have steadily declined throughout 2022 through February 2023 where it landed at $77.05 per barrel).[19] The Russia-

[17] "Personal Income and Outlays, January 2023," U.S. Bureau of Labor Statistics, February 24, 2023 (https://www.bea.gov/news/2023/personal-income-and-outlays-january-2023).
[18] "The Budget and Economic Outlook: 2023 to 2033," February 2023, The Congressional Budget Office (www.cbo.gov).
[19] "Crude Oil," NASDAQ (www.nasdaq.com/markets/crude-oil.aspx).

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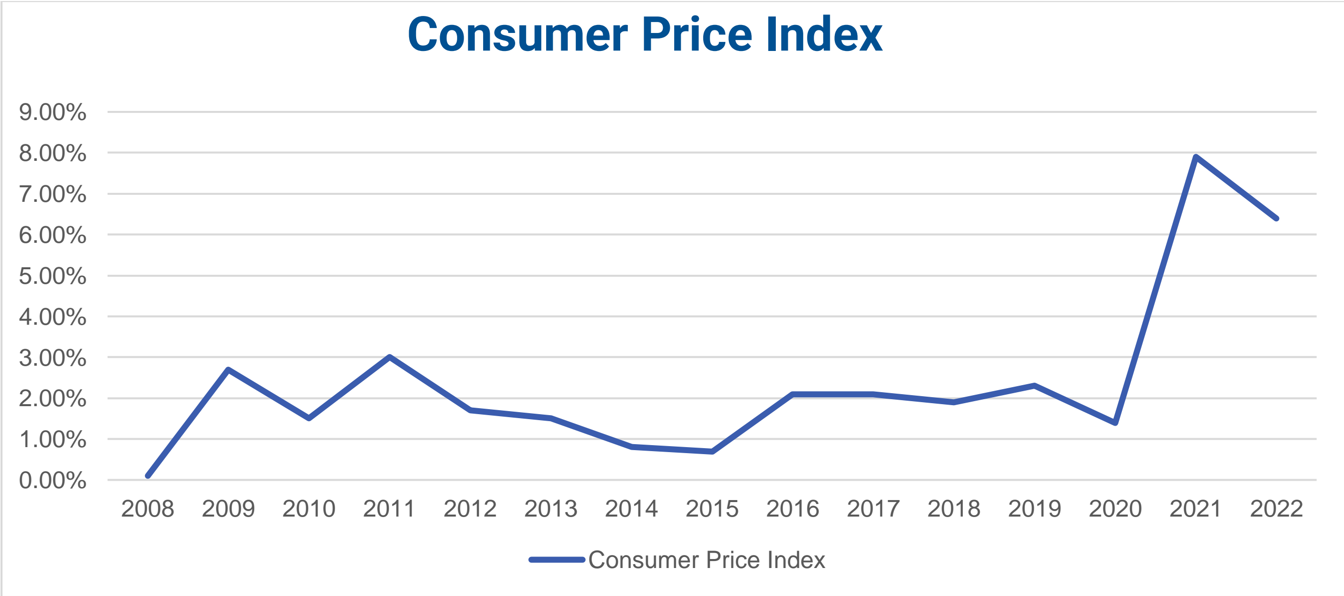
Ukraine war and related sanctions against Russia's oil industry continue to affect natural gas prices, triggering concerns about global supplies.

Consumer spending

The consumer price index (CPI) represents changes in prices of all goods and services purchased by consumers. It reflects spending patterns for each of two population groups — all urban consumers and urban wage earners and clerical workers. Just prior to the pandemic, the consumer price index for all urban consumers (CPI-U) had been steadily increasing since summer 2016.[20] In early 2020, spending levels fell off rapidly as businesses had to close and consumers went into lockdown mode to wait out the pandemic. However, by March 2022, the 12-month average CPI had increased 7.9% and remained fairly steady over the remainder, ending at 6.4% for the 12-month period as of January 2023.[21] This is the smallest 12-month increase since the 12-month period ending October 2021.



[20] The data in this section comes from the U.S. Bureau of Labor Statistics Consumer Price Index News Releases (www.bls.gov).
[21] Consumer Price Index Summary for January 2023 (February 14, 2023) (www.bls.gov).

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Knowledge check

2. Which statement correctly reflects a current economic trend as of the end of February 2023?

    a. The consumer price index is well above its pre-pandemic levels.
    b. The stock market indexes are at all-time highs in early 2023.
    c. The rate of unemployment remains above 4% in early 2023.
    d. The projected annual rate of inflation is expected to remain under 2.0% for 2023.

Case study

Consider how 2023 economic conditions affect overall engagement risk for the following entities:

1. Small retailer of higher-end products, such as luggage, home furnishings, and luxury goods.
2. Local community bank whose market base is largely tied to commercial real estate and business lending for agricultural products, furniture manufacturers, and textiles.
3. Oil and gas distributor. Volatility in gas and energy prices over the past few years has created risks for oil and gas distributors, significantly affecting projected profitability.

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Executive views of top risks for 2023

In December 2022, the Enterprise Risk Management Initiative at North Carolina State University, in partnership with Protiviti, released its 11th annual survey, *Executive Perspectives on Top Risks for 2023 and 2032*. The purpose of this survey is to seek executive-level perspectives of the top risks likely to be on the horizon for organizations throughout 2023 and a decade later, 2032.[22] The survey focused on 38 key risk issues related to macroeconomic, strategic, and operational issues.

Collectively, over 1,304 executives responding to the survey indicate that the overall global business context is riskier in 2023 relative to 2022, which is the highest level of that assessment in all 11 years the study has been conducted. Respondent perspectives about each of the 38 risks surveyed were higher in average risk scores than the averages noted in the prior year. Clearly, there are overarching concerns about the risk environment for 2023 relative to prior years.

It is interesting to note that respondents tended to rate specific risk issues differently depending on the issue at hand, the size of the organization and its industry, and their position in the organization. For example, board members rated 4 of 38 risks as a "significant impact" risks, with most of those representing operational risk concerns, whereas CEOs rated 5 of 38 risks as significant impact risks but with most of those being strategic concerns. CFOs rated none of the 38 risks as significant impact risks, whereas Chief Human Resources Officers rated all 38 risks as significant impact risks. So, who has the correct assessment of these risks? Business leaders need to engage in robust conversations to tease out the underlying realities.

The following exhibit summarizes the top 10 risks for 2023 according to survey respondents:

[22] *Executive Perspectives on Top Risks for 2023 & 2032: Key Issues Being Discussed in the Boardroom and C-Suite*, by Protiviti Inc. and North Carolina State University's ERM Initiative, December 2022 (download report for free from www.erm.ncsu.edu).

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Exhibit: Executive perspectives of top risks for 2023

The following are the top 10 risks for 2023, according to executives and boards as reported in *Executive Perspectives on Top Risks for 2023 and 2032*:

1. Our organization's succession challenges and the ability to attract and retain top talent in a tightening labor market may limit our ability to achieve operational targets.
2. Economic conditions in the markets we currently serve may significantly restrict growth opportunities for our organization.
3. Anticipated increases in labor costs may affect our opportunity to meet profitability targets.
4. Resistance to change may restrict our organization from making necessary adjustments to the business model and core operations on a timely basis.
5. Uncertainties surrounding core supply chain ecosystem may continue to create significant challenges in meeting revenue/profitability goals.
6. Changes in the overall work environment, including shifts to hybrid work environments, expansion of digital labor, and changes in the nature of work, may lead to challenges to sustaining our business model and culture.
7. The adoption of digital technologies (e.g., artificial intelligence, robotics, natural language processing) in our organization may require new skills that either are in short supply or require significant efforts to upskill and reskill existing employees.
8. Our organization's culture may not sufficiently encourage the timely identification and escalation of risk issues.
9. Our organization's approach to managing ongoing demands on or expectations of a significant portion of our workforce to work remotely or as part of a hybrid work environment may negatively impact our ability to retain talent needed to operate our business.
10. Our organization may not be sufficiently resilient and/or agile to manage an unexpected crisis.

The following briefly highlights the risks comprising the overall top 10 list of risks for 2023:

1. Succession challenges and talent acquisition and retention – Respondents continue to perceive that significant operational challenges may arise if their organizations are unable to build and sustain a workforce with the requisite skills needed to implement their growth strategies, forcing them to consider alternative forms of labor.
2. Increased concern among most executives about economic conditions restricting growth prospects in relevant markets, but with some exceptions – The broad, long-term economic impacts of the pandemic, including concerns about inflation, continue to represent significant challenges for executives in many industries. Uncertainties associated with central bank policies around interest rates; the effects of slow-to-recover supply chains on the economic rebound from pandemic lows;

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the hamstringing effects on the economy of COVID-19 variants; escalating fuel, food, and other costs; and a slowdown triggered by the Russia-Ukraine war are contributing factors to these concerns.

3. Increasing labor costs – Organizations are responding to shortages in available talent by increasing their wages to attract critical talent, and that is having a ripple effect across the workforce in many organizations as other employees are also demanding more competitive wages, particularly considering the more difficult work environment triggered by the pandemic.
4. Resistance to change – Respondents are growing even more focused on their organization's potential unwillingness or inability to pivot and make necessary timely adjustments to the business model and core operations that might be needed to respond to changes in the overall business environment and industry. Executives continue to be concerned about their companies' resilience and ability to enable change.
5. Changes in overall work environment – The hybrid and remote work environments that were created at the beginning of the pandemic continue to affect the overall culture as workers are less able to interact informally on an *ad hoc* basis given their isolation and asynchronous work schedules. Board members and executives are concerned about how hybrid and remote working situations might negatively alter the organization's culture and talent development as well as its ability to execute its business model.
6. Uncertain supply chain – Another operational risk is linked to uncertainties surrounding the organization's core supply chain and instabilities in its supply chain ecosystem. The lingering challenges related to managing a complex, global supply chain in a world encumbered with uncertainties are top of mind for executives and boards. Unexpected disruptions along the value chain can arise from multiple directions.
7. The adoption of digital technologies in transforming the business may require new skills that the organization may not be able to attract or retain – The rapid need to embrace digital technologies to reach customers in a virtual, socially distanced manner, as well as to support a remote workforce environment, has strained the technology capabilities for many organizations. Those entities without access to talent that understands the technologies and how they may be deployed may find themselves lagging behind competitors that can react quickly to assimilate innovations into their business.
8. Escalation of risks – Notably, respondents also expressed concerns about the impact of their organization's culture on the ability and willingness for employees across the organization to escalate risk concerns on a timely basis to those at the top, including executives and boards. That lack of escalation may stem from a lack of awareness of how to escalate risk concerns or it may also stem from a reluctance or fear to be the bearer of bad news. Both are worth evaluating.
9. Workforce demands – Tight labor markets are allowing the workforce to have a louder voice as organizations rush to attract and retain needed talent. Employee workplace expectations continue to evolve, and respondents are concerned that the organization may not be able to adjust appropriately to compete in the highly competitive talent marketplace. This continues to create challenges for

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organizations as they attempt to determine their long-term strategies for talent acquisition and retention.

Crisis management – This risk relates to concerns about the organization's resilience and agility to navigate an unexpected crisis that might significantly affect its operations and reputation. Because uncertainties abound, most are realizing that it is not a matter of *if* the organization will face a crisis but, rather, *when* a crisis might occur.
over economic conditions (including inflationary pressures) significantly restricting growth opportunities or affecting margins are also a top risk concern for 2023. Uncertainty over central bank policies amid persistent inflation, rising labor costs, and supply chain disruptions, along with the specter of a possible global recession on the horizon, contribute to clouded perceptions regarding the economy, both now and in the future.

Uncertainty surrounding the viability of key suppliers and energy sources, unpredictable shipping and distribution logistical issues, and price stability in the supply chain ecosystem are raising concerns over the ability to deliver products or services at acceptable margins. Survey participants indicate that the fundamentals underpinning this risk will normalize over the long term.

As auditors conduct their engagement planning and risk assessment procedures for 2023–2024 engagements, they will want to consider how these risk concerns may affect the preparation and presentation of information in the financial statements. Some of these emerging risks may affect a number of accounting estimates or they may affect incentives or pressures to engage in fraud. At worst, they may affect an entity's ability to continue as a going concern.

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Resources that contain audit considerations

The AICPA continually releases resources to help auditors navigate uncertainties in the global business environment. The AICPA's Insights Blog periodically includes resources helpful to auditors as they consider current developments in the environment. Additionally, the Center for Audit Quality (CAQ) has issued several resources to help auditors consider unique engagement challenges created by the COVID-19 pandemic. Although the CAQ's focus is to assist auditors of public companies, the topics addressed by some of their resources are relevant to all auditors, not just auditors of public companies.

Audit challenges for 2023

In December 2022, the AICPA, through its Enhancing Audit Quality Initiative, posted in its AICPA Insights Blog, "4 Audit Challenges Firms Could Face in 2023,"[23] that identified the following issues for audits in 2023 and ways to overcome them:

- Risk assessment: As part of engagement planning, auditing standards require the auditor to obtain an understanding of the entity and its environment, including its system of internal controls, in every audit. As organizations continue to adjust their business model and operating processes, internal controls may be affected. The recently issued SAS No. 145, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, will take effect for audit clients with 2023 calendar-year ends. Now is the time for auditors to make sure they understand the new requirements.
- Single audits: Single audits are highly specialized and require in-depth technical expertise. The volume of single audits is expected to continue to surge due to federal COVID-19 relief funding. Auditors engaged to perform single audits should pay particular attention to the following:
  - Identifying and testing sufficient and appropriate major programs
  - Documenting the testing of controls and compliance for the relevant assertions related to each applicable compliance requirement with a direct and material effect for the major program
  - Documenting the adequacy of planned sample size for test of controls over compliance to achieve a low level of control risk
  - Documenting procedures related to the Schedule of Expenditures of Federal Awards (SEFA), including internal controls over the preparation of the SEFA
  - Including required elements of professional standards in the Independent Auditor's Report on Internal Control over Financial Reporting on Compliance and Other Matters

[23] AICPA Insights Blog, "4 Audit Challenges Firms Could Face in 2023," (December 8, 2022) (www.aicpa.org).

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- Auditor’s report: Recently issued auditing standards (SAS Nos. 134–146) have affected required elements of the auditor’s report. Auditors should ensure that all the reporting requirements are included in the reports they issue and express the appropriate opinion. Auditors should read their reports to avoid errors and incorrect statements regarding the audit’s scope, entity’s accounting principles, audit findings, or any other statement of substance.
- Technology-enabled auditing: Technology is leading to more informed decision-making and the timely delivery of information and reports to clients. Technology enhancements are improving the auditor’s ability to analyze complete data sets, increase the efficiency and effectiveness of risk assessments, and design appropriate audit procedures. As auditors embrace these tools, they need to obtain the training and experience to ensure the tools are correctly implemented in an audit context.

Risk of remote audits

In August 2022, the AICPA, through its Enhancing Audit Quality Initiative, posted in its AICPA Insights Blog “Embrace Fluidity and Remove the Risks of Remote Audits”[24] several important considerations as audit engagement teams continue to work remotely or in a hybrid fashion, with less contact time on-site at a client. Remote and hybrid environments are not risk free, which requires audit firms to ensure their audits remain high quality.

Remote audits are enabled by advancements in technology and digitization that allow auditors and clients to connect online, but these advantages also come with potential concerns about security breaches and documentation authenticity. Auditors need to be aware of potential risks and be diligent as they assess documents that are received electronically, such as receiving documents directly from third parties (e.g., the bank), rather than from the client.

As clients have also moved to remote or hybrid settings, auditors will also want to consider whether controls normally in place in an in-person environment have been altered to fit the remote/hybrid context, such as forgoing two signatures on disbursements or forgoing the review of journal entries. Furthermore, audit teams will also want to consider whether the remote setting is diluting the focus of the team on professional skepticism in any way. For example, how do virtual meetings with clients affect the ability for auditors to observe unusual body language?

Remote audits offer flexibility, but they introduce new types of risks that auditors should not overlook as they plan and supervise their engagements.

Assessment of risk

Auditing standards require auditors to perform risk assessment procedures sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement and to design further audit procedures. Because almost all organizations continue to face ongoing uncertainties and volatile

[24] AICPA Insights Blog, “Embrace Fluidity and Remove the Risks of Remote Audits,” (August 4, 2022) (www.aicpa.org).

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economic conditions, the overall nature of risks affecting organizations may be changing drastically. Depending too much on risks identified in prior years may lead to insufficient understanding of risks affecting financial statements. Changing conditions may be creating incentives or pressures for management to meet certain expectations thereby heightening potential fraud risk, and changes in operations to shift suddenly to a more remote, virtual world may be creating deficiencies in internal controls that increase control risk. That is also true for the changing conditions in Eastern Europe as the Ukrainian crisis continues to unfold.

A thought paper issued by the CAQ, *Focus on the Auditor's Risk Assessment*,[25] notes that although the assessment of risks of material misstatement is required to continue throughout the audit, the rapidly changing conditions may require frequent revisions to the auditor's initial risk assessments. As the assessments are updated, the auditor's responses based on the initial assessment need to be updated, and the auditor needs to ensure responses are made in light of the updated understanding about risks. Those responses may need to include more experienced personnel, increased involvement of specialists, greater levels of ongoing supervision of engagement team members, and new, innovative ways of collecting audit evidence. Auditors are reminded to exercise professional skepticism. This may be especially challenging as both management and auditors continue to work remotely and as auditors obtain evidence that is in different forms and of a different nature than what was originally planned.

Knowledge check

3. Which statement correctly reflects how an auditor should assess risk in the current environment?

    a. Changing conditions do not affect the initial assessment of risk.
    b. The initial risk assessment is established and followed regardless of the current environment.
    c. The rapidly changing conditions may require frequent revisions to the auditor's initial risk assessments.
    d. Depending on risks identified in prior years leads to sufficient understanding of risks affecting financial statements.

[25] *Focus on the Auditor's Risk Assessment*, CAQ, June 2020 (https://www.thecaq.org/focus-on-the-auditors-risk-assessment/).

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Considering fraud risks

Auditing standards require the auditor to assess the risks of material misstatement in the financial statements, whether due to error or fraud. Assessing fraud risk can be especially challenging given that fraud involves an intent to deceive. Staying alert to incentives and pressures, opportunities, and attitudes and rationalization that may lead to fraud requires continued focus throughout the audit. In January 2021, the Anti-Fraud Collaboration (AFC) issued a research report, *Mitigating the Risk of Common Fraud Schemes: Insights From SEC Enforcement Actions*,[26] that is based on its analysis of common financial statement fraud schemes described in SEC enforcement actions against companies, company employees, and outside auditors. The objective of this study is to provide observations about higher-risk areas that are susceptible to fraud and insights as to what organizations can do to identify and mitigate these types of fraud risks. This section briefly highlights some of the key findings.

Common fraud schemes

Several types of frauds appeared frequently in the enforcement actions. To no surprise, fraud schemes that increase income either through revenue recognition or expense manipulation occur most frequently. Common fraud schemes involved manipulations of reserves, inventory accounts, and impairments of assets. Revenue-related issues included improper revenue recognition attributable to timing valuations, fictitious revenues, and percentage of completion. Reserve manipulations related to improper reduction of reserves, timing of reserves, and recording of expenses, and failure to record liabilities. Impairment manipulations included loan impairment deferral, failure to record asset impairment, faulty valuations, and improper reserves. Some of the schemes also included manipulating disclosures or books and records, creating unsupported journal entries, or taking advantage of internal control deficiencies.

Root causes

The AFC's report highlights the following three primary root causes:

Tone from above: Several of the enforcement actions revealed elements of an overall culture and tone at the top that did not encourage ethical behavior or deter wrongdoing. Examples of an ineffective tone include a focus on revenues and profits at all costs, condoning an acceptance or culture of lax procedures or disregard for controls, tying compensation or bonuses to unrealistic goals, and retaliating against employees who report fraud or other misconduct.

High-pressure environment: A high-pressure environment where demands are placed on employees to meet unrealistic goals may cause some employees to feel as if their jobs are threatened if they don't circumvent certain standards or procedures. When the organization's culture causes some employees to

[26] Mitigating the Risk of Common Fraud Schemes: Insights From SEC Enforcement Actions, January 2021, CAQ (https://www.thecaq.org/wp-content/uploads/2020/12/afc-mitigating-the-risk-of-common-fraud-schemes-2021-01.pdf).

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perceive it is unacceptable to deliver bad news, employees may take steps to affect the underlying accounting to meet the numbers that are expected.

Lack of personnel with sufficient accounting experience or training: In light of new or complex accounting standards, the need for an accounting staff that is experienced and well trained is growing. Less experienced personnel may not recognize the underlying complexities in accounting and may fail to obtain the right kinds of supporting documentation to comply with those standards.

Characteristics of fraud cases

The AFC's report highlights some of the characteristics associated with the SEC enforcement actions examined.

Alleged perpetrators: The ATC study notes that company CFOs are the most commonly charged employees, followed by CEOs and other officers such as chief accounting officers.

Industries: The ATC study found that the industry sector most commonly charged was technology services. The finance, energy, manufacturing, and health care industries also experienced several accounting and reporting issues. Technology companies often were charged for having revenue recognition issues, particularly premature recording of revenue. Finance and energy companies were often charged for reserve- and impairment-related issues.

Size: About 60% of the cases involved companies with market capitalization under $2 billion, including 39% of the population of cases examined involving market capitalizations under $250 million.

Importance of maintaining and applying professional skepticism

As auditors plan and perform current and upcoming audit engagements, they should adopt an attitude of professional skepticism. So, what is professional skepticism? The PCAOB defines *professional skepticism* as "an attitude that includes a questioning mind and a critical assessment of audit evidence."

Professional skepticism is essential to the performance of effective audits and is to be maintained throughout the audit by each individual on the engagement team. This is especially important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business, as well as in the assessment of fraud risk. For example, a questioning mindset or critical assessment of evidence is needed when examining high-risk transactions such as nonrecurring reserves, financing transactions, and related-party transactions. Professional skepticism is also imperative in the diligent pursuit of sufficient appropriate audit evidence, particularly when contrary evidence may exist.

Auditors may be challenged when maintaining a questioning mindset and critical assessment of audit evidence because of unconscious human biases and other circumstances that can cause auditors to gather, evaluate, rationalize, and recall information in a manner that is more consistent with expectations and pressures from the client than the best interests of external users.

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Other incentives and pressures can also interfere with the auditor's application of professional skepticism. Fee pressures, scheduling, or workload demands may lead auditors to accept information too quickly. Also, for longtime clients, auditors may be lured into placing too much trust in management in order to avoid negative encounters with members of management.

The PCAOB publishes Staff Audit Practice Alerts to highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the PCAOB standards. The PCAOB issued Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (PCAOB Staff Guidance, sec. 400), which focuses on the appropriate application of professional skepticism in audits. This alert may serve as a good refresher of the importance of applying professional skepticism in the performance of attest work.[27]

SAS No. 145

The Auditing Standards Board included new guidance and examples in SAS No. 145 related to maintaining professional skepticism during risk assessment procedures and related activities.

> Professional skepticism is necessary for the critical assessment of audit evidence gathered when performing risk assessment procedures. In addition, professional skepticism assists the auditor in remaining alert to audit evidence that is not biased toward corroborating the existence of risks or that may be contradictory. Professional skepticism is an attitude that is applied by the auditor when making professional judgments that then provide the basis for the auditor's actions. The auditor exercises professional judgment in determining when the auditor has audit evidence that provides an appropriate basis for risk assessment.
>
> Examples of maintaining professional skepticism by the auditor may include the following:
>
> • Considering information that may be used as audit evidence
>
> • Taking into account contradictory information that comes to the auditor's attention
>
> • Considering responses to inquiries and other information obtained from management and those charged with governance
>
> • Being alert to conditions that may indicate possible misstatement due to fraud or error

[27] See PCAOB Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (December 4, 2012).

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• Considering whether audit evidence obtained supports the auditor’s identification and assessment of the risks of material misstatement in light of the entity’s nature and circumstances

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Summary

Current auditing standards require the auditor to obtain an understanding of the entity and its environment as part of audit planning to help the auditor pinpoint areas that may represent higher risks of material misstatement. This course highlights many of the important considerations auditors should make to help them in obtaining this understanding. In particular, this course highlights key matters auditors consider in making their assessment of the risk of material misstatement in the financial statements. These include the client's industry, regulatory requirements, and economy, the nature of the entity, and the organization's objectives and strategies.

Auditors need to be aware of key economic trends as they plan current audit engagements so that they can effectively reduce audit engagement risk to an acceptably low level. In some cases, economic trends may lead to tremendous uncertainties that may stretch the entity's abilities to generate accurate and reliable financial information, or they may require new business models or ways of doing business that may affect the nature and extent of disclosures needed in financial statements. This course presents key economic trends and recent legislative and regulatory decisions for auditors to consider during the performance of their current and upcoming audits.

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Solutions

The Current Environment and Implications for Audit Planning

Case study solutions

1. Stimulus money provided by the CARES Act helped boost consumer spending following the shock of the pandemic in March 2020. Although spending on travel and hospitality came to a halt, consumers shifted their spending to other tangible products and services, particularly home furnishings and appliances. Demand for many consumer products, including high-end luxury items, has remained strong. The biggest issue has been supply chain challenges that have limited the availability of certain goods. Low unemployment throughout 2022 and 2023 are helping to maintain a relatively strong retail sector. Concerns about inflation may lead to some dampening of spending on high-end luxury items.

2. Extended periods of low interest rates made it difficult for banks to generate profits through lending following the pandemic, but recent rate increases by the Federal Reserve have re-opened opportunities to enhance bank profitability, despite their higher borrowing costs. With interest rate increases occurring, lending activities related to commercial real estate are having to anticipate whether more permanent moves to remote working environments may trigger less demand from businesses for leasing and owning real estate for their businesses. That may affect the demand for commercial real estate loans. Volatility in certain agricultural markets (e.g., wheat), triggered by the Russian invasion of Ukraine, may affect loan demand from agriculture-based entities.

3. Over the past few years, many organizations in the oil and gas industry had to reduce operating costs through layoffs and other cost-cutting measures, given the continued low oil prices. The reduction in oil prices affected valuations of fixed assets and other investments. Although oil prices plummeted drastically in mid-2020 as the stay-at-home shutdowns occurred, those prices had returned to around $120 per barrel in March 2022 as sanctions imposed on Russia-produced oil took effect. However, since March 2022, prices have fallen back to below $80 per barrel as of February 2023. Uncertainties about supply and demand along with increasing regulation and the focus on fossil fuels and the drive towards alternative energy sources may affect long-term outlooks for oil and gas distributors. Those challenges may affect the underlying processes important to financial reporting.

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Knowledge check solutions

1.

   a. Incorrect. Although business risks are important in planning an audit, the auditor does not provide assurance about business risks.

   b. Correct. The purpose of obtaining an understanding of the entity and its environment, including internal controls, is to assess the risk of material misstatements in the financial statements.

   c. Incorrect. The auditor does not assess management performance, which is more of an internal people's team function.

   d. Incorrect. The auditor of a nonissuer does not provide assurance about the effectiveness of internal control as part of the financial statement audit.

2.

   a. Correct. This statement about the current economic environment is accurate, given the consumer price index was at 6.4% in January 2023 — well above pre-pandemic levels.

   b. Incorrect. This statement is incorrect with both the Dow Jones Industrial Average and NASDAQ indexes at new record levels in early 2022 and falling thereafter.

   c. Incorrect. This statement is inaccurate with unemployment at 3.4% in early 2023.

   d. Incorrect. This statement is inaccurate. Inflation was at 6.0% in February 2023, and only a gradual decrease is expected.

3.

   a. Incorrect. This statement is inaccurate because changing conditions require greater levels of ongoing risk assessment and vigilance.

   b. Incorrect. The auditor's responses based on the initial assessment may need to be updated more frequently in light of the quickly changing environment.

   c. Correct. The rapidly changing conditions may require frequent revisions to the auditor's initial risk assessments. As the assessments are updated, the auditor's responses based on the initial assessment need to be updated, and the auditor needs to ensure responses are made in light of the updated understanding about risks.

   d. Incorrect. Depending too much on risks identified in prior years may lead to insufficient understanding of risks affecting financial statements.

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New Statements on Auditing Standards

Learning objectives

- Determine the key elements related to the auditor's risk assessment, in particular, obtaining an understanding of the entity's system of internal control and assessing control risk outlined in SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.[1]

- Identify the key elements included in the recently issued new SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*.

- Determine the impact from the issuance of SAS No. 148, *Amendment to AU-C Section 935,* which makes conforming changes to AU-C Section 935, *Compliance Audits*[2], based on the recently issued SAS No. 142, *Audit Evidence*, and SAS No. 145, *Understanding the Entity and Its Environment and Assessing Risks of Material Misstatement*.

- Identify the fundamental aspects of the recently issued new SAS No. 149, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*.

[1] All SASs can be found in AICPA *Professional Standards*.

[2] All AU-C sections can be found in AICPA *Professional Standards*.

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This course presents some of the most significant changes to the audit process resulting from the issuance of these three new Statements on Auditing Standards issued by the Auditing Standards Board (ASB) from mid-2020 through February 2023. In addition to these new auditing standards, the ASB also issued SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, which is discussed in a separate course regarding the new Statements on Quality Management Standards (SQMS). Recent exposure drafts and other audit and attest guidance are addressed in a different course.

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SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

In October 2021, the ASB issued SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

This new SAS affects the guidance in certain AU-C sections as follows:

- Supersedes AU-C section 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements*
- Amends the following AU-C sections:
  - Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
  - Section 210, *Terms of Engagement*
  - Section 230, *Audit Documentation*
  - Section 240, *Consideration of Fraud in a Financial Statement Audit*
  - Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
  - Section 260, *The Auditor's Communication With Those Charged With Governance*
  - Section 265, *Communicating Internal Control Related Matters Identified in an Audit*
  - Section 300, *Planning the Audit*
  - Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
  - Section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
  - Section 500, *Audit Evidence*
  - Section 501, *Audit Evidence — Specific Considerations for Selected Items*
  - Section 505, *External Confirmations*
  - Section 530, *Audit Sampling*
  - Section 540, *Auditing Accounting Estimates and Related Disclosures*
  - Section 550, *Related Parties*
  - Section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
  - Section 610, *Using the Work of Internal Auditors*
  - Section 620, *Using the Work of an Auditor's Specialist*
  - Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
  - Section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*
  - Section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*
  - Section 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*
  - Section 930, *Interim Financial Information*
  - Section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

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Effective date

SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023.

Background

In August 2020, the ASB issued an exposure draft of the proposed SAS that would supersede the guidance in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The goal of that project is to modernize the risk assessment standard by enhancing the requirements and guidance with respect to identifying and assessing the risks of material misstatement. In particular, the guidance is intended to address the effort related to gaining an understanding of the entity's system of internal control and assessing control risks. Further, it includes extensive new guidance on information technology.

The AICPA's Enhancing Audit Quality Initiative identified the auditor's risk assessment as an area of focus in 2019, in part because deficiencies in the process of obtaining the required understanding of internal control is a common audit issue identified by practice monitoring programs worldwide. The ASB has also followed the project of the International Auditing and Assurance Standards Board (IAASB) to revise ISA 315, *Identifying and Assessing the Risks of Material Misstatement* (ISA 315 Revised). ISA 315 (Revised) is effective for audits of financial statements for periods beginning on or after December 15, 2021. The ASB Risk Assessment Task Force was formed to consider the implications of this project when identifying and assessing the risks of material misstatements for audits of nonissuers.

In developing the exposure draft, the ASB used ISA 315 (Revised) as the base standard but made certain changes to the language in ISA 315 (Revised) to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment, which has led to the issuance of SAS No. 145.

Key provisions of SAS No. 145

Although SAS No. 145 does not fundamentally change the key concepts underpinning audit risk, the scope of SAS No. 145 is significant because it clarifies and enhances a number of aspects that address the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements. The following sections provide an overview of the key provisions of SAS No. 145.

Overarching objective of SAS No. 145

An objective of this new standard is to enhance the auditing standards relating to the auditor's risk assessment to enable auditors to appropriately address the following:

- *a.* Understanding the entity's system of internal control; in particular, relating to the auditor's work effort to obtain the necessary understanding
- *b.* Modernizing the standard in relation to IT considerations, including addressing risks arising from entity's use of IT

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c. Determining risks of material misstatements, including significant risks

Process for identifying and assessing risks of material misstatement

Auditing standards require auditors to perform risk assessment procedures to identify and assess the risk of material misstatement at the overall financial statement and at the relevant assertion level and to design further audit procedures. Risk assessment procedures include inquiries of management and other appropriate individuals within the entity, analytical procedures, and observation and inspection.

The new SAS emphasizes the importance of understanding the entity's IT environment, with particular focus on those aspects that are relevant to financial reporting. To modernize the standard, the new SAS includes significant enhancements that now require the auditor to understand certain aspects of the entity's use of IT in its business and system of internal control to help the auditor identify risks of material misstatement that may arise from the entity's use of IT. The guidance also enhances requirements related to the identification of general IT controls.

SAS No.145 also contains several enhancements to the auditor's

- exercise of professional skepticism;
- consideration of inherent risk factors that may affect the entity's susceptibility of misstatement due to fraud; and
- understanding of the applicable financial reporting framework, which is critical to identifying and assessing potential risks of material misstatement.

Scalability of guidance

Although SAS No. 145 does not change key concepts underpinning audit risk, such as inherent risk and control risk, the new standard provides expanded guidance to emphasize the importance of an effective risk assessment for entities of all sizes. SAS No. 145 acknowledges that, although size of the entity matters, it is the level of complexity in the nature of the entity and its financial reporting that are the primary drivers of scalability. Even smaller entities have complex business models and financial reporting processes, which require the performance of detailed risk assessments. The new standard notes that some of the considerations for entities that are less complex may be applicable in audits of large but less complex entities.

SAS No. 145 includes application guidance to address risk assessment considerations for less complex entities (that may or may not be small). Some of that guidance is placed side-by-side with the guidance for more complex entities to demonstrate scalability. The new standard removes the extant "Considerations Specific to Smaller Entities" sections but incorporates that guidance throughout.

Understanding the entity's system of internal control

Because inspection findings and outreach have highlighted some confusion about the expectations related to the requirements for obtaining an understanding of the entity's system of internal control in every audit, the ASB has included in the new SAS a number of clarifications specific to this understanding. The term *internal control* has been changed to *system of internal control*. The use of the term *controls* has been clarified by including the following definition in the standard:

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"Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context

i. *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."*

These clarifications are included because the ASB believes that understanding certain aspects of the entity's system of internal control is integral to the auditor's identification and assessment of risks of material misstatement, regardless of the auditor's planned reliance on internal controls as part of the audit strategy.

SAS No. 145 makes it clear that the required understanding of internal control includes understanding each of the five components of the system of internal control that include the following:

- The control environment
- The entity's risk assessment process
- The entity's process to monitor the system of internal control
- The information system and communication
- Control activities

The ASB believes that the auditor needs to obtain an understanding of certain aspects of each of the five components of the system of internal control. The new SAS requires the auditor to perform risk assessment procedures for each of the five components, and inquiry alone is not sufficient. The new SAS also recognizes that a deficiency may arise in any of the five components of the entity's system of internal control.

Distinguishing direct from indirect controls

SAS No. 145 notes that each component of the system of internal control comprises a collection of controls, which may be director or indirect. SAS No. 145 differentiates indirect controls from direct controls:

- *Indirect controls*. Controls that are typically more "indirect" in nature given that they generally do not directly address the risks of material misstatement at the assertion level. Rather, they are more indicative of risks at the financial statement level. The three components of internal control that are "indirect controls" include the control environment, risk assessment, and monitoring.
- *Direct controls*. Controls that typically directly address the risks of material misstatement at the assertion level. The two components of internal control that are "direct controls" include information system and communication and control activities.

The new SAS clarifies the requirements related to understanding each of the five components by setting out matters that need to be understood. The ASB also clarifies the list of the types of control activities that are always relevant to the risks of material misstatement. These include understanding

- control activities that address a significant risk,
- controls over journal entries, including nonstandard journal entries, and

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- controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.

It also clarifies that controls that address the risk of material misstatement at the financial statement assertion level are primarily control activities.

SAS No. 145 includes appendix C, which further describes the nature of an entity's system of internal control and inherent limitations of internal control.

Modernizing the standard for evolving nature of business and increased automation

The complex nature of business, the rapid embrace of technologies, and the evolving regulatory aspects are changing underlying business models for entities and their related internal controls. One of the goals of SAS No. 145 is to update the context of the guidance to reflect the current business environment. Auditors are increasingly using automated tools and techniques (including audit data analytics) when performing risk assessment procedures. Although changes recognize the use of these tools, the ASB is not requiring the use of specific tools or techniques.

The most significant enhancements related to addressing the use of IT are in the requirements for understanding the information and communication component of the entity's system of internal control. The auditor is now required to understand the related IT environment in order to gain a high-level understanding of the nature and complexity the IT environment and its supporting processes. Based on that understanding, the auditor determines which IT applications and aspects of the IT environment are subject to risks arising from the use of IT. This helps the auditor identify IT applications for which risks arising from the entity's use of IT may exist and affect the design, implementation, and operating effectiveness of automated controls.

The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system because the entity's use of IT applications may give rise to risks resulting from the use of IT. The auditor's understanding of the IT environment may focus on identifying and understanding the nature and number of the specific IT applications that are relevant to the flows of transactions and processing of information in the information system.

Understanding IT general controls

SAS No. 145 includes revisions that now require the auditor to identify general IT controls that address the risks arising from the use of IT, including evaluating their design and implementation. This guidance is presented in the guidance related to understanding control activities.

The new SAS defines the terms *risks arising from the use of IT* and *general IT controls* as follows:

> General 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.

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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 IT processes.

SAS No. 145 notes that general IT controls need not be identified for every IT process. Rather, the auditor identifies general controls that address risks related to the design, implementation, and operating effectiveness of automated controls that are important to addressing risks of material misstatement. The ASB believes that it is not necessary for the auditor to identify risks that arise from the entity's use of IT or general IT controls unless they relate to IT applications that are determined to be relevant for the auditor's purposes.

To identify the risks arising from the use of IT, the auditor identifies the IT application and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risk of material misstatement at the assertion level.

The new SAS clarifies that when an entity's IT environment consists only of commercial software for which the entity does not have access to the underlying source code such that no program changes can be made, the auditor's procedures regarding the entity's IT applications may be more limited.

Appendix E of the SAS No. 145 contains guidance on understanding the entity's use of IT in the five components of the system of internal control. Appendix F contains guidance to assist the auditor in understanding general IT controls.

Determining the risk of material misstatement

The new standard emphasizes that the auditor's risk assessment process is iterative and dynamic. Initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process.

SAS No. 145 includes clearer descriptions of the required risk identification and assessment process. The key changes to accomplish this include the following:

- More detailed inherent risk characteristics that affect the susceptibility of an assertion to misstatement — SAS No. 145 includes appendix B, which contains further explanation about inherent risk factors and the auditor's consideration of those factors when identifying and assessing the risks of material misstatement.
- Inclusion of the concept of "spectrum of inherent risk" to recognize that inherent risk factors are higher for some assertions relative to others
- Requirement to identify the relevant assertions in which risks of material misstatement exist and need to be addressed by further audit procedures
- Inclusion of the concept of "significant class of transactions, account balance or disclosure" to clarify the scope of the auditor's understanding of the information system — SAS No. 145 notes that a class of transactions, account balance, or disclosure is considered significant when it has an identified risk of material misstatement at the assertion level. That determination is made before considering any related controls.
- Emphasis on the fact that "significant risks" are based on inherent risk considerations only

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- Making it clear that if the auditor does not contemplate testing the operating effectiveness of controls or is not required to test controls, control risk is assessed at maximum — That is, the assessment of the risk of material misstatement is the same as the assessment of inherent risk.
- Clarification that the auditor's work on evaluating the design and implementation of controls may affect the assessment of risks of material misstatement and therefore the nature and extent of substantive procedures performed

The new standard does not prescribe an order in which the requirements related to the identification of risks of material misstatements are to be applied given firms have different methodologies regarding the implementation of these requirements and given the risk assessment process if iterative.

Separate assessements of inherent risk and control risk

The new standard now requires that a separate assessment of inherent risk and control risk should be made. The auditor should assess inherent risk by assessing the likelihood and magnitude of misstatement. If the auditor plans to test the operating effectiveness of controls, the auditor should assess control risk. If not, 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. In other words, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level.

Identifying and assessing risks of material misstatement at the financial statement level

SAS No. 145 includes expanded descriptions of risks of material misstatement at the financial statement level. It attempts to clarify the relationship between risks at the assertion level and risks at the financial statement level. The new SAS notes that 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 consist of two components — inherent risk and control risk.

When risks at the assertion level relate to a number of assertions in multiple classes of transactions, account balances, or disclosures, the risk is considered to exist at the financial statement level. The assessment of risks at the financial statement level may also involve identifying risks that are pervasive at the financial statement level (e.g., risks of management override of controls) that cannot be linked to specific assertions. Risks at the overall financial statement level require an overall response by the auditor.

The ASB also recognizes that deficiencies in "indirect controls," in particular, the control environment, are likely to have a more pervasive effect on a number of assertions related to classes of transactions, account balances, and disclosures.

Identifying significant risks

SAS No. 145 revises the definition of "significant risks" to focus on those risks for which the assessment of inherent risks is close to the upper end of the spectrum of inherent risk, not on the response to those risks. The new SAS emphasizes that significant risks are based on inherent risk alone, excluding the effects of identified controls related to the risks.

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The new SAS also acknowledges that the determination of whether a risk is a significant risk requires application of professional judgment. A significant risk is not limited to those risks with both a higher likelihood of occurrence and higher magnitude of potential misstatement should the risk occur. A significant risk could also include risks potentially lower in likelihood but for which the magnitude could be very high if it occurred.

SAS No. 145 no longer requires the auditor to determine whether a financial statement level risk is a significant risk. However, identified risks of material misstatement at the financial statement level may affect the auditor's assessment of significant risks at the assertion level.

"Stand-back" requirement

SAS No. 145 includes a new "stand-back" requirement to evaluate the completeness of the identification of significant classes of transactions, account balances, and disclosures. The goal is to strengthen the completeness of the identification of the risks of material misstatement. The stand-back requirement particularly focuses the auditor on material classes of transactions, account balances, and disclosures that have not been determined to be significant.

For material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures, SAS No. 145 requires the auditor to evaluate whether the auditor's determination remains appropriate. Materiality is in the context of the financial statements. Accordingly, classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements.

Amendments to other AU-C sections

SAS No. 145 includes a number of amendments to other AU-C sections to conform that guidance to concepts and terminology contained in the new SAS.

Documentation requirements

SAS No. 145 includes the following documentation requirements:

a. The discussion among the engagement team and significant decisions reached
b. Key elements of the auditor's understanding of the entity and its environment, including internal control, the sources of information the auditor used to obtain the understanding, and the risk assessment procedures performed
c. The evaluation of the design of identified controls and determination of whether such controls have been implemented (This is a new documentation requirement in SAS No. 145.)
d. The identified and assessed risks of material misstatement at the financial statement and at the assertion level, including significant risks and the risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence and the rationale for the significant judgments made
e. The rationale for significant judgments made regarding the identified and assessed risks of material misstatement (This is a new documentation requirement in SAS No. 145.)

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Knowledge check

1. Given SAS No. 145, *Understanding the Entity and Its Environment and Assessing Risks of Material Misstatement*, how should the auditor consider inherent and control risk?

    a. The auditor must conduct a combined assessment of inherent risk and control risk.
    b. The auditor would need to consider the relevant control risk in addition to inherent risk when determining that a risk is a significant risk.
    c. The auditor should identify the relevant assertions in which risks of material misstatement exist and need to be addressed by further audit procedures.
    d. The auditor may rely on the operating effectiveness of controls when control risk is assessed at maximum.

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SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*

In June 2022, the ASB issued SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*, 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 regulation.

This new SAS amends SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, as amended*, section 210, *Terms of Engagement*.

Effective date

The amendments to AU-C section 210, *Terms of Engagement*, resulting from the issuance of SAS No. 147 are effective for audits of financial statements for periods beginning on or after June 30, 2023.

Background

The ASB undertook this project to consider changes to AU-C section 210 to complement a related project by the AICPA's Professional Ethics Executive Committee (PEEC) regarding interpretations of the AICPA Code of Professional Conduct and to converge AICPA standards with those at the international level. Coinciding with the issuance of SAS No. 147, the PEEC has adopted "Responding to Noncompliance with Laws and Regulations" interpretations (ET sec. 1.180.010 and ET sec. 2.180.010).

International Standards

The International Ethics Standards Board for Accountants (IESBA) *International Code of Ethics for Professional Accountants* (IESBA code) requires a predecessor auditor to "provide all relevant facts and other information concerning the identified or suspected noncompliance (with laws and regulations) to the proposed accountant. The predecessor accountant shall do so even … where the client fails or refuses to grant the predecessor accountant permission to discuss the client's affairs with the proposed accountant, unless prohibited by law or regulation."

In 2016, the International Auditing and Assurance Standards Board (IAASB) revised ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, to reflect certain relevant changes as adopted in the IESBA code. For example, ISA 250 (Revised) includes a conforming change to paragraph .A9 of ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*, which states, in part, "where the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-compliance with laws and regulations, the IESBA Code requires that the predecessor auditor, on request by a proposed successor auditor, provide all such facts and other

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information concerning such non-compliance that, in the predecessor auditor's opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment." As the AICPA Code of Professional Conduct (AICPA code) has not been similarly revised, the ASB has not revised AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements.* AU-C section 250 was last revised in October 2011 with the issuance of SAS No. 122

PEEC developments

In March 2017, the AICPA's Professional Ethics Executive Committee (PEEC) issued an exposure draft with proposals for two new interpretations titled "Responding to Noncompliance with Laws and Regulations." Although similar to the IESBA code, the exposure draft explained that certain differences were necessary to enhance the clarity of the proposed interpretations and make them relevant to AICPA members in the United States. Most notably, certain provisions were not included in the AICPA proposals because they were believed to be incompatible with most state laws and regulations on client and employer confidentiality. The AICPA code does not permit a CPA to disclose confidential client information without client or employer consent unless required by professional standards. The following is the applicable excerpt from the AICPA code:

1.700.001 Confidential Client Information Rule

.01 A *member* in *public practice* shall not disclose any *confidential client information* without the specific consent of the *client*.

.02 This rule shall not be construed (1) to relieve a *member* of his or her professional obligations of the "Compliance With Standards Rule" [1.310.001] or the "Accounting Principles Rule" [1.320.001]

In response to PEEC's exposure draft, comments were received expressing concern that the proposed language would discourage CPAs from acting in the public interest even after the CPA demonstrated compliance with all relevant professional standards. PEEC issued a revised exposure draft on February 25, 2021. In February 2022, the PEEC issued the final amended interpretations as "Responding to Noncompliance with Laws and Regulations" interpretations (ET sec. 1.180.010 and ET sec. 2.180.010). ET sec. 1.180.010 applies to all members in public practice and ET sec. 2.180.010 applies to all members in business. The interpretations establish a member's responsibilities when they are informed of a client's or employer's noncompliance with laws and regulations (NOCLAR) and guide the member on how to respond to such information. The new ethics interpretations are effective June 30, 2023, and early implementation is allowed.

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Key provisions of SAS No. 147

SAS No. 147 clarifies requirements and guidance related to the auditor's inquiries of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement.

The new standard does not change the existing audit requirement that the auditor request management to authorize the predecessor auditor to respond fully to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement. However, as an option to address identified or suspected fraud and matters involving NOCLAR, SAS No. 147 revises auditing standards generally accepted in the United States of America (GAAS) 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 and matters involving NOCLAR. SAS No. 147 also clarifies that once the engagement is accepted, the auditor should document the inquiries of the predecessor auditor and the results of those inquiries.

The ASB believes this approach is similar to the approach included in the PCAOB's AS 2610, *Initial Audits — Communications Between Predecessor and Successor Auditors*[3] (PCAOB AS 2610), which directs the auditor to make more specific inquiries of the predecessor auditor after requesting permission from management to make an inquiry of the predecessor auditor. Furthermore, the absence of authorization by management for an auditor to make inquiries of a predecessor auditor should alert the auditor to carefully consider engagement acceptance, regardless of the basis for the lack of authorization.

SAS No. 147 does *not* change GAAS to require auditors to report fraud or NOCLAR to other outside parties, such as the appropriate authorities.

The following illustration highlights the narrow revisions to existing standards. The additional procedures are in purple.

[3] All PCAOB sections can be found in *PCAOB Standards and Related Rules*.

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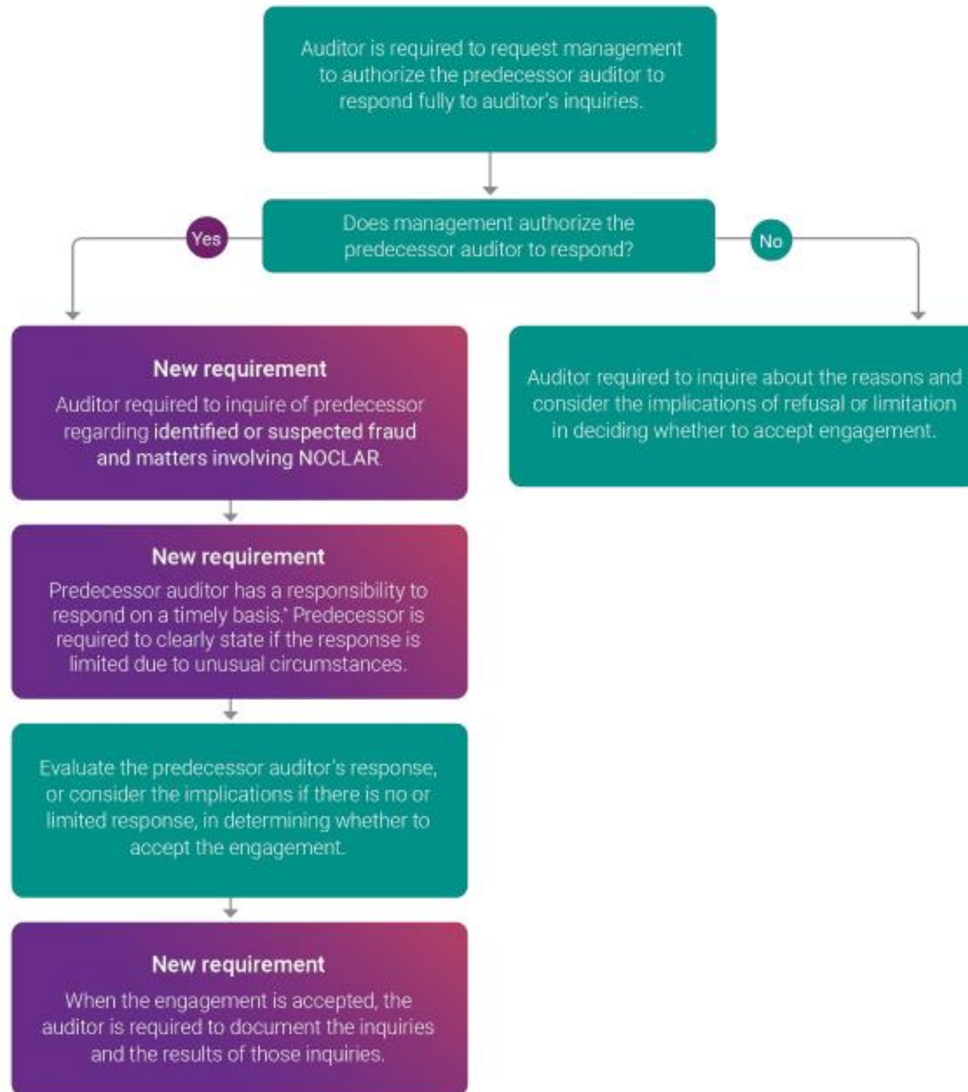

Management authorization of communication between auditor and predecessor auditor

The ASB considered an approach in which the auditor would be required to make inquiries of the predecessor auditor but would not be required to request management to authorize the predecessor auditor to respond fully to the auditor's inquiries. A majority of the ASB members concluded that such an approach would not be practical for the audit of financial statements of a nonpublic entity because the predecessor auditor may have no way of verifying that management was considering engaging the auditor, or the auditor may not be aware of the identity of the predecessor auditor. As a result, the ASB decided to retain the requirement in paragraph .11 of existing AU-C section 210 for the auditor, prior to

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accepting an initial audit, including a reaudit engagement, to request management to authorize the predecessor auditor to respond fully to the auditor's inquiries.

Further, the ASB believes that the requirement for the auditor to inquire about the reasons for a refusal to authorize the predecessor auditor to respond fully to the auditor's inquiries and to consider the implications of that refusal or limitation in deciding whether to accept the engagement results in sufficiently drawing the auditor's attention to potential concerns that could influence the engagement acceptance process.

This requirement is consistent with the requirements in PCAOB AS 2610.

Knowledge transfer from predecessoar auditor to auditor

If management authorizes the predecessor auditor to respond to the auditor's inquiries, SAS No. 147 requires the auditor to make specific inquiries regarding identified or suspected fraud and matters involving noncompliance with laws and regulations. The new SAS requires the auditor to inquire of the predecessor auditor about the following:

a. Identified or suspected fraud involving
   i. Management
   ii. Employees who have significant roles in internal control or
   iii. Others, when the fraud resulted in a material misstatement in the financial statements

b. Matters involving noncompliance or suspected noncompliance with laws and regulations that came to the predecessor auditor's attention during the audit, other than when the matters are clearly inconsequential.

These inquiries are consistent with matters that the predecessor auditor is required to communicate to those charged with governance.

The communication with the predecessor auditor may be either written or oral.

Timely response from predecessor auditor

The AICPA Code of Professional Conduct states that members have a responsibility to cooperate with one another. Therefore, the predecessor auditor is expected to respond to the auditor's inquiries promptly and, in the absence of unusual circumstances, fully, unless prohibited by applicable law, on the basis of known facts.

SAS No. 147 adds a requirement that when the predecessor auditor decides, due to impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to fully respond to the auditor's inquiries, the predecessor auditor should clearly state that the response is limited. Such circumstances are expected to be rare.

The intent of the new standard is to facilitate a knowledge transfer of identified or suspected fraud and matters involving NOCLAR from a predecessor auditor to an auditor.

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Evaluation of the response

SAS No. 147 intends to assist the auditor in determining whether to accept the engagement. Thus, it requires the auditor to evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response, in determining whether to accept the engagement.

Additional documentation requirements

The new standard requires the auditor to document the inquiries and the results of those inquiries with the predecessor auditor, once the engagement is accepted.

Knowledge check

2. Which statement is accurate regarding SAS No. 147 on the auditor's inquiry of predecessor?

   a. Allow the predecessor auditor to respond without client consent
   b. Eliminate the confidentiality rule in the AICPA Code of Professional Conduct.
   c. Require the successor auditor to inquire of the predecessor auditor specifically about any identified or suspected fraud.
   d. Include specific inquiries about noncompliance with laws and regulations, including those that are clearly inconsequential.

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SAS No. 148, *Amendment to AU-C Section 935*

In August 2022, the ASB issued SAS No. 148, *Amendment to AU-C Section 935,* to amend AU-C section 935, *Compliance Audits*, to update that guidance to conform with recently issued SAS No. 142, *Audit Evidence* (AU-C section 500), and SAS No. 145.

Effective date

The amendment relating to AU-C section 501, *Audit Evidence — Specific Considerations for Selected Items,* in the appendix "AU-C Sections that are Not Applicable to Compliance Audits" is effective for compliance audits for fiscal periods 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 effectiveness of SAS No. 145.

Background

AU-C section 935, *Compliance Audits*, addresses the application of 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.

SAS No. 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 No. 142 (AU-C section 500, *Audit Evidence*)
- SAS No. 145 (AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*)

The ASB determined that no amendment is necessary to AU-C section 935 to reflect the issuance of the following SASs:

- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C section 540, *Auditing Accounting Estimates*)
- SAS No. 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 Information Sources*

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SAS No. 143 is codified in AU-C section 540, which is listed in the appendix as not applicable in its entirety to a compliance audit. SAS No. 144 amends only certain application material that is not relevant to AU-C section 935.

Key provisions arising from SAS No. 142

SAS No. 142 superseded SAS No. 122 and amended various AU-C sections, including AU-C section 501.

SAS No. 142 moved content relating to using the work of a management's specialist from AU-C section 500 to AU-C section 501, without any substantive changes. That guidance was applicable to compliance audits when it was in AU-C section 500 and that applicability did not change when it was relocated to AU-C section 501. Accordingly, the amendments in SAS No. 148 revise the appendix in AU-C section 935 to reflect that those provisions that were moved to AU-C 501 continue to apply in a compliance audit.

SAS No. 148 clarifies that no other paragraph in AU-C section 501 applies to a compliance audit.

Key provisions arising from SAS No. 145

Paragraphs 28 and 29 of SAS No. 145 include additional requirements related to control activities related to risks arising from the use of IT that also apply to a compliance audit.

Required risk assessment procedures

SAS No. 148 adds requirements for the auditor to perform risk assessment procedures, beyond inquiry, to evaluate whether controls that address the risks of material noncompliance are effectively designed and determine whether those controls have been implemented. This requirement amends AU-C section 935 to address certain controls that relate to guidance in paragraphs 26 and 27b–30 of SAS No. 145, which address requirements related to the control activities component, apply to a compliance audit. In particular, paragraph 27b–d addresses certain controls that the auditor is required to identify.

A new requirement has been added by SAS No. 148 to AU-C section 935 to address the auditor's responsibility in adapting and applying paragraphs 27b–30 of SAS No. 145 in a compliance audit. This new requirement also includes controls over compliance that are required to be tested for operating effectiveness by a governmental audit requirement (paragraph .20 of extant AU-C section 935). Thus, the new requirement combines the auditor's responsibilities under AU-C section 315 and AU-C section 935.

SAS No. 148 now requires the auditor to inquire about the following controls:

- *a.* Controls over journal entries and other adjustments as required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- *b.* Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include
    - i. controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, and

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ii. controls that are required to be tested for operating effectiveness by the governmental audit requirement as required by paragraph 24 of this section

c. Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to identify and assess risks of material noncompliance and design further audit procedures.

Required considerations of inherent risk

SAS No. 148 also adds a requirement that for identified risks of material noncompliance for each applicable compliance requirement, the auditor should assess inherent risk by assessing the likelihood and magnitude of noncompliance. In doing so, the auditor should take into account how, and the degree to which, inherent risk factors affect the susceptibility of compliance requirements to noncompliance.

Additionally, SAS No. 148 now requires the auditor to determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material noncompliance.

Required considerations of control risk

SAS No. 148 also adds a requirement that for identified risks of material noncompliance 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 noncompliance is the same as the assessment of inherent risk.

Paragraphs .28–.29 of AU-C section 315 include additional requirements related to control activities related to risks arising from the use of IT that also apply to a compliance audit. SAS No. 142 superseded AU-C section 500, *Audit Evidence* (AU-C sec. 500A), and amended various AU-C sections.

Extant AU-C section 935 excludes, within the appendix, the documentation requirement related to the identified and assessed risks at the financial statement level and assertion level (paragraph .33c of AU-C section 315A). The ASB believes that this requirement, adapted as necessary, is applicable to a compliance audit and has added a new requirement to AU-C section 935 based on paragraph 42d of SAS No. 145, which, consistent with other revisions, excludes significant risks. Specifically, SAS No. 148 amends AU-C section 935 to require the auditor to document the following:

> The identified and assessed risks of material noncompliance, including risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for significant judgments made.

Revisions to the Appendix in AU-C section 935

SAS No. 148 clarifies in the appendix to AU-C section 935 that the guidance in certain paragraphs of SAS No. 145 do *not* apply to compliance audits.

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- SAS No Paragraphs 27a of SAS No. 145, which relates to controls over significant risks, and paragraph 40, which relates to classes of transactions, account balances, and disclosures that are not significant but are material, were added to the appendix in AU-C section 935 as *not* applicable in a compliance audit.
- Historically, the concept of significant risks has not been applicable to a compliance audit. Likewise, the concept of classes of transactions, account balances, and disclosures that are material is *not* applicable to a compliance audit.

Knowledge check

3. What does the SAS No. 148 amendment to AU-C section 935, *Compliance Audits*, generally include?

    a. It requires the auditor in a compliance audit to perform risk assessment procedures beyond inquiry for controls that address risks for which substantive procedures alone do not provide sufficient appropriate evidence.
    b. It includes revisions to AU-C section 935 resulting from the issuance of SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C section 540).
    c. It integrates the concept of significant risks into AU-C section 935, *Compliance Audits*.
    d. It prohibits the use of evidence from management's specialists in a compliance audit.

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SAS No. 149, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*

In March 2023, the ASB issued SAS No. 149, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)* that supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification,* as amended, and AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*.

The SAS also amends the following AU-C sections:

- Section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- Section 230, *Audit Documentation*
- Section 260, *The Auditor's Communication With Those Charged With Governance*
- Section 300, *Planning an Audit*
- Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- Section 320, *Materiality in Planning and Performing an Audit*
- Section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- Section 450, *Evaluation of Misstatements Identified During the Audit*
- Section 501, *Audit Evidence — Specific Considerations for Selected Items*
- Section 510, *Opening Balances — Initial Audit Engagements, Including Reaudit Engagements*
- Section 550, *Related Parties*
- Section 610, *Using the Work of Internal Auditors*
- Section 700, *Forming an Opinion and Reporting on Financial Statements*
- Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
- Section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- Section 720, *The Auditor's Responsibilities Related to Other Information Included in Annual Reports*
- Section 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*
- Section 920, *Letters for Underwriters and Certain Other Requesting Parties*
- Section 930, *Interim Financial Information*
- Section 935, *Compliance Audits*, as amended
- Section 940, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*

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Effective date

SAS No. 149 will be effective for audits of group financial statements for periods ending on or after December 15, 2026.

Background

The ASB proposed revisions to the standards in the United States due to the same issues that led the IAASB to update its group audit standard. The ASB believes that it is particularly important to converge with International Standard on Auditing (ISA) 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)* ISA 600 [Revised]) for two primary reasons:

1. The ASB believes that the issues that led the IAASB to revise its standards are of equally critical importance in the United States.
2. For firms that perform engagements in accordance with standards of the IAASB and the ASB, it is not feasible for those firms to comply with fundamentally different standards for group audits.

Changes to extant AU-C section 600

The changes made to extant AU-C section 600 address the following issues:

- Concerns about the scope and applicability of extant AU-C section 600, including the need for greater clarity about whether, how, and the extent to which AU-C section 600 applies in certain circumstances
- Inadequate consideration by the auditor of certain matters that may be relevant when deciding whether to accept or continue a group audit engagement
- Inadequate involvement of the group engagement team in assessing the risks of material misstatement at the group financial statement level and in designing and performing appropriate responses to assessed risks
- Deficiencies in communication between component auditors and the group engagement team during the planning and performance of the group audit
- Variability in the application of the concepts of component materiality and component performance materiality in a group audit, in particular, in relation to the concept of aggregation risk
- The need for additional guidance on documentation related to
    - — restrictions on access to people or information, and
    - — the nature, timing, and extent of the group engagement team's direction and supervision of component auditors and review of their work.

Fundamental aspects of SAS No. 149

The following is a summary of the fundamental aspects and changes introduced by the new SAS:

- The new SAS clarifies the scope and applicability by
    - — Defining group financial statements as financial statements that include the financial information of more than one entity or business unit through a consolidation process. The addition of the words "through a consolidation process" is new to the definition of group

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financial statements and was added because a consolidation process is an integral part of the preparation of group financial statements.

  - Identifying the various ways in which consolidation may occur. This includes *(a)* proportionate consolidation, inclusion, or an equity method of accounting; *(b)* the presentation in combined financial statements of the financial information of entities or business units that are under common control or common management; and *(c)* the aggregation of the financial information of entities or business units such as branches or divisions.
  - Providing guidance on whether and how the SAS applies to entities with branches and divisions, shared service centers, and non-controlled entities.
- The new SAS clarifies that all the AU-C sections apply to a group audit and establishes stronger linkages to certain AU-C sections, particularly AU-C sections 220, 230, 300, 315, and 330. The requirements and application material in the new SAS build on, and are consistent with, the principles and requirements in those AU-C sections.
- The new SAS introduces a risk-based approach to planning and performing a group audit to achieve greater alignment with the requirements in AU-C sections 315 and 330; place greater focus on identifying and assessing the risks of material misstatement and performing further audit procedures in response to the assessed risks; and place greater focus on planning an appropriate approach to obtaining sufficient appropriate audit evidence. Under the risk-based approach, there is no longer a requirement for the group auditor to identify significant components and to audit those components. Rather, the group auditor determines an appropriate approach to obtain sufficient appropriate audit evidence to address assessed risks of material misstatement of the group financial statements, which may, and often will, involve audit procedures being performed at the component level.

New and revised terms and definitions

SAS No. 149 retains the two reporting options available to the group auditor in extant AU-C section 600, which are referred to as "assuming responsibility for the work of component auditors" and "making reference to the audit of a component auditor." In SAS No. 149, the "assuming responsibility" option is now referred to as "being involved in the work of component auditors" or "when component auditors are involved" and the terminology for the "making reference" option is unchanged.

SAS No. 149 introduces new terms and revises the definitions of certain terms. The new SAS revises the definition of *component auditor* and *engagement team* as reflected in AU-C section 220. AU-C section 220 provides the definition for an engagement team as follows:

> ***Engagement team:*** All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, excluding an auditor's external specialist and internal auditor who provide direct assistance on an engagement.

The new SAS revises the definition of *component auditor* as follows:

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Component auditor: An auditor who performs audit work related to a component[4] for purposes of the group audit. A component auditor is part of the engagement team for a group audit.

The new SAS introduces and defines the term *referred-to-auditor* as follows:

Referred-to auditor: An auditor who performs an audit of the financial statements of a component to which the group engagement partner determines to make reference in the auditor's report on the group financial statements. A referred-to auditor Is not a component auditor, and accordingly, is not a part of the engagement team for a group audit.

This is different from the extant AU-C 600 where an auditor for whom the group auditor assumes responsibility and an auditor to whom the group auditor makes reference are both termed *component auditors*. A referred-to auditor in the new SAS is equivalent to a component auditor to whom the group auditor makes reference in extant AU-C section 600. The definition of component auditor has been revised so that it excludes referred-to auditors

The new SAS replaces the term *group engagement team* used in extant AU-C section 600, with the term *group auditor*. A group auditor is defined as follows:

Group auditor: The group engagement partner and members of the engagement team other than component auditors. The group auditor is responsible for the following:

i. Establishing the overall group audit strategy and group audit plan.
ii. Directing and supervising component auditors and reviewing their work.
iii. Evaluating the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the group financial statements.

SAS No. 149 also revises the definition of *group financial statements* as follows:

Group financial statements: Financial statements that include the financial information of more than one entity or business unit through a consolidation process.

The consolidation process includes consolidation, proportionate consolidation, inclusion, or an equity method of accounting; the presentation in combined financial statements of the financial information of entities or business units that are under common control or common management; and the aggregation of the financial information of entities or business units such as branches or divisions.

Emphasis on engagement partner's overall responsibility

The new SAS requires the group engagement partner to take overall responsibility for managing and achieving quality on the group audit engagement. The group engagement partner should take responsibility for creating an environment for the group audit engagement that emphasizes the expected

[4] A *component* is defined as "An entity business unit, function or business activity, or some combination thereof, determined by the group auditor for purposes of planning and performing audit procedures in a group audit."

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behavior of engagement team members. AU-C section 220 explains that a culture that demonstrates a commitment to quality is shaped and reinforced by the engagement team members as they demonstrate expected behaviors when performing the engagement. The group engagement partner may communicate directly to other members of the engagement team (including component auditors) and reinforce this communication through personal conduct and actions (for example, leading by example).

The new SAS requires sufficient and appropriate involvement by the group engagement partner or group auditor throughout the audit engagement in the work of component auditors such that the group engagement partner has the basis for determining whether the significant judgments made, and the conclusions reached, are appropriate given the nature and circumstances of the group audit engagement.

Acceptance and continuance of the group audit engagement

Before accepting or continuing the group engagement, the group engagement partner should determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained (including through involving component auditors or through making reference to the audit of a referred-to auditor in the auditor's report on the group financial statements) to provide a basis for forming an opinion on the group financial statements. If after the acceptance or continuance of the group engagement the group engagement partner concludes that sufficient appropriate audit evidence cannot be obtained, the group engagement partner should consider the possible effects on the group audit.

Understanding the group and its environment

SAS No. 149 requires the group auditor to take responsibility for understanding the following:

- The group and its environment, its organizational structure, and business model The regulatory factors, and the measures used internally or externally to assess the entities or business units' financial performance.
- The applicable financial reporting framework and the consistency of accounting policies and practices across the group.
- The group's system of internal control.

The group auditor should communicate to the component auditors on a timely basis matters that the group auditor determines to be relevant to the component auditor's design or performance of risk assessment procedures for purposes of the group audit, including identified significant risks to the group financial statements. The group auditor should also communicate related party relationships and transactions identified by group management. Additionally, the group auditor should communicate events or conditions identified by group management or the group auditor that may raise substantial doubt about the group's ability to continue as a going concern for a reasonable period of time that are relevant to the work of the component auditor.

Responsibilities for risk assessment

The new SAS requires the group auditor to take responsibility for the identification and assessment of the risks of material misstatements of the group financial statements, including with respect to the consolidation process. The group auditor should evaluate whether the audit evidence obtained from the

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risk assessment procedures performed by the group auditor and component auditors provides an appropriate basis for the identification and assessment of the risks of material misstatement of the group financial statements.

Materiality considerations

The group auditor is responsible for determining component performance materiality. To address aggregation risk, such amount should be lower than group performance materiality. The group auditor is also responsible for determining the threshold above which misstatements identified in the component financial information are to be communicated to the group auditor. Such threshold should not exceed the amount regarded as clearly trivial to the group financial statements. The group auditor is responsible for communicating these matters to the component auditors.

Planning and performing audit procedures in response to assessed risks

The group auditor determines an appropriate approach to planning and performing audit procedures in response to the assessed risks of material misstatement in the group financial statements. The group auditor determines the components at which the audit work will be performed, including the performance of further audit procedures. The group auditor is also responsible for determining the nature, timing, and extent of further audit procedures to be performed and the components at which to perform the further audit procedures.

The group auditor should communicate with the component auditor about matters that the group auditor or component auditor determine to be relevant to the design of responses to the assessed risks of material misstatement of the group financial statements. For areas of higher assessed risks of material misstatement of the group financial statements, or significant risks identified on which a component auditor is determining the further audit procedures to be performed, the group auditor should evaluate the appropriateness of the design and performance of those further audit procedures.

Evaluating the component auditor’s communications and adequacy of work

SAS No. 149 requires the group auditor to request the component auditor to communicate matters relevant to the group auditor’s conclusion about the group audit. Such communications should include the following:

- Identification of the financial information on which the component auditor has been requested to perform audit procedure
- Whether the component auditor has performed the work requested by the group auditor
- Whether the component auditor has complied with the relevant ethical requirements, including those related to independence, that apply to the group audit engagement
- Information about instances of noncompliance with laws or regulations
- Corrected and uncorrected misstatements of the component financial information
- Indicators of possible management bias
- Description of any deficiencies in the system of internal control identified
- Fraud or suspected fraud

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- Other significant matters that may be relevant to the group audit, or that the component auditor determines are appropriate to draw to the attention of the group auditor, including exceptions noted in written representations that the component auditor requested from component management
- Overall findings or conclusions

The group auditor should discuss significant matters arising from communications with the component auditor and evaluate whether communications with the component auditor are adequate for the group auditor's purposes. If such communications are not adequate for the group auditor's purposes, the group auditor should consider the implications for the group audit.

Evaluating the sufficiency and appropriateness of audit evidence obtained

The new SAS requires the group auditor to evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed. Therefore, the group auditor should determine whether, and the extent to which, it is necessary to review additional component auditor audit documentation. When making this determination, the group auditor should consider the nature, timing, and extent of the work performed by the component auditor, the competence and capabilities of the component auditor, and the direction and supervision of the component auditor and review of their work. If the group auditor concludes that the work of the component auditor is not adequate for the group auditor's purposes, the group auditor should determine what additional audit procedures are to be performed and whether they are to be performed by a component auditor or the group auditor.

Considerations regarding making reference to the audit of a referred-to auditor

The group engagement partner should determine whether to make reference to the audit of a referred-to auditor in the auditor's report on the group financial statements. To assist with this determination, the group engagement partner should determine that the referred-to-auditors have been made aware of relevant ethical requirements that are applicable given the nature and circumstances of the group audit engagement and confirm whether the referred-to auditors understand and will comply with the ethical requirements that are relevant to the group audit engagement, including those related to independence. The group engagement partner should also determine that referred-to auditors have the appropriate competence and capabilities.

The reference to the audit of a referred-to auditor in the auditor's report on the group financial statements should not be made unless the group engagement partner has determined that the referred-to auditor has performed an audit of the financial statements of the component in accordance with relevant requirements of GAAS or PCAOB standards. The referred-to auditor's report cannot be restricted as to use.

When the group engagement partner determines to make reference to the audit of a referred-to auditor in the auditor's report on the group financial statements, the group auditor should obtain sufficient appropriate audit evidence with regard to such components. In addition to performing the procedures required by the new SAS , the engagement partner should also read the component's financial statements and the referred-to auditor's report to identify any significant findings or issues.

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Documentation

The audit documentation of a group audit engagement needs to be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing, and extent of audit procedures performed; the evidence obtained; and the conclusions reached with respect to significant matters arising during the group audit. Matters specific to component audits that should be documented include the following:

- The resolution for significant matters related to restrictions on access to people or information within the group that were considered before deciding to accept or continue the engagement, or that arose subsequent to acceptance or continuance.
- The basis for the group auditor's determination of components for purposes of planning and performing the group audit.
- The basis for determining component performance materiality and the threshold for communicating misstatements in the component financial information to the group auditor.
- The basis for the group auditor's determination that component auditors have the appropriate competence and capabilities, including sufficient time, to perform the assigned audit procedures at the components.
- Key elements of the understanding of the group's system of internal control
- The nature, timing, and extent of the group auditor's direction and supervision of component auditors and the review of their work, including, as applicable, the group auditor's review of additional component audit documentation
- Matters related to communications with component auditors, including matters, if any, related to fraud, related parties, or going concern and matters relevant to the group auditor's conclusion with regard to the group audit. This would include how the group auditor has addressed significant matters discussed with component auditors, component management, or group management.
- Matters specific to the financial statements of the component when the group auditor references the referred-to auditor's report in the auditor's report on the group financial statements.
- Components for which the group auditor uses audited financial statements of a noncontrolled entity that is accounted for by the equity method as sufficient appropriate audit evidence regarding the noncontrolled entity's financial results.
- The group auditor's evaluation of, and response to, findings or conclusions of the component auditor's or referred-to auditors about matters that could have a material effect on the group financial statements.

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Knowledge Check

4. What is a key objective of SAS No. 149, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*?

   a. To restrict the ability to use other audit firms when conducting an audit.
   b. To build mostly off the PCAOB's guidance related to group and component auditors.
   c. To exempt compliance with most of the AU-C sections for the portion of the audit conducted by the component auditors.
   d. To strengthen the quality of audits performed by group and component auditors and to increase consistency with international standards.

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Summary

This course presents some of the most significant changes to the audit process resulting from the issuance of new auditing standards. SAS No. 145 contains new guidance related to the auditor's risk assessment, which includes extensive changes to guidance related to understanding the entity and its environment, including internal controls, for purposes of assessing risks of material misstatement in the financial statements. SAS No. 147 includes updated guidance about auditor communications with the predecessor auditor, with particular focus on inquiries related to fraud and noncompliance with laws and regulations. SAS No. 148 includes several amendments to auditing standard related to compliance auditor due to the issuance of new standards related to audit evidence and risk assessment. SAS No. 149 provides a risk-based approach to planning and performing a group audit.

Participants should monitor the AICPA website for further developments. Particularly helpful for auditing standards is the ASB's section of the website. You can find meeting notices, agenda items, and meeting minutes that give information on current and upcoming activity throughout the year: www.aicpa.org/research/standards/auditattest/asb.html

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Solutions

New Statements on Auditing Standards

Knowledge check solutions

1.

a. Incorrect. SAS No. 145 requires that a separate assessment of inherent risk and control risk be made, consistent with the new requirements of SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.
b. Incorrect. SAS No. 145 notes that "significant risks" are based on inherent risk considerations only.
c. Correct. SAS No. 145 requires the auditor to identify the relevant assertions in which risks of material misstatements exist and need to be addressed by further audit procedures.
d. Incorrect. SAS No. 145 notes that when control risk is assessed as maximum, the auditor is not relying on the operating effectiveness of controls.

2.

a. Incorrect. SAS No. 147 still requires client permission for the predecessor auditor to respond to the successor auditor's inquiries.
b. Incorrect. SAS No. 147 does not include any proposed changes to the AICPA Code of Professional Conduct.
c. Correct. SAS No. 147 includes explicit inquiries of the predecessor auditor's knowledge of identified or suspected fraud.
d. Incorrect. SAS No. 147 includes explicit inquiries of the predecessor auditor's knowledge of noncompliance with laws and regulations, excluding those that are clearly inconsequential.

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3.

a. Correct. SAS No. 148 amendments to AU-C 935, *Compliance Audits*, require the auditor to perform risk assessment procedures beyond inquiry regarding controls that address risks for which substantive procedures alone do not provide sufficient appropriate evidence.
b. Incorrect. SAS No. 148 amendments to AU-C 935 incorporate key provisions from SAS No. 142, *Audit Evidence*, and 145, *Understanding the Entity and Its Environment and Assessing Risks of Material Misstatements*, but not SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.
c. Incorrect. SAS No. 148 amendments to AU-C 935 do not include revisions that incorporate the concept of significant risks into a compliance audit.
d. Incorrect. SAS No. 148 amendments now include guidance in the appendix of AU-C 935 related to use of management's specialists in a compliance audit.

4.

a. Incorrect. It does not restrict the ability to use other audit firms when conducting an audit. Instead, it aims to provide clearer direction when dealing with referred-to auditors and their work in the context of group audits.

b. Incorrect. It builds off both the PCAOB's guidance and IAASB with some fundamental differences related to group audits.

c. Incorrect. The new SAS does not exempt compliance with most of the AU-C sections for the portion of the audit conducted by the component auditors. In fact, one of the fundamental aspects highlighted in the new SAS is the clarification that all AU-C sections need to be applied in a group audit, which aims to establish stronger links to the other AU-C sections.

d. Correct. The new SAS seeks to strengthen the quality of audits performed by group and component auditors and to increase consistency with international standards.

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Other Standards-Setting Activities Affecting Audit and Attestation Engagements

Learning objectives

- Determine when a user auditor may rely on a SOC 2® service auditor's report when a SOC 1® report is not issued.
- Distinguish auditor responsibilities for other information included in the annual report when information is received after the auditor's report date.
- Identify whether a practitioner is required to perform an engagement in accordance with AT-C section 315, *Compliance Attestation*, when the practitioner is not engaged to report and does not report.

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This course highlights the key provisions contained in a recently issued auditing interpretation. It also highlights audit-related Technical Q&As issued by the AICPA and a new attestation interpretation.

Note: The Auditing Standards Board (ASB) has issued new Statements on Quality Management Standards that also include a related new SAS. Those new standards are addressed in a separate course focused on quality control.

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Recently issued auditing interpretation

The most recently issued auditing interpretation by the ASB was in December 2022 to provide clarifying guidance about a user auditor's consideration of a SOC 2 service auditor's report when a SOC 1 report is not issued.

New audit interpretation on audit considerations related to an entity using a service organization

Interpretation No. 1, "Considerations Related to the Use of SOC 2® Report in an Audit of a User Entity's Financial Statements," (AU-C sec. 9402, par. .01) of AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization,* provides guidance on how an auditor complies with the requirements in AU-C section 402.

Background

AU-C section 402 defines a *user entity* as an entity that uses a service organization and whose financial statements are being audited. It also defines a *service organization* as an organization or segment of an organizaiton that provides services to user entities that are relevant to those user entities' internl control over financial reporting (ICFR).

AU-C section 402 contains requirements and guidance for a user auditor related to the following:

- Obtaining an understanding of the nature and signficance of the services provided by a service organization and their effect on the user entity's internal control relevant to the audit, sufficiently to identify and assess the risks of material misstatement.
- Designing and performing audit procedures responsive to those risks.

This consideration involves understanding the nature and materiality of the transactions processed or accounts or financial reporting processes affected by the serivce organizations and the degree of interaction between the activities of the service organization and those of the user entity. It also involves understanding the nature of the relationship between the user entity and the service organization, including relevant contractual terms for the activities undertaken by the service organization.

SOC 1 reports

A service auditor may perform a SOC 1 engagement under the attestation standards to report on management of a service organization's description of its system (description) and the service organization's controls included in that description that are relevant to a user entity's ICFR. A SOC 1 report addresses the risks related to a financial statement audit and is intended to complement AU-C section 402. A SOC 1 report is the preferred report for use in an audit of a user entity's financial statements.

SOC 2 reports

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A service auditor may perform a SOC 2 engagement to report on an examination of controls at a service organization relevant to one or more of the trust services categories of criteria, which include security, availability, processing integrity, confidentiality, and privacy.

Although a SOC 2 report may provide a user auditor with information about the nature of the services provided by the service organization and the suitability of the design and operating effectiveness of certain controls at the service organization, a SOC 2 report is not specifically designed to address controls at a service organization relevant to a user entity's ICFR and therefore is unlikely to achieve the same purpose as a SOC 1 report.

New interpretative guidance

Because a SOC 2 report is not designed to serve the same purpose as a SOC 1 report, this interpretation provides guidance for a user auditor to understand the differences between the two types of reports and to provide considerations when determining whether a SOC 2 report may be used in the audit of a user entity's financial statements.

The following are some considerations when determining whether a SOC 2 report may be used in the audit of a user entity's financial statements and some of the limitations of using a SOC 2 report in these circumstances:

- *Purpose of the report*. A SOC 2 engagement, which is performed under AT-C section 205, *Assertion-Based Examination Engagements*, addresses controls at a service organization that are intended to provide reasonable assurance that the service organization's service commitments and system requirements are achieved, based on the applicable trust services criteria. Importantly, a SOC 2 engagement is not designed to address the services performed by a service organization that are likely to be relevant to a user entity's ICFR and therefore is unlikely to completely address the effect that the service organization has on a user entity's financial reporting.
- *Potential overlap with financial reporting*. A SOC 2 report may address certain areas that could be relevant to a user entity's ICFR, such as logical access and change management. However, in a SOC 2 engagement, the service auditor's tests of such controls may be designed to address a different set of risks and are unlikely to provide sufficient appropriate audit evidence regarding controls at a service organization relevant to a user entity's ICFR.

Example: Potential overlap with financial reporting

The service organization's service commitments and system requirements in a SOC 2 engagement typically address the effect that the change has on the security and availability of systems and therefore may not address the completeness, accuracy, and timeliness of the processing and reporting of transactions and balances relevant to a user entity's ICFR (for example, testing, approval, and implementation of changes into production).

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- *Scope of the report and understanding of the nature of the services provided by the service organization*. Because a SOC 2 report is not specifically designed to address services relevant to a user entity's ICFR, the description in a SOC 2 report may not include all the services, reports, statements, processes, and controls relevant to a user entity's ICFR.
- *Complementary user entity controls*. In a SOC 2 report, complementary user entity controls (CUECs) represent controls that management of the service organization assumed, in the design of the service organization's system, would be implemented by user entities and are necessary, in combination with controls at the service organization to provide reasonable assurance that the service organization's service commitments and system requirements would be achieved, based on the applicable trust services criteria. However, in a SOC 1 report, the CUECs represent controls that management of the service organization assumes, in the design of the service organization's system, will be implemented by user entities and are necessary to achieve a set of control objectives stated in the description that are relevant to user entities' ICFR. As a result, it is unlikely that a SOC 2 report will include the same set of CUECs that would be included in a SOC 1 report addressing similar services.

Example: Complementary user entity controls

If a service organization is responsible for performing logical access administration for users at the user entity, a SOC 1 report may include a CUEC indicating that the user entity provides complete, accurate, and appropriately authorized instructions for access changes. However, in a SOC 2 report, this control may not be identified as a CUEC because the service organization is able to meet its service commitments to administer access based on the instructions provided by the user entity, regardless of the completeness and accuracy of those instructions.

- *Access to the SOC 2 report not provided to downstream users*. For carved-out subservice organizations, paragraph .A70 of AT-C section 320 indicates that a user entity is also considered a user entity of the service organization's subservice organizations if controls at the subservice organizations are relevant to the user entity's ICFR. Paragraph .A70 refers to such user entities as *indirect* or *downstream* user entities. Because the definition of *user entity* in a SOC 2 engagement is substantially the same as it is in a SOC 1 engagement, downstream user entities of a SOC 2 report would be considered intended users of a SOC 2 report.
- *Services provided by subservice organizations likely to be relevant to a user entity's ICFR*. An additional user auditor consideration is that the scope of a SOC 2 report may not include all the services provided by subservice organizations that are likely to be relevant to a user entity's ICFR.

Example: Services provided by subservice organizations likely to be relevant to a user entity's ICFR

Although a service provider that provides pricing data for investments may be a relevant subservice organization for a SOC 1 report, it may not be relevant to the SOC 2 report based

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on the applicable trust services criteria, which are intended to address the service organization's service commitments and system requirements.

- *Information prepared for user entities*. The information included in a SOC 2 report may address information prepared for user entities that is relevant to the service organization's service commitments.

Example: Information prepared for user entities

System uptime reports address availability commitments and user access listings related to security commitments — but may not address other types of information and reports that would be relevant to a user entity's ICFR

- *Intended users of the report*. The restricted-use paragraph in a type 2 SOC 2 report indicates that the intended users of a SOC 2 report include user entities of the system during some or all of the period covered by the report and practitioners providing services to such user entities. A user auditor would qualify as a practitioner providing services to a user entity and therefore would be considered an intended user of a SOC 2 report.

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- *Service auditor's consideration of deficiencies*. In a SOC 2 engagement, the service auditor evaluates identified deficiencies in the design or operating effectiveness of controls based on their effect on the service organization's service commitments and system requirements, as opposed to their effect on the service organization's identified control objectives, as is the case in a SOC 1 engagement.

The audit interpretation includes the following table summarizing how a SOC 2 report may address the requirements in AU-C section 402.

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Requirement in Paragraph .09 of AU-C Section 402	How a SOC 2 Report May Address the Requirement in Paragraph .09 of AU-C Section 402
.09 A user auditor should obtain an understanding of how the user entity uses the services of a service organization in the user entity's operations, including the following:	
a. The nature of the services provided by the service organization and the significance of those services to the user entity, including their effect on the user entity's internal control	A SOC 2 report may be useful in understanding the nature of some of the services provided by the service organization, including the service organization's service commitments and controls relative to categories of trust services criteria such as security and processing integrity. However, due to the intended scope of the report it may not address all the services relevant to a user entity's internal control over financial reporting.
b. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization.	A SOC 2 report is unlikely to address the nature and materiality of transactions processed by the service organization unless it includes the processing integrity category of the trust services criteria.
c. The degree of interaction between the activities of the service organization and those of the user entity.	A SOC 2 report may address the interaction between the activities of the service organization and those of the user entity especially as it relates to the service commitments that the service organization has made to its user entities based on the scope of the report.
d. The nature of the relationship between the user entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization.	Like a SOC 1 report, a SOC 2 report is unlikely to address the relevant contractual terms; however, it will provide some information about the relationship between the user entity and the service organization. For example, the disclosure of the service organization's key service commitments relative to the trust services categories of criteria that are addressed by the SOC 2 report may assist the auditor in understanding the nature of the relationship between the user entity and the service organization.

Knowledge check

1. Which are limitations when using a SOC 2 report?

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a. It is not designed to address the services relevant to a user entity's internal control over financial reporting.

b. It is not designed to address the nature of the relationship between the user entity and the service organization, including their effect on internal control.

c. It is not designed to address the degree of interaction between the activities of the service organization and those of the user entity.

d. It is not designed to be used without a SOC 1 report.

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Recently issued Technical Questions and Answers

Technical Questions and Answers (Q&As) address selected practice matters identified by staff of the Association of International Certified Professional Accountants (the Association) that monitor the AICPA's Technical Hotline and various other bodies within the Association. The questions and answers have not been approved, disapproved, or otherwise acted upon by any senior committee of the AICPA. Thus, the questions and answers are not sources of established authoritative principles.

Association staff issued one new Q&A in 2022.

New Q&A related to other information included in annual reports

In May 2022, the Association issued Q&A section 9165, *Other Information Included in Annual Reports*,[1] which contains three new questions and answers. This Q&A section intends to clarify the auditor's responsibilities related to other information in the annual report that is outside the audited financial statements.

.01 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.[2]

[1] All Q&A sections can be found in *Technical Questions and Answers*.

[2] Paragraph .24 of AU-C section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*.

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.02 Reissuance of the Auditor’s Report on Financial Statements to Address Other Information Obtained After the Original Report Date

Inquiry — Although the auditor is not required to report on other information obtained after the date of the auditor’s report on the financial statements, when the entity subsequently issues its annual financial report, may the auditor, if requested or otherwise determines it appropriate, reissue the auditor’s report on the financial statements to include a separate section addressing the other information?

Reply — Yes, although not required, the auditor may reissue the auditor’s report to include a separate section addressing other information when the other information is obtained after the original date of the auditor’s report on the financial statements.

.03 Dating a Reissued Auditor’s Report to Address Other Information Obtained After the Original Report Date

Inquiry — If the auditor reissues the auditor’s report on the financial statements to address other information obtained after the original auditor’s report date, how could the auditor date such a reissued report?

Reply — If the auditor reissues the auditor’s report on the financial statements to address other information obtained after the original auditor’s report date, the auditor could

a. "dual date" the report, for example, “February 28, 20X2, except for the Other Information section of our report, as to which the date is March 30, 20X2." When the other information is obtained after the date of the auditor’s report, the auditor is not required to update the procedures performed in accordance with AU-C section 560, *Subsequent Events and Subsequently Discovered Facts; or*
b. date the reissued report as of the date that the auditor performed the required procedures on the other information. In this instance, the auditor's responsibility for subsequent events extends to this later report date and, accordingly, the procedures outlined in AU-C section 560 should be extended to that date.

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Knowledge check

2. An auditor completed a report on the financial statements of XYZ Company on February 28, 20X2. On March 30, 20X2, the auditor received other information included in the annual report. The auditor decided to reissue the report to include a separate section addressing the other information. How should the auditor date the reissued report?

    a. Dual date the report, for example, "February 28, 20X2, except for the Other Information section of our report, as to which the date is March 30, 20X2."

    b. Date the reissued report as of February 28, 20X2, without any reference to the other information.

    c. Date the reissued report as of February 28, 20X2, after updating the procedures performed in accordance with AU-C section 560.

    d. Date the reissued report as of March 30, 20X2, without updating the procedures performed in accordance with AU-C section 560.

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Recently issued attestation standards

The ASB has not issued any new or revised Statements on Standards for Attestation Engagements (SSAE) since December 2020 when they last issued SSAE No. 22, *Review Engagements* (not covered in this course). There are no outstanding exposure drafts related to SSAEs as of early March 2023.

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Recently issued attest interpretation

The most recently issued attest interpretation by the ASB was in October 2022 to provide clarifying guidance about whether a practitioner is required to perform the requirements in AT-C section 315, *Compliance Attestation*, when the practitioner is not engaged to report, and does not report on the entity's compliance with specific requirements.

New attest interpretation on compliance attestation

AT-C section 315 contains performance and reporting requirements, and application and other explanatory material, for a practitioner examining an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants (specified requirements) or an assertion about compliance with specified requirements.

Interpretation No. 1, "Examination and Review Engagements on Subject Matter Measured or Evaluated in Accordance with Criteria Specified in Laws, Regulations, Rules, Contracts, or Grants," (AT-C sec. 9315, par. .01) clarifies that the practitioner is not required to perform an engagement in accordance with AT-C section 315 when the practitioner is not engaged to report, and does not report, on the entity's compliance with specified requirements and either

a. the measurement or evaluation criteria are specified in a law, regulation, rule, contract, or grant or
b. the assertion relates to the responsible party's' measurement or evaluation in accordance with such criteria.

New interpretative guidance

This interpretation notes that the practitioner is not required to perform an engagement in accordance with AT-C section 315 when not engaged to report on the entity's compliance with specified requirements. The interpretation notes that AT-C section 315 applies when a practitioner

- is engaged to examine an entity's compliance with specified requirements,
- is engaged to examine an assertion about compliance with specified requirements, or
- the law, regulation, rule, contract, or grant requires that the engagement be performed in accordance with AT-C section 315.

Reviews of compliance with specified requirements or an assertion are specifically prohibited.

A compliance examination in accordance with AT-C section 315 is designed to obtain reasonable assurance that the entity complied with the specified requirements, in all material respects, including designing the examination to detect both intentional and unintentional material noncompliance. A practitioner is not required to apply AT-C section 315, even if the criteria are specified in a law, regulation, rule, contract, or grant when a practitioner is only engaged to examine or review whether

1. underlying subject matter is measured or evaluated in accordance with (or based on) criteria or

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2. an assertion related to such measurement or evaluation is fairly stated.

In such instances, a practitioner may examine whether the underlying subject matter is presented in accordance with AT-C section 205, *Assertion-Based Examination Engagements*, or may perform a review in accordance with AT-C section 210, *Review Engagements*.

Knowledge check

3. Hamue Corporation receives a government grant with specific compliance requirements. Which scenario requires the practitioner to follow AT-C section 315?

   a. When the practitioner is engaged to examine Hamue's compliance with the grant requirements.

   b. When the practitioner reviews Hamue's financial statements.

   c. When the practitioner reviews Hamue's compliance with the grant requirements.

   d. When the practitioner is conducting an audit of Hamue's financial statements.

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ASB work plan

The following table provides a high-level summary of the ASB's work plan for 2022 and 2023. Participants should monitor the AICPA website for updates.

Project	Project Objective
Attestation Standards	Consider revisions to the attestation standards to address emerging areas of assurance, including third-party assessments (e.g., HITRUST, Fedramp).
Audit Evidence	Monitor the IAASB on ISA 500, *Audit Evidence*, and explore whether additional changes are needed to AU-C section 500 based on revisions to ISA 500.
Audits of Less Complex Entities (LCE)	Consider additional guidance or actions that might be taken to address issues and challenges associated with audits of financial statements of LCEs.
Definition of listed entities and public interest entities	Monitor the IAASB project on the definition of public interest entities and PEEC's related actions, if any, and consider the implications to the ASB standards.
ESG/Sustainability	Monitor the IAASB project on ESG/Sustainability and identify and prioritize possible actions the ASB should take in addressing assurance on Sustainability/ESG reporting.
Fraud	Consider additional guidance or actions that might be taken to address issues and challenges relating to the identification of fraud in an audit of financial statements.
Going Concern	Consider additional guidance or actions that might be taken to address issues and challenges relating to addressing going concern in an audit of financial statements.
Group Audits	Revise AU-C section 600 to strengthen the auditor's approach to planning and performing a group audit and clarify the interaction with other AU-C sections.
Leveraging Technology	Consider additional guidance or actions that might be taken or further encourage the effective and appropriate use of technology, including data analytics, to enhance audit quality.
Quality Management Standards	Strengthen and modernize firm quality management through three new standards that take a risk-based approach.

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Summary

This course highlights recently issued audit and attest interpretations and technical Q&As that affect audit engagements. There are no outstanding exposure drafts affecting Statements on Standards for Attestation Engagements, and the ASB has not issued any new or revised SSAEs since December 2020 when SSAE No. 22 was issued.

Participants should monitor the AICPA website for further developments; particularly helpful for attestation standards is the ASB’s section of the website.

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Solutions

Other Standards-Setting Activities Affecting Audit and Attestation Engagements

Knowledge check solutions

1.

a. Correct. Importantly, a SOC 2® engagement is not designed to address the services performed by a service organization that are likely to be relevant to a user entity's ICFR and therefore is unlikely to completely address the effect that the service organization has on a user entity's financial reporting.

b. Incorrect. It will provide some information about the relationship between the user entity and the service organization. For example, the disclosure of the service organization's key service commitments relative to the trust services categories of criteria that are addressed by the SOC 2 report may assist the auditor in understanding the nature of the relationship between the user entity and the service organization.

c. Incorrect. A SOC 2 report may address the interaction between the activities of the service organization and those of the user entity especially as it relates to the service commitments that the service organization has made to its user entities based on the scope of the report.

d. Incorrect. A SOC 2 report can be used with or without a SOC 1 report depending on the situation.

2.

a. Correct. The auditor may choose to dual date the reissued report when addressing other information obtained after the original auditor's report date. Dual dating allows the auditor to maintain the original report date for the financial statements while indicating the date they performed the required procedures on the other information.

b. Incorrect. It does not address the other information received after the original report date, which the auditor has decided to include in the reissued report.

c. Incorrect. If the auditor does not dual date the reissued report, then the reissued report date is the date the auditor performed the required procedures on the other information.

d. Incorrect. The auditor's responsibility for subsequent events extends to this later report date and, accordingly, the procedures outlined in AU-C section 560 should be extended to that date

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3.

a. Correct. When a practitioner is engaged to examine an entity's compliance with specific requirements (e.g., laws, regulations, contracts, or grants), they should perform the engagement in accordance with AT-C section 315, *Compliance Attestation*.

b. Incorrect. When reviewing an entity's financial statements, the practitioner should follow AT-C section 210, *Review Engagements*, not AT-C section 315.

c. Incorrect. Reviews of compliance with specified requirements are specifically prohibited under AT-C section 315.

d. Incorrect. When conducting a financial statement audit, the practitioner should follow the guidance and standards in AU-C sections, not AT-C section 315.

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New Quality Management Standards and Related New Standards

Learning objectives

- Distinguish key elements included in the recently issued Statements on Quality Management Standard (SQMS) No. 1, *A Firm's System of Quality Management,* and SQMS No. 2, *Engagement Quality Reviews*.
- Determine how newly issued Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, affects auditing standards.
- Identify key elements of Statement on Standards for Accounting and Review Services (SSARS) No. 26, *Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services*.

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New quality management standards

In June 2022, the AICPA Auditing Standards Board (ASB) issued new quality management standards that address a firm's responsibilities to design, implement, and operate a system of quality management for its accounting and auditing practice. These new standards supersede the AICPA's Statements on Quality Control Standards (SQCSs). This section provides an overview of the content of the following new standards and related outstanding exposure draft:

- SQMS No. 1, *A Firm's System of Quality Management*
- SQMS No. 2, *Engagement Quality Reviews*
- SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*
- SSARS No. 26 *Quality Management for an Engagement Performed in Accordance With Statements on Standards for Accounting and Review Services*.

These new standards do the following:

- SQMS No. 1 supersedes Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control, (QC sec. 10)* and creates new QM sec. 10 of the AICPA *Professional Standards*.
- SQMS No. 2 creates new QM sec. 20 of the AICPA *Professional Standards*.
- SAS No. 146 supersedes AU-C section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* (QM SAS) and amends several sections of existing auditing standards to conform those standards to the provisions in new AU-C section 220.
- SSARS No. 26 amends AR-C sections 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 of Financial Statements*; and AR-C section 90, *Review of Financial Statements*.

The existing "Statements on Quality Control Standards" are retitled "Statements on Quality Management Standards."

Background

The ASB last made significant changes to its quality control standards in October 2006 with the issuance of Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*, followed by SQCS No. 8, *A Firm's System of Quality Control (Redrafted),* issued in November 2010 that applied the ASB's clarity drafting conventions to SQCS No. 7. Many believe that the environment in which firms operate has evolved significantly since then. For example, the expanded use of IT-based resources by entities and accounting firms has increased, as have expectations of regulators. SQCS No. 8's "one size fits all" approach does not embrace differences in the size or nature of firms or their services. Furthermore, the ASB believed that the existing standards did not embrace a system of quality management that is informed and responsive to specific areas of risk.

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Concerns about audit quality expressed by peer reviewers and regulators have often included these observations:

- Risks to quality reviews resulting from limited experience of engagement partners who perform a low volume of such quality review engagements
- Improvements needed in firm governance and leadership and the culture and tone at the top of the firm
- Inconsistencies in the performance of engagements and a lack of focus on planning
- Overreliance on resources, such as third-party quality control materials, without modifying them to the nature and circumstances of the firm
- Smaller firms facing unique challenges applying the standards, which tend to use a "one size fits all" approach

IAASB quality management project

The ASB has been following the International Auditing and Assurance Standards Board's (IAASB's) project on its quality management standards. In December 2020, the IAASB issued new standards relating to quality management at both the firm and audit engagement level (IAASB Quality Management Standards). These new standards included the following:

- International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1), *Quality Management for Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*
- ISQM 2, *Engagement Quality Reviews*
- International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

PCAOB quality control project

On December 17, 2019, the PCAOB issued a concept release entitled "Potential Approach to Revisions to PCAOB Quality Control Standards." The concept release outlines that the PCAOB is considering an approach that would use proposed ISQM 1 as a starting point. The PCAOB stated that

> [i]nformation gathered through our oversight, outreach, and research activities persuades us that our QC standard should be built on an integrated risk-based framework, as Proposed ISQM 1 is. In addition, many firms that follow PCAOB standards are also subject to other QC standards (including the IAASB's and the AICPA's standards), so they are required to implement QC systems that comply with both PCAOB standards and those other standards. Due to the foundational nature of QC systems, we believe that it would not be practical to require firms to comply with fundamentally different QC standards.

The comment period for the PCAOB concept release ended on March 16, 2019. There were 36 respondents as of May 11, 2020. Most respondents commented that they are supportive of a potential quality control standard that is principles-based and scalable with minimal incremental requirements to proposed ISQM 1. (Subsequent to the issuance of SQMS Nos. 1 and 2, SAS No. 146, and SSARS No. 26, the PCAOB issued in November 2022 an exposure draft of a proposed new quality control standard that would supersede current PCAOB quality control standards with an integrated, risk-based approach that

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creates reporting requirements on quality control matters, and a new, non-public reporting form, Form QC. The comment period for this exposure draft expired February 1, 2023.)

Convergence

The ASB's new standards build on the international standards based on the view that the issues that led the IAASB to revise its standards are of equally critical importance in the United States. The ASB also considered elements of the PCAOB's concept release given that complying with fundamentally different quality management standards is not feasible for firms that perform engagements in accordance with the standards of the ASB, the IAASB, or the PCAOB. Additionally, performing an audit in accordance with multiple sets of auditing and quality management standards would be exponentially impracticable.

In the new standards, the ASB has used the terms *quality management* and *engagement quality review*, instead of the terms *quality control* and *engagement quality control review*, respectively, that were used in its previous standards. In addition, "Statements on Quality Control Standards" have been retitled "Statements on Quality Management Standards."

The comment deadline for the ASB's proposed standards was August 31, 2021. During the exposure period, the ASB's Quality Standards Task Force held 15 roundtables with a total of 424 participants, excluding task force members and AICPA staff. The roundtables were publicized by state societies and included practitioners from firms of all sizes. Many participants were also peer reviewers.

In total, 171 comment letters were received on the exposure drafts of the proposed standards. The ASB reviewed the issues raised through the comment letters received as well as comments made during the round table discussions and issued the final new standards in June 2022.

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SQMS No. 1, A Firm's System of Quality Management

In June 2022, the Auditing Standards Board (ASB) issued Statement on Quality Management Standard No. 1, *A Firm's System of Quality Management,* to address the firm's responsibility to design, implement, and operate a system of quality management for its accounting and auditing practice. This SQMS is to be read in conjunction with the AICPA Code of Professional Conduct (AICPA Code) and other relevant ethical requirements. SQMS No. 1 applies to all firms that perform any engagement included in a firm's accounting and auditing practice.

This SQMS

- Supersedes Statement on Quality Control Standards No. 8 (extant QC sec. 10)

Effective date

Systems of quality management in compliance with SQMS No. 1 are required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management (required by paragraphs 54–5) is required to be performed within one year following December 15, 2025.

Key elements of SQMS No. 1

SQMS No. 1 takes a new approach that focuses the firm leadership's attention on risks that may have an impact on engagement quality for its accounting and auditing practice. The new standard emphasizes the responsibility of firm leadership for proactively managing quality. It also recognizes the need for quality management systems to be scalable to deal with differences in the size of firms and nature of the services they provide.

The new approach requires a firm to customize the design, implementation, and operation of its system of quality management based on the nature and circumstances of the firm and the engagements it performs. SQMS No. 1 is more complex than the approach in extant QC section 10. The ASB acknowledges that firms will need to invest time and resources to implement the revised standard initially; however, the ASB believes that over time a more enhanced system of quality management will lead to better use of firm resources and improvements in engagement quality.

Objectives of quality management system

The objectives of a quality management system include both the *objective of the firm* and the *objective of the system of quality management.* The *objective of the firm* 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.

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The objectives of the system of quality management include the achievement of these 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. Reasonable assurance is obtained through the operation of the system as a whole. The following illustration depicts the intersection of these objectives:

Responsibilities for the system of quality management

The firm is required to assign ultimate responsibility and accountability for the system of quality management to the firm's CEO, managing partner (or equivalent) or, if appropriate, managing board of partners (or equivalent). In addition, the firm is required to assign the following to designated individuals:

- Operational responsibility for the system of quality management
- Operational responsibility for specific aspects of the system of quality management, including compliance with independence requirements and the monitoring and remediation process

SQMS No. 1 requires that, at least annually, the individual or individuals assigned ultimate responsibility and accountability for the system of quality management, on behalf of the firm, evaluate the system of quality management and conclude whether the system of quality management provides the firm with reasonable assurance that the objectives of the system are being achieved.

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The components of the system of quality management

SQMS No. 1 expands the system of quality management from six to eight components:

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

The new approach also requires an integrated and iterative approach that reflects upon the system as a whole rather than stand-alone elements with an emphasis on a continual flow of remediation and improvement. The continuous and iterative process emphasizes the importance of systems of quality management adjusting to changes in the nature and circumstances of the firm and its engagements. The components are highly integrated and do not operate in a linear manner, as shown in the following figure from the exposure draft:

Risk assessment process

SQMS No. 1 focuses a firm's attention on risks that may have an impact on engagement quality. That risk-based approach influences the design, implementation, and operation of the components of quality management in an interconnected and coordinated manner such that engagement quality is proactively managed. The firm's risk assessment process is a new component that includes a three-step process:

1. Establish quality objectives. The new standard requires the firm to establish specific quality objectives for each component. The firm is required to establish additional quality objectives when

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necessary to achieve the objective of the system of quality management; however, based on the nature and circumstances of the firm and its engagements, the firm may not find it necessary to establish additional quality objectives.

2. Identify and assess risks to the achievement of the quality objectives (referred to in the new standard as *quality risks*). Identifying and assessing quality risks involves
   a. understanding the factors (that is, the conditions, events, circumstances, actions, or inactions) that may adversely affect the achievement of the quality objectives, and
   b. identifying and assessing the quality risks by considering how and the degree to which the factors may adversely affect the achievement of the quality objectives.

   The new standard acknowledges that not all risks meet the definition of a *quality risk*. Determining what constitutes a quality risk requires professional judgment that requires assessment of whether there is a reasonable possibility of the risk occurring, individually or in combination with other risks, and adversely affecting the achievement of one or more quality objectives. Factors to be considered include the anticipated frequency of the occurrence of the quality risk and the time it might take for the quality risk to have an impact and whether in that time the firm would have an opportunity to respond to mitigate the effect of the quality risk.

3. Design and implement responses to address the quality risks. The firm designs and implements responses to address the quality risk and those responses will vary in their nature, timing, and extent depending on the assessment of the risk. The new standard specifies certain responses, particularly related to establishing policies or procedures for addressing compliance, independence, and complaints, among other matters, but acknowledges that other responses will be needed to address all its quality risks.

SQMS No. 1 identifies the following specific responses that the firm should design and implement.

- Identify, evaluate, and address threats to compliance with relevant ethical requirements and any breaches of those requirements.
- Obtain at least annually a documented confirmation of compliance with independence requirements from all personnel who are subject to ethical requirements that require independence.
- Receive, investigate, and resolve complaints and allegations about failures to perform work in accordance with professional standards and relevant requirements.
- Address circumstances when the firm (1) becomes aware of information after accepting or continuing a client relationship that would have caused the firm to make a different decision or (2) is obligated by law or regulation to accept a client relationship or specific engagement.
- Describe when it is appropriate to communicate with external parties and what information is appropriate when communicating externally about the firm's system of quality control.
- Provide direction on when engagement quality reviews are required or appropriate.

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Governance and leadership

A firm's governance and leadership set the "tone at the top" by establishing the firm's culture and ethics and how it self-regulates, and they serve as the framework for how the firm's decisions are made. That collectively establishes the environment that supports quality management. SQMS No. 1 provides a number of provisions designed to strengthen firms' governance and leadership.

The new standard addresses the expected behavior of firm leadership in setting the tone at the top, the appropriate qualifications of leadership, and holding leadership accountable through performance evaluations. The standard also now addresses the importance of quality in the firm's strategic decisions and actions, including financial and operational priorities, as well as firm leadership's ability to influence decisions about the firm's resources. SQMS No. 1 identifies the following quality objectives that address the firm's governance and leadership, which establish the environment that supports the system of quality management:

- The firm demonstrates a commitment to quality through a culture that exists throughout the firm that recognizes the firm's role in serving the public interest, the importance of professional ethics, responsibilities and behaviors of all personnel for quality, and the importance of the firm's strategic decisions and actions.
- Leadership is responsible and accountable for quality.
- Leadership demonstrates a commitment to quality through its actions and behaviors.
- The organizational structure and assignment of roles, responsibilities, and authority is appropriate to enable effective quality management.
- Resource needs are planned for, obtained, and assigned in a manner consistent with the firm's commitment to quality.

Relevant ethical requirements

Although this component was part of the extant quality control standards, SQMS No. 1 emphasizes that the firm is to establish quality objectives that address the fulfillment of responsibilities in accordance with relevant ethical requirements, including those specific to independence. Those include objectives that

- the firm and its personnel understand the relevant ethical requirements and fulfill those responsibilities, and
- others — including the network, network firms, individuals in the network or network firms and service providers who are subject to relevant ethical requirements — understand and fulfill those requirements.

Acceptance and continuance of client relationships and specific engagements

This component was part of the extant quality control standards, but now SQMS No. 1 emphasizes that the firm should establish quality objectives that address acceptance and continuance of client

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relationships and specific engagements. SQMS No. 1 highlights how judgments by the firm on whether to accept or continue a client relationship or specific engagement are to be based on the following:

- Information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client.
- The firm's ability to perform the engagement.

SQMS No. 1 emphasizes that financial and operational priorities of the firm do not lead to inappropriate decisions about whether to accept or continue a client relationship or engagement.

Engagement performance

This component was part of the extant quality control standards, but now SQMS No. 1 emphasizes that the firm should establish quality objectives that address the following performance objectives:

- Engagement teams understand and fulfill their responsibilities in connection with an engagement, including engagement partner oversight and involvement throughout an engagement.
- The nature, timing, and extent of direction and supervision of engagement teams, review of the work performed, and resources dedicated to an engagement are appropriate based on the nature and circumstances of the engagement.
- Engagement teams exercise appropriate professional judgment and maintain professional skepticism.
- Consultation on difficult or contentious matters is undertaken and conclusions agreed to are implemented.
- Differences of opinion within the engagement teams or with the engagement quality reviewers are brought to the attention of the firm and resolved.
- Engagement documentation is assembled on a timely basis after the date of the engagement report and is appropriately maintained and retained.

Resources

Extant QC section 10 addressed only human resources. SQMS No. 1 expands this component to address all resources that the firm needs both to operate the system and to perform engagements. These resources include the following:

- Technological resources, for example, audit tools or IT applications used by the firm for independence monitoring
- Intellectual resources, for example, the firm's methodology, guidance, templates, or tools
- Human resources, which may include people outside the firm used in engagements, including component auditors or engagement quality reviewers who are external to the firm

The new standard focuses on what resources are needed, how they are used and maintained, and whether they are appropriate. For example, the new standard notes that the appropriate level of human resources includes objectives designed to ensure that personnel who are hired and retained are competent and capable; that they are committed to quality; and that those with appropriate

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competencies and capabilities are assigned to the engagement and given sufficient time to perform assigned tasks. SQMS No. 1 also covers the use of resources from service providers and how to determine that resources are appropriate for the intended use by the firm.

Information and communication

SQMS No. 1 includes a new component: information and communication. Extant QC section 10 did not address the broader need for information and communication across the system and the communication of relevant, reliable information with engagement teams, which is essential for the effective operation of the system of quality management and the performance of engagements. Effective quality management involves identification, capture, processing, and maintaining of relevant and reliable information that supports the system of quality management, whether from internal or external sources.

The extant quality control standards did not acknowledge the two-way nature of communication. The new standard reinforces the need for robust two-way internal communication throughout the firm, and it emphasizes the importance of a continuous flow of information and communication by linking the exchange of information to the firm's culture, so that it is driven from top leadership throughout the firm.

From an external perspective, the standard encourages firms to be transparent to external parties about their quality management systems in a relevant, innovative, and proactive manner. To drive the proactivity of communication, SQMS No. 1 requires firms to establish policies and procedures that address when communications with external parties are appropriate.

Firms may communicate through various mechanisms. In order to promote continual innovation in this area, the new standard provides flexibility regarding the specific information communicated, the form of that communication, and the nature, timing, and extent of communication.

Monitoring and remediation

SQMS No. 1 shifts the focus from engagement-level monitoring to monitoring the entire system of quality management, with greater emphasis on more proactive and effective monitoring activities. The new standard emphasizes tailoring the monitoring activities to provide a sufficient basis for the firm to evaluate the system. Monitoring activities may include a combination of ongoing and periodic monitoring activities.

SQMS No.1 notes that the firm should design and perform monitoring activities to provide a basis for the identification of deficiencies. The new standard does not prescribe all the monitoring activities that need to be performed. Instead, the standard emphasizes a number of factors that the firm would consider in designing its monitoring activities, including the following:

- The reasons for the assessments given to the quality risks
- The design of the responses
- The design of the firm's risk assessment process and monitoring and remediation process
- The extent of changes to the system of quality management
- The results of previous monitoring activities or external inspections

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- Other relevant information, including complaints and allegations about failures to perform work in accordance with standards and legal and regulatory requirements.

The new standard includes a requirement to inspect completed engagements and for engagement partners to be inspected on a cyclical basis. The firm determines its inspection criteria, including how often to select completed engagements, which completed engagements to select, which engagement partners to select, and how frequently to select an engagement partner, considering factors such as other types of monitoring the firm does, areas of risk, and how the system is designed.

SQMS No. 1 includes requirements for evaluating findings and identifying deficiencies and evaluating the severity and persuasiveness of the deficiencies. These include a new requirement to investigate the root cause of identified deficiencies. The requirement is intended to be flexible to encourage firms to scale the nature, timing, and extent of the procedures to investigate the root cause of the deficiencies so that they are appropriate and tailored to the circumstances. The evaluation of the severity and pervasiveness of deficiencies is also used by leadership in evaluating the system and concluding whether it achieved its objectives.

The new standard also emphasizes that the firm should design and implement remedial actions to address identified deficiencies that are responsive to the root causes. Those performing the monitoring procedures should evaluate whether the remedial actions are appropriately designed to address the identified deficiencies and whether they have been implemented.

Network requirements

A firm may belong to a network, which may establish requirements regarding the firm's system of quality management or may make services (including resources) available that the firm may choose to implement or use in the design, implementation, and operation of its system of quality management. Concerns have been raised that firms sometimes place undue reliance on network requirements or network services without sufficient consideration of whether the requirements or services are appropriate and suitable for the nature and circumstances of the firm. SQMS No. 1 reminds firm leaders that the firm is solely responsible for its own system of quality management; a network is not responsible for the firm's system.

As an example, a firm may be subject to common policies or procedures established by the network, and the network may hold the firm accountable for complying with such policies or procedures. A network may also provide services to the firm such as IT applications or a methodology or monitoring activities. Such requirements or services may be intended to promote the consistent performance of quality engagements across the firms that belong to the network.

SQMS No. 1 requires that if a firm is subject to network requirements or uses network services, the firm should understand how those requirements or services fit into the firm's system of quality management and determine whether the requirement or service needs to be adapted or supplemented to be appropriate for use in the firm's system of quality management. The new standard addresses monitoring activities undertaken by the network and requires the firm to determine the effect of network-level monitoring activities on the firm's monitoring activities.

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The firm is also required to understand the overall scope of the monitoring activities undertaken by the network across the network firms, including monitoring activities to determine that network requirements have been appropriately implemented across the network firms and to obtain information annually about the results of the network's monitoring activities. This is intended to drive improvements at the network level because firms will need networks to provide more information than they may be providing now.

Documentation

SQMS No. 1 requires the firm to prepare documentation of its system of quality management that is sufficient to do the following:

- Support a consistent understanding of the system of quality management by personnel.
- Support the consistent implementation and operation of the responses.
- Provide evidence of the design, implementation, and operation of the responses to support the evaluation of the system of quality management by individuals who are ultimately accountable for the system of quality management.

That documentation should include the following information:

- Identification of the individual or individuals assigned ultimate responsibility and accountability for the system of quality management and its operations.
- Firm's quality objectives and quality risks.
- Description of the responses and how the firm's responses address the quality risks.
- Evidence of monitoring activities performed; the evaluation of findings; identified deficiencies and their related root causes; remedial actions to address identified deficiencies; and communications about monitoring and remediation.
- The conclusion reached about whether the firm's quality management system provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

Scalability

Finally, the new standard discusses scalability. The new quality management approach encourages a firm to think about the nature and circumstances of the firm and the engagements it performs in designing, implementing, and operating its system of quality management, and focuses that system on achieving quality objectives that are outcome based. Although this approach is expected to generate multiple benefits for engagement quality, one of the most important benefits is a tailored system of quality management that is suitable for the nature and circumstances of the firm and the engagements it performs. Thus, this approach is intended to be scalable for firms of different sizes and complexity.

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Knowledge check

1. Which option best describes the new Statements on Quality Management Standards?

    a. They largely build off the PCAOB quality controls standards.
    b. They move guidance for quality control to the auditing standards.
    c. They emphasize quality management at both the firm and engagement levels.
    d. They place ultimate responsibility for engagement quality on the engagement quality reviewer.

2. Which option represents an entirely new component of a system of quality management?

    a. Information and communication.
    b. Human resources.
    c. Engagement performance.
    d. Monitoring.

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SQMS No. 2, *Engagement Quality Reviews*

In June 2022, the ASB issued SQMS No. 2, *Engagement Quality Reviews,* to address the appointment and eligibility of an engagement quality reviewer and to outline the responsibilities of the engagement quality reviewer. An engagement quality review is a specified response that is designed and implemented by the firm in accordance with responsibilities outlined in SQMS No. 1. The objective of an engagement quality review is to perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

This SQMS

- Establishes Statement on Quality Management Standards (QM sec. 20)

Effective date

SQMS No. 2 is effective for

a. Audits or reviews of financial statements for periods beginning on or after December 15, 2025, and
b. Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025.

Key elements of SQMS No. 2

SQMS No. 2 contains requirements for policies and procedures addressing the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews. An *engagement quality review* is defined by SQMS No. 2 as

> an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached thereon, performed by the engagement quality reviewer and completed before the engagement report is released.

An engagement quality review is a specified response designed and implemented by a firm to address quality risks. Although the performance of an engagement quality review is undertaken at the engagement level, it is a response that is implemented by the engagement quality reviewer on behalf of the firm.

The requirements for engagement quality reviews previously resided in extant QC section 10 and AU-C section 220. Having a separate standard for engagement quality reviews places emphasis on the importance of the engagement quality review. Although there will no longer be requirements for the performance of engagement quality reviews in AU-C section 220, newly issued SAS No. 146 contains requirements regarding the engagement partner's responsibilities relating to the engagement quality review, which largely focus on how the engagement partner and the engagement team interact with the engagement quality reviewer.

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Appointment and eligibility of reviewers

The requirements in SQMS No. 2 for the appointment and eligibility of the engagement quality reviewer (whether internal to the firm or external) are more robust than those in extant QC section 10. Requirements and application material have been added to address the following:

- The eligibility of individuals within the firm responsible for the appointment of engagement quality reviewers
- The eligibility of who can be an engagement quality reviewer
  - Engagement quality reviewers should not be a member of the engagement team; they should have the competence, capability, time and authority to perform the review; and they should comply with relevant ethical requirements and laws and regulations.
- The eligibility of individuals to assist the engagement quality reviewer in performing the engagement quality review
  - Those individuals also cannot be a member of the engagement team; they should have the competencies, and capabilities to perform the reviews; and they should comply with relevant ethical requirements.
- The engagement quality reviewer taking responsibility for the performance of the engagement quality review, including that the work of individuals assisting in the review is appropriate

To reduce threats to objectivity to an acceptable level, SQMS No. 2 requires firm policies or procedures to include limitations on the eligibility of an individual to be appointed as engagement quality reviewer and apply appropriate safeguards for an engagement on which the individual previously served as engagement partner. For example, the firm may choose to establish policies or procedures that specify a cooling-off period of two years (or a longer period if required by relevant ethical requirements) before the engagement partner can assume the role of engagement quality reviewer. This kind of limitation may be necessary to ensure that the engagement quality reviewer is in a position to objectively evaluate and, where appropriate, challenge the significant judgments made and the professional skepticism exercised by the engagement team.

Impairment of the engagement quality reviewer’s eligibility

SQMS No. 2 requires the firm establish policies and procedures that address circumstances in which the engagement quality reviewer’s eligibility to perform the engagement quality review is impaired. Those policies and procedures should include a process for identifying and appointing a replacement. Factors to consider include the following:

- Whether changes in the circumstances of the engagement result in the engagement quality reviewer no longer having the appropriate competence and capabilities to perform the review.
- Whether changes in the other responsibilities of the engagement quality reviewer indicate that the individual no longer has sufficient time to perform the review.
- Notification from the engagement quality reviewer that he or she becomes aware of circumstances that impair the reviewer’s eligibility.

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Performance of the engagement quality review

The requirements for the performance of the engagement quality review focus the engagement quality reviewer's attention on significant judgments and significant matters. SQMS No. 2 requires the engagement quality reviewer to perform the following:

- Read and obtain an understanding about information communicated by (1) the engagement team regarding the nature and circumstances of the engagement and the entity and (2) the firm related to the firm's monitoring and remediation process about identified deficiencies that may affect areas involving significant judgments made by the engagement team.
- Discuss with the engagement partner and other members, if applicable, significant matters and significant judgments made in planning, performing, and reporting on the engagement.
- Review selected documentation related to significant judgments made by the engagement team and evaluate the basis for making those judgments, whether documentation supports the conclusions reached, and whether the conclusions are appropriate.
- Evaluate the basis for the engagement partner's determination that relevant ethical requirements related to independence (when applicable) have been fulfilled.
- Evaluate whether appropriate consultation has taken place on difficult or contentious matters or matters involving differences of opinion and conclusions reached.
- For engagements conducted in accordance with GAAS, evaluate the basis for the engagement partner's determination that the engagement partner's involvement has been sufficient and appropriate throughout the engagement so that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement.
- Review
  - for audits of financial statements, the financial statements and the auditor's report, including the description of key audit matters;
  - for reviews of financial statements or financial information, the financial statements or financial information and the review report; or
  - for other engagements, the engagement report and the subject matter information when applicable.

If the engagement quality reviewer is concerned that significant judgments made or conclusions reached by the engagement team are not appropriate, the engagement quality reviewer should notify the engagement partner. If the concerns are not resolved to the engagement quality reviewer's satisfaction, the engagement quality reviewer should notify the appropriate individual(s) in the firm that the engagement quality review cannot be completed.

Completion of the review

SQMS No. 2 includes a stand-back requirement for the engagement quality reviewer to determine whether the performance requirements of the engagement quality review have been fulfilled. Once the engagement quality reviewer has made this determination, the engagement quality reviewer is required to inform the engagement partner that the engagement quality review is complete. The engagement

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partner is precluded from dating the engagement report before receiving notification from the engagement quality reviewer that the engagement quality review is complete.

Timing of the review

An effective engagement quality review is achieved when the engagement quality reviewer is involved at appropriate points in the engagement, consistent with when significant judgments are being made by the engagement team because doing so facilitates the resolution of issues in a timely manner. Accordingly, SQMS No. 2 includes a new requirement addressing the engagement quality reviewer's responsibility to perform the procedures at appropriate points in time during the engagement.

Documentation

SQMS No. 2 includes a specific requirement for the engagement quality reviewer to take responsibility for documentation of the engagement quality review and adds a requirement that the documentation be filed with the engagement documentation. The new standard also includes an overarching requirement for the documentation to be sufficient to enable an experienced practitioner, having no previous connection to the engagement, to understand the nature, timing, and extent of the engagement quality review procedures performed.

Knowledge check

3. According to SQMS No. 2, *Engagement Quality Reviewers,* when should the engagement quality reviewer be involved in the review?
    a. The reviewer should "stand back" and wait for a notification from the engagement partner to proceed.
    b. The reviewer should wait for the review documentation to be filed by the engagement partner.
    c. The reviewer should wait for the engagement partner to complete the engagement report.
    d. The reviewer should be involved when significant judgments are being made by the engagement team.

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SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*

In June 2022, the ASB issued SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards,* to address the appointment and eligibility of an engagement quality reviewer and to outline the responsibilities of the engagement quality reviewer. An engagement quality review is a specified response that is designed and implemented by the firm in accordance with responsibilities outlined in SQMS No. 1. The objective of an engagement quality review is to perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

SAS No. 146

- Supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, as amended*
- Supersedes AU-C section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*
- Amends the following sections in *Professional Standards*:
  - AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
  - AU-C section 210, *Terms of Engagement*
  - AU-C section 230, *Audit Documentation*
  - AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
  - AU-C section 300, *Planning an Audit*
  - AU-C section 500, *Audit Evidence*
  - AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
  - AU-C section 620, *Using the Work of an Auditor's Specialist*
  - AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
  - AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
  - AU-C section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*
  - AU-C section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*
  - AU-C section 930, *Interim Financial Information*
  - AU-C section 935, *Compliance Audits*
  - AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*
- Amends Statement on Standards for Attestation Engagements, section 105, *Concepts Common to All Attestation Engagements*

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Effective date

SAS No. 146 is effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2025.

Key elements of SAS No. 146

SAS No. 146 addresses how the engagement partner leverages the firm's system and manages quality at the audit engagement level. SAS No. 146 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. These behaviors include the responsibility of all engagement team members for quality; the importance of professional ethics, values, and attitudes; and the importance of professional skepticism to a quality audit.

Engagement partner responsibilities

The engagement partner remains ultimately responsible and, therefore, accountable, for compliance with the requirements of the new SAS. The phrase *take responsibility for* is used for those requirements for which the engagement partner is permitted to assign the design or performance of procedures, tasks, or actions to appropriately skilled or suitably experienced members of the engagement team. For other requirements, SAS No. 146 expressly intends that the requirement or responsibility be fulfilled by the engagement partner.

To fulfill the requirement, the engagement partner may obtain information from the firm or other members of the engagement team. For example, the engagement partner is required to determine that members of the engagement team collectively have the appropriate competence and capabilities to perform the audit engagement. To make a judgment on whether the competence and capabilities of the engagement team are appropriate, the engagement partner may need to use information compiled by the engagement team or from the firm's system of quality management.

Ordinarily, the engagement team may depend on the firm's policies or procedures in complying with the requirements of this new SAS. The new standard notes that in some circumstances the engagement team's understanding or practical experience indicates that the firm's responses to quality risks are ineffective in the context of the specific engagement, or information provided by the firm or other parties indicates that the firm's policies or procedures are not operating effectively.

Engagement partner's leadership responsibility for managing quality on audits, including engagement performance and stand back

The engagement partner should take overall responsibility for managing and achieving quality on the audit engagement, including taking responsibility for creating an environment for the engagement that emphasizes the firm's culture and expected behavior of engagement team members. To fulfill that responsibility, SAS No. 146 notes that the engagement partner needs to be sufficiently and appropriately involved throughout the engagement. This overall responsibility includes the following:

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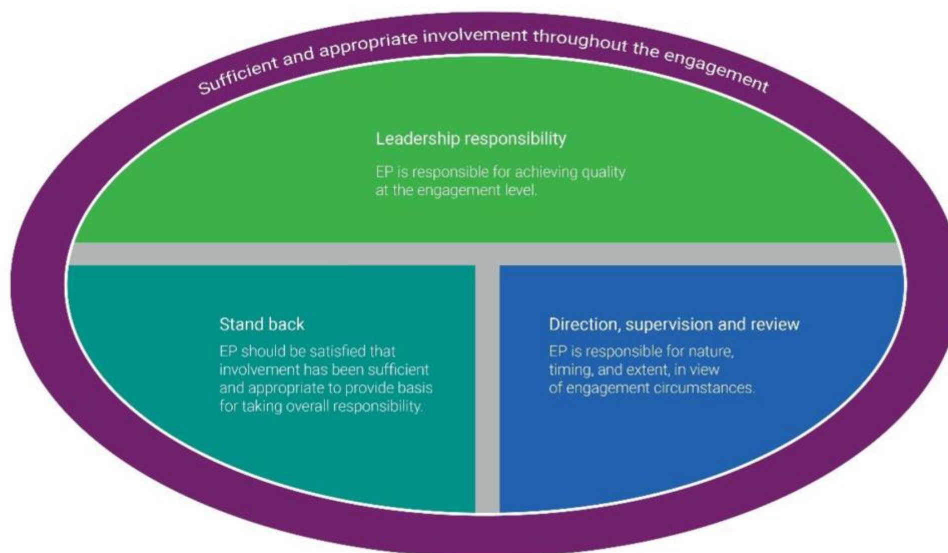
1. **Fulfill leadership responsibilities.** This includes taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks, or actions to other members of the engagement team.
2. **Support engagement performance.** This includes taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed.
3. **"Stand-back" evaluation.** This involves determining whether the engagement partner has taken overall responsibility for managing and achieving quality, including determining that the engagement partner's involvement has been sufficient and appropriate throughout the engagement and that the nature and circumstances of the engagement have been considered. Note that this is a new requirement.

The following diagram illustrates how the engagement partner's overall responsibility to manage and achieve quality on the engagement is demonstrated through sufficient and appropriate involvement throughout the engagement, such that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the audit.



Relevant ethical requirements

SAS No. 146 requires the engagement partner to do the following:

- Understand relevant ethical requirements and whether other members of the engagement team are aware of those requirements and the firm's related policies or procedures, including those related to independence.
- Evaluate threats to compliance with or breaches of relevant ethical requirements, including those related to independence, and determining whether appropriate action has been taken.
- Determine whether relevant ethical requirements, including those related to independence, have been fulfilled, prior to dating the auditor's report.

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It also includes new application material that links with the firm-level requirements in SQMS No. 1; describes possible appropriate actions if noncompliance is indicated; and links to the requirement in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, for the auditor's report to include a statement regarding the auditor's independence.

Acceptance and continuance of audit engagements

SAS No. 146 requires the engagement partner to determine if firm policies related to acceptance and continuance of client relationships and audit engagements have been followed and the conclusions reached are appropriate. The engagement partner should take into account information obtained in acceptance and continuance process when planning and performing the engagement. The engagement partner should communicate information promptly to the firm if the engagement team becomes aware of information that may have caused the firm to decline the audit engagement had the information been known by the firm prior to accepting or continuing the engagement.

Engagement resources

The engagement partner is responsible for determining that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner. This includes determining that members of the engagement team, including specialists, collectively have the appropriate competence and capabilities, including sufficient time, to perform the engagement.

In addition to human resources, the engagement partner is also responsible for determining that sufficient and appropriate technical and intellectual resources are assigned. Technical resources may include tools that allow the auditor to more effectively and efficiently manage the audit, evaluate large amounts of data, and conduct meetings and communicate to the engagement team. Intellectual resources may include audit methodologies, implementation tools, auditing guides, model programs, templates, and checklists or forms.

If the resources are insufficient or inappropriate, the engagement partner is required to take appropriate action.

Engagement performance

The engagement partner should take responsibility for the direction and supervision of the engagement team and review of their work. The engagement partner should review audit documentation at appropriate points in time during the engagement, including documentation related to significant matters, significant judgments, conclusions reached, and other matters that, in the engagement partner's professional judgment, are relevant to the engagement partner's responsibilities.

On or before the date of the auditor's report, the engagement partner should determine, through review of audit documentation and discussion with the engagement team, that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The engagement partner should take responsibility for the engagement team undertaking consultation on difficult or contentious matters and matters on which the firm's policies or procedures require

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consultation. SAS No. 146 requires the engagement partner to determine that the nature and scope of, and conclusions resulting from, such consultations are agreed upon with the party consulted and that the conclusions agreed to have been implemented.

For engagements for which an engagement quality review is required, the engagement partner should determine that an engagement quality reviewer has been appointed. The engagement partner is required to cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so and to discuss significant matters and significant judgments arising from the audit engagement with the engagement quality reviewer.

If differences of opinion arise within the engagement team or between the engagement team and the engagement quality reviewer, the engagement team should follow the firm's policies and procedures for dealing with and resolving such differences. The engagement partner should take responsibility for differences of opinion being addressed and resolved and ensure that conclusions are documented.

The engagement partner cannot release the auditor's report until completion of the engagement quality review.

Monitoring

The engagement partner is responsible for obtaining an understanding of the information from the firm's monitoring and remediation process and for determining the relevance of that information for the engagement and taking appropriate action. The engagement partner should remain alert throughout the audit engagement for information that may be relevant to the firm's monitoring and remediation process and for communicating such information to those responsible for the process.

Taking overall responsibility

SAS No. 146 requires the engagement partner to determine that the engagement partner has taken overall responsibility for managing and achieving quality on the audit engagement. This is a "stand-back" evaluation that occurs before the audit report is released. In doing so the engagement partner should determine the following:

- The engagement partner's involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate.
- The nature and circumstances of the audit engagement, and any changes thereto, and the firm's related policies or procedures have been taken into account in complying with the provisions of SAS No. 146.

Documentation

SAS No. 146 emphasizes the importance of documenting significant issues identified; relevant discussions with personnel; conclusions reached in fulfilling ethical requirements, including independence; and information with respect to client acceptance and continuance. SAS No. 146 also

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requires the auditor to document the nature, scope, and conclusions related to consultations undertaken during the audit engagement.

This new standard also requires documentation that the engagement quality review has been completed before the release of the auditor's report.

Group audit engagements

In addition to firm personnel, engagement team members in a group audit engagement may include personnel who are external to the firm (for example, engagement team members who are from network firms or are service providers, such as component auditors from firms not within the firm's network). AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, deals with special considerations that apply to an audit of group financial statements, including when component auditors are involved.

Application guidance in SAS No. 146 states that the firm or engagement partner may take different actions with respect to component auditors or other personnel who are external to the firm than the actions applicable to firm personnel.

Amendments to existing standards

SAS No. 146 also included a number of conforming amendments to various AU-C and AT-C sections for consistency with the new standard.

Knowledge check

4. Which is a provision of SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*?

    a. The new standard embeds all the new Statements on Quality Management Standards within auditing standards.
    b. The new standard places responsibility on the engagement quality reviewer to ensure the engagement team members have appropriate competence and capabilities.
    c. The new standard requires the engagement partner to perform "stand-back" procedures.
    d. The new standard places ultimate responsibility for managing and achieving quality on the engagement quality reviewer.

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SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*

In June 2022, the AICPA Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 26, to enhance certain concepts related to quality management for engagements performed in accordance with SSARS. The new standard helps ensure that the concepts related to quality management are consistent between auditing standards and SSARS.

Additionally, SSARS No. 26 includes a technical revision to AR-C section 90, *Review of Financial Statements*, to remove the requirement that a review engagement letter be obtained *prior to the start of the review engagement*. This change makes the requirement consistent with preparation, compilation, and auditing and attestation engagement standards.

SSARS No. 26 amends the following sections in *Professional Standards*:

- 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*

Effective date

The amendments contained in SSARS No. 26 are effective for engagements performed in accordance with SSARS for periods beginning on or after December 15, 2025, with the exception of the change to AR-C section 90 related to engagement letters that is effective upon issuance of SSARS No. 26.

Key elements of SSARS No. 26

Existing quality control standards of the AICPA apply to all CPA firms with engagements in their accounting and auditing practice, which includes audit, attestation, compilation, review, and any other services for which standards have been promulgated by the ASB or ARSC. SSARS No. 26 ensures that certain concepts related to quality management in SSARSs are consistent with concepts in the auditing standards and the new quality management standards.

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Technical revisions to AR-C section 60

SSARS No. 26 includes a number of technical revisions to AR-C section 60 to conform that guidance with the new SQMSs and SAS No. 146. Some of the key revisions to the general principles for SSARS engagements include the following:

- Clarification and emphasis on the engagement partner's responsibility to determine that members of the engagement team have the appropriate competence and capabilities, including sufficient time, to perform the engagement
- Explicit guidance for the engagement partner to determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, considering the nature and circumstances of the engagement, the firm's policies or procedures, and any changes that may arise during the engagement
- Modified guidance noting that the firm's quality management system includes establishing a monitoring and remediation process designed to provide the firm with reasonable assurance that the firm's policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively to
  - provide relevant, reliable, and timely information about the design, implementation, and operation of the system of quality management
  - take appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis

Technical revision to paragraph .16 of AR-C section 90

Paragraph .11 in the extant AR-C section 90 related to review engagements states the following (changed wording is in ***bold italics***):

> ~~.11~~.16 The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate~~***, prior to performing the engagement***~~. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement between the parties and should include the following: (Ref: par. .A18–.A23)

When ARSC issued SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions,* ARSC incorporated the best practice of obtaining the engagement letter prior to the start of the review engagement. That revision was not included in the corresponding requirement for a preparation engagement (paragraph .10 of AR-C section 70, *Preparation of Financial Statements*); a compilation engagement (paragraph .10 of AR-C section 80, *Compilation Engagements*); a compilation of pro forma financial information (paragraph .09 of AR-C section 120, *Compilation of Pro Forma Financial Information*); or in the corresponding requirements in the auditing or attestation standards.

After discussion, ARSC concluded that the additional wording in paragraph .16 of AR-C section 90 was overly prescriptive and should be removed. That revision is included in SSARS No. 26.

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Knowledge check

5. Which statement is correct concerning SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*?

    a. Exempts the risk assessment component of a system of quality management from applying to SSARSs engagements.
    b. Makes the engagement quality reviewer primarily responsible for ensuring the SSARS engagement has the appropriate resources to perform the engagement.
    c. Removes a requirement that an engagement letter be obtained before starting a review engagement.
    d. Exempts the SQMS from SSARS engagements.

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Summary

We have just reviewed recently issued standards related to quality management, including related changes to auditing and preparation, compilation, and review engagement standards. These standards introduce new SQMSs, a new Quality Management SAS, and revisions to SSARSs.

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Solutions

New Quality Management Standards and Related New Standards

Knowledge check solutions

1.
   a. Incorrect. Although the ASB monitored the PCAOB's proposed changes to quality control standards, the new SQMSs largely build off the International Auditing and Assurance Standards Board's new quality management standards.
   b. Incorrect. The new SQMSs retitle the Statements on Quality Control to be Statements on Quality Management (SQMS), which provide the primary guidance for quality management for firms.
   c. Correct. The new SQMSs place emphasis on the need for the firm to design and implement a system of quality management that outlines processes at the firm level and at the engagement level.
   d. Incorrect. The new SQMSs note that the engagement partner, not the engagement quality reviewer, has primary responsibility for engagement quality management.

2.
   a. Correct. The new SQMSs adds Information and Communication as one of the new components of a system of quality management because extant QC section 10 did not address this.
   b. Incorrect. Human resources is one of the current components of quality control. The new SQMSs expand that component to be Resources.
   c. Incorrect. Engagement performance is one of the current components of quality control. The new SQMSs retain that component.
   d. Incorrect. Monitoring is one of the current components of quality control. The new SQMSs expand that to be Monitoring and Remediation.

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3.

a. Incorrect. SQMS No. 2 includes a stand-back requirement for the engagement quality reviewer to determine whether the performance requirements of the engagement quality review have been fulfilled. Once the engagement quality reviewer has made this determination, the engagement quality reviewer is required to inform the engagement partner that the engagement quality review is complete.

b. Incorrect. SQMS No. 2 includes a specific requirement for the engagement quality reviewer to take responsibility for documentation of the engagement quality review and adds a requirement that the documentation be filed *with* the engagement documentation.

c. Incorrect. SQMS No. 2 requires the engagement partner to wait for the engagement quality reviewer to complete the report.

d. Correct. SQMS No. 2 includes a new requirement addressing the engagement quality reviewer's responsibility to be involved at appropriate points in time during the engagement, consistent with when significant judgments are being made by the engagement team.

4.

a. Incorrect. The new QM SAS No. 146 mainly focuses on the engagement partner's overall responsibilities for quality management and does not embed SQMSs within the auditing standards.
b. Incorrect. The engagement quality reviewer is responsible for documentation, and the engagement partner is responsible for using team members that have the necessary skills to perform the engagement.
c. Correct. Although SQMS No. 2 includes a stand-back requirement for the engagement quality reviewer, the new QM SAS No. 146 includes a stand-back requirement for the engagement partner.
d. Incorrect. The new QM SAS No. 146 makes it clear that the engagement partner has overall responsibility for managing and achieving quality.

5.

a. Incorrect. The new QM for SSARS does not alter any of the eight components of a system of quality management.
b. Incorrect. The new QM for SSARS makes the SSARS engagement partner, not the engagement quality reviewer, responsible for ensuring the engagement has sufficient and appropriate resources.
c. Correct. The new QM for SSARSs eliminates the requirement that an engagement letter be obtained before starting a review engagement.
d. Incorrect. The new QM for SSARS does not exempt SQMSs from SSARS engagements; rather, it places more emphasis on the importance of quality management for SSARS engagements.

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PCAOB Update

Learning objectives

- Identify strategic priorities of the PCAOB.
- Determine the key responsibilities for planning and supervising audits involving other auditors and dividing responsibility for the audit with another accounting firm included in the recently approved amendments to existing PCAOB auditing standards (AS), *Planning and Supervision of Audits Involving Other Auditors*, and a new AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*.
- Identify key elements of the PCAOB's proposed new quality control standard, together with other amendments to PCAOB standards, outlined in a recent exposure draft issued by the PCAOB.
- Determine the key responsibilities related to the auditor's use of confirmations and other related proposed amendments to the PCAOB AS outlined in a recent exposure draft issued by the PCAOB.

Although the primary focus of this course is to provide an overview of current auditing and other attest standards applicable to engagements involving non-issuers, this course highlights recent activities at the PCAOB because it informs the broader audit profession. In fact, the AICPA's Auditing Standards Board (ASB) considered some of these new standards as it developed recently issued Statements on Auditing Standards. Practitioners are encouraged to monitor the PCAOB website at www.pcaob.org for current developments.

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About the PCAOB

The PCAOB was established by the Sarbanes-Oxley Act of 2002 to oversee the audits of public companies. The PCAOB has the following four primary duties:

1. Register public accounting firms that prepare audit reports for issuers, brokers, and dealers.
2. Establish or adopt auditing and related attestation, quality control, ethics, and independence standards.
3. Inspect registered firms' audits and quality control systems.
4. Investigate and discipline registered public accounting firms and their associated persons for violations of specified laws, rules, or professional standards.

The board of the PCAOB has five members, including a chairman, who are appointed to staggered five-year terms by the SEC, after consultation with the chair of the Board of Governors of the Federal Reserve System and the secretary of the Treasury. Only two of the five board members can be CPAs. The SEC has oversight authority over the PCAOB, including the approval of the board's rules, standards, and budget.

The PCAOB has approximately 800 staff members. According to the latest Annual Report (2021)[1] issued in March 2022, the PCAOB oversees more than 1,700 public accounting firms that audit more than 8,600 U.S. public companies that file financial statements with the SEC. During the 2021 fiscal year, PCAOB inspectors reviewed 782 unique audit engagements performed by 191 audit firms.

Changes to the PCAOB

In June 2021, the SEC announced changes to the PCAOB, replacing all members except Duane DesParte. The sudden changes are allegedly in response to criticisms that the PCAOB was not sufficiently focused on issues important to investors, suggested by its no longer holding meetings of the Investor Advisory Group or Standing Advisory Group and fewer open public meetings of the PCAOB.

New members of the PCAOB include the following:

- Erica Y. Williams was appointed as Chair of the PCAOB by the SEC in November 2021 and sworn in on January 10, 2022. Her current term expires on October 24, 2024. Williams previously served as a Special Assistant and Associate Counsel to President Barack Obama, advising the president and his senior advisers on legal and constitutional issues involving economic policy, financial regulation and reform, financial technology, trade, intellectual property, and data protection and privacy.
- Duane M. DesParte was appointed as a board member by the SEC in December 2017 and sworn in on April 9, 2018. He was reappointed in May 2019. He was designated as Acting Chairperson from June 2021 to January 2022. His current term expires on October 24, 2023. DesParte joined the board after retiring from Exelon Corporation, where he served as corporate controller and in other financial roles for 15 years, following an 18-year career in the audit assurance business. He is a CPA.
- Christina Ho was appointed as board member of by the SEC in November 2021 and sworn in on November 9, 2021. Her current term expires on October 24, 2025. Ho previously served as Vice

[1] See *Annual Report*, PCAOB, 2021, at [2021-annual-report.pdf (pcaobus.org)](https://pcaobus.org).

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President of Government Analytics and Innovation at Elder Research, as Controller and Interim Chief Financial Officer for the University of Maryland College Park, and in a number of senior roles at the U.S. Department of the Treasury. She is a CPA.

- Kara M. Stein was appointed as board member by the SEC in November 2021 and sworn in on November 18, 2021. Her current term expires on October 24, 2026. Prior to joining the PCAOB, Stein served as a Distinguished Policy Fellow and Lecturer-in-Law at the University of Pennsylvania Carey Law School and was Director of the AI, Data, and Capital Markets Initiative at the Center on Innovation, University of California Hastings Law. From 2013 to 2019, Stein was a Commissioner of the SEC.
- Anthony C. Thompson was appointed as a board member by the SEC in November 2021 and sworn in on January 3, 2022. He was reappointed in June 2022, and his current term expires on October 24, 2027. Prior to joining the PCAOB, Thompson served as the Executive Director and Chief Administrative Officer of the Commodity Futures Trading Commission (CFTC), which he joined in 2011. Prior to that, he held senior positions at the U.S. Department of Agriculture, after serving in the United States Air Force for 32 years, where he served as the Chief Budget Officer for the service branch.

PCAOB's Strategic Plan 2022–2026

In November 2022, the PCAOB approved its 2022–2026 Strategic Plan.[2]

Since 2007, the PCAOB has each year drafted a five-year strategic plan. The PCAOB sought input from a number of external constituencies, including investors, financial statement preparers, audit committee members, academics, auditors, and other important stakeholders. They also held public meetings with the Investor Advisory Group and the Standards and Emerging Issues Advisory Group to obtain their input. Additionally, they sought input from the SEC and from PCAOB employees. The PCAOB published a draft strategic plan for comment, and it received comment letters in response. They updated that plan in November 2022 for the 2022–2026 timeframe.

Three priorities guided the development of this plan.

Investor protection: The PCAOB's standards-setting, inspections, and enforcement programs must fulfill the investor protection mission.

Engagement: Regular and meaningful engagement with key stakeholders, including investors, investor advocates, audit committee members, financial statement preparers, audit firms, regulators, Congress, and academics, is critical to the fulfillment of the PCAOB's mission.

Adaptability: The PCAOB must continually anticipate and respond to developments affecting the audit profession, including emerging trends and modernizing standards.

[2] See *Strategic Plan: 2022–2026*, PCAOB, (November 2022), strategic-plan-2022-2026.pdf (pcaobus.org).

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Strategic goals

The 2022–2026 strategic plan contains the following four strategic goals:

1. **Modernize standards**: **Modernize standards**: The PCAOB intends to modernize and streamline its existing standards and to issue new standards where necessary.
2. **Enhance inspections**: The PCAOB intends to continue performing robust inspections, increase transparency and timeliness in reporting inspection results, provide useful guidance, and place greater emphasis on firm remediation actions to address findings.
3. **Strengthen enforcement**: The PCAOB intends to rigorously enforce PCAOB and applicable laws, impose more significant penalties, increase transparency in enforcement actions, and collaborate with other regulators to enforce concurrent actions.
4. **Improve organizational effectiveness**: The PCAOB intends to improve employee experience, enhance engagement with a number of key stakeholders, and improve internal processes to advance the mission of the PCAOB.

For each of the goals, the PCAOB identified a number of objectives to guide their efforts. You can view the strategic plan by visiting the PCAOB website (www.pcaobus.org).

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Recently issued PCAOB auditing standards

In the past few years, the PCAOB has not been actively releasing new auditing standards. However, in June 2022, it issued the following amendments to existing PCAOB Auditing Standards (AS), which also created a new AS 1206.

- *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm* (Release No. 2022-002 approved by the PCAOB in June 2022 and by the SEC in August 2022)

This release affects PCAOB AS as follows:

- Revises
  - AS 1015, *Due Professional Care in Performance of Work*
  - AS 1105, *Audit Evidence*
  - AS 1201, *Supervision of the Audit Engagement*
  - AS 1215, *Audit Documentation*
  - AS 1220, *Engagement Quality Review*
  - AS 2101, *Audit Planning*
- Rescinds
  - AS 1205, *Part of Audit Performed by Other Independent Auditors* and Audit Interpretation 10, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of AS 1205*
- Adopts
  - AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*

The release also makes other conforming amendments to existing standards. This section summarizes the key elements of this new guidance.

Effective date

The amendments will take effect for audits of financial statements for fiscal years ending on or after December 15, 2024.

Key elements of amended and new standard on audits involving other auditors[3]

This recently issued guidance contains the following:

- Amendments to existing standards relating to the supervision of audits involving other auditors
- A new standard on dividing responsibility for the audit with another accounting firm[4]

[3] See PCAOB Release No. 2022-002, *Planning and Supervision of Audits Involving Other Auditors and Dividing Responsibility for the Audit with Another Accounting Firm* (June 21, 2022).

[4] See PCAOB Release No. 2016-002, *Proposed Amendment Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard — Dividing Responsibility for the Audit with Another Accounting Firm* (April 12, 2016).

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The goal of this new guidance is to strengthen the requirements that apply to audits involving other accounting firms and individual accountants outside of the accounting firm that issues the audit report (other auditors). The PCAOB intends that this new guidance will lead to a more uniform approach to the lead auditor's supervision of other auditors. The new standard applies when the firm issuing the audit report (referred to as the "lead auditor") divides responsibility for an audit with another accounting firm (referred to as the "referred-to auditor") and refers to the audit report of the other firm in the lead auditor's own audit report.

Background

Over the past several years, the PCAOB has been considering revisions to its guidance to strengthen requirements that apply to audits involving multiple audit firms. In April 2016, the PCAOB issued an exposure draft with proposed guidance related to the use of other auditors. Since then, the PCAOB has continued to seek input about that proposed guidance. In September 2017, the PCAOB sought additional comment on that exposure draft. The PCAOB issued a second call in September 2021 for comment on the proposed guidance. The final amendments and new standard were approved by the PCAOB in June 2022 and by the SEC in August 2022.

In today's global business environment, companies have operations all over the world. Although a particular audit firm may lead the audit and sign the report, a firm will often work with other auditors around the world to help complete the audit. The work performed by other auditors may account for a significant share of the audit, including areas of high risk of material misstatement.

When conducting an audit, it is important for the lead auditor to determine that the audit work has been done in accordance with auditing standards of the PCAOB and that sufficient appropriate evidence obtained collectively (by both the lead auditor and other auditors) supports the lead auditor's opinion on the financial statements. Working with other auditors creates challenges that differ from working with auditors within the same firm. Different quality control systems, business practices, and culture may create issues when coordinating the audit work and communicating key findings.

In light of new standards issued at the international level and changes in audit firm policies and procedures, the issue of involving other auditors has evolved over time. PCAOB inspections involving the work of other auditors as well as both the lead auditor and the other auditors have found deficiencies. In some cases, deficiencies such as noncompliance with the lead auditor's instructions or the failure to communicate significant audit and accounting issues to the lead auditor have been identified. In other cases, deficiencies in the lead auditor's work were noted, such as the failure to determine whether the work conducted by the lead auditor reflected sufficient participation in the audit to warrant serving as the lead auditor.

Recently, some of the larger global firms have increased their supervision by the lead auditor of other auditors in light of changes in international standards and PCAOB findings. However, not all firms have significantly changed their methodologies. As a result, the PCAOB has issued these amendments and a new auditing standard to strengthen guidance in this area.

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Key definitions

The new guidance includes definition of terms such as *engagement team*, *lead auditor*, *other auditor*, and *referred-to auditor*. The term *engagement team* is commonly used in PCAOB standards but has not been expressly defined. The terms *lead auditor* and *referred-to auditor* are not currently used in PCAOB auditing standards. Although the term *other auditor* is not defined in PCAOB auditing standards, its meaning is described or implied by the context of the requirements in which it is used. See the definitions in the exhibit.

Exhibit: Key definitions

The PCAOB's revisions include these definitions:

engagement team. Includes partners, principals, and shareholders of (and accountants and other professional staff employed or engaged by) the lead auditor or other accounting firms, who perform audit procedures on an audit or assist the engagement partner in fulfilling their planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201, *Supervision of the Audit Engagement*. The engagement team also includes specialists who (1) are employed by the lead auditor or an other auditor participating in the audit and (2) assist their firm in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure. This definition would exclude the engagement quality reviewer and those assisting the reviewer and engaged specialists.

lead auditor. The registered public accounting firm issuing the auditor's report on the company's financial statements and, if applicable, internal control over financial reporting. The lead auditor also includes the engagement partner and other engagement team members who (1) are partners, principals, shareholders, or employees of the registered public accounting firm issuing the auditor's report (or individuals who work under that firm's direction and control and function as the firm's employees) and (2) assist the engagement partner in fulfilling their planning or supervisory responsibilities on the audit pursuant to AS 2101 or AS 1201.

other auditor. A member of the engagement team who is not a partner, principal, shareholder, or employee of the lead auditor or an individual who works under the direction and control of the registered public accounting firm issuing the auditor's report and functions as that firm's employee. Other auditors also include a public accounting firm, if any, of which such engagement team member is a partner, principal, shareholder, or employee.

referred-to auditor. A public accounting firm, other than the lead auditor, that performs an audit of the financial statements and, if applicable, internal control over financial reporting, of one or more of the company's business units and issues an auditor's report in accordance with the standards of the PCAOB to which the lead auditor makes reference in the lead auditor's report on the company's financial statements and, if applicable, internal control over financial reporting.

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Enhanced planning of audits involving other auditors

The revised guidance supersedes AS 1205 and amends AS 2101 to strengthen planning requirements, including procedures the lead auditor should perform to determine whether the lead auditor's participation is sufficient to serve as the lead auditor. The guidance eliminates the lead auditor's ability to use the "work and reports" of other auditors and requires the lead auditor to either (1) supervise the other auditor's work when the lead auditor assumes responsibility for that work or (2) comply with the revised guidance when the lead auditor divides responsibility for the audit with another accounting firm.

The engagement partner is responsible for the engagement and its performance. The engagement partner is now required to determine whether the participation of their accounting firm is sufficient for the firm to carry out its responsibilities of a lead auditor and to report as such on the company's financial statements. Generally, participation of the firm is ordinarily not sufficient to serve as lead auditor if more than 50% of the assets or revenues are audited by the referred-to auditors. The new standard requires that the engagement quality reviewer review that determination made by the engagement partner.

The lead auditor should understand the knowledge, skill, and ability of the other auditor's engagement team members who assist the lead auditor with planning and supervision. And the other auditor is required to provide written affirmation that the engagement team members possess the knowledge, skill, and ability to perform assigned tasks. The lead auditor also needs to determine the other auditor's compliance with SEC and PCAOB independence and ethics rules.

Note: Only the lead auditor of the financial statements can serve as lead auditor of internal control over financial reporting.

Enhanced supervision audits involving other auditors

The revised guidance amends AS 1201 to help the lead auditor apply a risk-based approach to the supervision of other auditors to result in a more appropriate level of involvement by the lead auditor. The lead auditor retains responsibility for the supervision of the entire audit.

The amendment requires the lead auditor to inform the other auditor about the scope of the work to be performed by the other auditor, including information about the following:

- Identified risks of material misstatement associated with the location or business unit audited by the other auditor
- Tolerable misstatement, the identified risks of material misstatement
- The amount below which misstatements are clearly trivial

The lead auditor should also obtain and review the other auditor's written description of audit procedures to be performed and discuss with and communicate in writing to the other auditor any needed changes to the planned approach. The other auditor is required to provide written affirmation to the lead auditor about whether the other auditor has performed the work in accordance with the lead auditor's instructions. If the other auditor has not performed the work in accordance with the instructions, the other auditor must describe the nature of what was not performed, the reasons why, and alternative

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procedures conducted. The other auditor must also provide specified documentation concerning work that was performed.

Based on the lead auditor's review of the documentation provided by the other auditor, discussions with the other auditor, and other information obtained by the lead auditor, the lead auditor should determine whether the other auditor performed the work in accordance with the lead auditor's instructions. The lead auditor should also determine if additional audit evidence should be obtained by the lead auditor or the other auditor to address any previously unidentified risk of material misstatement or when sufficient appropriate evidence has not been obtained.

Dividing responsibility for the audit

The PCAOB also issued a new, separate standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, to oversee situations in which the lead auditor divides responsibility for the audit with and makes reference in the audit report to another firm (the *referred-to auditor*; see definition in the preceding exhibit). This new standard supersedes AS 1205, *Part of the Audit Performed by Other Independent Auditors*. The revised guidance now requires the lead auditor to supervise work performed by other auditors under AS 1201, *Supervision of the Audit Engagement*, in all cases, unless the lead auditor divides responsibility for the audit with another auditor.

The new standard requires the lead auditor to communicate (in writing) the plan to divide the responsibility for the audit to the referred-to auditor. The lead auditor may divide responsibility for the audit with a referred-to auditor only if the following conditions are present:

- The referred-to auditor represents that they performed its audit and issued its report in accordance with PCAOB standards.
- The lead auditor determines that the referred-to auditor is familiar with the relevant financial reporting requirements and PCAOB standards.
- The referred-to auditor is registered with the PCAOB if it played a substantial role in the audit.
- If the business unit financial statements audited by the referred-to auditor were based on another financial reporting framework, the lead auditor or the referred-to auditor have audited the conversion of those statements to that used by the company.

The lead auditor should determine that audit procedures are performed to test and evaluate the consolidation or combination of the financial statements of the business units audited by the referred-to auditor into the company's financial statements.

The lead auditor's report must clearly indicate the division of responsibility and refer to the referred-to auditor by name. The lead auditor's report must also refer to the referred-to auditor's report and disclose the magnitude of the portion of the financial statements audited by the referred-to auditor.

Documentation requirements

The PCAOB's revised guidance also includes amendments to other PCAOB standards, including conforming amendments. Here are some of the key amendments.

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The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet applicable requirements is prepared and maintained. AS 1215, *Audit Documentation*, is revised to explicitly state that the other auditor must retain documentation of the work that it performs.

Prior to the report release date, the office that issues the auditor's report must obtain, review, and retain documentation related to the work performed by other auditors including the following:

- An engagement completion document
- A list of significant risks, the auditor's responses, and the results of procedures performed
- Sufficient information related to any significant findings or issues that are inconsistent with or contradict the final conclusions
- Any findings affecting the consolidation or combining of accounts in the consolidated financial statements
- Sufficient information to agree or reconcile the financial statement amounts to the information underlying the consolidated financial statements
- A schedule of accumulated misstatements and an evaluation of uncorrected misstatements
- All significant deficiencies and material weaknesses in internal control over financial reporting
- Letters of representation from management
- All matters to be communicated to the audit committee

Additional amendments

The PCAOB's revised guidance also includes amendments to other PCAOB standards, including conforming amendments. Here are some of the key amendments.

AS 1220, *Engagement Quality Review*, is amended to require the engagement quality reviewer in an audit involving other auditors or referred-to auditors to evaluate the engagement partner's determination of the partner's sufficiency of participation in the audit. For example, the new guidance adds responsibilities for the engagement partner to determine whether the participation of the partner's firm is sufficient for the firm to fulfill the responsibilities of lead auditor, including responsibilities related to the audit of internal control over financial reporting. The engagement quality reviewer is required to evaluate that judgment.

AS 2101, *Audit Planning*, is amended to require the lead auditor to assess the other auditor's compliance with PCAOB independence and ethics requirements. That includes receiving written affirmation from the other auditor about whether (1) the other auditor has procedures that provide reasonable assurance that the other auditor maintains compliance with SEC and PCAOB independence and ethics requirements, and (2) the other auditor is in compliance with those requirements.

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Knowledge checks

1. Which is correct regarding the PCAOB's new guidance related to audits involving other auditors?

    a. It prohibits other auditors from participating in a public company's audit.
    b. It requires the lead auditor to explicitly divide responsibility in the audit report whenever other auditors are involved.
    c. It allows the other auditor to determine materiality and tolerable misstatement for areas of the audit conducted by the lead auditor.
    d. It requires the lead auditor to hold discussions with other auditors about risks of material misstatement.

2. Which new PCAOBPCAOB auditing standard is related to dividing work with other auditors?

    a. AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm.*
    b. AS 1215, *Audit Documentation*.
    c. AS 1015, *Due Professional Care in Performance of Work.*
    d. AS 1201, *Supervision of the Audit Engagement*.

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Recently issued exposure drafts

In 2022, the PCAOB issued two exposure drafts of proposed revisions to the PCAOB Auditing Standards.

- *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (Release No. 2022-006, issued in November 18, 2022)
- *Proposed Auditing Standard — The Auditor's Use of Confirmation, and Other Proposed Amendments to PCAOB Standards (*Release No. 2022-009, issued December 20, 2022)

Proposed new quality control standard

In November 2022, the PCAOB proposed a new quality control standard — *A Firm's System of Quality Control* — that also includes other proposed amendments to PCAOB standards, rules, and forms.[5] The goal of this proposed new guidance is to significantly improve the quality control systems for firms registered with the PCAOB.

This proposed new standard would do the following:

- Supersede existing PCAOB quality control standards and replace that with a new QC 1000, *A Firm's System of Quality Control*.
- Create new reporting requirements on quality matters and a new, nonpublic Form QC.
- Amend and retitle AS 2901, *Responding to Engagement Deficiencies After Issuance of the Audit Report (*previously titled, *Consideration of Omitted Procedures After the Report Date)*, which will include expanded requirements related to responses to deficiencies on completed engagements.
- Supersede ET 102 with a new standard, EI 1000, *Integrity and Objectivity*.
- Amend other PCAOB standards, rules, and forms.

Background

The PCAOB believes there is room for significant improvement in quality control systems based on the PCAOB's insights from its inspections and enforcements activities, in addition to the research and outreach they have conducted. The PCAOB's current quality control standards have been in place for several decades; however, during that time, the auditing profession and business context have change noticeably. In particular, significant developments in the use of technologies and data analytic techniques have evolved, leaving room for a number of areas for improvements to the quality control standards.

In December 2019, the PCAOB issued a concept release, *Potential Approach to Revisions to PCAOB Quality Control Standards*, to seek public comment on a potential approach to revising the PCAOB's Quality Control Standards.[6] In that concept release, the PCAOB outlined how it was considering whether

[5] See PCAOB Release No. 2022-006, *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms* (November 18, 2022).

[6] See PCAOB Release No. 2019-003, *Concept Release: Potential Approach to Revisions to PCAOB Quality Control Standards* (December 17, 2019).

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new guidance is warranted related to audit firms' systems of quality control to address deficiencies noted in PCAOB inspections. In particular, the PCAOB is considering whether changes are needed to strengthen guidance related to the assignment and documentation of firm supervisory responsibilities.

The staff has also been monitoring developments related to the International Auditing and Assurance Standards Board's (IAASB's) project on quality control. The PCAOB's potential approach outlined in the concept release was based on the IAASB's proposed International Standards on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, which was issued as a final standard by the IAASB in December 2020. In addition, the AICPA's ASB has recently issued new Statements on Quality Management Standards (SQMS)[7].

The PCAOB inspection process has identified a number of ongoing deficiencies in quality control systems. Although firms have made improvements over time, PCAOB inspections continue to reveal that not all firms have made needed improvements, and progress is uneven. PCOAB inspectors observe that firms' quality control systems do not provide reasonable assurance that firm personnel will comply with applicable professional standards. For example, inspections have revealed that firms sometimes fail to identify violations of independence rules, or they fail to (1) identify and test controls that address risks of material misstatement, (2) sufficiently evaluate review controls, or (3) evaluate significant assumptions or data used in developing an estimate. Additionally, inspections have revealed problems with inadequate engagement quality reviewer evaluations. These examples imply deficiencies in the firms' quality control systems.

Key elements of the proposed new quality control standard

The PCAOB's proposed new standard is designed to strengthen quality control systems for firms that are registered with the PCAOB. Here are key elements.

The PCAOB's proposal is structured in a similar manner as ISQM 1 and SQMS 1. That allows for building a common approach consistent with all standards for addressing quality control. The PCAOB standard incorporates the same eight components of quality control as in ISQM 1 and SQMS 1.However, the PCAOB proposal presents them in a slightly different order.

Two process components

1. The firm's risk assessment process
2. The monitoring and remediation process

[7] The new Statements on Quality Management Standards (SQMS) are addressed in a separate course.

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Six Components related to the firm's organization and operations

1. Governance and leadership
2. Ethics and independence
3. Acceptance and continuance of client relationships and specific engagements
4. Engagement performance
5. Resources
6. Information and communication

Although the PCAOB's proposed approach uses the same basic approach as the IAASB and AICPA standards, the proposal includes important additional or modified provisions to address particular needs in the firms registered with the PCAOB. And, because it is principles-based, the structure allows for scalability and application to a variety of organizations.

Objectives of quality control

The exposure draft emphasizes that the objective of a quality control system is to provide reasonable assurance about the firm's compliance with professional and legal requirements that apply to the firm's engagements. Reasonable assurance is a high level of assurance but not absolute assurance. Even in a well-designed system, there is a risk of human error, uncertainty in judgment, or other events beyond what can be influenced by the firm.

Firms would be required to identify and assess quality risks to the achievement of the established quality objectives and to develop quality responses to those risks to the objectives.

Risk-based approach to quality control

Consistent with IAASB and AICPA standards, the proposed standard requires the firm to use a risk-based approach to quality control. That process would involve the identification and response to risks on an ongoing, structured basis.

The risk assessment component would include an approach that would be based on well-defined quality objectives that articulate the firm's desired outcomes for the six components that address the firm's organization and operations. The risk assessment process would include processes to identify and assess risks to the achievement of those quality objectives ("quality risks") and processes to design and implement procedures to address quality risks ("quality responses"). Risk assessment processes would also include procedures to monitor developments that might require changes to the quality control system. This risk-based process would drive how the firm develops and refines its quality control processes and procedures.

The monitoring and remediation component (the second "process component" in addition to the risk assessment component) would apply to all of the components of the quality control system, including the monitoring and remediation component. The monitoring and remediation process helps the firm pinpoint areas of the quality control system that are working effectively, and it helps identify opportunities for addressing deficiencies.

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Responses to address quality risks

Based on the firm's risk assessment processes, the firm's quality control system would include policies and procedures that lead to the design and implementation of responses to risks to quality control. Some quality responses may address multiple quality risks, and those responses would be tailored specifically to the firm.

Reporting on the quality control system

Based on the results of its monitoring and remediation activities, the proposed standard would require the firm to evaluate and report on its QC system annually. The firm would need to conduct the evaluation to conclude as of November 30 (the "evaluation date") that its quality control system

a. is effective with no unremediated quality control deficiencies,
b. is effective except for one or more unremediated quality control deficiencies that are not major quality control deficiencies, or
c. is not effective (one or more major quality control deficiencies).

The proposed standard describes an *unremediated quality control deficiency* as *"one for which the remedial actions that completely address the QC deficiency have not been fully implemented, tested, and found effective."*

The proposed standard also defines a *major quality control deficiency* as *"an unremediated QC deficiency or combination of unremediated deficiencies that severely reduces the likelihood of the firm achieving the reasonable assurance objective or one or more quality objectives." According to the exposure draft, a major QC deficiency is analogous to a material weakness in the context of internal control over financial reporting.*

The exposure draft also includes amendments to AS 1301, *Communications with Audit Committees*, to require the auditor to communicate to the audit committee about the firm's most recent evaluation of its QC system.

New Form QC

If approved, the new standard will require the firm to use Form QC to report the results of the evaluation of its QC system to the PCAOB annually, no later than January 15 of the year following the evaluation. The PCAOB will use the data provided on Form QC to help guide its inspections efforts.

Documentation of QC system

The proposed standard would require the firm to prepare and retain documentation of the design, implementation, and operation of the quality control system and the annual evaluation of the system. That would include documentation regarding decisions made regarding all the various responsibilities for quality control across the firm and how they are to be implemented. For example, the firm would document the lines of responsibility and supervision within the firm's QC system at the various senior levels up to and including the principal executive officer(s) or equivalent. Documentation about the operation would provide evidence that policies and procedures were performed in the manner intended.

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Amendments to other standards, rules, forms

The exposure draft includes other amendments to various standards and rules of the PCAOB.

The proposed standard would amend AS 2901, *Consideration of Omitted Procedures After the Report Date*, to update the standard in light of current practice and to incorporate concepts and terminology from the new quality control standard. It would introduce a new term *engagement deficiency* that represents *"an instance of noncompliance with applicable professional or legal requirements by the firm, firm personnel, or other participants with respect to an engagement of the firm, or by the firm personnel with respect to an engagement of another firm."*

The exposure draft also includes a proposed recission of ET section 102, *Integrity and Objectivity*, and replace it with a new standards EI 1000, *Integrity and Objectivity*. That replacement builds upon the extant ET section 102 and its related interpretations, but it also reflects updating revisions the PCAOB believes is necessary.

Other changes are included to amend various other standards, rules, and forms to conform them to the provisions of the new standard.

Proposed effective date

The PCAOB is seeking feedback on the amount of time auditors would need before the proposed new quality control standard and the amendments should become effective. The PCAOB is considering an effective date of December 15 of the year after approval by the SEC.

Knowledge check

3. Which is a process component incorporated into the PCAOB's proposed Quality Control Standards?
   a. The firm's governance and leadership.
   b. The firm's risk assessment process.
   c. The firm's hiring practices.
   d. The firm's engagement and performance.

Proposed AS on use of confirmations

In December 2022, the PCAOB issued proposed revisions to AS 2310, *The Confirmation Process*, that would replace AS 2310 with a new standard titled *The Auditor's Use of Confirmations*.[8] The goal of this revised standard is to strengthen and modernize the confirmation process.

[8] See PCAOB Release No. 2022-009, *Proposed Auditing Standard — The Auditor's Use of Confirmation, and Other Proposed Amendments to PCAOB Standards*, (December 20, 2022).

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Background

The confirmation process involves the auditor sending a confirmation request to another party (referred to as the "confirming party") and then evaluating the response information received. When responses are not received or when they are incomplete, the auditor must address those situations to obtain sufficient audit evidence. Designed correctly, the confirmation process can provide important evidence for the audit process.

The guidance on the auditor's use of confirmations has been in existence for more than 30 years with little modifications to it over time. That guidance was written at a time when confirmations were primarily paper based.

In recent years, the confirmation process has evolved with an increased use of electronic communications, including email, and third-party intermediaries now helping to facilitate the process. Many of the largest financial institutions now require the use of intermediaries to assist with the process. Although the PCAOB has considered potentially modifying that guidance as early as 2009–2010, it did not issue a proposed exposure draft with revisions until 2022.

Current standards allow the auditor to use both positive and negative confirmations.

- Positive confirmations: A confirmation that requests the recipient to respond directly to the auditor about whether the recipient agrees with information that is stated in the request or asks the recipient to provide the requested information by filling in a blank form.
- Negative confirmation: A confirmation that requests the recipient to respond only when the recipient disagrees with the information included in the request.

PCAOB inspection findings and enforcement actions have noted deficiencies in the auditor's use of confirmations. Those have highlighted noncompliance with existing standards, particularly involving maintaining control over the confirmation process. Noted deficiencies have included the following issues:

- Failure to perform procedures to verify the source of confirmation responses received electronically
- Failure to perform alternative procedures when responses were not received
- Using negative confirmations in situations where the risk of material misstatement was not assessed as low
- Failure to maintain appropriate control over the confirmation process, including use of company personnel to manage the delivery and receipt of confirmations
- Failure to adequately respond when confirmation procedures generated contradictory information
- Failure to perform confirmation procedures to address fraud risk
- Inappropriately designed confirmations
- Failure to evaluate responses received

Because the audit confirmation process impacts nearly every financial statement audit, the PCAOB is embarking on these enhancements to the confirmation guidance.

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Key elements of the proposed revisions to the use of confirmations

The proposed new standard will replace the current guidance in AS 2310 in its entirety. The proposed new standard will establish requirements when the auditor uses confirmations as audit evidence. Here are key elements.

Expansion of types of confirmations

The proposed standard continues to provide guidance not only on the use of traditional paper based confirmations, but it also is expanded to provide guidance about the use of email or intermediaries to facilitate the process. It also allows for other possibilities that are not currently developed. The proposed new standard does not prescribe a particular format for a confirmation request. The exposure draft retains information about the details regarding the types of information to be included on a confirmation request.

Risk-based approach to confirmations

The exposure draft expands guidance to emphasize risk-based considerations for determining whether confirmations as a tool to obtain audit evidence. The proposal integrates the guidance on the use of confirmations with the PCAOB's risk assessment standards adopted since the guidance on confirmations was developed in the early 1990s. The guidance notes that confirmations can be an effective and efficient way of obtaining relevant and reliable external evidence, including situations in which there is a heightened risk of material misstatement due to error or fraud. Although confirmations may be an appropriate response to significant risks, the proposal encourages but does not mandate their use as a response to significant risks.

Required use for cash and accounts receivable

The proposed new standard adds a new requirement that the auditor should perform confirmation procedures for cash held by third parties. It also carries forward the requirement that the auditor should perform confirmation procedures for accounts receivable. Furthermore, the proposal requires that the auditor consider confirming the terms of certain transactions for significant risks of material misstatement linked to a complex or significant unusual transaction.

The exposure draft does not include consideration of whether the auditor can overcome a presumption that confirmation of cash is needed. The PCAOB believes that other substantive procedures do not provide evidence as persuasive as the confirmation of cash. In contrast, however, the proposed guidance retains the ability for the auditor to overcome the presumption to confirm accounts receivable when the auditor determines that an audit response that includes only substantive procedures other than confirmation can provide evidence that is at least as persuasive as confirmations.

Limitations on the use of negative confirmations

The proposed new standard emphasizes that although negative confirmations may be used, they provide only sufficient appropriate evidence when combined with other substantive audit procedures. (Other

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substantive procedures might include examining subsequent cash receipts, examining shipping documents, or sending positive confirmation requests.)

Maintaining control over the confirmation process

The proposed new standard continues to emphasize the auditor's responsibility to maintain control over the entire confirmation process, including the design of the confirmation and the sending, receiving, and evaluating confirmation request and replies. The exposure draft emphasizes that it would not be appropriate for company employees, including internal audit, to send or receive confirmations.

The exposure draft expands the guidance on identifying the appropriate party to whom the confirmation request should be sent, but it stops short of requiring specific procedures to assess the validity of addresses of confirmation recipients.

Use of intermediaries

Existing standards do not address the use of intermediaries in the confirmation process. The exposure draft adds guidance to reflect that reality, but it refers to them as "facilitators of the electronic transmission of confirmation requests and responses between the confirming party and auditor." The proposed standard notes that the use of an intermediary does not relieve auditors of their responsibility to control the entire confirmation process. The proposal requires auditors to evaluate the implications of involving intermediaries in the process, including consideration of processes that address the risk of interception and altercations of the communications by the company. Although it does not prescribe specific procedures, it allows the auditor to consider the facts and circumstances of the engagement.

Evaluation of responses to confirmations

The exposure draft highlights the auditor's responsibility to evaluate the information received in the confirmation response and to address nonresponses and incomplete responses. When confirmation responses are not reliable, the proposed standard requires the auditor to perform other procedures beyond confirmation. The new guidance includes expanded considerations to help the auditor consider the reliability of confirmation responses, including examples of indicators that a confirmation may have been intercepted or altered. The proposed standard continues to note that the auditor is not expected to be an expert in document authentication; however, it also notes that if the auditor is unable to conclude that the confirmation response is reliable, alternative procedures should be performed.

The exposure draft notes that the auditor should evaluate confirmation exceptions and determine implications for the audit by considering the exceptions individually and in the aggregate. However, the proposed guidance does not require investigating all confirmation exceptions to determine why every confirmation exception occurred.

If a confirmation reply is sent to someone other than the auditor, the proposed new standard requires the auditor to contact the confirming party and request the response be resent directly to the auditor. If a response is not sent directly to the auditor, the standard would require the auditor to treat that as a nonresponse.

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Performing alternative procedures

The proposed standard expands guidance related to the requirement for the auditor to perform alternative procedures to address a range of possible scenarios related to identifying confirming parties, evaluating the reliability of confirmation responses, or addressing incomplete or nonresponses. The new standard provides examples of alternative procedures to perform.

Use of internal audit

Existing standards do not address the use of internal audit in the confirmation process. The proposed standard includes guidance about when the auditor should not use internal audit in the confirmation process. Specifically, the auditor would not be permitted to use internal audit to select items to be confirmed, to send the confirmation requests, or to receive the responses.

Proposed effective date

The exposure draft seeks input on the amount of time auditors would need before the new proposed standard would become effective. For example, the PCAOB is considering whether compliance with adopted amendments and a new auditing standard should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if SEC approval occurs in the fourth quarter of a calendar year).

Knowledge check

4. Which standards is intended to modernize the confirmation process that has been in place for 30 years and currently does not take advantage of electronic conveniences?

   a. AS 2310, *The Confirmation Process*.
   b. AS XXXX, *The Auditor's Use of Confirmations*.
   c. ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements*.
   d. AS 2311, *The New Confirmation Process*.

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Summary

This course summarizes recently issued PCAOB auditing standards and outstanding exposure drafts related to ongoing projects of the PCAOB.

Although many practitioners may not perform audits of public companies, much of the guidance discussed in this course is relevant in the audits of non-issuer financial statements and possible future implication to audit standards used in audits of closely held companies.

Participants should monitor the PCAOB website at www.pcaob.org for future developments and new releases.

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Solutions

PCAOB Update

Knowledge check solutions

1.

   a. Incorrect. The new standard acknowledges how the nature of the global business environment means other auditors who are in other areas of the world may be needed to complete the audit.
   b. Incorrect. Although the new standard includes guidance for a lead auditor to divide responsibility with another auditor, the new standard would not require the responsibility to be divided.
   c. Incorrect. In the new standard, the lead auditor is required to inform the other auditor (not vice versa) about materiality, tolerable misstatement, and other planning considerations.
   d. Correct. In the new standard, the lead auditor is responsible for engaging in discussions with other auditors about the risk of material misstatement.

2.

   a. Correct. AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, is the appropriate standard for dividing work with other auditors.
   b. Incorrect. AS 1215, *Audit Documentation,* has been revised to explicitly state that the other auditor must retain documentation of the work it performs. However, it is not the new standard for dividing work.
   c. Incorrect. AS 1015, *Due Professional Care in Performance of Work,* has been revised in light of a new standard.
   d. Incorrect. AS 1201, *Supervision of the Audit Engagement,* has been amended to help the lead auditor apply a risk-based approach to the supervision of other auditors.

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3.

a. Incorrect. The firm's governance and leadership are a component of the PCAOB's proposed Quality Control Standards, but that component is related to the firm's organization and operation.
b. Correct. The firm's risk assessment process is a process component incorporated into the PCAOB's proposed Quality Control Standards.
c. Incorrect. The firm's hiring practices are not specified as a component of the PCAOB's proposed Quality Control Standards.
d. Incorrect. The firm's engagement and performance is a component of the PCAOB's proposed Quality Control Standards, but that component is related to the firm's organization and operation.

4.

a. Incorrect. AS 2310, *The Confirmation Process*, is the current outdated standard.
b. Correct. *The Auditor's Use of Confirmations* will replace AS 2310; however, it is currently an exposure draft, and input is still being sought from auditors.
c. Incorrect. ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements,* pertains to quality control standards.
d. Incorrect. It is currently an exposure draft and is not an official new standard.

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Preparation, Compilation, and Review Engagement Update

Learning objectives

- Distinguish among the nature and elements of reviews, compilations, and preparation engagements of financial statements following the completion of the Statement on Standards for Accounting and Review Services (SSARS) Clarity Project.
- Determine the key purpose of amendments to SSARS in the recently issued SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Engagements.*
- Identify best practices for performing analytical procedures in a review engagement outlined in the recently issued AICPA Practice Aid *Analytical Procedures in a Review Engagement.*
- Distinguish important considerations for implementing the FASB's lease standard in compilation and review engagements.

This course highlights specific issues related to nonaudit financial statement engagements that CPAs can provide. Until the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 26 in June 2022, ARSC had not issued any new SSARS since the issuance of SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions,* in February 2020. The course content briefly summarizes SSARS No. 26 and a related new Statement on Auditing Standard and also highlights three recently issued nonauthoritative publications relevant to compilation and review engagements. As of the end of February 2023, there are no outstanding exposure drafts of proposed SSARS.

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Reminder of SSARS-related engagements

The Accounting and Review Services Committee (ARSC) completed its Clarity Project in October 2014 when it issued SSARS No. 21, *Statement on Standards for Accounting and Review Services: Clarification and Recodification* (AR-C sections 60A, 70A, 80A, and 90A)[1] and SSARS No. 22, *Compilation of Pro Forma Financial Information*, (AR-C section 120). The primary purpose of the Clarity Project revisions was to conform the compilation and review standards to the clarity drafting conventions and to make additional changes to existing standards.

As a brief refresher, the clarified SSARS standards provide guidance primarily related to the following engagement types for nonissuers:

- *Preparation engagements*. The objective of an engagement to prepare financial statements is for the "accountant to prepare financial statements pursuant to a specified financial reporting framework."
- *Compilation engagements*. The objective of a compilation engagement is "to assist management in the presentation of financial statements and to report in accordance with this section, without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework." Management is responsible for the financial statements.
- *Review engagements*. The objective of a review engagement is "to obtain limited assurance 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 primarily through the performance of inquiry and analytical procedures."

The guidance related to those engagements are codified in AICPA *Professional Standards* as follows:

- AR-C section 60A, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*, provides general principles for SSARSs engagements.
- AR-C section 70A, *Preparation of Financial Statements*, provides requirements and guidance to an accountant who is engaged to prepare financial statements for an entity but is not engaged to perform a compilation, review, or audit with respect to those financial statements.
- AR-C section 80A, *Compilation Engagements*, provides requirements and guidance to an accountant engaged to perform a compilation of financial statements, prospective financial information, pro forma financial information, or other historical financial information.
- AR-C section 90A, *Review of Financial Statements*, provides requirements and guidance to an accountant when engaged to review financial statements.

[1] All AR-C sections can be found in AICPA *Professional Standards*.

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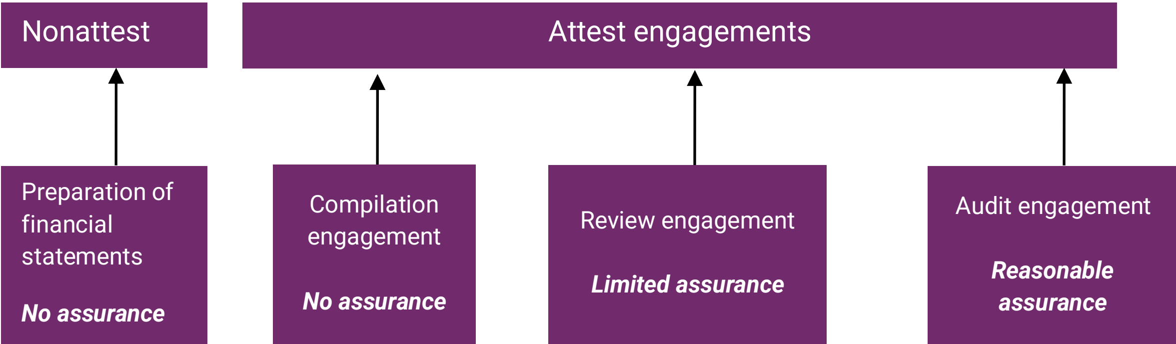
The following diagram illustrates the relationship between preparation and the three attest engagements: compilation, review, and audit engagements. As illustrated, there are varying levels of assurance provided in review and audit engagements and preparation and compilation engagements provide no assurance.



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SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*

In June 2022, the ARSC issued SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*, in conjunction with the Auditing Standards Board's (ASB) project related to quality control This new SSARS is part of a suite of standards issued by the AICPA to enhance firm systems of quality management.

New SQMS , SAS, and SSARS on quality management

In June 2022, the Auditing Standards Board (ASB) issued new Statements on Quality Management Standards (SQMS) combined with the new Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards,* and ARSC issued the new SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*. These standards work collectively to address quality management systems for firms performing preparation, compilation, review, audit, and attestation services.

Background

The AICPA made significant changes to quality control standards in October 2006 with the issuance of SQCS No. 7, *A Firm's System of Quality Control*, followed by SQCS No. 8 issued in November 2010 that applied clarity drafting conventions to SQCS No. 7. Many believe that the environment in which firms operate has evolved significantly since then, such as the expanded use of IT-based resources by entities and accounting firms, as well as the expectations of regulators. SQCS No. 8's "one-size-fits-all" approach does not embrace differences in the size or nature of firms or their services. Some suggest that the extant standards did not embrace a system of quality management that informed and responded to specific areas of risk.

Concerns about engagement quality expressed by peer reviewers and regulators often include these observations:

- Risks to engagement quality are often associated with audits, reviews, and attestation engagements performed by engagement partners who perform a low volume of such engagements.
- There is a need to improve firm governance and leadership and the culture and tone at the top of the firm.
- There have been noted inconsistencies in the performance of engagements and a lack of focus on planning.

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- Firms sometimes over-rely on resources, such as third-party quality control materials, without modifying them to the nature and circumstances of the firm.
- Smaller firms face unique challenges applying the standards, which tend to use a "one-size-fits-all" approach.

SQMS No. 1 addresses the system of quality management that forms the foundation for the firm's management of quality. It addresses how the engagement partner leverages the firm's system and manages quality at the audit engagement level. SQMS No. 1 retitled the existing "Statements on Quality Control Standards" to "Statements on Quality Management Standards (SQMS)," which now consists of two new SQMS statements:

- SQMS No. 1, *A Firm's System of Quality Controls Management*.
- SQMS No. 2, *Engagement Quality Reviews*.

In addition, the following new SAS was issued to revise auditing standards in light of SQMS Nos. 1and 2:

- Statements on Auditing Standards No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* (QM SAS).

SSARS No. 26 on quality management amends existing SSARS.

SSARS No. 26 on quality management

In November 2021, the ARSC issued an exposure draft of a proposed new SSARS, *Quality Management for an Engagement Performed in Accordance with Statements on Standards for Accounting and Review Services*. That proposed standard was issued to align SSARS with the proposed new Statement on Quality Management Services (SQMS) and the proposed new SAS on quality management. The comment period ended January 31, 2022, and ARSC issued the final guidance as SSARS No. 26 in June 2022.

SSARS No. 26 amends

- AR-C section 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*, which provides general principles for SSARSs engagements.
- AR-C section 70, *Preparation of Financial Statements*, which provides requirements and guidance to an accountant who is engaged to prepare financial statements for an entity but is not engaged to perform a compilation, review, or audit with respect to those financial statements.
- AR-C section 80, *Compilation Engagements*, which provides requirements and guidance to an accountant engaged to perform a compilation of financial statements, prospective financial information, pro forma financial information, or other historical financial information.
- AR-C section 90, *Review of Financial Statements*, which provides requirements and guidance to an accountant when engaged to review financial statements.

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Effective date

The amendments contained in SSARS No. 26 are effective for engagements performed in accordance with SSARS for periods beginning on or after December 15, 2025, with the exception of the change to AR-C section 90 related to engagement letters that is effective upon issuance of SSARS No. 26.

SAS No. 145

Until the effective date of SSARS No. 26, extant AR-C sections 60, 70, 80, and 90 are designated with an “A” suffix to denote content that does not reflect the codification of SSARS No. 26. Upon implementation of SSARS No. 26, auditors and firms should no longer use content from these AR-C sections and should follow the standard as codified.

Background

Existing quality control standards of the AICPA apply to all CPA firms with engagements in their accounting and auditing practice, which includes audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA Auditing Standards Board (ASB) or the ARSC. SSARS No. 26 helps to ensure that certain concepts related to quality management in SSARS are consistent with concepts in the auditing standards and the new quality management standards.

Technical revisions to AR-C Section 60

SSARS No. 26 includes a number of technical revisions to AR-C Section 60, *General Principles*, to conform that guidance with the new SQMSs and QM SAS. Some of the key revisions to the general principles for SSARS engagements include the following:

- Clarification and emphasis on the engagement partner’s responsibility to determine that members of the engagement team have the appropriate competence and capabilities, including sufficient time to perform the engagement
- Explicit guidance for the engagement partner to determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the engagement, the firm’s policies or procedures, and any changes that may arise during the engagement
- Modified guidance noting that the firm’s quality management system includes establishing a monitoring and remediation process designed to provide the firm with reasonable assurance that the firm’s policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively to
  - provide relevant, reliable, and timely information about the design, implementation, and operation of the system of quality management and
  - take appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis

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Technical revision to Paragraph .16 of AR-C Section 90

Paragraph .11 in the extant AR-C section 90 related to review engagements states the following (changes are in ***bold italics***):

> .~~11~~***16*** The accountant should agree upon the terms of the engagement with management or those charged with governance, as appropriate~~***, prior to performing the engagement***~~. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement between the parties and should include the following: (Ref: par. .A18–.A23)

When ARSC issued SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions,* the ARSC incorporated the best practice of obtaining the engagement letter prior to the start of the review engagement. That revision was not included in the corresponding requirement for a preparation engagement (paragraph .10 of AR-C section 70, *Preparation of Financial Statements*), a compilation engagement (paragraph .10 of AR-C section 80, *Compilation Engagements*), a compilation of pro forma financial information (paragraph .09 of AR-C section 120, *Compilation of Pro Forma Financial Information*), or in the corresponding requirements in the auditing or attestation standards.

After discussion, the ARSC concluded that the additional wording in paragraph .16 of AR-C section 90 was overly prescriptive and should be removed. That revision is included in SSARS No. 26.

Knowledge check

1. Which statement is correct regarding SSARS No. 26 on quality management?
    a. It exempts the new Statements on Quality Management Standards from SSARS engagements.
    b. It places explicit responsibilities on the engagement partner to ensure the engagement team has the time and resources to complete the SSARS engagement.
    c. It adds a requirement for the engagement letter to be agreed upon prior to starting the review engagement.
    d. It shifts quality management from the engagement partner to the engagement quality reviewer.

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New interpretations of SSARS

As of the end of February 2023, there have been no recently issued preparation, compilation, or review interpretations. Practitioners should monitor the AICPA website for further developments related to SSARS.

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New AICPA Practice Aid *Analytical Procedures in a Review Engagement*

In December 2022, the Audit and Attest Standards staff, with input from the AICPA Accounting and Review Services Committee, issued the new Practice Aid *Analytical Procedures in a Review Engagement* to illustrate and demonstrate the importance of the following two most misunderstood concepts when applying analytical procedures in a review engagement:

1. Forming expectations, and
2. Considering the precision of the expectation.

These concepts are particularly important because the results of the accountant's analytical procedures substantially contribute to the information the accountant uses to provide a reasonable basis for obtaining limited assurance. Understanding the precision of the expectation is vital because limited assurance — although less than the reasonable assurance obtained in an audit — is a meaningful level of assurance that is significantly more than minimal.

This practice aid is expected to improve the quality of review engagements performed. It has no authoritative status; however, *such other preparation, compilation, and review publications* might help the accountant understand and apply the SSARSs.

Background

In conducting a review of financial statements, as stated in paragraph .04 of AR-C Section 90, *Review of Financial Statements*, the accountant's objectives are to

a. Obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, and
b. Report on the financial statements as a whole and communicate, as required by AR-C section 90.

An accountant cannot perform a review of financial statements without performing analytical procedures. Paragraph .08 of AR-C section 90 defines analytical procedures as

> … evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

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In accordance with paragraph .24 of AR-C section 90, based on the accountant's understanding of the industry, knowledge of the entity, and awareness of the risks that the accountant may unknowingly issue an inappropriate accountant's review report, the accountant should design and perform analytical procedures, make inquiries, and perform other procedures, as appropriate, to obtain sufficient appropriate review evidence as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework. The analytical procedures and inquiries should be performed to address (*a*) all material items in the financial statements, including disclosures and (*b*) areas in the financial statements where the accountant believes there are increased risks of material misstatements.

Forming expectations

Analytical procedures are most effective when the accountant develops expectations that can reasonably be expected to identify unexpected relationships. Those expectations are the accountant's predictions of recorded amounts or ratios. The practice aid emphasizes that in performing analytical procedures, the accountant develops the expectation that any significant difference between the expected amount and the recorded amount indicates a possible misstatement. When such a difference is identified, the accountant seeks to obtain explanations for it (for example, an unusual event occurred) that are reasonable and consistent in light of the results of other review procedures (such as the accountant's inquiry procedures and other procedures performed to obtain limited assurance) and the accountant's knowledge of the entity's business.

The practice aid reminds readers that an accountant develops expectations by identifying plausible relationships (such as a store's square footage and its retail sales) that, based on the accountant's understanding of the entity and of the industry in which it operates, the accountant can reasonably expect to exist. The accountant may select information from various sources to form expectations. For example, the accountant may use prior-period information adjusted for expected changes, management's budgets or forecasts, industry data, or nonfinancial data. The source of information partly determines how precise the accountant's prediction of an account balance is; therefore, to obtain the limited assurance from an analytical procedure, it is important to consider the information's source when developing an expectation.

Forming an expectation is the first — and most important — phase of the analytical procedure process. The more precise the expectation (that is, the closer the accountant's expectation is to the correct balance or relationship), the more effective the procedure will be at identifying potential misstatements.

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There are four types of expectation methods:

1. **Trend analysis.** This is the analysis of changes in an account balance over time. Simple trends typically compare the prior period's account balance to that of the current period. More sophisticated trend analyses encompass multiple periods.

2. **Ratio analysis.** This is the comparison of relationships between financial statement accounts (between two periods or over time); the comparison of an account with nonfinancial data (such as revenue per order or sales per square foot); or the comparison of relationships between entities in an industry (for example, gross-profit comparisons). Ratio analysis entails comparing interrelations between accounts, nonfinancial information, or both.

3. **Reasonableness testing.** This is the analysis of account balances or changes in account balances within an accounting period that involves the development of an expectation based on financial data or nonfinancial data, or both. For example, an expectation for hotel revenues could be developed using the average occupancy rate, the average rate for all rooms, or rate by category or class of room.

4. **Regression analysis.** More commonly used in financial statement audits, regression analysis is the use of statistical models to quantify the accountant's expectation in dollar terms, with measurable risk and precision. In many cases, the entity has developed analytical procedures or internal models, or both, that it uses to monitor and evaluate its business and performance.

Precision

The practice aid highlights that the effectiveness of analytical procedures depends on their precision. Precision is a measure of how close the accountant's expectation is to the correct amount. The precision of expectations is a way the accountant can address areas believed to have increased risks of material misstatement.

In performing analytical procedures in connection with a financial statement review, the level of precision of the expectations the accountant develops might directly affect the level of assurance the accountant obtains. In a review engagement, the expectation needs to be precise enough to provide limited assurance that potential misstatements (individually or when aggregated with other misstatements) would be identified for the accountant to then inquire of management regarding their cause. Although limited assurance is less than the reasonable (that is, high) level of assurance obtained in an audit engagement, it is a sufficiently meaningful level of assurance to provide a basis for the accountant's conclusion in the review report that users can rely on in making determinations regarding the financial statements.

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Factors that affect the precision of analytical procedures include the following:

- The type of expectation developed
- The reliability and other characteristics of the data used in forming the expectation (both internally and externally prepared data)
- The consistency of characteristics of the data
- The nature of the account

In forming an expectation, an accountant considers two broad factors related to the characteristics of the data included in the account:

- The level of detail on which the accountant can base the expectation
- The reliability of the data.

The practice aid provides an example about an accountant planning to obtain limited assurance with respect to interest income. The accountant can obtain more assurance by developing a relatively precise expectation by selecting the appropriate type of procedure (such as a reasonableness test instead of a simple trend analysis); the level of detail of the data (such as quarterly versus annual data); and the reliability of the source of the data. The precision of the expectation primarily determines the degree of assurance obtained from the analytical procedure and affects the accountant's ability to ascertain whether an unexpected difference in an account balance results from misstatement.

The practice aid notes that, in general, the more disaggregated the data, the more precise the expectation. For example, using monthly — rather than annual — data tends to improve the precision of the expectation. Preparing an expectation by an individual business unit (such as a retail location or a product division) is also more precise than one based on consolidated data. The accountant can further increase precision (and simultaneously achieve greater consistency) by disaggregating data based on its characteristics.

The more reliable the data source, the more precise the expectation. Factors that relate to data reliability that the accountant might consider in forming the expectation include the following:

- ***External versus internal data and degree of independence.*** Data from independent sources are typically more reliable (for example, data sourced from a third party versus from entity management).
- ***Nonfinancial versus financial data***. The use of reliable nonfinancial data (such as a store's square footage or occupancy rates) improves the precision of the expectation.

When using analytical procedures to test for both overstatement and understatement, the accountant needs to ensure that the data used to build the expectation are reliable in both directions.

The greater the precision of the expectation (that is, the closer the expectation is to the correct amount), the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than non-misstatement causes. The difference between an accountant's

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expectation and the recorded book value of an account could be due to any of or all the following three causes:

- The difference is due to misstatement.
- The difference is due to inherent factors that affect the account (such as the predictability or the subjectivity of the account).
- The difference is due to factors related to the reliability of data used to develop the expectation.

The practice aid highlights that the greater the precision of the expectation, the more likely the difference between the accountant's expectation and the recorded value is due to misstatement (cause *a*). Conversely, the less precise the expectation, the more likely it is that a misstatement cannot be identified because the difference might be due to factors related to the precision of the expectation (causes *b* and *c*).

Evaluation of differences

The practice aid notes that the accountant considers the difference between the expected value and the recorded amount in the final phase of the analytical procedure process. It is generally not practicable to identify factors that explain the exact amount of a difference identified for inquiry, but the accountant attempts to quantify that portion of the difference that can be plausibly explained. Any portion of the difference that cannot be plausibly explained might be of a sufficiently small amount, in the accountant's professional judgment, to enable a conclusion on the absence of material misstatement.

If a reasonable explanation cannot be obtained, the accountant should consider the impact of uncorrected misstatements identified during the review. In doing so, the accountant may consider (*a*) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures, and in relation to the financial statements as a whole and the particular circumstances of their occurrence; and (*b*) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and on the financial statements as a whole.

Documentation

The practice aid notes that the accountant is expected to document, at a minimum, the following:

- The expectation and the factors considered in its development when that expectation and those factors are not otherwise readily determinable from the review documentation.
- Results of the comparison of the recorded amounts, or ratios developed from recorded amounts, with the expectations.
- Any inquiries of management and other review procedures relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such procedures. The

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documentation of inquiries of management are expected to include management's responses to the accountant's inquiries and the accountant's determination about whether management's responses appear reasonable.

Knowledge check

2. Which should the accountant provide in order to develop more effective analytical procedures?

    a. An expectation of the predicted amounts or ratios.
    b. A precise recorded value.
    c. Data primarily acquired from internal sources.
    d. Reliable financial data without using nonfinancial data.

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New reports on the implementation of the new lease standard for compilations and reviews

In January 2023, the AICPA's Center for Plain English Accounting issued two new reports — *Compilation Engagements: Implementation of the New Lease Standard* and *Review Engagements: Implementation of the New Lease Standard* — to provide nonauthoritative guidance to address how practitioners may comply with the new requirements for a compilation and review engagements in SSARS as they relate to the client's implementation of FASB Accounting Standards Codification (ASC) 842, *Leases*.

Background

In 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases*, codified in FASB *Accounting Standards Codification®* (FASB ASC) 842, *Leases* There are elements of the new standard that could impact almost all entities to some extent, although lessees will likely see the most significant changes. The standard became effective for nonpublic entities (as defined by the standard) for annual reporting periods beginning after December 15, 2021.

As a result of the new standard, practitioners will face significant challenges, not only in learning about and understanding the standard, but also in performing effective compilation or review engagements. Advance consultation on the approach management may use, for the first year of implementation and beyond, to comply with the new standard is beneficial. These topical discussions between the practitioner and the client can be helpful in early identification of complex issues that could arise.

All entities that issue financial statements prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) need to develop a plan for implementation of the lease standard. Lessees will need to recognize a right-of-use asset and a lease liability for virtually all leases (other than leases for which the entity elects the short-term lease exemption). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or financing. Operating leases will result in straight-line expense (similar to current operating leases) while financing leases will result in front-loaded expense pattern (similar to current capital leases). Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines.

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Compilation considerations

The report reminds accountants that a compilation engagement requires an "intelligent read" of the financial statements and issuing a compilation report. The practitioner cannot ignore apparent accounting and disclosure deficiencies in the financial statements simply because the engagement is "only" a compilation.

Although a compilation engagement does not require the accountant to verify, corroborate, or review information supplied by the client, accountants do bring a certain level of knowledge to the table. If the financial statements are prepared using U.S. GAAP, the accountant should have a requisite knowledge of U.S. GAAP and how that guidance would be applied to client financial statements. With the significance of FASB ASC 842 for most entities, it would be reasonable to expect that the accountant would have a working knowledge of the lease guidance and client implications, especially to the balance sheet. Therefore, although accountants are not required to make inquiries or perform other procedures in a compilation engagement, they should be in a position, based on their knowledge of U.S. GAAP, generally, and FASB ASC 842, specifically, to be able to recognize when information supplied by the client appears to not conform to the new lease standard.

The practitioner's knowledge should include an understanding of FASB ASC 842 and how the client has implemented that guidance. Specifically, that may include knowledge about the following matters:

- The types and nature of the client's contracts and leases, including oral or implied contracts
- Whether the client has taken a comprehensive inventory of all existing leases and contracts and the processes used to take the inventory
- How the client identifies a lease under FASB ASC 842 and how those leases are accounted for
- The transition method elected by the client and related transition adjustment
- Whether the client has adopted any of the available practical expedients
- The existence of any related party leases
- Prior accounting policies and practices related to leases including those related to disclosure of operating leases under FASB ASC 840
- Current process (if any) to apply FASB ASC 842 (remeasurements, modifications, new leases, terminated leases, etc.)

If, on the basis of the accountant's knowledge of the client and its industry, the information does not conform to the new lease standard, accountants are required to determine the appropriate course of action. Also, depending upon the type of compilation engagement, it will be much more readily apparent as to whether the client has properly implemented FASB ASC 842.

If the engagement is a compilation omitting substantially all disclosures, the financial statements that reflect the adoption of FASB ASC 842 could look very similar to financial statements prepared under FASB ASC 840 depending upon the presentation selected by the client, because the right of use (ROU) assets and lease liabilities are not required to be separately identified on the face of the financial statements. If it is a compilation with disclosures, it will be much easier to determine whether the client has implemented the standard.

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AR-C 80 does not require modification of the standard compilation report if the adoption of FASB ASC 842 is properly accounted for and disclosed in the financial statements. Nonetheless, practitioners may emphasize in a separate emphasis-of-matter paragraph that an accounting change has occurred. The following is an example of this optional paragraph:

> *Emphasis-of-Matter*
> *As discussed in Note X to the financial statements, in 2022, the Company adopted FASB ASC 842,* Leases.

Review considerations

The report reminds accountants that the objective of a review engagement performed under AR-C section 90, *Review of Financial Statements,* is to obtain limited assurance as a basis for reporting whether the practitioner is aware of any material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework. A review engagement is an assurance engagement as well as an attest engagement in which the practitioner accumulates review evidence to obtain a limited level of assurance.

Based on the practitioner's understanding of the industry, knowledge of the client, and awareness of the risks that the review report may not be appropriately modified, the practitioner should design and perform analytical procedures and make inquiries and perform other procedures, as appropriate, to obtain limited assurance as a basis for reporting whether there are any material modifications that should be made to the financial statements for the statements to be in accordance with the applicable financial reporting framework.

In the first year of implementation, analytical procedures over leases will be more challenging, especially to determine whether the client has properly implemented FASB ASC 842. However, analytical procedures are required in the performance of a review engagement and would need to be performed with respect to other elements of the financial statements. There are additional tests of details the accountant can perform to obtain limited assurance regarding FASB ASC 842 implementation; however, the Report is limited to a discussion of inquiry procedures.

The Report contains illustrative inquiries that may be helpful for accountants to consider with regard to leases (although they are not intended to serve as a program or checklist to be utilized); rather, they address the following areas where inquiries might be made in a review engagement.

- Has FASB ASC 842 been implemented and, if so, has management quantified the potential impact to the financial statements?
- How does the entity use property, plant, and equipment in the ordinary course of business and has management reviewed the related contracts for lease implications?
- What accounting policy elections have been made with respect to leases?
- What was the process used to review existing contracts for lease implications?
- Have any practical expedients been elected?

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- Has management obtained all information necessary for the new required disclosures?
- What tools are used to track and account for leases (Excel, accounting software, etc.)?
- Have related party leases been reviewed for applicability with FASB ASC 842?
- Based on responses to the previous inquiries, the following more detailed inquiries may be appropriate:
  - How was the lease term determined?
  - What discount rates are used?
  - What amounts are included in lease payments for the ROU asset and lease liability?
  - How are nonlease components treated?
  - What process was used to determine the lease classification (operating or financing)?
- Has the entity applied the transition provisions of FASB ASC 842 for the transition adjustment appropriately for existing leases?
- How has the entity accounted for leases under FASB ASC 842 after the effective date including modifications, remeasurements, reassessments, and impairment?
- What is the entity's process for making the appropriate disclosures under FASB ASC 842, in particular those disclosures that are new (short term lease cost, variable lease cost, weighted-average discount rate and lease term, etc.)

The Report notes that based on the responses to these inquiries, the accountant may need to perform additional follow-up procedures, which may include the following:

- Obtain the entity's inventory of leases and reconcile to prior year lease disclosure and to listing of leases included in the entity's transition adjustment
- Select a sample of contracts not included in the lease inventory and review for potential lease implications under FASB ASC 842
- Based on the inventory of leases, recalculate year-end balances in ROU lease assets and liabilities

The Report also provides additional nonauthoritative guidance to assist the accountant in considering whether any modifications to the standard review report may be needed.

Knowledge check

3. What is the purpose of selecting a sample of contracts not included in the lease inventory?

   a. To review excluded contracts for potential lease implications under FASB ASC 842.
   b. To verify the calculation of depreciation for all fixed assets.
   c. To evaluate the compliance with revenue recognition standards.
   d. To ensure that they are included in year-end balances in ROU lease assets and liabilities.

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Summary

This course reminds participants of the differences among the various types of engagements contained in the clarified SSARSs. Throughout the course, we have highlighted the key changes to SSARS resulting from the issuance of SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*. We also briefly summarized recently issued nonauthoritative guidance provided by the AICPA to assist accountants in the performance of compilation and review engagements.

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Solutions

Preparation, Compilation, and Review Engagement Update

Knowledge check solutions

1.
   a. Incorrect. SSARS No. 26 embraces the new Statements on Quality Management Standards as providing the foundation for quality management for SSARS engagements.
   b. Correct. SSARS No. 26 adds an explicit requirement for the engagement partner to determine that the engagement team has the resources needed, including available time, to complete the SSARS engagement.
   c. Incorrect. SSARS No. 26 removes the requirement for engagement letters to be agreed upon prior to starting the review engagement.
   d. Incorrect. SSARS No. 26 places greater expectations for quality management on the engagement partner.
2.
   a. Correct. Analytical procedures are most effective when the accountant develops expectations that can reasonably be expected to identify unexpected relationships. Those expectations are the accountant's predictions of recorded amounts or ratios.
   b. Incorrect. A precise recorded value may represent a misstatement. Instead, there should also be an evaluation of differences between expected value and recorded amount in the final phase of the analytical procedure process.
   c. Incorrect. Data from independent sources are typically more reliable (for example, data sourced from a third party versus from entity management).
   d. Incorrect. The use of reliable nonfinancial data (such as a store's square footage or occupancy rates) improves the precision of the expectation.

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3.

a. Correct. Select a sample of contracts not included in the lease inventory and review for potential lease implications under FASB ASC 842. If the sample reveals lease arrangements, then it may require further investigations and adjustments.
b. Incorrect. Although verifying depreciation expense calculations is an essential part of reviewing fixed asset accounting, it is not specifically related to the review of lease accounting under FASB ASC 842. The focus of lease accounting review should be on identifying and accounting for lease assets and liabilities.
c. Incorrect. Assessing revenue recognition compliance is crucial in reviewing the entity's overall financial reporting, but it is not a key follow-up procedure specifically related to lease accounting under FASB ASC 842. The primary focus of lease accounting review should be on the proper identification, measurement, and disclosure of lease assets and liabilities in the financial statements.
d. Incorrect. Assuming the sample of contracts not included in the inventory are accurately excluded, then they would not be included in year-end balances. If inaccuracies are found, then the accountant would recalculate year-end balances in ROU lease assets and liabilities.

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Accounting and Auditing Glossary

account. Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims.

account payable. Amount owed to a creditor for delivered goods or completed services.

account receivable. Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.

accountants' report. Formal document that communicates an independent accountant's (1) expression of limited assurance on financial statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (type of Attestation Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountant's report does not result from the performance of an audit.

accounting. Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

accounting change. Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

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.

accrual basis. Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid.

accrued expense. An expense incurred during an accounting period for which payment is not due until a later accounting period. This results from the purchase of services which at the time of accounting have only been partly performed, are not yet billable, or have not been paid for.

accumulated depreciation. Total depreciation pertaining to an asset or group of assets from the time the assets were placed in service until the date of the financial statement or tax return. This total is the contra account to the related asset account.

additional paid in capital. Amounts paid for stock in excess of its par value or stated value. Also, other amounts paid by stockholders and charged to equity accounts other than capital stock.

adjusting entries. Accounting entries made at the end of an accounting period to allocate items between accounting periods.

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amortization. The process of reducing a recognized liability systematically by recognizing revenues or by reducing a recognized asset systematically by recognizing expenses or costs. In accounting for postretirement benefits, amortization also means the systematic recognition in net periodic postretirement benefit cost over several periods of amounts previously recognized in other comprehensive income, that is, gains or losses, prior service cost or credits, and any transition obligation or asset.

analytical procedures. Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; and (4) comparison of financial information with industry norms.

annual report. The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs. The Form 10-K, which must be filed with the SEC, typically contains more detailed information about the company's financial condition than the annual report.

appropriateness (of audit evidence). 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.

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..

audit evidence. 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 risk. The risk that the auditor may unknowingly fail to modify appropriately his/her opinion on financial statements that are materially misstated.

audit sampling. Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

auditors' report. Written communication issued by an independent certified public accountant (CPA) describing the character of his/her work and the degree of responsibility taken. An auditor's report includes a statement that the audit was conducted in accordance with

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generally accepted auditing standards (GAAS), which require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, as well as a statement that the auditor believes the audit provides a reasonable basis for his/her opinion.

bad debt. All or portion of an account, loan, or note receivable considered to be uncollectible.

balance sheet. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities, and the equity of its owners. Also known as a statement of financial condition.

bond. One type of long-term promissory note, frequently issued to the public as a security regulated under federal securities laws or state blue sky laws. Bonds can either be registered in the owner's name or are issued as bearer instruments.

book value. Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

business combinations. Combining of two entities. Under the purchase method of accounting, one entity is deemed to acquire another and there is a new basis of accounting for the assets and liabilities of the acquired company.

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.

business segment. Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.

capital stock. Ownership shares of a corporation authorized by its articles of incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation.

capitalized cost. Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.

carrying value. Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as book value.

cash basis. A special purpose framework in which revenues and expenditures are recorded when they are received and paid.

cash equivalents. Short-term (generally less than three months), highly liquid investments that are convertible to known amounts of cash.

cash flows. Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period.

casualty loss. Sudden property loss caused by theft, accident, or natural causes.

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change in engagement. A request, before the completion of the audit (review), to change the engagement to a review or compilation (compilation) of financial statements.

class actions. A federal securities class action is a court action filed on behalf of a group of shareholders under Rule 23 of the Federal Rules of Civil Procedure. Instead of each shareholder bringing an individual lawsuit, one or more shareholders bring a class action for the entire class of shareholders.

common stock. Capital stock having no preferences generally in terms of dividends, voting rights, or distributions.

companies, going public. Companies become public entities for different reasons, but usually to raise additional capital. The SEC has prepared a guide for companies – Q&A: Small Business and the SEC – that provides a basic understanding about the various ways companies can become public and what securities laws apply. The SEC also has a list of some of the registration and reporting forms and related regulations that pertain to small and large companies.

comparative financial statement. Financial statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

compilation. Presentation in the form of financial statements information that is the representation of management (owners) without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP).

comprehensive income. Change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.

confirmation. Auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

consolidated financial statements. Combined financial statements of a parent company and one or more of its subsidiaries as one economic unit.

consolidation. The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances.

contingent liability. Potential liability arising from a past transaction or a subsequent event.

continuing accountant. An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

controls. Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context, (1) 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; 2) procedures are actions to implement policies.

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control risk. Measure of risk that errors exceeding a tolerable amount will not be prevented or detected by an entity's internal controls.

controls tests. Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial report.

current asset. Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.

current liability. Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

current value. (1) Value of an asset at the present time as compared with the asset's historical cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.

debt. General name for money, notes, bonds, goods, or services which represent amounts owed.

definite criteria. A special purpose framework using a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

depreciation. Expense allowance made for wear and tear on an asset over its estimated useful life.

derivatives. Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock.

detection risk. Risk that the auditor will not detect a material misstatement.

disclosure. Process of divulging accounting information so that the content of financial statements is understood.

discount. Reduction from the full amount of a price or debt.

dividends. Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporation's capital stock.

earnings per share (EPS). The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

employee stock options plans. An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan. Employee Stock Options Plans should not be confused with the term "ESOPs," or Employee Stock Ownership Plans, which are retirement plans.

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employee stock ownership plans (ESOPs). An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, you never buy or hold the stock directly. This type of plan should not be confused with employee stock options plans, which are not retirement plans. Instead, employee stock options plans give the employee the right to buy their company's stock at a set price within a certain period of time.

engagement partner. The partner or other individual appointed by the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

engagement quality review. An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed before the engagement report is released.

engagement quality reviewer. A partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review.

engagement team. All partners and staff performing the audit engagement and any other individuals who perform audit procedures on the engagement, excluding an auditor's external specialist5 and internal auditors who provide direct assistance on an engagement.

equity. Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets, less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities.

equity security. Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

error. Act that departs from what should be done; imprudent deviation, unintentional mistake or omission.

executive compensation: Where to find in SEC reports. The federal securities laws require clear, concise and understandable disclosure about compensation paid to CEOs and certain other high-ranking executive officers of public companies. You can locate information about executive pay in (1) the company's annual proxy statement; (2) the company's annual report on Form 10-K; and (3) registration statements filed by the company to register securities for sale to the public.

expenditures. Expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized).

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external information source. An external individual or organization that provides information that is used by the entity in preparing the financial statements or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of management's specialist, service organization, or auditor's specialist, the individual or organization is not considered an external information source with respect to that particular information.

extraordinary items. Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.

Fair Disclosure, Regulation FD. On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities – generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information – the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.

fair market value. Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell.

federal securities laws. The laws that govern the securities industry, include the Securities Act of 1933; Securities Exchange Act of 1934; Investment Company Act of 1940; Investment Advisers Act of 1940; and Public Utility Holding Company Act of 1935.

financial statements. Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.

Firm. A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in public practice.

first in, first out (FIFO). Accounting method of valuing inventory under which the costs of the first goods acquired are the first costs charged to expense. Commonly known as FIFO.

fiscal year. Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year.

fixed asset. Any tangible asset with a life of more than one year used in an entity's operations.

foreign currency translation. Restating foreign currency in equivalent dollars; unrealized gains or losses are postponed and carried in Stockholder's Equity until the foreign operation is substantially liquidated.

Form 10-K. This is the report that most publicly traded companies file with the SEC on an annual basis. It provides a comprehensive overview of the company's business and financial condition. Some companies choose to send their Form 10-K to their shareholders instead

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of sending a separate annual report. Currently, Form 10-K must be filed with the SEC within 90 days after the end of the company's fiscal year.

Form 10-Q. The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is currently due within 45 days of the close of the quarter. In addition to Form 10-Q, companies provide annual reports to their shareholders and file Form 10-K on an annual basis with the SEC.

Form 8-K. This is the "current report" used to report material events or corporate changes that have previously not been reported by the company in a quarterly report (Form 10-Q) or annual report (Form 10-K).

Forms 3, 4, 5. Corporate insiders-meaning a company's officers and directors, and any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934 – must file with the SEC a statement of ownership regarding those securities. The initial filing is on Form 3. Changes in ownership are reported on Form 4. Insiders must file a Form 5 to report any transactions that should have been reported earlier on a Form 4 or were eligible for deferred reporting.

fraud. Willful misrepresentation by one person of a fact inflicting damage on another person.

gain. Excess of revenues received over costs relating to a specific transaction.

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. Also see **IT environment**.

general ledger. Collection of all assets, liability, owners' equity, revenue, and expense accounts.

generally accepted accounting principles (GAAP). Conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest level of such principles is set by the Financial Accounting Standards Board (FASB).

generally accepted auditing standards (GAAS). Standards set by the American Institute of Certified Public Accountants (AICPA) which concern the auditor's professional qualities and judgment in the performance of his/her audit and in the actual report.

going concern. Assumption that a business can remain in operation long enough for all of its current plans to be carried out.

going private. A company "goes private" when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.

goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not for profit entity that are not individually identified and separately recognized.

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gross income. A tax term meaning all income from whatever source derived, except as otherwise provided in the income tax code.

guaranty. Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.

hedges. Protect an entity against the risk of adverse price or interest-rate movements on its assets, liabilities, or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on positions are counterbalanced by gains on separate positions in another market.

historical cost. The generally accepted method of accounting used in the primary financial statements that is based on measures of historical prices without restatement into units, each of which has the same general purchasing power.

income. Inflow of revenue during a period of time.

income statement. Summary of the effect of revenues and expenses over a period of time.

income tax basis. A special purpose framework that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

initial public offerings (IPO). IPO stands for initial public offering and occurs when a company first sells its shares to the public.

initial public offerings, lockup agreements. Lockup agreements prohibit company insiders – including employees, their friends and family, and venture capitalists – from selling their shares for a set period of time. In other words, the shares are "locked up." Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders do not enter the public market too soon after the offering.

insider trading. "Insider trading" actually includes both legal and illegal conduct. The legal version is when corporate insiders – officers, directors, and employees – buy and sell stock in their own companies. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

intangible asset. Asset having no physical existence such as trademarks and patents.

interest. Payment for the use or forbearance of money.

interim financial statements. Financial statements that report the operations of an entity for less than one year.

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.

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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. Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is referred to as *the spectrum of inherent risk*.

Inspection. Inspection is an evaluation of the adequacy of aspects of the firm's quality management policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them.

internal control. Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports.

inventory. Tangible property held for sale, or materials used in a production process to make a product.

investment. Expenditure used to purchase goods or services that could produce a return to the investor.

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. For the purposes of this definition, (1) an *IT application* is a program or a set of programs that is used in the initiation, processing, recording, and reporting of transactions or information. IT applications include data warehouses and report writers; (2) the IT infrastructure comprises the network, operating systems, and databases and their related hardware and software; and (3) the IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment, and manage IT operations.

journal. Any book containing original entries of daily financial transactions.

last in, first out (LIFO). Accounting method of valuing inventory under which the costs of the last goods acquired are the first costs charged to expense. Commonly known as LIFO.

lease. Conveyance of land, buildings, equipment, or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.

leasehold. Property interest a lessee owns in the leased property.

ledger. Any book of accounts containing the summaries of debit and credit entries.

lessee. Person or entity that has the right to use property under the terms of a lease.

lessor. Owner of property, the temporary use of which is transferred to another (lessee) under the terms of a lease.

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liability. Debts or obligations owed by one entity (Debtor) to another entity (Creditor) payable in money, goods, or services.

listing and delisting requirements. Before a company can begin trading on an exchange or the Nasdaq Stock Market, it must meet certain initial requirements or "listing standards." The exchanges and the Nasdaq Stock Market set their own standards for listing and continuing to trade. The SEC does not set listing standards. The initial listing requirements mandate that a company meet specified minimum thresholds for the number of publicly traded shares, total market value, stock price, and number of shareholders. After a company starts trading, it must continue to meet different standards set by the exchanges or the Nasdaq Stock Market. Otherwise, the company can be delisted. These continuing standards usually are less stringent than the initial listing requirements.

long-term debt. Debt with a maturity of more than one year from the current date.

loss. Excess of expenditures over revenue for a period or activity. Also, for tax purposes, an excess of basis over the amount realized in a transaction.

lower of cost or market. Valuing assets for financial reporting purposes. Ordinarily, "cost" is the purchase price of the asset and "market" refers to its current replacement cost. Generally accepted accounting principles (GAAP) requires that certain assets (e.g., inventories) be carried at the lower of cost or market.

management discussion and analysis (MD&A). SEC requirement in financial reporting for an explanation by management of significant changes in operations, assets, and liquidity.

management's specialist. An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

manipulation. Manipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include spreading false or misleading information about a company; improperly limiting the number of publicly-available shares; or rigging quotes, prices, or trades to create a false or deceptive picture of the demand for a security.

marketable securities. Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets.

mark-to-market. Method of valuing assets that results in adjustment of an asset's carrying amount to its market value.

matching principle. The concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

materiality. Magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

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mergers. Mergers are business transactions involving the combination of two or more companies into a single entity. Most state laws require that mergers be approved by at least a majority of the company's shareholders if the merger will have a significant impact on the company.

modified cash basis. A special purpose framework that begins with the cash basis method (see Cash basis) and applies modifications having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

NASDAQ. Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. The National Association of Securities Dealers, Inc. owns and operates The Nasdaq Stock Market.

net assets. Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

net income. Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

net sales. Sales at gross invoice amounts less any adjustments for returns, allowances, or discounts taken.

net worth. Similar to equity, the excess of assets over liabilities.

network. An association of entities that includes one or more firms.

network firm. Another firm or entity that belongs to the same network as the firm.

nonpublic entity. Any entity other than (a) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (b) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

no-par stock. Stock authorized to be issued but for which no par value is set in the articles of incorporation. A stated value is set by the board of directors on the issuance of this type of stock.

no-par value. Stock or bond that does not have a specific value indicated.

notional. Value assigned to assets or liabilities that is not based on cost or market (e.g., the value of a service not yet rendered).

objectivity. Emphasizing or expressing the nature of reality as it is apart from personal reflection or feelings; independence of mind.

paid in capital. Portion of the stockholders' equity which was paid in by the stockholders, as opposed to capital arising from profitable operations.

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par value. Amount per share set in the articles of incorporation of a corporation to be entered in the capital stocks account where it is left permanently and signifies a cushion of equity capital for the protection of creditors.

parent company. Company that has a controlling interest in the common stock of another.

partner. Any individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, *partner* may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms might use different titles to refer to individuals with this authority.

personnel. Partners and staff in the firm.

predecessor accountant. An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

preferred stock. Type of capital stock that carries certain preferences over common stock, such as a prior claim on dividends and assets.

premium. (1) Excess amount paid for a bond over its face amount. (2) In insurance, the cost of specified coverage for a designated period of time.

prepaid expense. Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle.

prescribed form. Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

present value. Current value of a given future cash flow stream, discounted at a given rate.

principal. Face amount of a security, exclusive of any premium or interest. The basis for interest computations.

professional standards. Standards promulgated by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under the “General Standards Rule” (ET sec. 1.300.001) or the “Compliance With Standards Rule” (ET sec. 1.310.001) of the AICPA code, or by other standard-setting bodies that set auditing and attest standards applicable to the engagement being performed and relevant ethical requirements.

proxy statement. The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

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purchase method of accounting. Accounting for a merger by adding the acquired company's assets at the price paid for them to the acquiring company's assets.

quiet period. The term "quiet period," also referred to as the "waiting period," is not defined under the federal securities laws. The quiet period extends from the time a company files a registration statement with the SEC until SEC staff declares the registration statement "effective." During this period, the federal securities laws limit what information a company and related parties can release to the public. Rule 134 of the Securities Act of 1933 discusses these limitations.

ratio analysis. Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.

real property. Land and improvements, including buildings and personal property that is permanently attached to the land or customarily transferred with the land.

receivables. Amounts of money due from customers or other debtors.

reconciliation. Comparison of two numbers to demonstrate the basis for the difference between them.

Registration Under the Securities Act of 1933. Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: (1) To require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.

Regulation D offerings. Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) provides three exemptions from the registration requirements, allowing some smaller companies to offer and sell their securities without having to register the securities with the SEC.

regulatory basis. A special purpose framework that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

reissued report. A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

related party transaction. Business or other transaction between persons who do not have an arm's-length relationship (e.g., a relationship with independent, competing interests). The most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a greater level of scrutiny.

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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).12 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).

Relevant ethical requirements. Principles of professional ethics and ethical requirements to which the engagement team and engagement quality reviewer are subject, which consist of the AICPA code together with rules of applicable state boards of accountancy and applicable regulatory agencies that are more restrictive.

research and development (R&D). Research is a planned activity aimed at discovery of new knowledge with the hope of developing new or improved products and services. Development is the translation of research findings into a plan or design of new or improved products and services.

response (in relation to a system of quality management). Policies or procedures designed and implemented by the firm to address one or more quality risks. Policies are statements of what should, or should not, be done to address a quality risk or risks. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.

retained earnings. Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

revenue recognition. Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

revenues. Sales of products, merchandise, and services; and earnings from interest, dividend, rents.

review. Accounting service that provides some assurance as to the reliability of financial information. In a review, a certified public accountant (CPA) does not conduct an examination under generally accepted auditing standards (GAAS). Instead, the accountant performs inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with a special purpose framework.

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. See **IT environment**.

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.

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risk management. Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.

security. Any kind of transferable certificate of ownership including equity securities and debt securities.

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, (1) 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, (2) that is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

short-term. Current; ordinarily due within one year.

SSARS. Statements on Standards for Accounting And Review Services issued by the AICPA Accounting and Review Services Committee (ARSC).

start-up costs. (1) Costs, excluding acquisition costs, incurred to bring a new unit into production. (2) Costs incurred to begin a business.

statement of cash flows. A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents.

statement of financial condition. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities, and the equity of its owners. Also known as *balance sheet*.

statutory basis. See Regulatory basis.

straight-line depreciation. Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a $10,000 asset expected to last ten years is $1,000.

strike price. Price of a financial instrument at which conversion or exercise occurs.

submission of financial statements. Presenting to a client or third party's financial statements that the accountant has prepared either manually or through the use of computer software.

subsequent event. Material event that occurs after the end of the accounting period and before the publication of an entity's financial statements. Such events are disclosed in the notes to the financial statements.

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successor accountant. An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

sufficiency (of audit evidence). 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 the audit evidence obtained (that is, its appropriateness).

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. For purposes of GAAS, the system of internal control consists of five interrelated components: (1) Control environment, (2) the entity's risk assessment process, (3) the entity's process to monitor the system of internal control, (4) the information system and communication, and (5) control activities.

tangible asset. Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process.

tax. Charge levied by a governmental unit on income, consumption, wealth, or other basis.

third party. All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

trade date. Date when a security transaction is entered into, to be settled on at a later date. Transactions involving financial instruments are generally accounted for on the trade date.

treasury bill. Short-term obligation that bears no interest and is sold at a discount.

treasury bond. Long-term obligation that matures more than five years from issuance and bears interest.

treasury note. Intermediate-term obligation that matures one to five years from issuance and bears interest.

treasury stock. Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options, or resold.

trial balance. A trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances. Also, in a trial balance, no attempt is made to establish a mathematical relationship among the assets, liabilities, equity, revenues, and expenses except that total debits equal total credits.

unearned income. Payments received for services which have not yet been performed.

updated report. A report issued by a continuing accountant that takes into consideration information that he/she becomes aware of during his/her current engagement and that re-expresses his/her previous conclusions or, depending on the circumstances, expresses

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different conclusions on the financial statements of a prior period as of the date of his/her current report.

valuation allowance. Method of lowering or raising an object's current value by adjusting its acquisition cost to reflect its market value by use of a contra account.

variance. Deviation or difference between an estimated value and the actual value.

work in progress. Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory.

working capital. Excess of current assets over current liabilities.

working papers. (1) Records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the course of the audit. (2) Any records developed by a certified public accountant (CPA) during an audit.

yield. Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.

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