Current Issues in Accounting and Auditing: An Annual Update

AAU4/23/V2-P1

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FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objective

After completing this chapter, you should be familiar with:
- Recently issued FASB Accounting Standards Updates (ASUs).

I. Introduction

Accounting Standards Updates are used by the FASB to amend its Accounting Standards Codification™ (Codification or ASC), which was launched on July 1, 2009 as the single source of authoritative nongovernmental U.S. GAAP. However, ASUs are not authoritative; they are only used to update the FASB Codification.

This chapter will discuss in depth all significant Accounting Standards Updates (ASU) issued by the FASB in 2023 and 2022, as well as those issued by the FASB prior to 2022 that are of most continuing significance to private entities.

Recent updates related to ASC 842, such as ASU 2023-01, will be reviewed separately in the course.

II. ASU No. 2023-02, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

A. Reason for issuance

This ASU was issued to allow consistent accounting for equity investments made primarily for the purpose of receiving income tax credits and other income tax benefits. Previously, the proportional amortization method was limited to investments in low-income housing tax credit (LIHTC) structures, while equity investments in other tax credit structures were typically accounted for using the equity method or Topic 321. Stakeholders requested that the proportional amortization method be made available for investments that generate income tax credits through other tax credit programs. The proportional amortization method allows the cost of the investment to be amortized in proportion to income tax credits and other income tax benefits received. The amortization of the investment and the income tax credits are shown net on the income statement within the “income tax expense” line item.

B. Entities affected

The ASU affects all entities that hold at least one of the following:

- Tax equity investments that an entity has elected to account for using the proportional amortization method. The investments are required to meet all conditions related to this election.
- An investment in a LIHTC structure through a limited liability entity that is not accounted for using the proportional amortization method and to which certain LIHTC-specific guidance removed by ASU 2023-02 has been applied.

C. Main provisions

This ASU allows entities to elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met. Entities will be able to make this election regardless of the tax credit program from which the income tax credits are received. The required conditions are listed below:

1. It is probable that the income tax credits allocable to the tax equity investor will be available.
2. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project.
3. Substantially all of the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other nonincome tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate consistent with the cash flow assumptions used by the tax equity investor in deciding to invest in the project.
4. The tax equity investor's projected yield is positive based solely on the cash flows from the income tax credits and other income tax benefits.
5. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

A reporting entity makes the above election related to the proportional amortization method on a tax credit program by tax credit program basis. ASU 2023-03 requires entities that make the above election to account for the receipt of investment tax credits using the flow-through method under Topic 740, *Income Taxes*. Further, an entity that elects the proportional amortization method is required to follow the delayed equity contribution guidance. This guidance can be found in paragraph 323-740-25-3. ASU 2023-02 also removes specialized guidance for LIHTC investments. LIHTC investments may elect the proportional amortization method if all conditions are met. However, if an entity does not elect this method, these investments will follow the appropriate GAAP guidance found in Topic 321 and Subtopic 323-10.

When an entity elects to account for investments that generate income tax credits and other income tax benefits with the proportional amortization method, certain disclosures are required by ASU 2023-02. These disclosures should also include information related to investments within the elected tax credit program that do not meet the conditions to apply the proportional amortization method. The entity should disclose the following:

1. The nature of its tax equity investments; and
2. The effect of its tax equity investments, related income tax credits, and other income tax benefits on its financial position and results of operations.

D. Effective date and transition

The effective date for ASU No. 2023-02 is as follows:

- Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within.
- All other entities – Fiscal years beginning after December 15, 2024, and interim periods within.

Early adoption is permitted for all entities in any interim period. ASU No. 2023-02 should be applied on either a modified retrospective or a retrospective basis. Specialized application guidance is provided for entities that have LIHTC investments that are affected by this ASU. This includes the possibility of prospective application. Entities or practitioners involved with LIHTC investments should reference ASU 2023-02 for further guidance.

III. ASU No. 2022-06, Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848

A. Reason for issuance

This ASU was issued in response to the UK Financial Conduct Authority (FCA) extending the intended cessation date of the USD LIBOR interest rates. ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* included a sunset provision related to exceptions and optional expedients for contract modifications and hedging relationships. This sunset provision assumed that the LIBOR rates would be discontinued by the end of 2021.

B. Entities affected

The ASU affects all entities that have contracts, hedging relationships, and other transactions that utilize the LIBOR rate or any other reference rate that is expected to be discontinued as a result of reference rate reform.

C. Main provisions

This ASU delays the sunset provision included in ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting.* ASU 2022-06 defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024. This deferment is based on the FCA delaying the intended cessation date of USD LIBOR rates to June 30, 2023. Entities should note that after December 31, 2024, the exceptions and optional expedients for contract modifications and hedging relationships will no longer be permitted.

D. Effective date

ASU No. 2022-06 was effective for all entities upon issuance.

IV. ASU No. 2022-05, Financial Services – Insurance (Topic 944): Transition for Sold Contracts

A. Reason for issuance

The FASB issued this ASU in response to stakeholders noting certain provisions within ASU 2018-12, *Financial Services – Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI),* were not cost-effective. Practitioner feedback indicated that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date would put an unnecessary burden on insurance entities. This ASU was implemented to reduce costs and complexity related to these transactions.

B. Entities affected

ASU 2022-05 affects insurance entities that have derecognized contracts before the LDTI effective date. Please see further details in the effective date section below.

C. Main provisions

The implementation of ASU 2018-12 requires insurance companies to apply a retrospective transition method from the beginning of the earliest period presented or the prior fiscal year if early application is chosen. This means that the provisions of ASU 2018-12 would apply to contracts that were derecognized prior to the effective date, which would be costly and would not provide useful information.

ASU 2022-05 allows insurance entities to make an accounting policy election on a transaction-by-transaction basis to exclude certain contracts from the application of ASU 2018-12. The derecognized contract must have been sold or disposed of, and the insurance company must have no continuing involvement with the contract to qualify for the accounting policy election.

D. Effective date

The effective dates of the amendments within ASU 2022-05 are consistent with the effective dates of the amendments in ASU 2020-11. ASU 2020-11 extended the effective dates noted in ASU 2018-12 due to the COVID-19 pandemic. Therefore, ASU 2018-12 and ASU 2022-05 are effective for public entities that meet the definition of an SEC filer and are not smaller reporting companies for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the effective date is fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early adoption is permitted.

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

A. Reason for issuance

ASU 2022-04 was issued to improve transparency related to supplier finance programs. Prior to the issuance of this update, GAAP did not include any disclosure requirements related to these arrangements. Financial statement users noted a lack of consistency with how entities were reporting payables that were included in supplier finance programs. This amendment provides users with additional information related to these programs.

B. Entities affected

This ASU affects all entities that utilize supplier finance programs when purchasing goods and services. An example of a supplier finance program is when an entity (buyer) offers suppliers the option to collect payment before the invoice due date from a third-party finance provider. Typically, the buyer has entered into an agreement with the third-party financer to provide this service to suppliers.

C. Main provisions

The ASU requires the buyer, as described above, to disclose qualitative and quantitative information about its supplier finance programs. Disclosures should allow users of the financial statements to understand the program's nature, activity during the period, changes from period to period, and potential magnitude.

This update explicitly requires the following information to be included in the disclosure:

1. Key terms of the program. This should include a description of the terms, which include payment timing and basis for its determination. The disclosure should include the assets pledged as security or other guarantees provided for the payment to the finance provider.
2. For the invoices the buyer has confirmed as valid to the third-party finance provider (intermediary):
    a. The amount outstanding at the end of the annual period.
    b. Description of where the outstanding obligations are presented on the balance sheet.
    c. Roll forward of those obligations during the annual period. This should include the amount of obligations confirmed and subsequently paid.

The buyer should also disclose, in each interim reporting period, the amount of obligations outstanding that have been confirmed as valid by the buyer to the finance provider as of the end of the interim period.

D. Effective date and transition

The amendments within ASU 2022-04 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. It is noted that the amendment related to roll-forward information is not effective until fiscal years beginning after December 15, 2023. Early adoption is permitted.

ASU 2022-04 should be applied retrospectively to each period in which a balance sheet is presented, except for the amendment on roll-forward information, which should be applied prospectively.

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

A. Reason for issuance

This ASU was issued to clarify the guidance in Topic 820, *Fair Value Measurement* when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security. The lack of clarity in the guidance has led to a diversity in practice in the accounting for such instruments.

The ASU also updates the related illustrative example of accounting for such restrictions and adds new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820.

B. Entities affected

The ASU affects all entities that have investments in equity securities measured at fair value that are subject to a contractual sale restriction.

C. Main provisions

Under this ASU, a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. Also, an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction.

The ASU adds the following disclosures related to such securities:

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

D. Effective date and transition

The effective date for ASU No. 2022-03 is as follows:

- Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within.
- All other entities – Fiscal years beginning after December 15, 2024, and interim periods within.

Early adoption is permitted. ASU No. 2022-03 should be applied on a prospective basis.

Entities that apply ASC 946 should continue to apply their historical accounting to such investments until the contractual restrictions expire.

VII. ASU No. 2022-02, Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures

A. Reason for issuance

This ASU addresses two issues raised by practitioners related to the application of ASC 326, *Credit Losses*. First, credit losses from loans modified as troubled debt restructurings (TDRs) have been incorporated into the allowance for credit losses under ASC 326. Investors and preparers observed that the additional designation of a loan modification as a TDR and the related accounting are unnecessarily complex and no longer provide decision-useful information.

Second, the ASU addresses feedback related to public business entities' disclosure of gross write-offs and gross recoveries by class of financing receivable and major security type in the vintage disclosures referenced in paragraph 326-20-50-6 and Example 15 in paragraph 326-20-55-79. Stakeholders observed that disclosing gross write-offs by year of origination provides important information that allows them to better understand changes in the credit quality of an entity's loan portfolio and underwriting performance.

B. Entities affected

The update impacting the accounting for TDRs impacts all entities that apply ASC 326. The update addressing vintage disclosures affects public business entities with investments in financing receivables.

C. Main provisions

The ASU eliminates the accounting guidance for TDRs by creditors in Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors*, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Under the new guidance, creditors would apply the guidance in ASC 310-20-35-9 through 35-11 to determine whether a modification results in a new loan or a continuation of an existing loan.

The ASU, for public business entities, requires that an entity disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of Subtopic 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*.

D. Effective date and transition

For entities that have adopted ASC 326, this ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASC 326, the effective dates for this ASU are the same as the effective dates for ASC 326.

The ASU should be applied prospectively, except for the TRD updates, for which an entity has the option to apply a modified retrospective transition method of adoption.

Early adoption of the ASU is permitted if an entity has adopted ASC 326, including adoption in an interim period. If an entity elects to early adopt this ASU in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes the interim period.

Also, an entity may elect to early adopt the amendments about TDRs and related disclosure enhancements separately from the amendments related to vintage disclosures.

VIII. ASU No. 2022-01, Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method

A. Reason for issuance

The FASB issued this ASU in order to address a variety of questions concerning use of the "last-of-layer" method when hedging a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments. The ASU addressed the following questions:

1. Whether only a single hedged layer could be designated (one hedging relationship associated with the closed portfolio), or whether an entity could designate multiple hedged layers (that is, multiple hedging relationships associated with a single closed portfolio).
2. Whether the scope of last-of-layer hedging could be expanded.
3. To clarify what types of hedging instruments are permitted when a single hedged layer is designated and when multiple hedged layers are designated.
4. To provide additional guidance on how to account for and disclose hedge basis adjustments of an existing last-of-layer hedge, as there is no explicit guidance on how to recognize and present in the income statement the portion of the basis adjustment associated with a hedged layer if the closed portfolio falls below the amount of the hedged layer.
5. How the accounting for last-of-layer hedge basis adjustments interacts with the guidance on credit losses.

B. Entities affected

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

C. Main provisions

The ASU addresses the above questions as follows:

1. The ASU allows nonprepayable financial assets to also 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.
2. The ASU also allows multiple hedged layers to be designated for a single closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments. In applying hedge accounting to multiple hedged layers, an entity has the flexibility to achieve hedge accounting using different types of derivatives and layering techniques that best align with their individual circumstances. Furthermore, the ASU specifies that an entity hedging multiple amounts in a closed portfolio with a single amortizing-notional swap is executing a single-layer hedge, not hedges of multiple layers.
3. The ASU clarifies the accounting for and promotes consistency in the reporting of hedge basis adjustments applicable to both a single hedged layer and multiple hedged layers as follows:

a. An entity is required to maintain basis adjustments in an existing hedge on a closed portfolio basis (that is, not allocated to individual assets).

b. An entity is required to immediately recognize and present the basis adjustment associated with the amount of the redesignated layer that was breached in interest income. In addition, an entity is required to disclose that amount and the circumstances that led to the breach.

c. An entity is required to disclose the total amount of the basis adjustments in existing hedges as a reconciling amount if other areas of GAAP require the disaggregated disclosure of the amortized cost basis of assets included in the closed portfolio.

4. An entity is prohibited from considering basis adjustments in an existing hedge when determining credit losses.

D. Effective date and transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. Early adoption is permitted on any date on or after the issuance of this update for any entity that has adopted the amendments in Update 2017-12 for the corresponding period.

If an entity adopts the ASU in an interim period, the effect of adopting the amendments related to basis adjustments should be reflected as of the beginning of the fiscal year of adoption (that is, the initial application date).

Upon adoption, any entity may designate multiple hedged layers of a single closed portfolio solely on a prospective basis. All entities are required to apply the portion of the ASU related to hedge basis adjustments under the portfolio layer method, except for those related to disclosures, on a modified retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings on the initial application date.

Entities have the option to apply the portion of the ASU related to disclosures on a prospective basis from the initial application date or on a retrospective basis to each prior period presented after the date of adoption of the amendments in Update 2017-12.

An entity may reclassify debt securities classified in the held-to-maturity category at the date of adoption to the available-for-sale category only if the entity applies portfolio layer method hedging to one or more closed portfolios that include those debt securities. The decision of which securities to reclassify must be made within 30 days after the date of adoption, and the securities must be included in one or more closed portfolios that are designated in a portfolio layer method hedge within that 30 day period.

IX. Other ASUs effective in 2023 or beyond

The following table details ASUs issued by the FASB prior to 2022 that will become effective for nonpublic business entities in 2023 or beyond:

ASU	Title	Summary	Effective Date
ASU No. 2016-13 and related ASUs	*Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*	Creates ASC 326, implementing CECL model for credit losses.	Years beginning on or after December 15, 2022.
ASU No. 2017-04	*Intangibles – Goodwill and Other (Topic 350)*	Replaces two-step goodwill impairment test with one-step test.	Years beginning on or after December 15, 2022.
ASU No. 2018-12	*Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*	Changes the accounting model for long-duration insurance contracts.	Years beginning on or after December 15, 2024.
ASU No. 2020-04 and 2021-01	*Reference Rate Reform (Topic 848) – Facilitation of the Effects of Reference Rate Reform on Financial Reporting* and *Reference Rate Reform (Topic 848): Scope*	ASUs provide elective guidance on accounting for the impact of reference rate reform on the following: • Convertible rate debt and receivables; • Leases; • Hedging transactions; and • HTM debt securities.	Elective guidance is available through December 31, 2024.
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*	Reduces the number of accounting models for accounting for convertible debt from five to two and results in fewer instances when the conversion feature must be separated from the host instrument and accounted for as a derivative.	Years beginning after December 15, 2023.
ASU No. 2021-07	*Compensation – Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards (a consensus of the Private Company Council)*	Allows nonpublic entities to determine the current price input of equity-classified share-based awards issued to both employees and nonemployees using a reasonable application of a reasonable valuation method.	Effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

ASU No. 2021-08	*Business Combinations (Topic 805) – Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*	Requires that an entity (acquirer) recognizes and measures contract assets and contract liabilities acquired in a business combination in accordance with Topic 606. At the acquisition date, an acquirer should account for the related revenue contracts in accordance with Topic 606 as if it had originated the contracts.	Effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.

Details on these previously issued ASUs can be found at the FASB website, www.FASB.org.

Discussion question:

Which of the FASB's new ASUs will have the most significant impact on either your clients or company?

X. FASB's technical agenda

The FASB's technical agenda provides information related to current FASB projects. Projects typically go through a six-step process. These steps include:

1. Topic is added to the agenda;
2. Initial deliberations;
3. Exposure draft;
4. Exposure draft comment period;
5. Exposure draft redeliberation; and
6. Final standard/concept.

The current technical agenda includes the following:

- Framework projects (3);
- Recognition and measurement: narrow projects (11); and
- Presentation and disclosure projects (5).

A. Framework projects

Framework projects do not change the FASB's Accounting Standards Codification (ASC) per se, but rather update the theoretical underpinnings of the accounting standards found in the FASB Concepts Statements. These updated concepts are then applied to accounting topics, the changes to which would update the ASC.

Per the FASB website, The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. A Statement of Financial Accounting Concepts does not establish generally accepted accounting standards.

There are currently five Concepts Statements.

The objective of this 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 Board'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.

With the issuance of the updated frameworks related to elements of financial statements and presentation in December 2021, the FASB currently has three framework projects on its agenda: measurement, the reporting entity, and recognition/derecognition.

Its project, dealing with its measurement conceptual framework, is focused on agreeing on the meanings of key terms and what the objectives and qualitative characteristics imply for measurement, identifying appropriate types of measurements, and determining which measurements to use in specific circumstances. This project is currently in initial deliberations, with no exposure documents issued.

The reporting entity framework project objective is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework would support 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 project is currently in the exposure draft redeliberations stage.

The FASB's conceptual framework project dealing with recognition and derecognition was proposed in November 2022. The project is currently in the exposure draft redeliberations stage. The goal of the project is to set forth recognition and derecognition criteria pertaining to when an item should be included or excluded from financial statements. Stakeholders were asked to provide input on the following criteria related to recognition and derecognition of financial statement items:

- *Definitions* – The item meets the definition of an element of financial statements.
- *Measurability* – The item is measurable and has a relevant measurement attribute.
- *Faithful representation* – The item can be depicted and measured with faithful representation.

The FASB completed its elements framework project in 2021 by updating its Conceptual Statement related to financial statement elements. The updated guidance provides an improved conceptual framework that provides a sound foundation for developing future accounting standards.

The FASB also completed its framework project on presentation in 2021. The new guidance provides the FASB with a framework for developing standards that summarize and communicate information on financial statements in a way that best meets the objective of financial reporting. Ultimately, it will become a basis for the Board when creating presentation requirements in future standards.

Following the issuance of the updated Concepts Statement related to disclosures, the FASB issued final ASUs that updated the disclosures related to the following:

- Fair value measurement; and
- Defined benefit plans.

Currently, draft ASUs related to the disclosures in two additional areas are at varying levels of the FASB's standard-setting process:

- Interim disclosures; and
- Income taxes.

B. Recognition and measurement projects: narrow projects

There are 11 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

- Accounting for and disclosure of crypto assets – Moving to a fair value accounting model from the current intangible asset model.
- Accounting and disclosure of software costs – Exploring ways to narrow the differences between the current internal use and external use models.
- Accounting for environmental credit programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits.
- Accounting for acquired financial assets within the scope of Update 2016-13 – Expanding the scope of the purchased credit deteriorated (PCD) accounting model and modifying the presentation of expected credit losses for acquired financial assets.

Details on the status of all projects can be found on the FASB website.

C. Other presentation and disclosure projects

The FASB is continuing its work on five presentation and disclosure projects. Significant new presentation and disclosure projects include the following:

- Disclosure framework updates – Updating disclosure requirements for sections of the ASC impacted by the FASB's recent Disclosure Framework project.
- Improvements to income tax disclosures – Updating income tax disclosures to improve transparency and usefulness.
- Disaggregation of performance information – Further disaggregation of certain income statement items.

For a complete overview and all of the details of the FASB's current technical agenda, please refer to the FASB's website at www.fasb.org.

XI. Update on the FASB's Post-Implementation Review of ASC 606

A. The PIR process

Following the issuance of significant new accounting guidance, the FASB will implement a PIR to review the implementation of the new standard. These reviews have been previously performed following the issuance of new guidance related to derivative and share-based payment accounting. Both of these reviews have led to recent significant updates to both ASC 805 and 718, respectively.

The FASB has begun PIRs for the following recently issued standards that significantly altered the existing accounting and disclosure guidance in their respective areas:

- ASC 606 – *Revenue from Contracts with Customers*;
- ASC 842 – *Leases*; and
- ASC 326 – *Credit Losses*.

The FASB's PIR process is an evaluation of whether a standard is achieving its objective by providing financial statement users with relevant information in ways that justify the cost of providing it. The FASB does not perform PIRs following the implementation of all standards, only significant ones such as ASC 606. During the PIR process, the FASB solicits and considers diverse stakeholder input and other research to evaluate the standards that are issued and whether there are areas of improvement that the FASB should address. Feedback obtained in the ASC 606 PIR was obtained from the following:

- Financial statement preparers – The focus of the discussions with this stakeholder group generally addresses the clarity of the standard, its ease of understanding and application, and the level of effort in its adoption and ongoing application.
- Financial statement users – The focus of the discussions with this stakeholder group generally addresses the usefulness of the information obtained from application of the new standard.
- Auditors – The focus of the discussions with auditors concentrates on the level of audit effort necessary to provide assurance on the application of the new guidance, including the impact on hours spent, fees, and auditors' perception of how well their clients understood and applied the new standard.

The PIR process consists of the following three stages:

- Stage 1 – Post-issuance date implementation monitoring;
- Stage 2 – Post-effective date evaluation of the costs and benefits; and
- Stage 3 – Summary of research and findings.

In Stage 1, the post-issuance date implementation monitoring stage, the FASB performs the following tasks:

- Actively monitor practice as stakeholders prepare for initial implementation;
- Develop and disseminate implementation guidance and educational material; and
- Communicate and perform outreach with stakeholder organizations.

Following the issuance of ASU No. 2014-09, the FASB created a Transition Resource Group, or TRG, to provide guidance on implementation questions stakeholders had regarding the new standard. The TRG, comprising a varied group of stakeholders, including FASB representatives, wrote approximately 60 position papers detailing how to apply the guidance in ASC 606 in response to the various questions the TRG received. Further, the FASB determined that certain questions it received from stakeholders required additional standard setting to adequately address. As a result of this process, the FASB issued various additions to the original guidance on revenue recognition found in ASU No. 2014-09. These updates, unlike the TRG position papers, became part of the ASC codification and thereby authoritative guidance.

Additionally, other entities, such as the AICPA and various accounting firms, published nonauthoritative guidance on the application of ASC 606. While not officially "GAAP," these guides were extremely helpful in disseminating a consistent understanding of the key provisions of ASC 606 and how it is to be applied.

Stage 2, a post-effective date evaluation of costs and benefits of the new standard, is complete with regard to public entities and is still ongoing with regard to nonpublic business entities. Stage 2 consists of the following activities:

- Understanding the costs that an entity incurred in applying the standard, as well as the costs that investors and other users incurred in analyzing and interpreting the information that the standard provides;
- Understanding the benefits of the standard to investors and other users as well as to entities; and
- Monitoring the ongoing application of the standard.

During Stage 2, a varied group of stakeholders provided responses on the cost/benefit question through a series of round-table discussions. The process will be repeated for similar stakeholders concerning nonpublic company implementation.

Stage 3 of the PIR process consists of publishing a summary of the research and developing suggestions for additional standard setting. There is no scheduled completion date for Stage 3 currently.

Stage 1 and 2 activities consisted of the following:

- Six meetings of the TRG;
- Variety of standard-setting activity;
- Responses to over 250 technical inquiries;
- Dissemination of technical materials;
- Various webcasts and other communication events; and
- Other activities outside a focus on 606:
    - Issuance of ASU No. 2021-03 and ASU No. 2021-09.

As mentioned, due to the later effective date of ASC 606 for nonpublic entities and subsequent deferral, the FASB's Stage 2 activities focused on gathering feedback from public company stakeholders. Activities in Stage 2 included:

- 42 company preparer surveys;
- Outreach to auditors and regulators;
- A focus on the impact of ASC 606 adoption on accounting systems;
- Gathering of feedback for advisory meetings;
- Performed analysis of XBRL;
- Stakeholder feedback;
- Investor-focused discussions;
- Feedback on cost-benefit analysis; and
- Academic research.

Stage 3 reporting will follow the completion of Stage 2 activities related to nonpublic companies.

B. Feedback from the PIR process

So, what were the results of the inquiries?

Overall feedback from stakeholders on ASC 606 adoption is favorable. The standard is generally achieving its objectives, namely creating a consistent revenue recognition approach applicable across industries and increasing the volume and consistency of disclosures related to revenue.

Most PIR participants noted little to no material impact on reported financial results following the adoption of ASC 606. Additionally, they stated that the increased ASC 606 disclosures provide more useful and transparent information than those under ASC 605. As a result, the application of ASC 606 generally improved comparability of revenue across industries, with certain exceptions.

Stakeholders commented that, due to the differing revenue recognition models used by software providers for licensed software and usage-based software, revenue comparisons in that sector are actually hindered by the application of ASC 606's license guidance, especially when it is applied to functional intellectual property.

Similarly, application of the ASC 606 guidance on price concessions also yielded conflicting results, with some healthcare providers recording bad debt expense and an allowance for doubtful accounts related to self-pay balances, and some not. This made inter-sector comparisons challenging.

On the cost side, both financial statement preparers as well as their auditors noted increased compliance costs. However, most of the incremental costs were generally related to the year of adoption, with scope and related costs reducing in the following years.

The PIR participants did suggest improvements to the ASC 606 revenue recognition model in the following areas:

- Requiring or allowing software companies to combine term licenses with PCS into one performance obligation.
  - This suggestion acknowledged the challenges in determining whether a license is distinct as well as the level of effort required to unbundle PCS services for software, especially when such services are generally marketed as a bundled resource.
- Allowing more flexibility in determining standalone selling price (SSP).
  - While ASC 606 offers three methods to determine SSP, it may be challenging to obtain objective-based evidence for SSP. Respondents requested more options in developing SSP.
- Providing an exception for estimating variable consideration for sale of IP licenses.
  - It can be complex to estimate such consideration.
- Changes to the ASC 606 disclosure requirements.

C. Next steps

The FASB is already contemplating additional research to support standard setting in the following areas related to ASC 606:

- Principal vs. agent and related consideration payable to a customer.
  - While the model in ASC 606 generally yields a similar result as the one followed in ASC 605, it can be challenging to determine the proper accounting for such arrangements. Specifically, it is often difficult to identify the customer, determine which party controls the good or service, or determine which payments should be accounted for as a reduction to revenue. The FASB may explore options to simplify this accounting model.

- Licensing.
  - As mentioned above, for software offering similar functionality, entities will obtain a significantly different revenue recognition result based on whether they follow a license model, resulting in up-front revenue recognition, or a usage model, where revenue recognition is generally recognized over time. With the recent rise in cloud-based technology solutions, the impact of these two different approaches makes intra-industry comparisons challenging for investors. Further, determining whether a license is distinct, and thereby a performance obligation or not, can be challenging and is often based on a technical assessment that can be difficult for an accountant to comprehend. The FASB may consider potential simplifications to the model to increase comparability and ease of application.
- Variable consideration.
  - Application of the variable consideration guidance in ASC 606 is judgmental and can be difficult to apply, especially in the case of sales or usage-based royalties. The FASB may research attempts to simplify this model.
- Disclosures.
  - While no specific problems with the disclosure requirements were noted in the review, the FASB is considering research into ways to improve the information presented concerning revenue.
- Short-cycle contract manufacturing.
  - Some short-cycle or contract manufacturers were required to change their revenue recognition models to an over-time approach, as opposed to the point-in-time approach employed under ASC 605. The application of the guidance could result in the application of different revenue recognition approaches for similar contracts.
- Standalone selling price.
  - Determining SSP can be challenging, especially when the product is not sold separately. Also, the guidance on allocating discounts and using the residual method can be difficult to apply. The FASB may research methods that would ease the estimation of SSP when objective evidence does not exist.
- Identifying performance obligations.
  - In some instances, determining whether a promise is a performance obligation is highly subjective, while that determination can have a significant impact on revenue recognition. The FASB may research ways to make the performance obligation assessment less subjective.
- Incremental cost of obtaining a project.
  - Determining costs to capitalize and their amortization period can be challenging, especially when the costs relate to contract renewals. The FASB may explore ways to simplify this model.

In summary, the PIR process has generally concluded that the objectives of ASC 606 are being met at an acceptable cost. It is unlikely that the inclusion of nonpublic entity stakeholders in the PIR model will change this conclusion. So, the core of the ASC 606 model is here to stay.

XII. Update on the FASB's Private Company Council

Since its creation, the PCC has become the sounding board for feedback from private companies concerning the costs and benefits of both proposed and enacted accounting standards. Additionally, the

PCC has both influenced new standard setting with regard to the concerns of private companies as well as advanced several simplification initiatives that have lightened the existing financial reporting burden on private companies. The influence of these simplification initiatives can be seen as the FASB has adopted similar simplifications in the areas of goodwill impairment testing and hedging. Additionally, the influence of the PCC can be seen in the FASB's decision in 2018, through ASU No. 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, to exempt nonpublic business entities from having to apply the variable interest entity (VIE) rules when determining whether to consolidate an entity, in certain situations. This influence can also be seen in the current direction of the FASB's proposed updated guidance on goodwill accounting, which mirrors the amortization election currently available for private companies.

A. Responsibilities

The PCC has two primary responsibilities:

1. To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are required to address the needs of users of private company financial statements; and
2. To serve as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

The PCC has completed this first responsibility and is now generally serving in a consulting and advisory role to the FASB as the FASB progresses on its technical agenda.

B. Makeup of the PCC

The PCC consists of between 9 to 12 members, including a Chairman, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC Chairman is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of his or her career. The Chairman works cooperatively with the FASB liaison member, the FASB Chairman, and the FASB Technical Director to accomplish the functions of the PCC and to help facilitate the work of the FASB with respect to private company standard setting activities.

PCC members include users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements. Members are appointed for a three-year term and may be reappointed for an additional term of two years. Membership tenure may be staggered for some members to establish an orderly rotation.

The PCC is still chaired by Candace E. Wright, a director with Postlethwaite & Netterville, a Louisiana-based accounting and business advisory firm. The current members of the PCC can be found on the FASB's website.

As mentioned, the PCC still consults with the FASB on the impact of proposed changes to the accounting codification on smaller and nonpublic entities.

The PCC is currently consulting with the FASB on a number of projects, including the following:

- Accounting for and Disclosure of Crypto Assets project;
- Accounting for and Disclosure of Software Costs project;
- Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method project;
- Accounting for Environmental Credit Programs project;
- Stock-Based Compensation project;
- Profits Interests and Their Interrelationship with Partnership Accounting project;
- FASB's Agenda consultation;
- Implementation issues related to ASC 606 and 842; and
- Targeted Improvements to Income Tax Disclosures project.

Discussion question:

How successful do you feel the PCC has been in attempting to simplify GAAP for nonpublic business entities?

ASC 842, *Leases*

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ASC 842, *Leases*

Learning objective

After completing this chapter, you should be familiar with:
- An overview of the FASB's comprehensive lease accounting guidance found in ASU No. 2016-02, *Leases (Topic 842).*

I. Effective for everyone…

Many years after its original issuance in 2016 and after two deferrals and a proposed third, ASC 842, *Leases* is effective for all entities.

The guidance of lease accounting for both lessees and lessors was effective as follows:
- Public business entities:
  - Effective since years beginning after December 15, 2018.
- Nonpublic business entities:
  - Effective since years beginning after December 15, 2021.

At this point in time, calendar year-end reporting entities should be recording new leases under the guidance of ASC 842. Further, they should have transitioned leases that existed at December 31, 2021 to ASC 842.

Implementation of ASC 842 has been difficult for many private companies. Therefore, this course is an in-depth review of ASC 842. Topics discussed include the accounting related to leases, the implementation guidelines, new ASUs related to ASC 842, and disclosure requirements.

To begin, both lessees and lessors should have applied a modified retrospective transition approach for finance/sales-type/direct finance and operating leases existing at or entered into after the beginning of the earliest comparative period presented in the financial statements. This approach does not require any transition accounting for leases that expired before this date. For calendar year-end reporting companies, this date would be December 31, 2020. Full retrospective treatment was not allowed.

However, in ASU No. 2018-11, the FASB issued an amendment to this transition guidance where an entity would have applied the guidance of Topic 842 at its effective date and not at the beginning of the earliest comparative period. For calendar year-end reporting companies, this date was December 31, 2021. Under this election, an entity does not need to apply the guidance of Topic 842 to leases that expired before the effective date of Topic 842.

Also, this amendment on applying the modified retrospective approach would be applicable for lessors as well. However, due to the mechanics of adoption for lessors, its impact would not be as significant as for lessees.

A. ASU No. 2021-05

While most of our discussion in this section will deal with lessee accounting, there was a significant update to the lessor accounting guidance issued by the FASB in 2021, which is discussed below.

As part of the FASB's Post-Implementation Review of ASC Topic 842, this ASU addressed an issue related to a lessor's accounting for certain leases with variable lease payments. When applying the guidance of ASC 842, lessors are often taking day-one losses on certain sales-type and direct financing leases with variable payments not tied to a rate or index. They subsequently record lease income when such payments are received over the term of the lease. As such, they believed that the application of ASC 842's guidance in this area does not reflect the economic reality of the lease arrangement.

Further, these stakeholders highlighted that lessors did not recognize a day-one loss under Topic 840, *Leases* because of the longstanding practice to account for certain leases with variable payments as operating leases based on an interpretation of a classification criterion in Topic 840. That classification criterion was not retained in Topic 842. Additionally, the resulting day-one loss issue was not identified or discussed by the Board in deliberations leading to the issuance of Update 2016-02.

ASU 2021-05 affected lessors with lease contracts that (1) have variable lease payments that do not depend on a reference index or a rate and (2) would have resulted in the recognition of a selling loss at lease commencement if classified as sales-type or direct financing.

The amendments in this update addressed stakeholders' concerns by amending the lease classification requirements for lessors to align them with practice under Topic 840. Lessors should classify and account for a lease with variable lease payments that do not depend on a reference index or a rate as an operating lease if both of the following criteria are met:

a. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria in paragraphs 842-10-25-2 through 25-3; and
b. The lessor would have otherwise recognized a day-one loss.

This ASU was effective for fiscal years beginning after December 15, 2021 for all entities, including interim periods within those fiscal years for public business entities, and interim periods within fiscal years beginning after December 15, 2022 for all other entities.

Entities that adopted Topic 842 before the issuance date of this update have the option to apply the amendments in this update either (1) retrospectively to leases that commenced or were modified on or after the adoption of Update 2016-02 or (2) prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments.

II. Similarities and differences between ASC 840 and 842

Although ASC 842 has been effective for all entities for at least one fiscal year, it is helpful to fully understand the similarities and differences between ASC 840 and ASC 842. Entities and practitioners have struggled with the implementation of ASC 842. Understanding the significant similarities and differences is crucial as we move forward with the updated lease accounting standards. The following chart summarizes these:

Differences	Similarities
Balance sheet recording of operating leases by lessees	Income statement treatment for lessees and lessors is unchanged.
Capital leases are now known as finance leases	Accounting for finance leases mirrors accounting for capital leases under ASC 840.
Principles-based lease classification guidance	Criteria for adding options to renew to lease term is similar: • ASC 840 – Reasonably assured criteria. • ASC 842 – Reasonably certain criteria.
No deferred or prepaid lease expense for operating leases	Lease modification and remeasurement accounting.
More stringent capitalization requirements for initial direct costs	
Significantly enhanced footnote disclosures	
Enhanced need for centralized recordkeeping	

A. Balance sheet recording of operating leases under ASC 842

Under ASC 840, operating lease payments were treated as financial commitments, not as a liability of the entity. Under ASC 842, payments related to the noncancelable term of the lease, plus those related to options to extend, for which it is reasonably certain that the option will be exercised, are recorded as a liability of the entity. While the criteria for considering options is similar between ASC 840 and 842, the underlying accounting for operating leases is significantly different between ASC 840 and 842.

Under ASC 840, no liability related to lessee operating lease obligations was recorded in the lessee's financial statements, and the obligation was merely disclosed, but under ASC 842, a liability and a corresponding right-of-use (ROU) intangible asset are recorded.

Under ASC 842, for both finance and operating leases, the lessee is required to recognize a lease liability equal to the present value of the lease payments. Lease payments consist of the following:

- Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments that depend on an index or a rate (i.e., Consumer Price Index), measured at the rate at lease commencement date. Fixed increases in variable lease payments are also included. However, true variable lease payments, such as a percent of sales, are not included. Variable payments not tied to such an index are also excluded and recognized in the period incurred.
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option.
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising this option.
- Fees paid by the lessee to the owners of a special purpose entity for structuring the transactions.
- For lessees only, amounts probable of being owed by the lessee under residual value guarantees. This is typically the difference between the guaranteed residual value and the market value of the leased asset at the end of the lease term.

Initial measurement of the right-to-use asset includes the following:

- The initial measurement of the lease liability determined above;
- Any lease payment made at or before the lease commencement date, less any incentives received; and
- Any initial direct costs incurred by the lessee.

The discount rate used to discount the future cash flows is determined as follows:

- First, use rate implicit in the lease. The implicit rate is the rate where present value of lease payments and residual value equal fair value of leased asset at lease commencement.
- If the rate is not known by lessee, lessees can use the following:
  - Incremental borrowing rate; or
  - Nonpublic company option to use its risk-free interest rate.

With the issuance of ASU No. 2021-09, the election to use the risk-free rate or incremental borrowing rate can be made by class of asset.

Note that initial recognition is identical for finance and operating leases under ASC 842. Further, the accounting for finance leases by lessees under ASC 842 is essentially unchanged from that under ASC 840. However, leases known as capital leases under ASC 840 are now known as finance leases under ASC 842.

B. Lease classification under ASC 842

When it comes to classifying leases as either finance or operating, the factors of ASC 842 are similar to ASC 840, with one addition. These factors are:

- Payments represent substantially all of the asset fair value.
- The lease term is for a major portion of the asset's economic life.
- There is a bargain purchase option that the lessee is reasonably certain to exercise.
- Title transfers automatically at the end of the lease.

The one new lease classification criteria under ASC 842 is that when the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term, the lease should be classified as a finance lease.

While no specific guidance is provided in ASC 842, thresholds for the fair value and economic life tests utilized by lessees are similar to the 90 percent and 75 percent tests pre-ASC 842, respectively. However, the bright lines of ASC 842 have been removed.

A key consideration in assessing the lease classification of a lease and its subsequent accounting under ASC 842 is determining the term of the lease. ASC 842 defines the term of a lease as the noncancelable period for which a lessee has the right to use an underlying asset, together with both of the following:

1. Periods covered by an option to extend the lease if the lessee has a significant economic incentive at the commencement date to exercise that option; and
2. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive at the commencement date not to exercise that option.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. As a note of distinction, the lease inception date is the earlier of the date of the lease or the date of commitment by the parties for principle provisions of the lease.

When determining the lease term an entity should consider all relevant factors that create a significant economic incentive to exercise an option to extend, or not to terminate, a lease. An entity should include such an option in the lease term only if it is “reasonably certain” that the lessee will exercise the option having considered the relevant economic factors. Reasonably certain in this case is a high threshold. The lease term also includes periods covered by renewal or early termination options if their exercise is controlled by the lessor.

Classification guidance for lessors, determining whether the lease is either a sales-type, direct financing or operating lease, is virtually unchanged under ASC 842, though a requirement to consider the collectability of the lease payments has been added and is similar to that in ASC 606.

Lessees or lessors have not seen major changes in how they classify leases under ASC 842, as compared to ASC 840.

C. Other changes in the lessee accounting model under ASC 842

With the recording of the lease liability for virtually all leases under ASC 842, the recognition of prepaid or deferred rent is eliminated under ASC 842. These amounts were recorded when, in the case of prepaid rent, the cash payment of the lessee to the lessor exceeded the amount of the expense recognized by the lessee and, in the case of deferred rent, the expense recognized by the lessee exceeded the amount of the lease payment made by the lessee to the lessor.

Further, ASC 842 has introduced a more stringent capitalization policy for initial direct costs. Under this approach, only incremental costs qualify as initial direct costs subject to capitalization in both lessor and lessee accounting. These costs are those that the entity would not have incurred if the lease had not been entered into. These include commissions or payments to existing tenants to obtain the lease and are the same for both the lessor and lessee.

The lessee should include initial direct costs in its initial measurement of the right-to-use asset and amortize them over the term of the lease.

Lessor accounting for such costs varies based on the type of lease. For sales-type leases, the lessor expenses such costs at lease inception if the lessor recognizes selling profit at the inception of the lease. Alternatively, the lessor should include these costs in determining the lease receivable by considering them in its measurement of the net investment in the lease.

Initial direct costs are deferred and included in the net investment in the lease at its commencement date for direct financing leases.

For operating leases, such costs should be expensed over the term of the lease.

While there was the need for effective information flows under ASC 840, especially related to accumulating disclosure information, the need for centralized record keeping is significantly enhanced under ASC 842. Calculations supporting initial classification and recording, subsequent accounting, and the development of disclosure information required by ASC 842 generally require a more centralized approach to gathering and maintaining such information. Entities should consider the value of using lease accounting software to accumulate and manage this information.

D. Income statement treatment of leases

The income statement treatment for both lessees and lessors of leases is essentially unchanged under ASC 842, as compared to ASC 840.

For a finance lease, the lessee separately recognizes in the income statement (unless the costs are included in the carrying amount of another asset in accordance with other ASC Topics) the unwinding of the discount on the lease liability as interest and the amortization of the right-of-use asset.

The lessee determines the unwinding of the discount on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability.

The lease liability is reduced by the amount of the annual lease payment less the amount of that payment attributable to interest expense, determined using the effective interest method detailed above.

The lessee amortizes the right-of-use asset on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits) from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

However, if the lessee has a significant economic incentive to exercise a purchase option, the lessee should amortize the right-of-use asset to the end of the useful life of the underlying asset.

For an operating lease, a lessee recognizes in profit or loss (unless the costs are included in the carrying amount of another asset in accordance with other ASC Topics) a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis.

However, the periodic lease cost should not be less than the periodic unwinding of the discount on the lease liability.

The lease liability is reduced by the amount of the annual lease payment less the amount of that payment attributable to interest expense, determined using the effective interest method (again, detailed above), while accumulated depreciation of the right-of-use asset is the difference.

As you can see from the above discussion, the initial recognition of and subsequent accounting for a finance lease is unchanged from that for a capital lease under ASC 840.

E. Consideration of lease modifications and remeasurement events

While there is some difference in the approach to the accounting for lease modifications and other remeasurement events between ASC 840 and 842, their treatment as activities to be accounted for on a subsequent basis is similar between the two standards. ASC 842 simplified the guidance in this area.

1. Lease remeasurements

Under ASC 842, after the lease commencement date, a lessee should remeasure the lease liability to reflect changes to the lease payments for any of the following:

a. The lease is modified and not accounted for as a new contract. Note that all assumptions should be updated when a lease is modified.

b. The contingency upon which some or all of the variable lease payments were excluded from the calculation of the lease liability has been resolved such as to meet the definition of a fixed payment.

c. A change in any of the following:

    i. The lease term (determine revised lease payments based on the revised lease term).

    ii. Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset (determine revised lease payments to reflect change in amounts payable under purchase option).

    iii. The amounts probable of being paid under residual value guarantees (determine revised lease payments to reflect change in amounts expected to be payable under residual value guarantees).

When a lessee remeasures the lease payments in accordance with the above, the variable payments based on an index or a rate used to determine lease payments should be measured using the rate or index at the remeasurement date (determine revised lease payments using index or rate at the end of the reporting period).

When one of the above events occurs, the lessee should remeasure the lease liability to reflect the changes to the lease payments due to these events. The amount of the remeasurement of the lease liability should be recorded as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, any remaining amounts would be recorded in the income statement.

Also, when remeasuring, the lessee should update the discount rate for the lease at the date of the remeasurement, unless the discount rate already reflects the lessee’s option to extend or terminate the lease or to purchase the underlying asset. The updated rate is the rate the lessor would charge the lessee at that date (or the lessee’s incremental borrowing rate at that date if the rate the lessor would charge the lessee at that date is not readily determinable, or the risk-free rate at that date for a nonpublic entity that elected to use the risk-free rate) on the basis of the remaining lease term.

Also, if the remeasurement is due to a change in the amounts probable of being owed under a residual value guarantee or a change from the resolution of a contingency over variable lease payments, the lessee does not update the discount rate.

2. Lease modifications and contract combinations

ASC 842 defines a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The substance of the modification should govern over its form.

Both lessees and lessors should account for lease modifications as a new lease, separate from the lease being modified, only when:

1. The modification grants the lessee an additional right of use that was not in the original lease; and
2. The additional right of use is priced commensurate with its standalone price.

When the modification is not accounted for as a new contract, as per the above, the lessee needs to reassess the lease classification as well as remeasure the lease liability after remeasuring and reallocating the consideration in the contract, if applicable, using the relevant assumptions at the date of the modification.

If the modification grants the lessee an additional right of use not in the original contract (i.e., use of an additional floor of a building), extends or reduces the term of an existing lease other than through exercise of an option (which is not a modification), or changes the consideration in the contract only, the lessee should adjust the value of the right-of-use asset for the amount of the change in the remeasured lease liability. When the modification partially or fully terminates a lease, the lessee should decrease the right-of-use asset proportionally to the impact that the termination of the existing lease has on the lease liability. Any difference between the reduction of the lease liability and the proportional reduction in the right-of-use asset would be recognized as a gain or loss.

F. Other considerations related to ASC 842

1. Preeffective date considerations

As a reminder, ASC 842 was effective for all calendar year-end private companies as of January 1, 2022. The following is a review of considerations entities should have made prior to implementation. Private companies have struggled with the implementation of ASC 842; therefore, the material below is pertinent to practitioners currently working with 2022 financials. Applying ASC 842 has many considerations, both before and after its effective date. While we will discuss transition accounting in greater detail later in this session, one of the most important considerations in transition accounting is consideration of the two transition practical expedients that ASC 842 offers. These are as follows:

- Package of three:
  - Reassessing classification;
  - Reassessing for embedded leases; and
  - Reassessing accounting for initial direct costs.
- Hindsight.

While each transition practical expedient can be selected individually, an entity must select all three elements of the “package of three” practical expedients when selecting the option.

The hindsight practical expedient allows an entity to ignore certain “hindsight” events such as modifications and impairment when transitioning to ASC 842. As the concept was challenging to apply, few public entities elected to apply it and it is expected that few private entities will as well. We’ll discuss these in greater detail when we discuss transition to ASC 842 later in this session.

Under ASC 842, both in transitioning existing leases and in accounting for new leases, entities can elect to not apply ASC 842 to leases with terms, as defined in the standard, of 12 months or less. Applying this guidance may result in a significant number of leases not being recorded under ASC 842. However, when applying the guidance, recall these two points:

1. The measurement of the 12 months starts at lease commencement, the date when the entity gains control of the leased asset, not 12 months from the effective date of ASC 842.
2. The definition of term includes both the noncancelable term of the lease as well as options to extend that meet the "reasonably certain" criteria.

2. Post-transition date accounting considerations

Key post-effective date accounting considerations include the following:

- Lease classification;
- Accounting for initial direct costs;
- Accounting for nonlease components; and
- Definition of a lease and embedded leases.

Generally, lease components and nonlease components, such as services like common area maintenance, would be separated and accounted for under applicable guidance. However, lessees may elect to not separate lease and nonlease components, accounting for the entire cash flow as a lease payment.

Lessors may similarly elect to not separate lease from nonlease components if certain criteria are met. If electing to not separate the components, the lessor would follow the guidance related to whichever component is predominant.

Lease classification and initial direct cost considerations were previously discussed above, and we will discuss the definition of lease and the concept of embedded leases shortly.

III. Accounting surprises under ASC 842

Applying ASC 842 can result in several potential surprises, the impact of which could be significant. So, these issues should be assessed as quickly as possible.

A. Embedded leases

In order for a contract to be accounted for as a lease, the contract must be one that:

- Conveys the right to use a specific asset (the underlying asset); and
- The right must be for a period of time and provided in exchange for consideration.

So, in order for a contract to be accounted for under ASC 842, there must be a specific asset identified, with no right to substitution by the lessor, except for defects or repairs. Further, there must be a term associated with the contract and substantive consideration. So, a "lease" for the use of an asset in perpetuity or with no or nominal consideration would not be accounted for under ASC 842.

In addition to specific contracts for such arrangements, they may also be embedded in other contracts, such as third-party service revenue contracts. If so, the lease component of such contracts should be carved out of the broader contract and accounted for as a lease. Entities should have effective internal controls which would enable them to identify such provisions in contracts and account for them accordingly.

While the number of contracts with embedded leases may be low, the valuation of the lease component may be complex.

B. The scope of ASC 842

The scope of ASC 842 is expansive, covering all leases for assets, with only the following exceptions:

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

As such, application of ASC 842 could and often does have a significant impact on an entity's balance sheet, especially related to large leases that are classified as operating leases. For example, one or multiple operating leases for real estate assets could have a significant accounting impact.

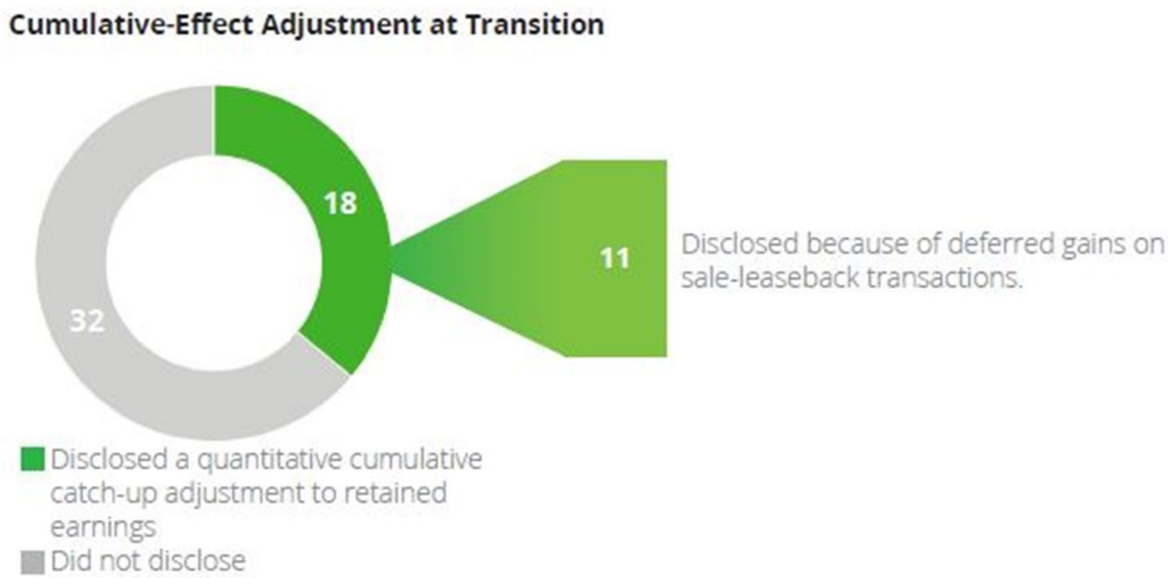
For example, a 10 year lease, $10,000 monthly payment lease would result in the recognition of a $1MM ROU asset and lease liability under ASC 842, when the same lease was off-balance sheet under ASC 840. Further, an entity may need some real estate expertise in order to apply ASC 842 to all aspects of these often-complex arrangements.

C. Equity is rarely affected when adopting ASC 842

While the impact of adopting ASC 842 can be significant, it often results in just an increase in the lease liability and the related ROU asset, and not a significant charge to equity.

While we will review transition accounting in detail, the combination of the transition guidance and impact of applying the package of three transition practical expedient generally results in no charge to beginning equity.

As per the following graphic, in a sample of public company entities that adopted ASC 842, most disclosed material charges to retained earnings as a result of the recognition of formerly deferred gains related to sales-leaseback arrangements, and not to the application of the guidance to more straightforward lease arrangements.



D. Inputs into calculations

There are many inputs into the lease accounting valuation model. While some, like fixed and variable payments, are objective, some are subjective and require judgment. These variables include the following:

- Incremental Borrowing Rate;
- Term and options to extend or terminate the lease;
- Economic life of the asset;
- Residual value guarantees; and
- Economic Life and fair value of the underlying asset.

There is a difference in determining the incremental borrowing rate under ASC 840 and 842. While both represent the rate at which an entity would borrow money to purchase the leased asset, the rate under ASC 842 is a secured or collateralized rate, while that under ASC 840 is an unsecured rate. So, all things being equal, an entity's incremental borrowing rate under ASC 842 would be lower than under ASC 840, resulting in the recognition of a larger lease liability and right-of-use asset.

Also, entities need to consider the impact of ASU No. 2021-09. The ASU allows lessees that are not public business entities to use the risk-free interest rate on a class of asset basis, as opposed to all assets for which the entity could not determine the rate implicit in the lease.

Prior to the issuance of ASU No. 2019-09, the election to use the risk-free rate was applied to all assets for which the rate implicit in the lease was not determinable. Now, it can be elected by class of asset, with the incremental borrowing rate used on other classes of assets for which the rate implicit in the lease is not determinable.

The entity making this election must disclose that it has made the election and the classes of underlying assets to which it was made.

As previously discussed, the term of the lease includes not just the noncancelable term but also consideration of options to extend or terminate the lease. Consideration of both could have a significant impact on the term of the lease, thereby impacting its classification and the accounting for the lease arrangement.

Residual value guarantees can also have a significant impact on both lessee and lessor accounting. A residual value guarantee insures the difference between the actual fair value of the asset at the end of the lease and its expected fair value at the end of the lease.

From a lessee perspective, the full amount of any residual value guarantee is considered in determining the payment stream under the lease when assessing lease classification. However, only the residual value guarantee expected to be paid by the lessee would be included in the lease liability.

Guaranteed and unguaranteed residual value guarantees are considered in determining a lessor's net investment in a lease, essentially its lease receivable.

Lastly, both the economic life of the leased asset and its fair value are key inputs into the lease's classification. The determination of both requires judgment, with both possibly not being readily available to the lessee, resulting in the need for the lessee to make estimates of either, or both.

E. Application of materiality under ASC 842

Unlike IFRS 16, which establishes a specific $5,000 materiality threshold, there is no explicit materiality threshold under ASC 842. However, entities can use judgment in applying materiality to leases.

Some entities have decided to follow a capitalization policy identical or similar to that used for PP&E. However, when applying the threshold, be sure to address the materiality of individual leases but also the impact of not applying ASC 842 to leases in the aggregate.

F. Applying ASC 842 to related party leases

The recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties based on the legally enforceable terms and conditions of the lease. The FASB is expected to release an update with a practical expedient for private companies related to "legally enforceable terms and conditions." Information on this expected update is discussed below. In addition, lessees and lessors will be required to apply the disclosure requirements for related party transactions in ASC 850, *Related Party Disclosures*.

Questions arise about applying the 12-month practical expedient to related party leases, which may often be month-to-month contractual arrangements or may not even have a written contract at all. In such instances, lessees should apply the written terms of the lease agreement in determining the term of the lease, considering whether the lessee has a significant economic incentive to extend the lease. Lessees should also consider verbal agreements with lessors, if applicable, to determine the true economic substance of the lease agreement. Please see below for an expected update related to common control leasing arrangements.

The FASB issued ASU 2023-01 in March 2023 related to private companies' common control leasing arrangements. The ASU addresses two issues with which stakeholders were concerned related to implementing ASC 842.

ASC 842 requires entities to account for related party leases, when both entities are under common control, in the same manner as leases with unrelated parties (on basis of legally enforceable terms and conditions). However, during the PIR process, stakeholders noted that it could be difficult to determine the enforceable terms and conditions of these arrangements. Private companies under common control could have lease terms between entities that might or might not be legally enforceable. These terms might not even be in writing.

The new amendment will provide a practical expedient that allows private companies and not-for-profit entities to use the written terms of the lease to determine whether a lease exists as well as the classification of and accounting for that lease. Basically, the "legally enforceable" caveat is avoided. This practical expedient does not apply to verbal leases.

Entities may apply the above practical expedient in two ways. The entity could apply the amendment prospectively to leases that commence or are modified on or after the date the entity first applies the amendment. The entity could also apply the amendment retrospectively to the beginning of the first period the entity applied ASC 842.

This new ASU also addresses leasehold improvements recognized by a lessee in a lease between parties under common control. ASC 842 requires leasehold improvements to be amortized over the shorter of the useful life of the improvements or the remainder of the lease term. Stakeholders noted that, within common control leases, leasehold improvements amortized over a lease term that is significantly shorter than the useful life of the improvements could result in financial reporting that is not fully representative of the economics of the arrangement. FASB noted that this is an issue for all entities with common control leases, as such amendments in this new update will add requirements related to leasehold improvements associated with leases between entities under common control. These requirements are listed below.

- Lessee will amortize the leasehold improvements over the useful life of the improvements, regardless of lease term, if the lessee controls the underlying asset through a lease. There is an exception if the lessor controls the underlying asset through a lease with an unrelated third party. In this scenario, the amortization period for the leasehold improvements cannot exceed the lease terms between the lessor and the unrelated entity.
- Once the lessee no longer controls the underlying asset, the unamortized portion of leasehold improvements will be transferred to the lessor through an adjustment to equity.

As noted previously, this amendment will apply to all entities under common control when leases are present, not just private companies. Entities that encounter the above scenario, where leasehold improvements will be amortized for a longer period than the lease term, should disclose the following:

- Remaining lease term;
- Leasehold improvements' remaining useful life; and
- Unamortized balance of leasehold improvements.

Entities applying the amendments related to leasehold improvements that have already adopted ASC 842 have the following options for application:

- Prospectively to new leasehold improvements recognized on or after the date the above amendments are first applied.
- Prospectively as noted above, while also amortizing existing leasehold improvements over the remaining useful life determined at the date of application.
- Retrospectively, to the beginning of the first period the entity applied ASC 842 for leasehold improvements that exist at the date of adoption of a final update, with any leasehold improvements that otherwise would not have been amortized recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the fiscal year of adoption.

The effective date of ASU 2023-01 for both issues discussed above is fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been made available for issuance.

IV. Avoiding common mistakes in applying ASC 842

One of the benefits of the gap between public company and private/NFP adoption of ASC 842 is that it allows for nonpublic business entities to learn from the mistakes of public companies in their adoption. Here is a summary of some of these common errors.

A. Timing of systems vs. processes

Adopting any new accounting standard is a process, not a one-time event. Good decisions made in developing and applying the process can significantly ease both transition and on-going accounting. Poor decisions made in developing and applying the process, or simply not developing a process at all, can have a significant negative impact both on transition and ongoing accounting.

One of the first considerations is to ensure the completeness of the lease population for transitioning to ASC 842. While this population should be complete when accumulating the current disclosure information under ASC 840, many entities have seen that they have missed some leases when developing their five-year table. This is especially the case with entities that account for leases in a decentralized environment. Take the time to identify all leases before calculating the transition adjustment.

The key is to not just leap into recording leases in a system, irrespective of what the system is. The entity should take appropriate time to consider its options when making policy elections, ensuring a thorough understanding of the lease accounting and payment process. Also, the entity will likely need to add accounts to its general ledger for operating leases. It should consider all applicable variables in establishing these general ledger accounts, considering not just the accounting but also the disclosure requirements of ASC 842.

Related to the process vs. systems is consideration of the appropriateness of the tools which an entity uses in its lease accounting process. While spreadsheets may have been sufficient in the ASC 840 environment to determine lease classification and lease expense, the calculations required to account for operating leases under ASC 842 are more complex. This is due to the need to amortize the lease liability and ROU asset over the term of the lease. The volume of these calculations may overwhelm the person, making them use a spreadsheet, potentially increasing the likelihood of error.

Further, a spreadsheet may not be sufficient to compute some of the disclosure requirements of ASC 842, especially related to weighted average remaining term and discount rate of the leases. Also, accounting for the remeasurement of leases using spreadsheets can be challenging. Collectively, the use of spreadsheets may not be well-controlled and could result in increased audit fees due to the entity's reliance on them. While ultimately a cost-benefit analysis, any process review related to ASC 842 adoption should consider the use of lease accounting software.

B. Potential trouble spots

While an entity can make errors in any number of areas when applying ASC 842, there are a few areas where errors are more likely.

First, when developing your transition cumulative-effect adjustment, if you are proposing to record an adjustment to retained earnings, its best to review your adjustment and the ASC 842 guidance before you record the entry. While the recording of an adjustment to retained earnings may occur when transitioning to ASC 842, it is usually due to the existence of specific circumstances, such as sales-leaseback transactions. Take the time to review your judgment or even run a question or two past your accounting firm to assure that your adjustment is correct. The extra time spent now reviewing the adjustment could pay dividends in avoiding more work down the road correcting an error.

Another common area for errors is the assessment of when to include options to extend a lease in its term. The guidance uses a "reasonably certain" threshold, which is similar to the "reasonably assured" in ASC 840. It is reasonable to apply similar judgment in applying this guidance under ASC 842 as you would when determining lease term under ASC 840. The "reasonably certain" threshold is a high bar. Just because a lease contains an option to extend, and the lessee has exercised a similar option in the past, does not necessarily mean that the option period should be added to the noncancelable term. An example of the "reasonably certain" threshold being met would be when an entity still requires a leased asset past the initial end date of the lease, and the lease contains a bargain renewal option. However, in all cases, judgment is required.

Lastly, the guidance is applied consistently to both arms-length and related party leases. The relationship between the parties doesn't matter when determining the term of the lease, only the facts and circumstances of the situation.

C. Unexpected business impacts

Adopting ASC 842 can have many business impacts, both expected and unexpected.

Remember that unless a lease meets an exception or is immaterial, all contracts containing leases must be recorded under ASC 842. While many companies justifiably focus on leases for significant items like real estate or large pieces of PP&E, the aggregation of many smaller leases may have a large impact on the financial statements. That is why it is so important to ensure the completeness of the lease population and to develop and apply a materiality threshold.

The impact of adopting ASC 842 could affect the calculation of debt covenants, especially ones that have liquidity or leverage calculations, such as a current ratio or debt/equity calculation. Entities adopting ASC 842 are very susceptible to such violations, as the standard results in the recording of a noncurrent ROU asset offset by a lease liability that is split between a current and noncurrent portion.

Entities should have a thorough understanding of their debt covenant or other contractual requirements, including any clauses which address new accounting standards. When it is not clear how the bank will treat the impact of ASC 842 on applicable covenants, it is best to discuss the issue with the banks as early as possible. Further, the entity should develop pro-forma results that include the adoption of ASC 842 as early as possible, so both the entity and the banks can assess the impact and negotiate any necessary adjustments to the covenants.

Lastly, ASC 842 provides increased transparency to the true cost of lease financing. Often entities default to lease financing because it is easier than to arrange for purchase financing, or that is what they have done in the past. With the full amount of lease commitments now visible, as well as their cost, entities may use this increased transparency around the full cost of lease financing to make better decisions concerning how to finance their purchases.

V. Lessee financial statement presentation

While it is important to complete all aspects of the ASC 842 transition successfully, many of the underlying calculations related to leases are already being performed under ASC 840. However, the capitalization of operating leases under ASC 842 will require specific consideration related to financial statement presentation under the updated standard.

A. Financial statement presentation

1. Statement of financial position

A lessee should present all of the following items in the statement of financial position (or disclose these items in the notes to the financial statements):

a. Right-of-use assets separately from other assets;
b. Right-of-use assets arising from finance leases separately from right-of-use assets arising from operating leases;
c. Lease liabilities separately from other liabilities; and
d. Lease liabilities arising from financing leases separately from lease liabilities arising from operating leases.

If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, the lessee should present right-of-use assets within the same line item where corresponding underlying assets would be presented if they were owned and disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

The following represents the results of a survey of ASC 842 adopters’ presentation of the short- and long-term lease liabilities:

This treatment generally represents the relative materiality of the account balances.

2. Statement of comprehensive income

A lessee should present both of the following items in the statement of comprehensive income:

a. For finance leases, the unwinding of the discount on the lease liability separately from the amortization of the right-of-use asset; and
b. For operating leases, the unwinding of the discount on the lease liability together with the amortization of the right-of-use asset.

3. Statement of cash flows

In the statement of cash flows, a lessee should classify:

a. Cash payments for the principal portion of the lease liability arising from finance leases within financing activities.
b. Cash payments for the interest portion of the lease liability arising from finance leases within operating activities.
c. Cash payments arising from operating leases within operating activities.
d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

B. Disclosures

The objective of the disclosures required under ASC 842 is to allow financial statement users to assess the timing, amount, and uncertainty of cash flows arising from leases. As such, lease disclosures under ASC 842 are likely to be more detailed than before and are of both a quantitative and qualitative nature. A lessee should aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

Qualitative disclosures for lessees include the following:

1. Information about the nature of its leases (and subleases), including:
   a. A general description of those leases;
   b. The basis, and terms and conditions on which variable lease payments are determined;
   c. The existence, and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of the ROU assets and lease liabilities and those that are not;
   d. The existence, and terms and conditions of residual value guarantees provided by the lessee; and
   e. The restrictions or covenants imposed by leases.
2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.
3. Information about significant assumptions and judgments made in applying the requirements of the leases standards, which may include the following:
   a. The determination of whether a contract contains a lease;
   b. The allocation of the consideration in a contract between leases and nonlease components; and
   c. The determination of the discount rate.
4. The main terms and conditions of any sale and leaseback transactions.
5. Whether an accounting policy election was made for the short-term lease exemption.

The FASB decided if the short-term lease expense does not reflect the lessee’s short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

The standard requires the following quantitative disclosures to be made by lessees:

1. Finance lease expense segregated between amortization of ROU assets and interest on lease liabilities.
2. Operating lease expense.
3. Short-term lease expense excluding expenses relating to leases with a lease term of one month or less.
4. Variable lease expense.
5. Sublease income.
6. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between finance and operating leases.
7. Supplemental noncash information on lease liabilities arising from obtaining ROU assets, segregated between finance and operating leases.
8. Weighted-average remaining lease term disclosed separately for finance and operating leases.
9. Weighted-average discount rate for finance and operating leases as of the reporting date.
10. Gains and losses arising from sale and leaseback transactions.

Expense items disclosed include any amounts capitalized as part of the cost of another asset. Additionally, a lessee must disclose a maturity analysis of its lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, and reconciling the undiscounted cash flows to the discounted lease liabilities recognized in the statement of financial position.

Lastly, both lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with Topic 850, *Related Party Disclosures*.

Note:

Nonpublic business entity considerations

The FASB decided **NOT** to provide any specified reliefs from the disclosure requirements for nonpublic business entities. Therefore, the lessee disclosure package is equally applicable to both public and nonpublic business entities. Nonpublic business entities should also review the SEC's EDGAR database in order to get industry-specific examples of ASC 842 disclosures for public companies on which they can mirror their own.

Examples of required lessee disclosures are found below:

	Year Ending December 31,	
	20X2	**20X1**
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating	X.X%	X.X%

The following is the lease disclosure from a public company adopter of ASC Topic 842:

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which may include options to extend the leases for up to 5 years, and some of which may include options to terminate the leases within 1 year. As of September 30, 2017 and June 30, 2017, assets recorded under finance leases were $3.4 billion and $2.7 billion, respectively, and accumulated depreciation associated with finance leases was $209 million and $161 million, respectively.

The components of lease expense were as follows:

(In millions)

Three Months Ended September 30,		2017		2016
Operating lease cost	**$**	**388**	$	260
Finance lease cost				
Amortization of right-of-use assets	**$**	**48**	$	15
Interest on lease liabilities		**30**		12
Total finance lease cost	**$**	**78**	$	27

29

Other information related to leases was as follows:

(In millions, except lease term and discount rate)

Three Months Ended September 30,		2017		2016
Supplemental Cash Flows Information				
Cash paid for amounts included in the measurement of lease liabilities:				
Operating cash flows from operating leases	**$**	**369**	$	267
Operating cash flows from finance leases		**30**		12
Financing cash flows from finance leases		**25**		6
Right-of-use assets obtained in exchange for lease obligations:				
Operating leases		**391**		55
Finance leases		**728**		267
Weighted Average Remaining Lease Term				
Operating leases		**7 years**		5 years
Finance leases		**14 years**		12 years
Weighted Average Discount Rate				
Operating leases		**2.5%**		2.3%
Finance leases		**4.7%**		5.1%

Future minimum lease payments under non-cancellable leases as of September 30, 2017 were as follows:

(In millions)

Year Ending June 30,		Operating Leases		Finance Leases
2018 (excluding the three months ended September 30, 2017)	$	1,110	$	205
2019		1,385		281
2020		1,267		287
2021		1,022		293
2022		833		299
Thereafter		2,333		3,133
Total future minimum lease payments		7,950		4,498
Less imputed interest		(930)		(1,225)
Total	$	7,020	$	3,273
Reported as of September 30, 2017				
Other current liabilities	$	1,252	$	146
Operating lease liabilities		5,768		0
Other long-term liabilities		0		3,127
Total	$	7,020	$	3,273

As of September 30, 2017, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $219 million and $2.3 billion, respectively. These operating and finance leases will commence between fiscal year 2018 and fiscal year 2019 with lease terms of 1 year to 20 years.

The following is an example of the ASC 842 disclosures of Tenet Healthcare, a for-profit operator of hospitals. Though it is from a for-profit entity, this disclosure example would serve as a good example for a not-for-profit entity as well, as the disclosure requirements are identical for both for and not-for-profit entities.

Example 2 – Tenet Healthcare Corp.

LEASES

The following table presents the components of our right-of-use assets and liabilities related to leases and their classification in our Condensed Consolidated Balance Sheet at March 31, 2019:

Component of Lease Balances	Classification in Condensed Consolidated Balance Sheet	March 31, 2019
Assets:		
Operating lease assets	Investments and other assets	$ 799
Finance lease assets	Property and equipment, at cost, less accumulated depreciation and amortization	441
Total leased assets		**$ 1,240**
Liabilities:		
Operating lease liabilities:		
Current	Other current liabilities	$ 146
Long-term	Other long-term liabilities	714
Total operating lease liabilities		860
Finance lease liabilities:		
Current	Current portion of long-term debt	141
Long-term	Long-term debt, net of current portion	224
Total finance lease liabilities		365
Total lease liabilities		**$ 1,225**

We determine if an arrangement is a lease at inception of the contract. Our right-of-use assets represent our right to use the underlying assets for the lease term and our lease liabilities represent our obligation to make lease payments arising from the leases. Right-of-use assets and lease liabilities are recognized at commencement date based on the present value of lease payments over the lease term. We use our estimated incremental borrowing rate, which is derived from information available at the lease commencement date, in determining the present value of lease payments. For our Hospital Operations and other Conifer segments, we estimate our incremental borrowing rates for our portfolio of leases using documented rates included in our recent equipment finance leases or, if applicable, recent secured debt issuances that correspond to various lease terms. We also give consideration to information obtained from our bankers, our secured debt fair value, and publicly available data for instruments with similar characteristics. For our Ambulatory Care segment, we estimate an incremental borrowing rate for each center by utilizing historical and projected financial data, estimating a hypothetical credit rating using publicly available market data and adjusting the market data to reflect the effects of collateralization.

Our operating leases are primarily for real estate, including off-campus outpatient facilities, medical office buildings, and corporate and other administrative offices, as well as medical and office equipment. Our finance leases are primarily for medical equipment and information technology and telecommunications assets. Our real estate lease agreements typically have initial terms of five to 10 years, and our equipment lease agreements typically have initial terms of three years. We do not record leases with an initial term of 12 months or less (“short-term leases”) in our consolidated balance sheets.

Our real estate leases may include one or more options to renew, with renewals that can extend the lease term from five to 10 years. The exercise of lease renewal options is at our sole discretion. In general, we do not consider renewal options to be reasonably likely to be exercised, therefore renewal options are generally not recognized as part of our right-of-use assets and lease liabilities. Certain leases also include options to purchase the leased property. The useful life of assets and leasehold improvements is limited by the expected lease term unless there is a transfer of title or purchase option reasonably certain of exercise. The majority of our medical equipment leases have terms of three years with a bargain purchase option that is reasonably certain of exercise, so these assets are depreciated over their useful life, typically ranging from five to seven years. Similarly, some of our leases of information technology and telecommunications assets include a transfer of title and, therefore, have useful lives of 15 years.

Certain sections of our lease agreements for real estate include payments based on actual common area maintenance expenses and others include rental payments adjusted periodically for inflation. These variable lease payments are recognized in other operating expenses, net, but are not included in the right-of-use asset or liability balances. Our lease agreements do not contain any material residual value guarantees, restrictions, or covenants.

We have elected the practical expedient that allows lessees to choose to not separate lease and nonlease components by class of underlying asset and are applying this expedient to all relevant asset classes. We have also elected the practical expedient package to not reassess at adoption (i) expired or existing contracts for whether they are or contain a lease, (ii) the lease classification of any existing leases, or (iii) initial indirect costs for existing leases.

The following table presents the components of our lease expense and their classification in our Condensed Consolidated Statement of Operations for the three months ended March 31, 2019:

Component of Lease Expense	Classification on Condensed Consolidated Statements of Operations	Three Months Ended March 31, 2019
Operating lease expense	Other operating expenses, net	$ 50
Finance lease expense:		
Amortization of leased assets	Depreciation and amortization	18
Interest on lease liabilities	Interest expense	5
Total finance lease expense		23
Variable and short term-lease expense	Other operating expenses, net	34
Total lease expense		**$ 107**

The weighted-average lease terms and discount rates for operating and finance leases are presented in the following table:

	March 31, 2019
Weighted-average remaining lease term (years)	
Operating leases	6.7
Finance leases	6.1
Weighted-average discount rate	
Operating leases	5.2%
Finance leases	5.5%

Cash flow and other information related to leases is included in the following table:

	Three Months Ended March 31, 2019
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash outflows from operating leases	$ 47
Operating cash outflows from finance leases	$ 5
Financing cash outflows from finance leases	$ 36
Right-of-use assets obtained in exchange for lease obligations:	
Operating leases	$ 28
Finance leases	$ 36

Future maturities of lease liabilities at March 31, 2019 are presented in the following table:

	Operating Leases	Finance Leases	Total
2019	$ 144	$ 120	$ 264
2020	171	122	293
2021	152	64	216
2022	132	16	148
2023	110	13	123
Later years	339	123	462
Total lease payments	1,048	458	1,506
Less: Imputed interest	188	93	281
Total lease obligations	860	365	1,225
Less: Current obligations	146	141	287
Long-term lease obligations	**$ 714**	**$ 224**	**$ 938**

Future maturities of lease liabilities at December 31, 2018, prior to our adoption of ASU 2016-02, are presented in the following table:

		Years Ending December 31,					
	Total	2019	2020	2021	2022	2023	Later Years
Capital lease obligations	$ 425	$ 140	$ 95	$ 57	$ 37	$ 21	$ 75
Long-term non-cancelable operating leases	$ 932	$ 171	$ 151	$ 133	$ 113	$ 92	$ 272

VI. Lessee transition to ASC 842

A. Lessee transition

As noted previously, ASC 842 has been effective for all entities for at least one fiscal year. The information below should be reviewed to confirm the accounting related to transitioning to ASC 842 was done correctly. A lessee should have applied a modified retrospective transition approach for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (the date of initial application). The modified retrospective approach would not require any transition accounting for leases that expired before the date of initial application.

As mentioned previously, the FASB issued ASU No. 2018-11, which includes an amendment to this transition guidance where an entity could have applied the guidance of Topic 842 at its effective date and not at the beginning of the earliest comparative period. Under this election, an entity would not have needed to apply the guidance of Topic 842 to leases that expired before the effective date of Topic 842.

A full retrospective transition approach was not permitted.

1. Practical expedients

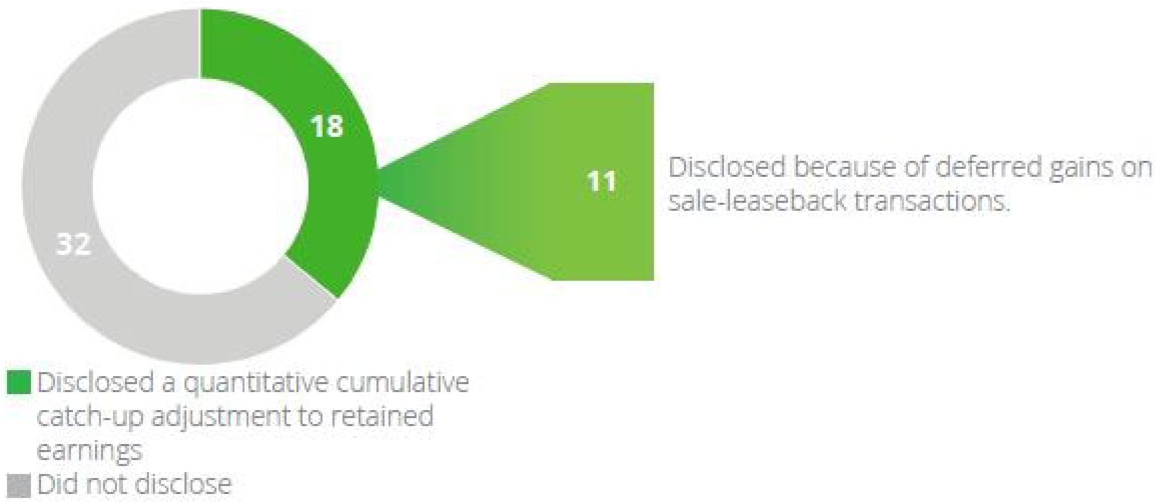
In transitioning to ASC 842 a lessee was permitted to elect the following specified reliefs, which must have been elected as a package and must have been applied to all of a lessee's leases (that is, they should not have been elected on a lease-by-lease or relief-by-relief basis), at the effective date:

- A lessee need not reassess whether any expired or existing contracts are or contain leases;
- A lessee need not reassess the lease classification for any expired or existing leases; and
- A lessee need not reassess initial direct costs for any existing leases (that is, whether those costs would have qualified for capitalization under ASC 842).

In addition, a lessee was also permitted to elect to use hindsight with respect to lease renewals and purchase options when accounting for existing leases. This specified relief could have been elected separately or in conjunction with the above-specified reliefs as an accounting policy election (that is, it cannot be elected on a lease-by-lease basis).

It is likely that most entities elected to employ these reliefs upon adopting ASC 842. As a result of not needing to reassess the classification of existing leases, many entities did not see a material impact on their retained earnings due to the adoption of ASC 842, unless due to other specific circumstances, such as preadoption sale-leaseback transactions. This result can be seen in this following transition survey:

Cumulative-Effect Adjustment at Transition



While there are four possible transition outcomes, the application of the "package of three" practical expedient reduces the potential outcomes to two, as an entity electing that expedient does not need to reassess lease classification. We'll review these two options now.

2. Transition accounting for existing operating leases under ASC 840

The modified retrospective transition approach should have been applied to existing **operating** leases that are classified as operating leases under Topic 842, as follows:

1. A lessee should have initially recognized a ROU asset and lease liability at the later of the date of the beginning of the earliest period presented in the financial statements and lease commencement.
2. Unless the lease is modified (and that modification is not a separate lease), or the lease liability is required to be remeasured, on or after the effective date, a lessee should have initially and subsequently measured the lease liability at the present value of the sum of:
    a. The remaining minimum rental payments (as defined under ASC 840) plus
    b. Any amounts the lessee expects to pay to satisfy a residual value guarantee, using a discount rate established in accordance with ASC 842 as of the "later of" date.
3. A lessee should have initially measured the operating ROU asset at an amount equal to the initial measurement of the lease liability, adjusted for any asset impairment, prepaid or accrued rent, lease incentives, or unamortized initial direct costs that would have qualified for capitalization under ASC 842, as well as the carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
4. Any unamortized initial direct costs at the "later of" date that would not have qualified for capitalization under ASC 842 should have been written off as an adjustment to equity.
5. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow the updated leases standard.

For existing operating leases that are classified as finance leases under ASC 842, the lessee should have measured the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined above. The applicable proportion is the remaining lease term at the beginning of the earliest comparative year presented relative to the total lease term. The lessee should have then adjusted the right-of-use asset recognized by the carrying amount of any pre-paid or accrued lease payments and the carrying amount of any liability recognized in accordance with Topic 420 for the lease. See the example of this transition that follows. However, as per above, if an entity uses the "package of three" practical expedients, it would not be in the situation of transitioning an operating lease under ASC 840 to a finance lease under ASC 842.

3. Transition accounting for existing capital leases under ASC 840

The modified retrospective transition approach should have been applied to existing **capital** leases that are accounted for as finance leases under Topic 842, as follows:

1. A lessee should have initially recognized a ROU asset and lease liability at the carrying amount of the leased asset and the capital lease obligation in accordance with ASC 840, *Leases*, at the later of the beginning of the earliest comparative period presented or the commencement date of the lease.
2. Any unamortized initial direct costs not included in the capital lease asset under ASC 840 that qualify for capitalization under ASC 842 should be included in the financing ROU asset; otherwise, those costs that would not have qualified for capitalization should be written off as an adjustment to equity.
3. Before the effective date, a lessee should have subsequently measured the ROU asset and lease liability in accordance with the subsequent measurement guidance in ASC 840.
4. Beginning on the effective date, a lessee should subsequently measure the ROU asset and lease liability in accordance with the subsequent measurement guidance in ASC 842 except that a lessee should not remeasure the ROU asset or lease liability for changes in the amount the lessee expects to pay under residual value guarantees unless it remeasures the asset or liability for other reasons (for example, because of a change in the lease term resulting from a reassessment).
5. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for purposes of presentation and disclosure.
6. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow guidance found in ASC 842.

ASC 842 contains additional transition guidance for leases classified as operating leases under ASU No. 2016-02 but as capital leases under Topic 840. This essentially involves derecognizing the carrying amount of the capital lease asset and related lease obligation at the later of the beginning of the earliest comparative period or the commencement date of the lease. Differences between the derecognized asset and liability should be recorded as prepaid or accrued rent. A ROU asset and liability should be recognized in accordance with the relevant guidance in Topic 842, depending on whether the lease commenced before or after the beginning of the earliest date presented in the financial statements and accounted for under Topic 842 subsequently. However, if an entity used the "package of three" practical expedients, it will not be in the situation of transitioning a capital lease under ASC 840 to an operating lease under ASC 842.

Discussion question:

Do you have any experiences with companies or clients utilizing the above reliefs with regard to transitioning to Topic 842?

4. Miscellaneous considerations in transition accounting

The following is guidance on certain transition accounting issues.

Variable lease payments included in the five-year minimum lease payment table
Under ASC 840, the five-year minimum lease payment disclosure includes variable payments based on a rate or index. The amount included in the five-year table is based on rate or index at lease inception. There is disparity in practice concerning whether an entity should update this disclosure for changes in rate or index at each accounting period. Some entities did update the amount of variable lease payments for changes in the rate or index while others did not update disclosure in the five-year table of minimum lease payments for such changes.

As the five-year minimum lease payment table is the basis for the transition adjustment for operating leases under ASC 842, questions have arisen as to which amounts to use when recording the cumulative-effect adjustment. However, ASC 842 is silent as to this issue.

The SEC issued guidance stating that if an entity was including minimum lease payments in its disclosure table based on the rate or index in effect at the inception of lease, it can either continue to do so at transition, or it may use the current rate or index when transitioning to ASC 842. However, if changing its approach, the entity should apply ASC 250 guidance to changes in accounting estimates.

If the entity already updates its five-year table of minimum lease payments for changes in the underlying rate or index, it should continue to use those amounts in its transition to ASC 842.

Discount rate considerations in transition
Discount rate to be used when determining the ASC 842 transition adjustment is the rate in effect at the application date. However, the application date will differ based on the transition method the entity elected.

When determining the rate that should have been used for recording the transition adjustment, the same discount rate options exist as when originally recording a lease under Topic 842:

- Use rate implicit in the lease, if known; or
- Use incremental borrowing rate, if not known. The entity can use the incremental borrowing rate either for original term of the lease or one for the remaining term of the lease, at transition. Approach should be consistently applied.

Nonpublic business entities can use the risk-free rate at transition, related to the remaining term of the lease.

5. Example transition options

The following are examples of several of these transition options.

The following example illustrates the practical application of the lease accounting guidance for lessee accounting for the transition of existing operating leases to an operating lease when applying the permitted alternative to a full retrospective transition approach. This is the most likely transition example for lessees to have to follow.

Lessee Transition – Operating Lease to Operating Lease

A lessee enters into a five-year lease of land on January 1, 20X1, with annual lease payments payable at the end of each year. The lessee originally accounts for the lease as an operating lease. On January 1, 20X2, before transition adjustments, the lessee has an accrued rent liability of $1,200 for the lease, reflecting rent that was previously recognized as an expense but was not paid at that date. Four lease payments remain: one payment of $31,000 followed by three payments of $33,000.

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in FASB ASC 842, *Leases*. At the effective date, the lessee's incremental borrowing rate is six percent. The lessee classifies the lease of land as an operating lease. On January 1, 20X2, the lessee measures the lease liability at $112,462, the present value of one payment of $31,000 and three payments of $33,000, discounted at six percent.

The right-of-use asset is equal to the lease liability before adjustment for accrued rent. The lessee does not include initial direct costs in determining the right-of-use asset as permitted by the transition guidance in FASB ASC 842.

January 1, 20X2	Right-of-use asset	112,462	
	Lease liability		112,462

The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognized accrued rent.

January 1, 20X2	Accrued rent	1,200	
	Right-of-use asset		1,200

The following example illustrates the practical application of the lease accounting guidance for how a lessee would account for the transition of existing operating leases to a finance lease when applying the permitted alternative to a full retrospective transition approach. Such a transition is not expected to occur often.

Lessee Transition – Operating Lease to Operating Lease, Using Package of Three Practical Expedients

A lessee that is a calendar-year public business entity entered into a 10-year lease of equipment that commenced on 1 January 2017 and was classified as an operating lease under ASC 840. The lessee makes annual payments that it pays in arrears on 31 December each year. The initial payment was $10,000, and the terms call for a $1,000 increase each year.

The deferred rent liability on 31 December 2018 is $8,000. The lessee incurred $7,500 of initial direct costs (IDCs) and half of the remaining unamortized IDCs of $6,000 qualify for capitalization under ASC 842 at lease commencement (i.e., $3,000 of remaining unamortized IDCs qualify for capitalization under ASC 842 at lease commencement).

The lessee elects to apply the package of practical expedients at transition and does not elect to apply the hindsight practical expedient. Therefore, lease classification and the remaining unamortized IDCs of $6,000 are not reassessed. The lessee cannot determine the rate implicit in the lease, and its incremental borrowing rate (IBR) as of 1 January 2019 is five percent. Finally, the lessee elects to apply the transition provisions at the beginning of the period of adoption (i.e., 1 January 2019).

Analysis: in this example, the lessee records the following journal entry as of 1 January 2019:

Right-of-use asset	$96,529 (1)	
Deferred rent liability	8,000 (2)	
Lease liability		$98,529 (3)
Capitalized IDCs		6,000 (4)

(1) The ROU asset equals the lease liability determined in (3) less the deferred rent liability determined in (2) plus remaining unamortized IDCs ($98,529 – 8,000 + 6,000).
(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative straight-line expense of $29,000 ($14,500 per year for 2017 and 2018).
(3) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of five percent ($98,529).
(4) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 – 1,500 for two years of amortization).

Not Using the Package of Three Practical Expedients

Assume the same facts as in Scenario A except the lessee does not elect to apply the package of practical expedients at transition.

Analysis: in this example, the lessee records the following journal entry as of 1 January 2019:

Right-of-use asset	$93,529 (1)	
Deferred rent liability	8,000 (2)	
Cumulative-effect adjustment	3,000 (3)	
Lease liability		$98,529 (4)
Capitalized IDCs		6,000 (5)

(1) The ROU asset equals the lease liability determined in (4) less the deferred rent liability determined in (2) plus remaining unamortized IDCs that qualify for capitalization under ASC 842 ($98,529 – $8,000 + $3,000).

(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative straight-line expense of $29,000 ($14,500 per year for 2017 and 2018).

(3) The cumulative-effect adjustment is the portion of remaining unamortized IDCs that do not qualify for capitalization under ASC 842 [$6,000 remaining unamortized IDCs ($7,500 – $1,500 for two years of amortization) x 50 percent].

(4) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of five percent ($98,529).

(5) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 – $1,500 for two years of amortization) (half was included in the measurement of the ROU asset, and the portion that does not qualify for capitalization under ASC 842 was adjusted in (3)).

Discussion question:

How much incremental effort have you expended in implementing ASC 842?

SAS 142 – Focus on Audit Evidence

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SAS 142 – Focus on Audit Evidence

Learning objectives

Upon completing this chapter, the reader will be able to:

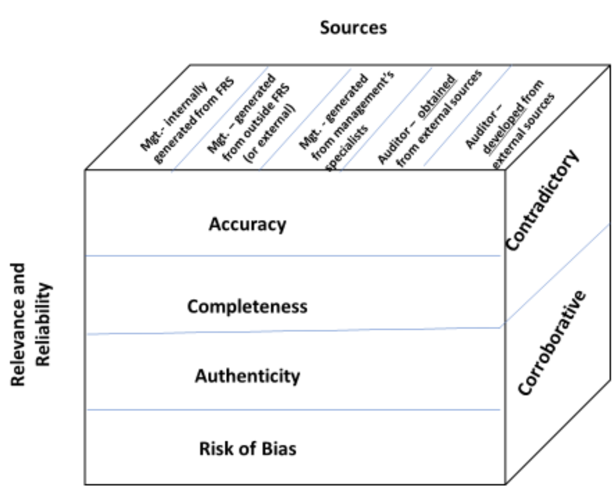
- Identify the provisions of SAS 142 related to Audit Evidence; and
- Be prepared to implement the audit standard.

I. SAS 142, Audit Evidence

A. Introduction

AU-C 500, *Audit Evidence,* has not had significant revisions since 2005 even though the standard was clarified in 2011. Much has changed since that time as the size and complexity of audited entities has increased and technology and its use by auditees and auditors has progressed. In 2017 the AICPA launched a project to assess whether it was time to revise the standard considering these issues. In addition, the AICPA's audit quality initiative identified issues related to lack of professional skepticism. In a separate project the IAASB was also seeing these issues.

The standard not only addresses emerging technologies but also discusses professional skepticism, management specialists, and audit documentation. Its primary focus is to assist the auditor in assessing whether sufficient and appropriate audit evidence has been obtained when the information is attained from sources not available when the earlier standard was issued. The ASB presents attributes and factors for auditors to use in evaluating audit evidence no matter the source or the way the auditor obtained the information (including the use of automated tools and techniques). These attributes and factors will be discussed throughout the chapter. Although the standard discusses and provides examples of newer technologies and methods, they are not described in detail



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SAS 142, issued in July 2020, is effective for periods ending on or after December 15, 2022. As most audits conducted in 2023 will fall under the scope of SAS 142, auditors should be aware of the provisions related to audit evidence within this standard.

B. Definitions

SAS 142 contains four definitions that set the foundation for this standard:

1. **Appropriateness (of audit evidence)** -- The measure of the **relevance and reliability** of audit evidence. Appropriateness relates to the quality of the audit evidence.
2. **Sufficiency (of audit evidence)** -- The measure of the **persuasiveness** of audit evidence. The persuasiveness of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement. Sufficiency relates to quantity.
3. **Audit evidence** -- Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
4. **External information source** -- An individual or organization external to the entity that develops information used by the entity in preparing the financial statements or used by the auditor as audit evidence, when the information is available 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.

C. Attributes and factors – Relevance and reliability

During the financial statement audit the auditor accumulates audit evidence to support his/her opinion on the financial statements. The term *sufficient appropriate audit evidence* is not new. The SAS explains that the attributes and factors in the cube above are to be evaluated to determine if sufficient appropriate evidence has been obtained. The auditor should evaluate the information to be used as audit evidence for relevance and reliability. This includes the source and whether it corroborates or contradicts assertions in the financial statements.

The front of the evidence cube discusses the important factors of **relevance and reliability**. The auditor considers the attributes: accuracy, completeness, authenticity, and bias.

1. Relevance

Relevance refers to the logical connection with an assertion under consideration. The factors that affect the relevance of information are:

- The objective of the procedures to be performed as well as the assertions;
- The account balances, classes of transactions or disclosures to which the information relates; and
- Period of time to which the information relates.

Example: An auditor was testing accounts payable. She considered the following:

- **Objective of procedures and account balance** -- to test the existence or valuation of accounts payable.

When testing existence, the auditor would test the recorded amount of accounts payable. The auditor could confirm accounts payable and reconcile the confirmations to the recorded balance and vendor statements. This would be relevant audit evidence.

- **Objective of procedures and account balance** -- to test the completeness of accounts payable the information discussed related to the recorded balance would not be relevant. However, information coming from subsequent disbursements, unpaid invoices, unmatched receiving reports, or supplier's statements would be.

When looking at an account balance the auditor has to pay careful attention to the assertions. For example, in evaluating marketable securities, a document (electronic or paper) may provide good evidence for an asset when it comes from an external source like a financial institution. On the other hand, a record viewed on blockchain may not be quite as good evidence unless the reliability of the blockchain has been confirmed. The auditor also needs to consider ownership and valuation through other tests. The evidence that a security exists is not the only consideration. A confirmation or statement does not provide information about valuation or ownership.

External confirmations can be very useful for more than account balances. The auditor might request confirmation of terms and conditions or even the absence of other accounts. For example, a bank confirmation will provide a balance (existence) but can also provide evidence of additional accounts that might be open or liabilities that the entity may or may not have disclosed.

Example: An audit senior was testing revenue and accounts receivable. She sent out confirmations to the largest accounts to determine whether the balances existed. She also evaluated subsequent receipts to evidence the amount being paid and that it existed at the balance sheet date. Confirmations and subsequent receipts are also supportive evidence for rights and obligations. The audit manager asked her to go back and perform a test of valuation by looking at the aging report and evaluating how many of those balances were paid. She also asked her to look in hindsight to determine if the allowance for bad debts was adequate in the prior year. Finally, she asked her to consider the aging of the receivables given the historical knowledge of the client's ability to estimate as well as any current conditions identified during the risk assessment process. These procedures, however, did not test completeness of revenue and receivables. The auditor generally tests debit balances (receivable) for overstatement and credit balances (revenue) for understatement. Analytical procedures are very helpful in this regard. The manager helped the senior auditor to develop an appropriate analytical procedure.

2. Reliability

The reliability of information is affected by accuracy, completeness, authenticity, and the risk of bias.

a. **Internal controls** – The auditor's judgment and professional skepticism play a significant role in his/her consideration of reliability. The auditor should consider that information is more reliable when controls over its accumulation, preparation and maintenance have been tested. Note that this information could be tested by the external auditor or if the information is accumulated, prepared and maintained at a service organization, then a combination of the service organization's auditor and the user auditor (complementary user controls).

Evidence accumulated in testing internal controls could be derived from written records such as board of director meeting minutes, observation by the auditor, evidence in documentary form such as an approval of an invoice, or orally. It is always appropriate to obtain oral explanations for how a control is performed. Corroboration of an assertion by an employee by an internal or external third party is helpful. But oral evidence alone is not as persuasive as review of documents or observation.

Tests of controls are required when information is only available in electronic form or in cases where substantive testing alone would not provide sufficient evidence.

b. **Accuracy and Completeness** – Evidence should be tested for completeness and accuracy. Before choosing a sample, the auditor should reconcile the population from which the sample is chosen to the general ledger to ensure completeness. Tests of controls also provide evidence about completeness.

An auditor may also use information developed outside of the financial reporting system as audit evidence. The auditor could use the entity's performance measures for substantive analytical procedures (SAP). To ensure that the report with the performance measures is accurate and therefore precise enough to use in an SAP, tests of controls or tests of accumulation of information could be needed.

Example: The sales department at a client provided an auditor with a scanned version of an executed sales contract. Since the contract was not an original the auditor considered whether it would be more effective and efficient to confirm key terms with the third party or test the operating effectiveness of internal controls around the operating effectiveness of the execution of the original contract and maintenance of the scanned version.

c. **Authenticity** – Auditors are required to consider the possibility of fraud in a financial statement audit. Auditors are not authentication experts but if there is suspicion that a document may be fraudulent the auditor will address this by corroborating the evidence by other means.

Example: An auditor was aware that the client scanned or obtained many source documents electronically in order to save storage space and reduce the entity's footprint. During the audit of investments, she noted that the investment statement looked as if it could be altered. Since investments were not material to the balance sheet and were deemed to be of less risk since they were all publicly traded, the auditor generally obtained the end of the year statement and used it for testing rather than confirming the balance. The auditor asked the controller to sit with her and she went to the client's portal to obtain the source document herself. She downloaded the document and compared it to the client's copy. She discovered that one of the balances at the bottom of one page was altered so that the balance of investments was lower by $10,000. This caused her to perform further procedures.

d. **Risk of bias** – The risk of bias is present in all audits, particularly as it relates to estimates. There are two forms of bias, management bias and auditor bias.

e. **Management bias** – There is a higher risk of management bias when information comes from internal sources. There are several considerations here:

- The ability of the entity to influence the external information source;
- Management's selection of information so that it "proves" management's assertions; and
- Management's unknowing use of information from an external source that is biased.

Example: An auditor was considering an estimate for the valuation of alternative investments prepared by the client. The client prepared a memo supporting each one of the investments citing industry information on rates of return, earnings of the companies in venture funds, and the views of investment fund managers. The partner on the engagement realized that this estimate had more risk of bias either because the client chose reports that were favorable to the investments to support the valuation or because management did not adequately challenge information provided to them by the fund managers. The auditor realized a high degree of skepticism and verification of sources would be necessary to reduce the risk of bias.

f. **Auditor bias** – Auditor's bias may actually be more challenging to address. The auditor's judgment may be hampered by:

- **Availability bias** – The auditor chooses information that is easily retrievable as being more likely, more relevant, and more important for a judgment.
- **Confirmation bias** – The auditor looks for information that is consistent with initial beliefs or preferences.
- **Overconfidence bias** – The auditor overestimates his/her ability to make accurate assessments. For example, in the case of complex financial instruments the auditor does not seek outside assistance to assist in evaluating an assertion.
- **Anchoring bias** – The auditor assesses an account balance by starting with a number and not adjusting far enough away from the initial value.

Example: An auditor was performing an SAP on payroll during an audit. He began with the prior year balance of payroll expense, divided it by the prior year number of employees, and multiplied it by the current year number of employees. He also adjusted the resulting balance for the average raise received by the employees. He concluded on the workpaper that the amount of the client's payroll balance was "reasonable" although his calculation was off by twice the entity's materiality.

Since there was a significant deviation from the general ledger balance, the manager on the engagement suggested he talk to the human resource director to determine if the larger raises were given to more highly compensated people and identify the salaries of the new hires and compare them to the average salary calculated in the SAP.

D. Sources of evidence

The top of the evidence cube identifies these five sources of evidence:

- From management – Generated internally from the financial reporting system;
- From management – Generated outside the financial reporting system, including from sources external to the entity;
- From management – Obtained from management's specialists;
- Auditor – Obtained from sources external to the entity; and
- Auditor – Developed from sources internal or external to the entity.

The auditor may use one or more of the sources identified above.

> ***Example:*** An auditor of an entity with a defined benefit pension plan was evaluating audit evidence used by management in their estimate of the accumulated benefit obligation. Some of the information involved in the calculation was generated internally from the financial reporting system. Other information was provided by an actuary, who was considered one of management's specialists. The auditor tested that information by obtaining, understanding, and testing the accumulation of data provided to the actuary by management. Then the auditor tested the information provided by the actuary using the audit guidance in AU-C 620, *Use of an Auditor's Specialist*, that is relevant when management uses a specialist.

1. Internal information – Data analytics and methodologies used in auditing

In the past much of the internal information requested by an auditor consisted of source documents such as checks, invoices, contracts, ledgers, journal entries, spreadsheets, cost allocations, computation, reconciliations and disclosures. And most of it was in paper form. With the many advances over the years in information technology, a significant amount of evidence is now in electronic form either having been transmitted to or from the client electronically or scanned in when received. Other internal forms of data might come from outside accounting in the form of sales, marketing or other system generated reports.

Auditors traditionally performed manual testing of internal controls and substantive testing along with straightforward analytical procedures using computer aided audit techniques. However, as companies and their systems and processes have become more complex and clients embrace newer technologies, auditors are, in many cases, expected to do the same.

Audit data analytics is described as a technique that analyzes patterns, identifies anomalies or extracts information from data through analysis, modeling or visualization. Some of the data used in these tests is financial and some is operational. For example, if an auditor wants to test retail sales by regression analysis, he/she may obtain information about square feet in the retail store and sales prices from management (internal) and changes in the consumer price index (external).

Typical uses of the automated techniques in the past have been to:

- Foot journals and ledgers to determine accuracy;
- Choose journal entries;
- Scan data to identify anomalies;
- Identify samples for testing; and
- Perform regression analysis.

Auditors may want or even need to be able to perform more sophisticated data queries and then portray the data visually so that patterns can be seen more easily. Data analytics can be used effectively for those purposes. This adds value to the auditor's work and also adds value to the client. These more sophisticated analytics are not without risk. If the data is not relevant and reliable the test will not provide appropriate evidence. Auditors need to consider the need for tests of controls or tests of accumulation of information to provide evidence of reliability of the data used. They also need to be skilled in understanding the client's business to ensure that the right data is used. They also need to be skilled in the application used to perform the test.

Audit data analytics is by far the most widely accepted of the newer audit methodologies. SAS 142 mentions other techniques that can be used by auditors but does not go into detail describing them. These are briefly described here:

- **Artificial Intelligence** (AI) is a set of algorithms that perform work that traditionally requires human intelligence. The algorithms are created to classify, analyze, and draw predictions from data. There are a number of different AI applications that involve acting on data, learning from new data, and improving predictability over time. AI can be simple or very complex. Some of the simpler examples are Google Search, Alexa, Siri and other personal assistants, and image recognition software.
- **Machine learning** is a type of AI. Machine learning feeds a computer with data and uses statistical techniques to help it "learn" how to get progressively better at a task. For example, if a user feeds a computer with large amounts of data on sales and advertising dollars spent, machine learning is used to see the patterns in data and make predictions of future sales based on dollars spent. Another useful application is the use of computer vision to read and analyze complex contracts.
- **Robotic process automation** is a technology application that automates routine business. An entity can use this tool to capture and interpret applications for processing transactions, manipulating data, triggering responses, and communicating with other digital systems. Applications of RPA can be very simple. For example, a robot can be created that generates an automatic response to an email. Some applications take routine business processes and automate them. For example, RPA can be constructed to take an electronic invoice, match it to a purchase order and receiving documents and either approve or reject it until discrepancies can be resolved. Auditors can use RPA to streamline repeatable processes as well.
- **Remote observation** tools such as drones can be used for many applications such as to count inventory in difficult to reach places.

Automated techniques may also be used both as risk assessment procedures and as substantive procedures concurrently if the objectives of both types of procedures are achieved.

2. External information

External information can be more challenging to test since the auditor may have less access to determine reliability and may be biased to believe that since the information is external to the client it is automatically reliable.

As defined earlier in this chapter, external information sources develop information that is available for use by a broad range of users. An external source is **not** a management's specialist, a service organization, or an auditor's specialist. External sources could be pricing services, governments, central banks, stock exchanges, media, or academic journals.

The auditor may consult these sources to obtain:

- Prices and pricing-related data;
- Macroeconomic data, such as historical and forecast unemployment rates and economic growth rates, or census data;
- Credit history data;
- Industry-specific data, such as an index of reclamation costs for certain extractive industries or viewership information or ratings used to determine advertising revenue in the entertainment industry;
- Mortality tables used to determine liabilities in the life insurance and pension sectors; and
- Documents or records on websites or in databases or distributed ledgers.

An entity or individual acting as a specialist or service organization may fill more than one role and professional judgment may be necessary to determine the capacity in which the person or organization is acting at a particular time.

Example 1: Actuaries are frequently involved in valuations, for example pension liabilities or claims payable. Acting in this capacity the actuary is not an external source. But when actuarial firms publish data on mortality or other such information they are functioning as external sources.

Example 2: Certain valuation specialists use models such as Black Scholes to estimate the valuation of derivative instruments since there is no observable market. If that entity is engaged to provide specific valuations and gives information to management for use in the entity's financial statements, then that entity is functioning as management's specialists. However, if the valuation company prepares information and provides it to the public and the entity takes and uses that information in its own estimation methods then the company would be considered an external source.

The auditor will need to consider the relevance and reliability of the information no matter whether it was obtained by management or the auditor. With external information the auditor considers:

- Information about the external information source or the preparation of the information by the external information source;
- Audit evidence obtained through designing and performing further audit procedures;
- Why management or, their specialist uses an external information source, and how the relevance and reliability of the information was considered so that the auditor can consider those attributes or variables;
- The nature and authority of the external information source;
- The ability of management to influence the information obtained, through relationships between the entity and the external information source;
- The competence and reputation of the external information source with respect to the information;
- Past experience of the auditor with the reliability of the information provided by the external information source;
- Evidence of general market acceptance by users of the relevance or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor;
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used;
- Whether the information is suitable for use in the manner in which it is being used;

- Alternative information that may contradict the information used;
- Nature and extent of disclaimers or other restrictive language relating to the information;
- Information about the methods used in preparing the information and how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods: and
- Information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

Should the auditor have doubts about the reliability of the information, he/she may decide to perform a comparison of the information obtained from the external source with information obtained from another independent information source. The auditor could also consider obtaining an understanding of management's controls over the reliability of external information and perhaps even test them.

If the auditor does not have a sufficient basis to consider the relevance and reliability of information from an external information source, it could mean that there is a scope limitation. If alternate evidence cannot be found, then the opinion may have to be modified.

3. Evaluating information used as audit evidence

Audit evidence can take many different forms depending on how it is accumulated. Different forms of evidence include:

- **Oral evidence** – Oral inquiries are made during the audit to internal sources such as management or to external sources such as attorneys. Inquiries are often the place the auditor starts in developing his/her understanding of the entity and its environment including internal control. Oral inquiries should be backed up with other forms of evidence.
- **Visual information** – Auditors use observation in risk assessment procedures such as understanding an entity's internal control. Observation is also used in connection with physical inventories. For example, an auditor could observe a message that appears on client personnel's computer screen evidencing restricted access to an IT application. Drones or video technology could be used as remote observation tools to facilitate inventory observations.
- **Paper documents** – Auditors will probably continue to see paper documents as forms of evidence for the foreseeable future until such time as entities embrace electronic forms of transmission. For example, executed contracts, leases, loans, and written confirmations are often presented to the auditor as paper documents.
- **Electronic information** – Many documents that at one time were presented to the auditor in paper form are now electronic and this trend will continue. Paper documents such as a paper contract can be scanned. Alternatively, some documents are executed electronically using Docusign or a similar application.
- **Data** – Data that is stored in the entity's IT system or obtained from an external source may be either manually input into the system or electronically generated. For example, there is often an electronic interface between an entity and a service organization which is used to transmit data.
- **Client records** – The auditor also inspects records that may be in paper form such as accounting entries, checks, electronic fund transfer confirmations, invoices, contracts, ledgers, journal entries, spreadsheets, cost allocations, reconciliations, and disclosures.

- **Information from published sources** – In performing procedures like regression analysis the auditor may use information from trade groups or government agencies often in combination with information from management.

Example: An auditor wanted to perform a predictive substantive analytical procedure on cost of sales of certain products. She obtained an index of product cost increases from a trade group and used that along with information provided by management on square footage of retail space and historical margin information to predict cost of sales by regression analysis.

E. Corroborative or contradictory information

The other side of the evidence cube illustrates the effect of corroborative and contradictory information. AU-C 330 states that when the auditor forms a conclusion about whether sufficient evidence has been obtained, he/she should consider **all** the evidence no matter if it corroborates or contradicts the assertions. Contradictory and corroborative information is considered together not in isolation. Sometimes the absence of information is used by the auditor and constitutes evidence.

Example 1: An auditor was auditing a financial institution with an extensive portfolio of loans secured by real estate in one geographic area. The auditor obtained industry information about the market where the real estate was located that contradicted the appraisals management gave the auditor to support the value of the collateral. The auditor had to perform additional procedures to reconcile the difference.

Example 2: An auditor was evaluating information related to management's assertions about the recorded balance of the entity's provision for warranties for a certain product. She inquired about the people handling returns of product and asked to see reports to determine the amount of sales returns during the period. She noted an absence of sales returns of the product in question which supported management's assertion about the completeness of the provision for warranties.

F. Audit procedures

The auditor obtains audit evidence by performing risk assessment procedures, tests of controls (when required or when the auditor chooses to perform them) and substantive procedures which take the form of tests of details and SAPs.

An auditor may use manual techniques or automated techniques such as audit data analytics, to process, organize, structure, or present data in a given context in order to generate useful information that can be used as audit evidence.

These days some information may be available only in electronic form or only at certain points or periods in time. This can impact the auditor's testing strategy. If the entity's data retention policies are not long enough the auditor may need to request that the client retain certain information during the year so that it can be used either at a later time or the auditor may choose to perform procedures when the data is available. Other electronic information such as records maintained on a blockchain is available on a continuous basis during the audit. This makes it easier for auditors to use audit data analytics or artificial intelligence to obtain information about transactions on a real-time basis.

Other audit procedures performed on information may include inspection, observation, confirmation, recalculation, reperformance, analytical procedures, and inquiry. Auditors use the procedures they believe will be most effective and efficient. Some of these procedures lend themselves to either manual testing or using automated tools. Inquiry is a very important part of auditing and can lead to further testing in some areas, but auditors should be aware that inquiry alone does not provide sufficient appropriate audit evidence.

1. Controls over information to be used as audit evidence

As noted earlier, when information is transformed from its original state, whether its scanned, filmed, digitized or transformed by other means, the data may lose its reliability. Accordingly, the auditor may need to perform additional audit procedures to address the reliability of the data such as inspection of the original documents or tests of internal controls over the transformation and maintenance of the information.

Testing internal controls becomes even more important when the information is electronically initiated, recorded, processed, or reported and is only available in electronic form. Here the sufficiency and appropriateness of the evidence usually depends on the effectiveness of controls related to data accuracy and completeness. When the source documents are electronic there is more risk that the documents could be inappropriately initiated or altered, and the fraudulent activity remain undetected.

2. Inspection

Auditors have always performed physical inspection of assets and documents. Over the years, things have evolved so that the documents are now, in large part, in electronic form. An automated technique that is being used currently is artificial intelligence programs that use text recognition programs to examine documents. These programs identify items for further audit consideration.

3. Observation

Observation consists of looking at a process or procedure being performed by employees. One example is the observation of inventory. Where this can be a manual process, automated tools and techniques such as use of drones not only assist but can add accuracy to a process.

> ***Example:*** An audit firm had a client with a significant amount of inventory in several warehouses. Management began using the drones to try to solve the continued differences between the perpetual inventory and the general ledger. They used drone technology to do cycle counts every month. The drones scanned the bar codes and took video which enabled management to understand where bar codes were damaged and needed to be replaced, identified issues earlier so they could be corrected, and cut down on manual errors made when humans performed the counts. In addition, it provided better coverage since the drones could do accurate counts in difficult to reach places. The client permitted the auditors to observe the use of the technology for counts during the year and also permitted them to use the technology to take test counts themselves.

4. External confirmation

An external confirmation is a direct response knowingly provided to the auditor by a third party (the confirming party).

5. Recalculation

Recalculation consists of testing the mathematical accuracy of information. Recalculation may be performed manually or using automated tools and techniques. Auditors have been using technology to recalculate reports as well as foot the general ledger.

Example: An auditor wanted to recalculate gross margin for each product sold to use in an analytical procedure. He was able to use automated tools to make those calculations. The process saves time and improves accuracy.

6. Reperformance

Reperformance involves the independent execution of procedures or controls that were originally performed as part of the entity's internal control.

7. Analytical procedures and use of audit data analytics

Auditors frequently use analytical procedures to test revenue and expense accounts as well as some balance sheet accounts. They are also used in risk assessment to identify anomalies in data that may point to a significant risk. When used as a risk assessment procedure a visual of transactional detail can provide auditors with an illustration of the volume and dollar value of a population. If the analytic can provide sufficient precision, the same analytic could be used for both risk assessment and substantive testing. The auditor may also use audit data analytics to obtain evidence about the effectiveness of the entity's internal control.

Example 1: An auditor wanted to test automated controls over sales invoices. The system was supposed to identify errors when the invoices were out of sequence or when duplicates existed. Data analytics were used to look for these issues. Not only did this procedure test an automated control, but it also provided information about the completeness of invoices issued during the period.

Example 2: An auditor was testing entity level internal controls and obtained information from the internal audit department to support the entity's monitoring activities. He decided that the information would be good to use in a substantive analytical procedure. Before using it, the auditor evaluated the information to ensure that it was sufficiently detailed and precise to use for the secondary purpose.

Example 3: An auditor wanted to use audit data analytics as a risk assessment procedure to look for unusual transactions or events and amounts, ratios, and trends that might indicate an area of higher risk. She found it easier to spot issues by looking at visualizations of transactional detail. She prepared an analytic of sales data displayed as a visual highlighting per unit values and number of items in a population. Although the procedure was primarily performed as a risk assessment procedure, the auditor determined that it yielded sufficiently precise information, and the output could be used in a substantive analytical procedure as well.

Auditors scan the general ledger to look for significant or usual items to test. Auditors can use programs to perform data analytics that will help them extract data that meet certain parameters. This could mean transactions ending in round numbers or transactions that are right above a dollar value required for additional approval, etc. The auditor can use these tools to run Benford's law, an algorithm that predicts anomalies in a population based on the expected frequency and placement of numbers in a monetary transaction.

8. Inquiry

Inquiry consists of seeking information, both financial and nonfinancial, from knowledgeable persons within the entity or outside the entity. Auditors use inquiry throughout the audit, coupled with other audit procedures. Evaluating responses to inquiries is an integral part of the inquiry process. Corroboration helps to confirm what one person has told the auditor. Often this is used in an understanding of internal control.

G. Documentation

Audit documentation is very important in all audits but particularly where new audit techniques are used. It is highlighted by the AICPA as an important component of SAS 142. However, AU-C 230 was not amended as a result of the standard.

As in all audits, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit:

- To understand the nature, timing, and extent of the audit procedures performed to comply with professional and legal requirements; and
- To understand the results of the audit procedures performed, and the audit evidence obtained.

Documentation should include discussion of instances where significant findings or issues arose during the audit, the conclusions reached about those issues, and significant professional judgments made in reaching those conclusions.

The auditor should document:

- The identifying characteristics of the specific items or matters tested;
- Who performed the audit work and the date such work was completed; and
- Who reviewed the audit work performed and the date and extent of such review.

Abstracts or copies of significant contracts or agreements should be included in the workpapers. The auditor should document discussions of significant findings or issues with management, those charged with governance, and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place.

Since audit data analytics can yield results that are different from recorded balances, SAS 142 specifically highlights the need to document areas where these discrepancies occur, the auditor's investigation of those instances, and how the auditor addressed the inconsistency.

II. Practice exercise and suggested solution

A. Practice exercise

True or False

1. ___The standard on audit evidence is likely to result in the auditor performing tests of the completeness and accuracy of the data in reports used in performing analytical procedures.

2. ___The audit evidence standard has extensive coverage on how to audit blockchain and robotic process automation.

B. Practice exercise – Suggested solution

1. **True**. Testing the completeness and accuracy of data will be important for the audit procedures to produce reliable results.

2. **False**. The standard mentions blockchain and robotic process automation but there is no detailed audit guidance.

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Other AICPA Activity

Learning objectives

Upon completing this chapter, the reader will be able to:

- Understand the reasons why so many new standards have been issued in such a short time;
- Identify the AICPA's priorities for 2023; and
- Gain familiarity with the standards on the horizon.

I. Overview

Over the past 20 years it has become more and more evident that we live in a world that is a global marketplace for goods and services and geographic boundaries make little difference when it comes to commerce, information flow, and access to capital. Companies have become more and more global; some are headquartered in the United States (US) with foreign subsidiaries, others are headquartered overseas and have US subsidiaries. Technology played a major role in this global evolution, which has advanced in ways that in 2000, we could not have imagined. The AICPA recognized these trends and its Board of Directors formalized and approved an international strategy focusing on high priority areas such as convergence of the AICPA standards with International Standards of Auditing (ISA).

Many countries use international standards for both the audit and attestation engagements. Since they are becoming more widely accepted, practitioners in the US are finding that they need to understand and use those standards in their multinational engagements. The Auditing Standards Board (ASB) has been working with the International Audit and Assurance Board (IAASB) on professional and regulatory matters for years and continues to work with them today. They also work with the International Federation of Accountants (IFAC). The IFAC and the AICPA are sensitive to the fact that most companies in the US as well as overseas are private and have made significant effort to ensure that the needs of all sizes of companies are considered.

Realizing how important it is to align standards across countries, the ASB has successfully implemented its convergence strategy with the IAASB over the past several years while trying to minimize differences with the auditing standards issued by the Public Company Accounting Oversight Board (PCAOB). Complete convergence with International or PCAOB standards is unlikely because of the differences in companies that are served by those organizations. However, this initiative, along with the need to address emerging technologies, has led the ASB to issue several new standards over the last few years. More are in exposure draft form and in the pipeline.

SASs 142–149 are discussed in the following chapters of this manual. As a reminder, SASs 134–141 were effective beginning with December 2021 year ends. SAS 142 was effective beginning with December 2022 year ends, and SASs 143–145 are effective for December 2023 year ends. SAS 147 is effective for periods beginning on or after June 30, 2023. SAS 148 effective dates are aligned with SAS 142 and SAS 145. Early implementation is permitted for SAS 148. Finally, SAS No. 149 is effective for December 2026 year ends.

The AICPA continues to advance its initiative and, in the process, has identified these environmental drivers that form the focus for the future:

- Emerging technology and the extent of its use;
- Increasing complexity in business transactions and globalization;
- Complexity in financial reporting standards where more estimates and management judgments come into play;
- External reporting with users of financial statements asking for additional information about internal control, sustainability, cybersecurity, and governance; and
- Changing expectations of stakeholders.

II. Auditing standards update

A. New SASs effective for 2023 and beyond

In addition to those we have discussed above, the following is a summary of other updates which will be effective in 2023 or later:

- New SASs effective for 2023:
  - SAS 143 – *Auditing Accounting Estimates and Related Disclosures*.
    - Updates auditor's responsibilities related to accounting estimates; and
    - Requires a more detailed risk assessment of the estimation process.
  - SAS 144 – *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*.
    - Updates auditor's guidance when using the work of management's specialists;
    - Updated guidance on auditor's use of the work of third-party pricing services as audit evidence; and
    - Includes guidance from PCAOB standards on auditing the fair value of financial instruments.
  - SAS 145 – *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
    - Attempts to address the root causes of audit quality issues noted on peer reviews;
    - Updates requirements and guidance related to obtaining an understanding of the entity's system of internal control and assessing control risk; and
    - Provides guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

- SAS 147 – *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*.
  - Clarifies and updates the guidance related to an auditor’s inquiries of a predecessor auditor related to engagement acceptance;
  - After management authorizes the predecessor auditor to respond, auditor is required to ask predecessor auditor about suspected fraud and noncompliance with laws and regulations;
  - Requires predecessor auditor to respond in a timely matter to inquiries noted above and to state if responses are limited for unusual reasons; and
  - If auditor accepts the engagement, auditor is required to document the inquiries and responses related to fraud and noncompliance with laws and regulations.
- SAS 148 – *Amendments to AU-C Section 935, Compliance Audits*.
  - Updates AU-C section 935, *Compliance Audits*, to align with the issuance of SAS 142–145;
  - Updates requirements of compliance audits related to the auditor’s responsibility in applying requirements related to control activities;
  - Updates guidance and requirements related to identifying and assessing the risk of material noncompliance and its related documentation; and
  - Amendment relating to AU-C section 501 was effective for compliance audits for fiscal periods ending on or after December 15, 2022.
- SAS 149 – *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*.
  - Updates the requirements and guidance by providing a risk-based approach to planning and performing a group audit;
  - Defines the term “referred-to auditor” as 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. Importantly, this auditor is not part of the engagement team. Previously, this auditor would have been referred to as a component auditor. Further, the definition of a “component auditor” has been revised to note that a component auditor is part of the engagement team; and
  - Provides guidance and requirements related to equity method investments.

Chapter 5 of this course provides a detailed review of SAS 145. The information below is a quick summary of SAS 145.

SAS 145 represents a significant overhaul of the current guidance on performing an audit risk assessment under AU-C 315. Specifically, SAS 145:

- Attempts to address the root causes of audit quality issues noted on peer reviews;
- Updates requirements and guidance related to obtaining an understanding of the entity's system of internal control and assessing control risk; and
- Provides guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

SAS 145 revises guidance and requirements in the following areas related to the risk assessment process:

- A revised definition of significant risk;
- Revised requirements to evaluate the design of certain controls within the control activities component, including general information technology (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 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;
- New guidance on scalability; and
- New guidance on maintaining professional skepticism.

B. SAS effective for 2022 audits

With SASs 143–145 effective for 2023 audits, don't forget that auditors should be implementing SAS 142 on their 2022 audits. Here is a quick summary of the requirements of SAS 142; however, Chapter 3 contains a detailed review of SAS 142.

142	*Audit Evidence*	• Supersedes AU-C section 500, *Audit Evidence* and amends multiple sections. • Provides guidance related to the sufficiency of appropriate audit evidence. • Updates guidance related to automated tools and techniques utilized during risk assessment and substantive procedures. • Updates the guidance related to professional skepticism when obtaining and evaluating audit evidence. ***Note:*** An entire chapter within this course is updated to SAS 142. Auditors should examine that chapter thoroughly as SAS 142 is effective for 2022 year-end audits.

III. Attestation standards

A. SSAE No. 21, *Direct Examination Engagements*

CPAs have traditionally added value by providing an opinion based on their examination of an assertion made by the party responsible for the subject matter to which the assertion relates. These engagements are performed in accordance with the AICPA's Attestation Standards, codified in the AICPA's AT-C

Standards (AT-C standards). The AT-C standards provide guidance on common concepts related to all attestation engagements performed under the AT-C standards, level of service guidance related to examination, review, and agreed-upon-procedures (AUP) engagements, as well as guidance related to the subject matter covered by the engagement. This collective guidance can be found in sections 100, 200 and 300, respectively, of the AT-C standards.

Until recently, the common thread to the level of service provided in attestation engagements is that the party responsible for the subject matter must measure or evaluate that underlying subject matter against a set of criteria and the responsible party must provide a written assertion concerning its measurement or evaluation. Without such an assertion, a CPA cannot perform an attestation engagement under the examination AT-C standards found in section 205 of the AT-C standards.

Recognizing the challenges responsible parties may face related to making an assertion concerning new, complex, or emerging nonfinancial subject matters, the AICPA's Auditing Standards Board recently issued Statement on Standards for Attestation Engagements No. 21, *Direct Examination Engagements* (SSAE No. 21), which allows CPAs to also perform examination engagements related to the subject matter's conformity with the criteria without first obtaining the responsible party's assertion related to the subject matter's conformity to the criteria. SSAE No. 21 added AT-C 206 in the codification of AT-C Standards.

With the newly issued AT-C section 206, *Direct Examination Engagements* (Section 206) guidance, effective for attestation examination reports dated on or after June 15, 2022, a CPA can now perform an examination on such subject matter without the responsible party either measuring or evaluating the underlying subject matter against the criteria or providing a written assertion to the CPA. A CPA can perform examinations with or without the assertion of a responsible party. When an assertion is provided under AT-C 205, the engagement is referred to as an assertion-based examination engagement.

Changes in SSAE No. 21 are similar to those made to AUP engagements with the issuance of SSAE No. 19 in December 2019, which was effective for AUP reports dated on or after July 15, 2021.

1. *Engagements that might be performed under AT-C 206*

A CPA might be engaged to perform a section 206 engagement to measure the rates of return (the subject matter information) on an entity's investment transactions over a period of time (the subject matter) based on specified criteria. Other scenarios could address whether an entity's environmental, social, and governance information (ESG information) is prepared in accordance with appropriate criteria or could include an evaluation of an entity's controls related to data security, availability, processing integrity, confidentiality, and privacy against the AICPA's Trust Services Principles and Criteria.

2. *Similarities and distinctions between engagements under AT-205 and AT-206*

In performing both section 205 and section 206 engagements the CPA must follow all of the applicable AT-C standards contained in AT-C section 105, *Common Concepts to All Attestation Engagements*. This section deals with such issues as engagement preconditions, acceptance and continuance (A&C) procedures, quality control, engagement documentation, and other considerations related to all attest engagements. Further, the CPA must be independent of the responsible party and engaging party, if different, when performing the examination engagement.

The biggest distinction between section 205 and 206 engagements is their respective objectives. In a section 205 engagement, a responsible party measures or evaluates the underlying subject matter against criteria and provides the CPA with a written assertion about the outcome of the measurement or evaluation. The CPA then expresses an opinion about whether the underlying subject matter is in accordance with (or based on) the criteria, or whether the responsible party's assertion is fairly stated. In a section 206 engagement, the CPA measures or evaluates the underlying subject matter against the criteria and performs other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of that measurement or evaluation. The responsible party does not provide an assertion about the results of its measurement or evaluation of the underlying subject matter against the criteria. Practically speaking, a section 205 engagement requires an assertion from the responsible party while a section 206 engagement does not.

In a section 206 engagement, the CPA applies the other applicable requirements of a section 205 engagement, with limited exceptions. Section 206 may also require the CPA to apply certain different or additional requirements as well. These differences cover certain A&C procedures, the terms of the engagement, the contents of the representation letter, and the elements of the examination report. Before accepting a section 206 examination, the CPA should obtain an understanding of the following through inquiries of the appropriate party:

- The intended purpose of the engagement, how the CPA's report will be used, and why the engaging party wishes to engage the CPA;
- Why the responsible party has not measured or evaluated the underlying subject matter against the criteria, if such measurement has not occurred; and
- If such measurement has occurred, why the responsible party does not intend to provide an assertion related to the measurement.

The CPA should use this information, plus that from previous engagements performed for the engaging party, if any, and preliminary discussions with the engaging party to decide whether to perform the engagement.

Section 206 engagement letters also require inclusion of the following terms:

- That the responsible party is responsible for the underlying subject matter; and
- That the responsible party or engaging party, as applicable, is responsible for the following:
  - Selecting the criteria for the measurement, evaluation, or disclosure of the underlying subject matter; and
  - Determining that such criteria are suitable, will be available to the intended users, and are appropriate for the purpose of the engagement.

Also, certain representations related to the responsible party's assertion that are made in a section 205 representation letter are not applicable in a section 206 engagement and are thereby not included in a section 206 representation letter. Further, representations related to the immateriality of uncorrected misstatements and significant assumptions used in making material estimates are not required in a section 206 engagement representation letter.

Lastly, the content of the CPA's report is different in a section 206 engagement, as compared to that of a section 205 engagement. As the objectives of sections 205 and 206 engagements differ, the independent accountant's report on such engagements will be different as well. Exhibits in section 206 provide sample reports that could be issued for such engagements.

B. SSAE No. 22, *Review Engagements*

Also in 2020, the AICPA's Auditing Standards Board issued SSAE No. 22, *Review Engagements*. SSAE No. 22 supersedes section 210, *Review Engagements*, which was issued by SSAE No. 18.

SSAE No. 22 includes revisions to the guidance for attest review engagements found in AT-C section 210, *Review Engagements*, in order to conform to the same concepts in the revised AT-C 205, *Assertion-based Examination Engagements*, as a result of the issuance of SSAE No. 21, discussed above. SSAE No. 22 describes the types of procedures a practitioner may review in a review engagement performed under the AICPA's attestation standard. Further, SSAE No. 22 addresses the following:

- Clarifies for practitioners that the objective of a review engagement is to obtain limited assurance instead of being an exercise in performing analytical procedures and inquiries;
- Results in more transparent reporting by requiring that the practitioner disclose in the review report the procedures performed to obtain limited assurance; and
- Allows the practitioner to issue a report containing an adverse review conclusion when the subject matter is materially and pervasively misstated. This is consistent with the changes made to review engagements under SSARS No. 25.

The revised review report also includes the phrase specifying that the accountant is required to be independent and to meet other ethical responsibilities in accordance with relevant ethical standards, thus conforming with the revised audit opinion in SAS 134, the revised opinions on examinations performed under AT-C 205 and 206, as well as the review report found in AR-C section 90 for reviews of financial statements.

IV. SSARS No. 25

In February 2020, the ARSC issued SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions.* SSARS No. 25 amends AR-C sections 60, 70, 80, and 90.

Further, SSARS No. 25 converges AR-C section 90 with International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*, and reduces differences with the auditing standards regarding concepts that are consistent irrespective of the level of service performed on the financial statements.

A. Major topics addressed by SSARS No. 25

1. Explicit requirement to determine materiality on a review engagement

Under SSARS No. 25, accountants determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. SSARS No. 25 also requires the accountant, in obtaining sufficient appropriate review evidence as a basis for a conclusion on the financial statements as a whole, to design and perform the analytical procedures and inquiries to address all material items in the financial statements, including disclosures.

2. Allowing the accountant to issue an adverse review conclusion when financial statements are materially and pervasively misstated

Prior to SSARS No. 25, the accountant was prohibited from modifying the standard report to state that the financial statements are not in accordance with the applicable financial reporting framework (that is, an adverse conclusion). However, ISRE 2400 (Revised) provides for the issuance of an adverse conclusion.

The ARSC concluded that it would be in the public interest to allow the expression of an adverse conclusion, when appropriate; otherwise, if the accountant withdrew from the engagement, users of the financial statements may not then be made aware of such misstatements.

SSARS No. 25 includes an illustrative accountant's review report including an adverse conclusion.

3. Required statement regarding independence in the accountant's review report

SSARS No. 25 added the requirement that the accountant's review report include a statement that the accountant is required to be independent of the entity and to meet the accountant's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the review. This statement is consistent with the statement required in the auditor's report in accordance with Statement on Auditing Standards No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*.

This requirement to be independent is not new, but this explicit reference should remind accountants to review their obligations under the Code and any other applicable independence rules.

4. Going concern reporting considerations

SSARS No. 25 addressed the implications for the Accountant's Report when substantial doubt exists about the entity's ability to continue as a going concern. If, after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the accountant should include a separate section in the accountant's review report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" that:

- a. Draws attention to the note in the financial statements that discloses:
  - (i) The conditions or events identified and management's plans that deal with these conditions or events; and
  - (ii) That these conditions or events indicate that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time.
- b. States that the accountant's conclusion is not modified with respect to the matter.

5. Other reporting considerations

SSARS No. 25 also provided guidance on reporting in the following scenarios:

- Correction of a material misstatement in previously issued financial statements;
- Reporting on other legal or regulatory requirements; and
- Reporting on SPF financial statements prepared in accordance with contractual provisions.

6. Effective date of SSARS No. 25

SSARS 25 is currently effective. SSARS 25 was first effective for SSARS engagements for periods ending on or after December 15, 2021.

V. AICPA's Quality Management Project

A. Quality management standards

In May 2022, the ASB voted to issue Statement on Quality Management Standards 1 and 2 (SQMS 1 and SQMS 2, respectively), SSARS No. 26, and SAS 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards* (SAS 146). In March of 2023, SQMS 3 was issued to revise the language of QM section 10, *A Firm's System of Quality Management* to conform with SAS 149 related to group audits. The strategy is to converge with the IAASB's new suite of standards with similar names. In comments letters related to the draft SQMS 1 and 2, SSARS 26, and SAS 146, larger firm respondents tended to support the standards with some revisions, most notably concerns about the clarity of the standard's risk assessment process (SQMS 1). Various issues were raised regarding the likelihood of firms interpreting and therefore implementing this standard in various ways which could possibly cause peer review issues. In addition, they felt that some of the provisions could have unintended consequences of increasing complexity beyond what the ASB intended.

Smaller firms and state societies had issues primarily with what is termed the "self-inspection" prohibition in the monitoring and remediation section of the standard. The feeling was that this would cause smaller firms unnecessary expenses, which could not then be passed along to their clients. This concern was addressed in the final version of SQMS 1.

There were fewer issues with SQMS 2, although smaller firms had issues with the cooling off period where the engagement partner cannot serve as the quality review partner for two years, which was in the exposure draft of SQMS 2. This two-year quantitative was changed to a "facts-and-circumstances"-based decision a firm would make regarding a cooling off period.

Lastly, the effective dates of these new standards were pushed until 2025 in order to provide more time for firms to consider how the provisions would be implemented and to implement them. The effective dates are:

Standard	Effective Date
SQMS 1 *System of Quality Management*	Systems of quality management would be required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management would be required to be performed within one year following December 15, 2025.
SQMS 2 *Engagement Quality Reviews*	Effective for: • Audits or reviews of financial statements for periods beginning on or after December 15, 2025; and • Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025. An engagement in the firm's accounting and auditing practice begins when an engagement letter or other agreement to perform attest services is signed, or when the firm begins to perform the engagement, whichever is earlier.
SQMS 3 *Amendments to QM Sections 10, "A Firm's System of Quality Management" and 20, "Engagement Quality Reviews"*	Revises the language of QM Section 10 to conform with SAS 149 and also provides clarity between the definition of a resource and an information source. Effective concurrently with firm's implementation of SQMS 1 and 2, for: • Audits or reviews of financial statements for periods beginning on or after December 15, 2025; and • Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025.
SAS 146 *Quality Management for an Engagement*	Engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025.
SSARS 26 *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*	Engagements performed in accordance with SSARSs for periods beginning on or after December 15, 2025.

The main changes to QC 10, AU-C 220, and AR-C sections 60, 70, 80, and 90, the current standards, are discussed below.

<u>Suite of quality management standards</u>

Instead of one standard, the ASB created two significant quality management standards and one statement on auditing standard (SAS). The ASB believes that separating the topic of quality management from engagement quality reviews helps to underscore the importance of the engagement quality review when deemed appropriate by a firm. The separation of the standard also clarifies that an engagement quality review can be a response to quality risks for any engagement type, not just audits. The separation provides a way to differentiate the requirements for the eligibility of the engagement quality reviewer and the performance and documentation of the review.

Another way to look at the integrated standards is that SQMS 1 addresses the firm's responsibility for establishing a system of quality management, including the new quality management approach. An engagement quality review, more fully discussed in SQMS 2, is one possible response 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. SQMS 1 requires that the firm determine when an engagement quality review is an appropriate response to quality risks. SQMS 2 contains implementation requirements such as policies and procedures to ensure the quality of engagement quality reviewers and performance of engagement quality reviews.

SAS 146 (audits) and SSARS 26 (preparations, compilations, and reviews) take the quality principles down to the engagement level. It discusses how the engagement partner uses the firm's system and manages quality at the engagement level. The new standard clarifies that the engagement partner has overall responsibility for managing and achieving quality, including creating the appropriate environment for the team focused on ethics, values, and professional skepticism that contributes to a quality engagement. The engagement partner is ultimately responsible and accountable for compliance with the requirements of SAS 146 and SSARS 26.

The five standards that make up the Quality Management suite are:

- Statement on Quality Management Standards 1, *A Firm's System of Quality Management*;
- Statement on Quality Management Standards 2, *Engagement Quality Reviews*;
- Statement on Quality Management Standards 3, *Amendments to QM Sections 10, A Firm's System of Quality Management, and 20, Engagement Quality Reviews;*
- Statement on Auditing Standards No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standard;* and
- Statement on Standards for Accounting and Review Services No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services.*

While using the IAASB standard as a base, the ASB and the ARSC also incorporated elements into its standards to be responsive to issues related to engagement quality, as noted by peer reviewers and other regulators. The major issues are:

- Risks to audit quality correlated with audits, reviews, and attestation engagements performed by engagement partners who perform a low volume of such engagements.
- A need to improve firm governance and leadership and the culture and tone at the top of the firm.
- Consistency issues in the performance of engagements and a lack of focus on planning.
- Over-reliance on intellectual resources, such as third-party quality control materials, which are not sufficiently tailored to the nature and circumstances of the firm.
- Challenges experienced by smaller firms in applying the standards.

The IAASB cited certain other challenges such as overreliance on firm networks, increasing the robustness of engagement quality reviews, and emerging trends, such as ways of communicating with stakeholders.

1. SQMS 1, A Firm's System of Quality Management

Approaching quality management from a risk management standpoint

This standard emphasizes an integrated and iterative approach that focuses on assessing risk and continuous improvement. The new approach requires a firm to customize its system of quality management rather than tailor a sample document from the firm's practice aids or other sources. This is currently the norm in many firms. The firm would customize the design, implementation, and operation of its quality management system based on the risks that may have impacted engagement quality in the past as well as the nature and complexity of the firm itself. The integrated approach is intended to cause firms to focus on the quality management system as a whole rather than focus on the required components as stand-alone elements. The new standard was written to be less prescriptive so that it could be easily scalable.

The new system of quality management as set forth in proposed SQMS 1 is designed to meet 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.

The quality management system is required to address the following 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 eight components are designed to be integrated throughout the system as illustrated below. A discussion of the main changes follows.

Component 1: Risk assessment process – This component is new and is designed to cause firm leadership to assume responsibility for the establishment of quality objectives in each component with the exception of monitoring and remediation. Firms are also required to establish additional quality objectives when needed based on the nature of the firm and its engagements. The second step to the risk assessment process is to identify risks to the achievement of the objectives (quality risks). To do this the firm considers how risks arise and how often they are likely to occur and how long the risk would take to have an effect on quality and whether the firm would, in that period of time, be able to respond and

mitigate the quality risk. Based on the assessment, the firm would initiate a response. The standard specifies certain responses, but these will not be sufficient for the firm to address all of its quality risks.

The two main issues identified by respondents related to this component of quality management are discussed below.

<u>Frequent comments from respondents</u>
Where the three steps seem to be straight-forward, small-to-midsize firms are concerned that the examples in the standard related to the risks of a smaller firm with few engagement partners and shared authority and accountability not clearly defined and assigned may not be able to be overcome, resulting in quality management failures. In addition, the standard suggests that responses to quality risks could cause additional quality risks, making the standard complicated to implement. Other issues revolve around the continuous update for changes to quality risks. Small-to-midsize firms are concerned that in the midst of keeping up with their engagements during busier times resources will need to be diverted to perform this continuous update.

Component 2: Governance and leadership – 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; and
- Operational responsibility for specific aspects of the system of quality management, including compliance with independence requirements and the monitoring and remediation process.

Component 6: Resources – The current standard addresses human resources. The new standard expands that to address:

- 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; and
- Human resources, which may include people outside the firm used in engagements, including component auditors or engagement quality (EQ) reviewers who are external to the firm.

The new standard also covers the use of resources from service providers such as methodologies, IT applications, or people the firm uses in engagements and provides guidance to determine that those resources are appropriate for the intended use by the firm.

Component 7: Information and communication – The current quality standard, QC 10, does not address the need for information and communication across the system and with engagement teams. The ASB and ARSC feel this is very important to ensure an effective quality management system and effective engagement performance. SQMS 1 includes a component designed to provide guidance on this two-way mechanism to supply a continuous flow of information and communication. The standard requires the firm to implement an information system that contains processes to identify, capture, process, and maintain information. The standard is scalable, acknowledging that less complex firms with fewer personnel and direct involvement of leadership may accomplish the objective with less rigorous or detailed policies and procedures. The standard addresses both internal and external communication.

Component 8: Monitoring and remediation process – QC 10 focused on engagement-level monitoring. SQMS 1 focuses on monitoring activities, broadening the focus to the entire system of quality management. The objective of this change is for the firm to be more proactive, thereby providing a better basis for management to evaluate the system of quality management. In designing the system, leadership considers the nature, timing, and extent of monitoring activities. These are primarily driven by:

- How the system is designed;
- The nature and circumstances of the firm and the engagements it performs;
- The extent of changes to the system; and
- The results of previous monitoring activities or external inspections.

The standard includes a requirement to inspect completed engagements and for engagement partners to be inspected on a cyclical basis. (Note that the standard permits monitoring activities to include inspection of in-process engagements.) The firm uses its own inspection criteria to identify the engagements to inspect, the frequency, and which partners will be selected. The standard contains requirement for evaluating findings and evaluating deficiencies identified.

Improvements were made to QC 10 to address remediation, including how firm leadership is assured that the remediation has been implemented and the actions taken are effective.

<u>Evaluating the system of quality management</u>
The individuals assigned ultimate responsibility and accountability for the system of quality management should evaluate the system of quality management at least annually.

<u>Networks</u>
Many firms belong to networks of firms which may prescribe a set of quality control standards for their members to follow in order to promote consistency. SQMS 1 requires that if a firm is subject to network requirements or uses network services, leadership 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 firm is also required to understand the monitoring activities taken by the network, including those 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. The purpose of this requirement is so that networks will provide firms with more information.

2. SQMS 2, Engagement Quality Reviews

This standard discusses the role of engagement quality reviewers and the characteristics of those individuals necessary to fill the role as well as the individuals who will assist the reviewer. It deals with the authority, competence, and capabilities required to fill the role and highlights the need to include enough time to perform the engagement quality review.

The engagement quality reviewer is responsible for the performance of the engagement quality review, including ensuring that the work of individuals assisting in the review is appropriate. The final standard implemented a "facts-and-circumstances" approach when firms assess a cooling off period between when the engagement partner can serve as the EQR partner, mitigating feedback on the exposure draft.

The standard calls for the engagement quality review, when performed, to be completed along with the approval by the engagement quality reviewer for release prior to the release of the report.

3. Statement on Auditing Standards 146, Quality Management for an Engagement Conducted in Accordance with GAAS and SSARS 26, Quality Management for an Engagement Conducted in Accordance with SSARS

SAS 146 is an amendment of AU-C 220. SSARS 26 amends AR-C sections 60, 70, 80, and 90. It clarifies that the engagement partner is ultimately responsible for the engagement even though that person may assign certain tasks to others within the engagement team. The updates state that the engagement partner needs to be sufficiently and appropriately involved throughout the engagement as this is fundamental to providing the engagement leadership required to achieve high quality engagements. The following requirements of the engagement partner were added to reinforce this point:

- **Fulfilling leadership responsibilities**, including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks, or actions to other members of the engagement team.
- **Supporting engagement performance**, including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed.
- **"Stand-back" requirement** to determine 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 standard also includes these new requirements related to ethics:

- Understanding of the relevant ethical requirements and whether other members of the engagement team are aware of those requirements and the firm's related policies or procedures.
- Threats to compliance with relevant ethical requirements.
- Determining whether relevant ethical requirements, including those related to independence, have been fulfilled.

SAS 146 and SSARS 26 include clarifying guidance in many areas. One especially significant area is clarification on what the engagement partner needs to review, specifically significant matters and significant judgments, and formal written communications to management and those charged with governance.

VI. Updates to the AICPA Code of Professional Conduct – NOCLAR

Since its re-codification, which was effective in 2014, the AICPA Code of Professional Conduct (Code) has remained stable for several years. From 2014 to roughly 2018, the only new Code guidance issued by the AICPA's Professional Ethics Executive Committee (PEEC) dealt with the independence implications of certain hosting arrangements. However, that is now changing.

The sections below will cover PEEC guidance that was effective in 2022 and guidance that will become effective in 2023.

- ET 1.170 and 2.170.
  - Noncompliance with Laws and Regulations (NOCLAR).
- ET section 1.295.145.
  - Information Systems Services.
- ET section 1.240.070.
  - Technical Correction Related to Section 529 Plan.
- ET section 1.230.010.
  - Unpaid Fees.
- ET section 1.000.010, 1.210.010, and 1.285.010.
  - Guidance Related to Officers, Directors, and Beneficial Owners.

These updates address a cross-section of Code requirements. We'll explore each in greater detail now and discuss what's still on the PEEC's agenda.

A. Noncompliance with laws and regulations (NOCLAR)

While auditors have a responsibility under AU-C 250 to consider the impact of NOCLARs on the entity's audited financial statements, there is no specific guidance in the Code related to the responsibilities of CPAs in public practice as well as those in industry when they come across actual or suspected NOCLAR. The International Ethics Standards Board for Accountants (IESBA) does detail specific responsibilities of CPAs in such circumstances. The AICPA used these standards as a baseline when they first proposed a NOCLAR standard, modifying them for the legal and regulatory environment in which U.S. CPAs operate. After receiving feedback on this proposal, the AICPA reissued its NOCLAR guidance exposure draft in 2021. The updated draft incorporated feedback the PEEC received from the original exposure draft.

The Code interpretation defines a CPA's responsibility to report a known or suspected noncompliance with laws and regulations (NOCLAR) to those both inside and outside of the client or employer, whatever the case may be. The PEEC reissued exposure draft in February 2021, with the comment period ending in June 2021. The revised standard addresses feedback from the 2017 exposure draft.

As mentioned, the Code currently has no specific guidance for CPAs in public accounting or business who encounter actual or suspected NOCLARs. The new Ethics Interpretation converges U.S. ethics standards with IESBA sections 260 and 360, *Responding to Non-compliance with Laws and Regulations* by adding sections ET 1.170 and 2.170 (for CPAs in public practice and in business, respectively) to the Code. The guidance is effective June 30, 2023.

The Interpretation defines a NOCLAR as an act containing the following:

- Acts of omission or commission, intentional or unintentional;
- Contrary to prevailing laws or regulations; and
- Committed by the following:
  - Client;
  - Employer;
  - Those charged with governance; and
  - Management or other individuals working for or under the direction of a client or employer.

The act must have violated or is suspected of violating a law or regulation which meets either of the following criteria:

- Those generally recognized to have a direct effect on material financial statement amounts or disclosures; or
- Those which are fundamental to the operating aspects of the client or employing organization.

NOCLARs do not encompass personal misconduct unrelated to the business activities of the client or employing organization, and they are not violations which are clearly immaterial to such operations.

The Ethics Interpretation Exposure Draft was a reissue of a NOCLAR exposure draft issued in 2017. Based on respondent feedback, the following changes were made to the original draft:

- The original draft had the NOCLAR guidance applying to all professional standards. The updated guidance separates reporting requirements between attest and nonattest work;
- The updated guidance clarifies that a CPA's reporting responsibility is to the engaging entity, not the responsible entity, if those two are different. Further, the updated guidance excluded certain services from the NOCLAR notification requirements;
- Along with the updated Code guidance, the Auditing Standards Board (ASB) issued a new SAS detailing the requirements of successor auditors to inquire of predecessor auditors regarding NOCLARs once management provides authorization; and
- The updated guidance allows a CPA in business to report a NOCLAR to a regulatory body and requires a CPA in business to disclose a NOCLAR to the external auditor, under ET 2.130, Preparing and Reporting Information Rule.

B. Details of the new guidance

1. AT-C section 1.170 – Responsibilities of CPAs in Public Practice

AT-C section 1.170 details the responsibilities of CPAs in public practice to report actual or suspected NOCLARs.

Before understanding a CPA's responsibilities, let's start with discussing the objectives of the new guidance. The objectives of a CPA in public practice when responding to a NOCLAR are as follows:

- To comply with the Integrity and Objectivity Rule of the Code;
- To alert management or, when appropriate, those charged with governance of the client, to enable them to:
  - Rectify, remediate, or mitigate the consequences of the identified or suspected NOCLAR; and
  - Deter the commission of the NOCLAR when it has not yet occurred.
- To determine whether withdrawal from the engagement is necessary; and
- To comply with applicable laws, regulations, and professional standards.

The guidance emphasizes the importance of communication of the NOCLAR to senior management and/or the Board of Directors so that they can take the appropriate corrective action. As the NOCLAR relates to the entity's activities, it is the entity's responsibility, not the CPA's, to rectify it. The CPA's responsibilities are to communicate and respond to the actions, or lack of action, taken by the client.

It is important to understand when the guidance is applicable and when it is not. The PEEC actually added to the list of exceptions following its exposure draft deliberations. The interpretation applies when the CPA is performing professional services to a client and does not apply in the following scenarios:

- Personal misconduct unrelated to client's business activity;
- Noncompliance by parties other than the client, those charged with governance, management, or others working for or under the client's direction;
- Litigation or investigation engagement under SSFS No. 1;
- An engagement pursuant to which the protections set forth in IRC section 7525, or any comparable state or local statute, may apply;
- An engagement where the primary purpose is to identify, reach a conclusion regarding, or otherwise respond to a known or potential NOCLAR;
- A matter otherwise subject to the International Standards for the Professional Practice of Internal Auditing; and
- An engagement where compliance with this interpretation would cause a violation of law or regulation.

While not applicable in these circumstances, a CPA may still find the NOCLAR guidance useful on these types of engagements or situations.

Many actions can constitute a NOCLAR, so no list of potential NOCLARs would be complete. However, here are some examples of NOCLARs:

- Fraud, corruption, and bribery;
- Money laundering;
- Securities markets and trading;
- Banking and other financial products and services;
- Data protection;
- Tax and pension liabilities and payments
- Environmental protection; and
- Public health and safety.

The CPA does not need to report clearly inconsequential NOCLARs.

Ultimately, the client, its management, and governance are responsible for the prevention of a NOCLAR, as well as the response when a CPA in public practice notifies them of the existence of a NOCLAR. Specifically, management and those charged with governance are responsible for the following:

- Ensuring client's business activities are conducted in accordance with laws and regulations; and
- Identifying and addressing any in-scope NOCLAR.

<u>Responsibilities when performing financial statement attest services</u>

The NOCLAR guidance creates differing responsibilities for CPAs in practice, based on the services provided to the entity. The CPA in public practice providing financial statement attest services to the client (services resulting in the issuance of a report) is responsible for the following:

- Obtaining an understanding of the matter, including obtaining knowledge of the relevant laws or regulations sufficient to undertake the engagement; and
- Discussing with appropriate level of management or governance.

It is a matter of professional judgment with whom the CPA should discuss the matter. However, generally, the discussion should occur with an individual or group, such as the Board of Directors, at least one level above the person or group involved with the NOCLAR.

The purpose of the communication is for the CPA in public practice to advise the following:

- Rectify, remediate, or mitigate the consequences of the NOCLAR;
- Deter the commission of the NOCLAR if it has not yet occurred; and
- Disclose the matter to appropriate authorities when required by law or regulation or when considered necessary in the public interest.

In communicating a NOCLAR, the CPA in public practice should comply with all of the following:

- Applicable laws and regulations; and
- Applicable professional standards, considering the following:
    - Identifying and responding to noncompliance, including fraud;
    - Communicating with those charged with governance;
    - Consideration of the noncompliance on reporting; and
    - Communicating a former client's NOCLAR to successor auditors.

Given the sensitivity of the matter, the CPA in public practice should follow any firm consultation requirements related to such communications and consult legal counsel, as necessary.

The new guidance also addresses other circumstances the CPA in public practice may encounter. When the CPA identifying the NOCLAR is working on a group audit, the matter should be communicated to the group audit partner in accordance with AU-C section 600. Then it is the group audit partner's responsibility to take appropriate action under both the audit and ethics standards.

Based on management's or the Board's response to the communication of the NOCLAR, the engagement partner should consider whether resignation from the engagement is necessary. In assessing management's response to the communication of the NOCLAR, the engagement partner should consider the following:

- The timeliness of the entity's response;
- Whether the NOCLAR is adequately investigated; and
- The appropriateness of any action taken.

The decision as to whether to withdrawal from the engagement would be based on many factors, such as the following:

- Any applicable legal and regulatory frameworks;
- The urgency and pervasiveness of matter; and
- Any impact on an assessment of the client's integrity.

Lastly, the CPA in practice must document the following regarding the NOCLAR:

- What the matter is;
- The results of the discussion and the client's response; and
- Courses of action considered, judgments made, and decisions taken.

Responsibilities when not performing financial statement attest services

As the CPA in public practice is expected to have less direct access to management and/or the Board when performing a nonattest service for a client, the CPA's reporting responsibilities when identifying a NOCLAR when performing such engagements are less than when performing an attest engagement. However, there is a similar responsibility in both types of engagements to obtain an understanding of the NOCLAR.

When performing the nonattest service for an attest client, the CPA has the following responsibilities when identifying a NOCLAR:

- Communication of the matter to the attest partner so that partner is informed of the matter;
- Communication of the NOCLAR within the firm, directly to the attest partner; and
- Communication of the NOCLAR across the firm's network.

Once communicated, it is the responsibility of the overall attest partner to assure that both communication of the matter and appropriate follow-up occur.

When identifying a NOCLAR when providing nonattest services to a client that is not an attest client, the engagement partner should still communicate the matter, in the best manner possible. However, in that circumstance, the nonattest engagement CPA is not permitted to communicate the NOCLAR to the client's external auditor, as this would breach that CPA's confidentiality requirement as it applies to the client.

2. ET-C section 2.170 – Responsibilities of the CPA in Business

The updated guidance related to NOCLAR applies to both CPAs in public practice and CPAs working in business. Given the nature of the working relationship, the responsibilities of the CPA are different. In this section, we'll review the responsibilities of the CPA in business when the CPA identifies an actual or suspected NOCLAR.

ET-C section 2.170 sets out the responsibilities of the CPAs in business when encountering NOCLARs. The standard guides the CPA in business in evaluating the implications of the matter and possible courses of action. Note that the definition of a NOCLAR is identical to that as found in ET section 1.170.010.

However, there are certain different and/or additional considerations for such CPAs. In assessing the NOCLAR, a CPA in business should not disclose the known or suspected NOCLAR to a third party without the employer's consent unless expressly permitted under ET section 2.400.070. When reporting the NOCLAR to a regulatory authority in order to comply with applicable laws and regulations, the CPA in business should obtain an understanding of all legal or regulatory provisions that are applicable and comply with those requirements.

ET-C section 2.170 – Responsibilities for a senior accountant in business

The applicability and scope, including scope exemptions, under ET-C section 2.170 are identical to ET-C section 1.170. However, in serving the public interest, ET-C section 2.170 creates a higher expectation for senior professional accountants in business to respond to NOCLAR, as opposed to a non-senior CPA in business.

The responsibilities of a senior professional accountant when becoming aware of credible information of an actual or suspected NOCLAR are as follows:

- Obtain an understanding of the matter;
- Cause or take steps to have the matter investigated internally; and
- Discuss the NOCLAR with immediate superior, or next higher level, if immediate superior is involved with the NOCLAR.

In performing these steps, the senior professional accountant should take steps to:

- Have the matter communicated to those charged with governance;
- Comply with applicable laws and regulations;
- Have the consequences of the NOCLAR rectified, remediated, or mitigated;
- Reduce the risk of reoccurrence; and
- Seek to deter the commission of the NOCLAR.

The senior professional accountant should also disclose the matter to the entity's external auditor if it is necessary to comply with ET 2.130.030 (Obligation of the member to his or her employer's external accountant).

Based on performing the above, and after necessary internal and external consultations, the senior accountant in business should evaluate the responses of those to whom communication was made, and take further action, as necessary. In making the decision as to take further action, the senior accountant in business should consider the following:

- The legal and regulatory framework;
- The urgency of the matter;
- The pervasiveness of the matter throughout the organization;
- When the senior professional accountant continues to have confidence in the integrity of the superior;
- Whether the actual or suspected NOCLAR is likely to reoccur; and
- Evidence of actual or substantial harm to stakeholders.

Such further action includes the following, as appropriate:

- Informing management of the parent entity;
- Resigning from the entity; and
- Reporting the NOCLAR to an appropriate authority, unless prohibited by law or regulation, considering the following:
    - Whether such appropriate authority exists;
    - Whether robust and credible protections, such as whistleblowing legislation, exist; and
    - Actual or potential threats to physical safety.

Responsibilities of the non-senior accountant

The NOCLAR standard acknowledges that a non-senior accountant potentially has less influence within an organization and, as such, creates a lower responsibility related to reporting NOCLARs for such accountants. These responsibilities include the following:

- Seeking to obtain an understanding of the matter;
- Informing an immediate superior to enable the superior to take appropriate action, or one higher level, if the immediate supervisor is involved with the NOCLAR;
- Disclosing the matter to the entity's external auditor if it is necessary to comply with ET 2.130.030 (Obligation of the member to his or her employer's external accountant); and
- Potentially reporting the matter to an appropriate authority, unless prohibited by law or regulation.

Whether a senior or non-senior accountant in business, the accountant should document the following:

- The matter;
- The results of discussions with superiors, and as applicable, management, and those charged with governance;
- How the member's superiors, and, as applicable, those charged with governance, responded to the matter;
- The judgments made and the course of action taken; and
- For only a senior professional accountant, how the CPA in business is satisfied that they fulfilled their responsibilities.

3. SAS 147 – Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations

The ASB also issued SAS 147 related to governing the communications between predecessor and successor auditors related to NOCLARs at a client. The SAS is effective for financial statement periods starting June 30, 2023.

This SAS addresses the conflict between a predecessor auditor discussing a NOCLAR with successor auditor and Code section ET 1.700.001, *Confidential Client Information Rule*. SAS 147 contains the following guidance:

- Clarifies and updates the guidance related to an auditor's inquiries of a predecessor auditor related to engagement acceptance;
- If management authorizes the predecessor auditor to respond, auditor is required to ask predecessor auditor about suspected fraud and noncompliance with laws and regulations;
- Requires predecessor auditor to respond in a timely matter to inquiries noted above and to state if responses are limited for unusual reasons; and
- If auditor accepts the engagement, auditor is required to document the inquiries and responses related to fraud and noncompliance with laws and regulations.

However, if management does not authorize or limits the predecessor auditor's response to the successor auditor, the successor auditor should perform the following:

- Inquire as to the reasons; and
- Consider the implications on the client acceptance process.

VII. Updates to the AICPA Code of Professional Conduct – Nonattest services and other matters

A. ET-C section 1.295.145 – *Information System Services*

1. Overview of the new guidance

The PEEC updated section 1.295.145, *Information System Services*. The section is a subsection of the Code's overall guidance on providing nonattest services to attest clients. When complying with this specific guidance related to information system nonattest services, the CPA and/or firm should also comply with the broad requirements when providing nonattest services for an attest client, namely not performing a management function when providing the nonattest services. The revised guidance in ET-C section 1.295.145 is effective January 1, 2023.

Under the updated guidance, a firm cannot perform the following services for an attest client:

- Design or develop an attest client's financial information system (FIS);
- Make more than insignificant modifications to the source code underlying the system;
- Operate an attest client's local area network;
- Supervise client's employees in their day-to-day use of the system; or
- Perform network maintenance, support, and monitoring services for such systems.

However, a firm may perform the following services for an attest client:

- Install and configure a commercial off-the-shelf (COTS) accounting software package;
- Set up a chart of accounts;
- Provide training on such systems; and
- Design, implement, integrate, or install an information system that is unrelated to the attest client's financial reporting process.

2. Applying the new guidance

With any nonattest service, assuring your independence is paramount. This is especially so with IT services, as the independence implications of services provided are likely to last for a significant period of time.

Clearly, you cannot provide any services that violate independence rules while also performing an attest engagement, which also requires independence. Also, if you provided services that were permissible under the extant guidance in ET section 1.295.145 but are prohibited by the updated guidance, independence is not impaired if the services were discontinued by December 31, 2022.

When assessing independence, you need to assess whether management can meet their requirements under ET section 1.295. Also, in addition to the independence considerations related to the individual engagement, remember to consider the cumulative effect of nonattest services on independence. Lastly, remember to adequately document the arrangement in an engagement letter that, among other items, clearly delineates the service providers and client's respective responsibilities.

Determining whether an IT service is permissible or not can be a complex exercise, as the differences between services that do and do not impair independence can be narrow. The following is a four-step framework developed by the AICPA to assist with the assessment of whether the services impair a CPA's independence when provided to an attest client.

Step 1 – Determine if the "discrete tool exception" is applicable

While designing a tool that calculates as part of a FIS would impair independence, ET-C section 1.295.145.03 provides an independence safe harbor when the IT services involve providing the attest client with a "discrete tool." When specific conditions are met, the information system is a "tool" and not a FIS, which would not impair independence.

To meet this exception, the tool must perform a discrete calculation and the client must perform the following responsibilities, such as:

- The tool performs only discrete calculations (i.e., Excel spreadsheet);
- The attest client evaluates and accepts responsibility for the inputs and assumptions; and
- The attest client has sufficient information to understand the calculation and its result.

If these conditions are met, the discrete tool exception applies and assisting an attest client with such a tool doesn't impair independence.

Step 2 – Determining if the services are related to a FIS

Step 2 of the framework involves determining if the services provided to an attest client are related to a FIS. Remember that the design, development, and certain implementation services of a FIS are prohibited. So, determining whether a system is a FIS is a key consideration when assessing independence.

The system is not a FIS if it will only be used in connection with controlling the efficiency and effectiveness of operations. When attempting to determine the use of the system, you should ask the following questions:

- Does the system aggregate source data that is significant to the financial statements?
- Does the system aggregate source data that is significant to a financial process, such as the following:
  - Budgeting or budgeting to actual reporting;
  - Price modeling;
  - Cash flow planning and projections;
  - Inventory process; and
  - Reconciliations.
- Does the system generate data that is significant to the financial statements?
- Does the system generate data that is significant to a financial process?

If answering "no" to all four questions, the system is not a FIS. Design, development, and implementation services can be provided to the attest client without independence concerns. However, independence issues may still arise due to post-implementation services. These will be assessed in Step 4 of the framework.

Step 3 – Determine which design, development, or implementation services impair independence

ET section 1.295.145 distinguishes between the following FIS:

- Those FIS developed, distributed, maintained, and supported by the CPA or firm.
  - Design, development, or implementation of these FIS impairs independence.
- Those FIS developed, distributed, maintained, and supported by a third party:
  - These are known as third-party or COTS solutions; and
  - The attest accountant may be able to perform certain services related to COTS without impairing independence.

Common COTS solutions include the following:

- Cloud-based bookkeeping software, such as QuickBooks;
- CRM or ERP software;
- Spreadsheets; and
- Data visualization programs, such as Tableau.

So, what constitutes design and development of a FIS? The following activities would be deemed design and development activities:

- Determining how a system or transaction will function, process data, and produce results (for example, reports, journal vouchers, and documents such as sales and purchase orders);
- Providing a blueprint or schematic for the development of software code (programs) and data structures;
- Creating software code for individual or multiple modules;
- Testing software code to confirm it is functioning as designed; and
- Defining system elements and determining outputs.

If performing any of these services related to a FIS of an attest client, then independence is impaired. If not performing any of these services, then a third-party vendor is designing and developing the FIS system. However, the attest accountant must still assess their system implementation services of the FIS to completely assess their independence.

If the attest accountant is installing the system, independence will not be impaired as long as the requirements for nonattest services are met, namely that the accountant is not performing a management function.

If the attest accountant is not installing the system, they must assess whether any configuration services they perform related to the system for the attest client will impair independence. Configuration activities that would impair independence include the following:

- Designing or developing new software code or features; and
- Modifying the functionality of the software not predefined by the vendor.

Configuration activities that would not impair independence include:

- Inputting client-selected features and functionality options;
- Selecting predefined format of certain data attributes; and
- Assisting the client in understanding the various configuration options and making selections based on the client's decisions.

However, customization of a FIS, even if a COTS, will impair the attest accountant's independence. Customizing a FIS includes modifying or enhancing the features and functions beyond the options provided by the third-party vendor to the customer. Examples of customization activities include the following:

- Altering the COTS code to change or add to the system functionality; and
- Writing new code that enhances the COTS to provide additional functionality.

If the attest firm provides interface or integration services, then independence is impaired if the service involves connecting two or more systems by designing and developing software code that allows data to be passed between one or more systems. However, independence is not impaired if the interface or integration service involves the attest firm's use of third-party application programming interface (API) to interface legacy systems with new systems.

The firm must also assess the independence impact of any data-translation services it provides. If the data-translation services involve the firm designing and developing the rules or logic necessary to convert legacy system data to a format compatible with that of the new system, independence will be impaired.

However, if the firm uses a third-party vendor's application, such as an API, to convert legacy system data to a format compatible with that of the new system, independence will not be impaired. This is because the firm did not design or develop the code for the application to work.

<u>Step 4 – Consideration of post-implementation support activities</u>
Certain post-implementation support activities could also impair an attest accountant's independence. Independence considerations depend on whether the tasks performed as part of the post-implementation support constitute a management responsibility.

First, the attest account should assess whether outsourced activities represent a management responsibility. If so, then independence is impaired. In making this assessment, the attest accountant should consider the scope, scale, frequency, and duration of the services being provided.

Activities which constitute assuming a management responsibility include the following:

- Operating an attest client's network;
- Having responsibility for performing ongoing network maintenance;
- Operating or managing an attest client's help desk; and
- Having responsibility for maintaining security of the network and systems.

Ad hoc activities, providing training or advice, or limited post-implementation support do not constitute a management responsibility and would not impair independence if performed by the attest accountant.
In summary, assessing independence under ET-C section 1.295.145 can be complicated. It is best not to rush into agreeing to any services. The attest accountant should do a thorough review of the services and make sure to document the independence assessment and, in the engagement letter, the scope of services and mutual responsibilities of the attest accountant and the client.

B. Other new independence interpretations

1. Technical correction related to section 529 plans (ET 1.240.070)

Guidance states that when a covered member is the account owner of a section 529 savings plan, the covered member is considered to have a direct financial interest in an attestation client in which the section 529 plan is invested. In some cases, after the covered member has invested in a section 529 plan, the plan subsequently invests in an attest client. For the financial interest threat to be at an acceptable level, and therefore not impair the independence of the covered member, the covered member was required to:

- Transfer the account to another sponsor's section 529 savings plan.
- Transfer the account to another account owner who is not a covered member.

A technical correction was issued to note a covered member only needs to take one of these actions to reduce the financial interest threat. This correction was issued in September 2022 and had an effective date of December 15, 2014 (effective date of the original interpretation).

2. Unpaid fees (ET 1.230.010)

The Professional Ethics Division provided revised interpretations related to unpaid fees and the covered member's independence. The revision updates current guidance with a principles-based approach to considering the independence implications of fees that remain unpaid for over a year. Generally, if unpaid fees are both insignificant and less than one year overdue, there is no threat to independence. However, if unpaid fees are significant and related to services provided more than one year prior to the issue date of the current year attest report, the threats to independence are at an unacceptable level. A covered member should also consider the following when evaluating threats to independence:

- Attest client's agreement to pay the unpaid fees; and
- An assessment of factors affecting the client's ability to pay the fees.

Safeguards should be applied if the covered member believes the threats related to independence are not at an acceptable level. The guidance gives the following examples of safeguards:

- Have a qualified reviewer who has no relationship with the client review the current year attest report before issuance.
- Obtain partial payment of unpaid fees such that the remaining balance is insignificant. Collections should occur before issuance of current year attest report.
- Obtain a payment schedule for unpaid fees before issuance of current year attest report.
- Suspend work on current attest engagements and not accept new engagements with the client.

The guidance states that in some situations applying multiple safeguards is necessary. The revisions were effective as of December 31, 2022.

3. Updated guidance related to officers, directors, and beneficial owners (ET-C 1.000.010, 1.210.010, and 1.285.010)

These interpretations revised the guidance related to advocacy and familiarity threats to independence. Previous guidance indicated a firm acting as an investment adviser for an officer, director, or a 10 percent shareholder of a client was an example of an advocacy threat. A member having a close business relationship with any of the aforementioned parties was considered a familiarity threat.

This guidance has been narrowed to the following parties:

- An officer of a client;
- A director of a client with the ability to affect decision-making; and
- An individual with a beneficial ownership interest that gives the individual significant influence over the client.

The above update will change the guidance from a 10 percent shareholder to an individual with a beneficial ownership interest that gives the individual significant influence over the client. This same revision is also effective when offering or accepting gifts or entertainment from a client or an attest client.

The revisions were effective as of December 31, 2022.

C. Other ethics interpretations effective in 2022 or 2023

In addition to what we discussed above, the PEEC also issued additional updates to the Code in 2022 and 2023. The new updates deal with the following:

- Accounting standards implementation services.
    - Improved guidance regarding assisting attest clients with implementing new accounting standards. Effective date was December 31, 2022.
- Loans, acquisitions, and other transactions.
    - Implements recent SEC changes related to certain financial arrangements into the AICPA Code of Conduct. Effective date was December 31, 2022.
- Compliance audits
    - Defined ***compliance audit*** and ***compliance audit client*** and issued a revised definition for the term ***financial statement attest client.*** Update is effective for compliance audits beginning after June 15, 2023. Early implementation is allowed.

Discussion question:

Which of these new ethics interpretations do you feel will impact you the most?

SAS 145 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

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SAS 145 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Learning objectives

Upon completing this chapter, the reader will be able to:

- Identify the provisions of the new standard on understanding the entity, its environment, and assessing the risks of material misstatement; and
- Be prepared to implement the new audit standard.

I. SAS 145, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

A. Introduction

SAS 145 contains significant revisions to AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. In recent years, peer reviews have commonly identified deficiencies in auditors' risk assessment procedures. AU-C 315 was the leading source of matters for further consideration in 2020 peer reviews. The ASB is also attempting to align with the International Standards on Auditing (ISA). ISA 315, *Identifying and Assessing the Risks of Material Misstatement* became effective for audits of financial statements for periods beginning on or after December 15, 2021. The ASB utilized this updated ISA standard as a foundation for SAS 145, only deviating where necessary. Therefore, with the issuance of SAS 145, the ASB hoped to enhance the auditing standards relating to the auditor's risk assessment and further converge auditing standards with ISA standards.

SAS 145 does not change the fundamental concepts of audit risk. Rather, SAS 145 aims to improve audit quality by providing additional guidance and clarification to auditors on how to identify and assess risks of material misstatement. The ASB hopes this enhanced guidance will result in better risk assessments, which in turn will lead to improved audit quality. The standard is designed to improve the overall effectiveness and efficiency of the audit process, ultimately resulting in more reliable financial reporting. Overall, SAS 145 will result in auditors having a better understanding of an entity's internal control systems and control risk. SAS 145 provides guidance on a number of other topics that will be discussed below. Specifically, SAS 145 attempts to modernize risk assessment in relation to an entity's use of information technology. SAS 145 also amends multiple sections of the Auditing Standards Codification.

SAS 145, issued in October 2021, is effective for audits of financial statements for periods ending on or after December 15, 2023.

B. Definitions

SAS 145 contains new and revised definitions that set the foundation for this standard:

1. **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.
2. **Controls** – Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context:
    a. 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.
    b. Procedures are actions to implement policies.
3. **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.
4. **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.
5. **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.
6. **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:
    a. 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.
    b. The IT infrastructure comprises the network, operating systems, databases, and their related hardware and software.
    c. 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.
7. **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 (its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (its magnitude). The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the determination is based on inherent risk).

8. **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.
9. **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.
10. **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.
11. **Significant risk** – An identified risk of material misstatement:
    a. 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
    b. That is to be treated as a significant risk in accordance with the requirements of other AU-C sections.
12. **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:
    a. Control environment;
    b. The entity's risk assessment process;
    c. The entity's process to monitor the system of internal control;
    d. The information system and communication; and
    e. Control activities.

C. Obtaining an understanding of the entity, its environment, and the applicable financial reporting framework

As a reminder, this course is focused on SAS 145. Therefore, not every requirement in AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* is discussed below. Instead, the discussion below focuses on the major changes to AU-C 315 and other AU-C sections related to SAS 145.

SAS 145 updated the auditor's requirements related to obtaining an understanding of the entity, the entity's environment, and the applicable financial reporting framework. The new requirements require the auditor to perform risk assessment procedures to understand the following related to the entity and its environment:

a. The entity's organizational structure, ownership, and governance, and its business model, including the extent to which the business model integrates the use of IT;
b. Industry, regulatory, and other external factors; and
c. The measures used, internally and externally, to assess the entity's financial performance.

SAS 145 enhances previous guidance by requiring the auditor to understand the entity's business model. Although current AU-C 315 guidance requires that the auditor understand the nature of the entity, the auditor will now be required to have a greater understanding. The ASB states that an entity's business model describes how the entity creates, preserves, and captures financial or broader value for its stakeholders.

When attempting to gain an understanding of the business model, an auditor will need to understand the strategies of management. Strategies are dynamic but revolve around how an entity will handle future opportunities and risks. Other aspects of understanding an entity's business model include:

- The scope of the entity's activities and why it does them;
- The entity's structure and scale of its operations;
- The entity's geographical and demographic characteristics and the basis on which it competes;
- The entity's business or operating processes (for example, investment, financing, and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving, or capturing value;
- The resources (for example, financial, human, intellectual, environmental, and technological) and other inputs and relationships (for example, customers, competitors, suppliers, and employees) that are necessary or important to its success; and
- How the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders, and other stakeholders through IT interfaces and other technologies.

Previous guidance also did not include a requirement to understand how an entity's business model integrates the use of IT. An auditor is now required to understand the structure and complexity of the entity's IT environment. If the auditor does not have the knowledge base to understand a complex IT environment, the use of an IT specialist could be necessary. In many cases, entities that are not technologically advanced have very complex IT environments due to multiple legacy IT systems that are not integrated properly. SAS 145 also significantly revises understanding an entity's IT systems in relation to internal controls. We will discuss this later in further detail.

Business risks and activities of the entity are also included in an understanding of an entity's business model. However, these requirements are generally unchanged from prior guidance. Auditors should utilize Appendix A, "Considerations for Understanding the Entity and Its Business Model" when attempting to understand an entity's business model.

SAS 145 did not significantly change the guidance related to understanding the entity's accounting policies and the applicable financial framework. Based on this understanding and the understanding of the entity and its environment noted above, the auditor is required to understand how inherent risk factors affect the susceptibility of assertions to misstatement and the degree to which they do so in the preparation of the financial statements in accordance with the applicable financial reporting framework.

Many auditors will note that this has always been the goal of understanding the entity, its environment, the applicable financial reporting framework, and its accounting policies. However, SAS 145 now explicitly requires the auditor to utilize this information to understand the entity's inherent risk factors. Inherent risk factors may affect the susceptibility of assertions about classes of transactions, account balances, or disclosures to misstatement. An auditor should understand that inherent risk factors may influence the likelihood of occurrence or the magnitude of misstatement. The application guidance lists the following inherent risk factors related to the preparation of information required by the financial framework:

- **Complexity** – Occurs based on the nature of the information or the way the information is prepared.
- **Subjectivity** – Arises from inherent limitations in the ability to prepare required information in an objective manner due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements.
- **Change** – Results from events or conditions that, over time, affect the entity's business or the economic, accounting, regulatory, industry, or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information.
- **Uncertainty** – Arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation.
- **Susceptibility to misstatement due to management bias or other fraud risk factors** – Susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional.

The following table provides examples of events and conditions grouped by relevant inherent risk factor that could indicate the existence of risks of material misstatement at the assertion level.

Relevant inherent risk factor	Examples that could indicate the existence of risks of material misstatement at the assertion level
Complexity	Transactions: • Use of off-balance sheet financing and derivatives. Business model: • Multiple subsidiaries and joint ventures. Regulatory: • Operations that are subject to complex regulation.
Subjectivity	Applicable financial reporting framework: • Management has a wide range of possible accounting estimates (depreciation, construction income, and expenses).
Change	IT: • Installation of new IT systems related to financial reporting. Human resources: • Change of key personnel, including CEO, CFO, CTO. Customer loss: • Liquidity and going concern issues. Regulatory: • Investigations into the entity by regulatory or government bodies.
Uncertainty	Reporting: • Pending litigation and contingent liabilities.
Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk	Transactions: • Significant or a high number of related party transactions. • Large revenue transaction near period end. • Classification of marketable securities.

An understanding of the inherent risk factors above will assist an auditor in assessing inherent risk, which is also a new requirement of SAS 145. As introduced in SAS 143, auditors should consider inherent risk on a spectrum. The inherent risk level will vary based on how risk factors impact an assertion's chance of misstatement. Auditors should consider the intersection of magnitude and likelihood of the material misstatement. The inherent risk spectrum helps gauge the importance of a misstatement's likelihood and size. Assessing inherent risk will be discussed in detail later in this course.

D. Understanding the components of the entity's system of internal control

SAS 145 replaced the term "internal control" with "system of internal control." This change reflects the ASB's attitude that an entity's internal control system comprises five interrelated components. These components are the control environment, risk assessment process, process to monitor the system of internal control, information system and communication, and control activities. The control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control are considered indirect controls. The entity's information system and communication are typically made up of direct and indirect controls. Finally, an entity's control activities are almost always direct controls. SAS 145 includes new requirements related to identification and evaluation of specific control activities. These are discussed later in this section. The five components of the internal control system are discussed below.

1. Control environment

SAS 145 converts much of the current application guidance of AU-C 315 into explicit requirements. Through performing risk assessment procedures, the auditor is now required to understand the following related to the control environment:

- Understanding the set of controls, processes, and structures that address:
  - Management's role in promoting a strong company culture, integrity, and ethical values;
  - The distinction between governance and management and the independent oversight of internal controls;
  - The distribution of authority and responsibility within the entity;
  - The entity's strategies for attracting, developing, and retaining skilled personnel;
  - The methods employed to ensure individual accountability in pursuing internal control objectives.

Utilizing this understanding, the auditor will evaluate whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;
- The control environment provides an appropriate foundation for the other components of the entity's system of internal control considering the nature and complexity of the entity; and
- Control deficiencies identified in the control environment undermine the other components of the entity's system of internal control.

As noted above, many auditors have already been doing the new requirements when attempting to understand the control environment. However, SAS 145 explicitly requires the auditor to document the understanding and evaluation of the components listed above. Furthermore, the ASB provides new application guidance related to evaluating the control environment as it relates to IT. For example, the auditor should evaluate whether governance over IT aligns with the nature and complexity of business operations enabled by IT. The auditor should also evaluate whether the entity has hired employees that have the appropriate IT skills.

2. Entity's process for risk assessment and monitoring the system of internal control

SAS 145 does not contain any significant changes to the auditor's responsibility when obtaining an understanding of the entity's risk assessment process or the entity's process for monitoring the system of internal control. SAS 145 does include a minor revision related to the entity's process for monitoring the system of internal control. The auditor will be required to understand how the entity conducts ongoing and separate evaluations for monitoring the effectiveness of controls. This could include the following:

- The design of monitoring activities;
- The performance and frequency of monitoring activities;
- Whether management is evaluating the results of monitoring activities on a timely basis;
- How management is addressing control deficiencies; and
- How management is monitoring controls related to IT.

3. Information system and communication

The auditor's responsibilities related to understanding the entity's information system and communication will not change dramatically under SAS 145. Auditors are reminded that understanding an entity's information system is vital. An entity's information system includes the financial reporting process used to prepare the entity's financial statements, including disclosures. An entity's information system will typically conduct the following:

- Initiate, record, and manage entity transactions;
- Address incorrect transaction processing;
- Process and account for system control overrides;
- Integrate transaction data into the general ledger;
- Capture and process nontransactional financial statement information, such as asset depreciation; and
- Ensure required disclosures comply with the financial reporting framework and are accurately reported in the financial statements.

Auditors should pay special attention to the flow of information related to the entity's significant classes of transactions, account balances, and disclosures. The term "significant classes" is found in previous guidance, but SAS 145 explicitly defines it as "A class of transactions, account balance, or disclosure for which there is one or more relevant assertions." Inherent risk factors assist the auditor in identifying the significant classes of transactions, account balances, and disclosures of an entity.

SAS 145 adds one minor requirement to the auditor's responsibility of understanding how the entity communicates significant matters related to the preparation of the financial statements, the internal control system, and the information system. The new guidance requires an understanding of how the entity communicates these matters between individuals within the entity. For example, how does the CFO communicate the controller's role and responsibilities? Similar to pre-SAS 145, the auditor still needs to understand how the significant matters noted above are communicated between management and those charged with governance and with external parties. Finally, the auditor is still charged with evaluating whether the information system and communication adequately support the preparation of financial statements.

4. Control activities

SAS 145 contains significant revisions related to the auditor performing risk assessment procedures and obtaining an understanding of an entity's control activities. These updates focus on what type of controls an auditor should concentrate on, the requirements related to these controls, and controls surrounding IT. For the sake of comparison, current guidance and SAS 145 guidance are shown below.

<u>Pre-SAS 145 guidance</u>

The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.

An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT.

<u>SAS 145 guidance – guidance is in italics</u>

The auditor should identify the following controls that address risks of material misstatement at the assertion level:

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

The requirements of SAS 145 are more extensive than prior guidance. SAS 145 requires the auditor to identify and evaluate specific controls. The new requirements begin by requiring the auditor to identify controls that address a significant risk. The revised definition of "significant risk" follows.

Significant risk – An identified risk of material misstatement:

a. 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

b. That is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

As noted previously, SAS 145 has an enhanced focus on inherent risk. Inherent risk factors were discussed in a previous section, and assessing inherit risk will be covered later in this course. In general, the identification of significant risks will not be drastically different than pre-SAS 145. However, auditors are explicitly required to identify and understand control activities that management has put into place to address significant risks, even if the auditor does not plan on testing the operating effectiveness of these controls. The identification and understanding of these controls will help the auditor comprehend management's approach to significant risks. Further, an auditor may use this understanding to assist in designing substantive procedures related to significant risks as required by AU-C section 330.

b. Controls over journal entries and other adjustments as required by AU-C section 240.

Auditors are also required to identify controls over journal entries and other adjustments. This understanding should incorporate how an entity processes transactions in the general ledger. The auditor should understand the controls related to automated and manual entries. This is an opportunity for the auditor to utilize automated tools and techniques. For example, in the audit of a small entity, a spreadsheet could be created with all entries. Filters within the spreadsheet would allow the auditor to examine manual or nonstandard entries.

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

The auditor is not required to test the operating effectiveness, but if testing is planned, the auditor is first required to identify and understand these control activities. Auditors test the operating effectiveness of controls when it is not possible to obtain sufficient appropriate audit evidence through substantive procedures alone.

Other examples of when an auditor may test the operating effectiveness of controls include:

- Large volumes of routine transactions.
- System-generated reports.
- Compliance objectives when related to data used in applying audit procedures.

d. Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of risk assessment procedures in respect to risks at the assertion level.

The auditor should utilize the knowledge gained from the requirements above to decide whether it is necessary to devote further attention to other controls. Examples of other controls the auditor may select are:

- Controls addressing risks that are high on the spectrum of inherent risk but are not significant risks;
- Controls related to accounting estimates (see SAS 143); and
- Controls related to reconciling records to the general ledger.

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

For the IT applications and other aspects of the IT environment identified in the guidance above, the auditor should identify the following:

a. The related risks arising from the use of IT.

b. The entity's general IT controls that address such risks.

SAS 145 emphasizes that the auditor is required to identify risks arising from the use of IT and the controls in place to address these IT risks. Therefore, the auditor first needs to identify IT applications and other aspects of the entity's IT environment that are subject to risks related to the use of IT. SAS 145 includes application guidance that will assist the auditor in identifying these occurrences. Auditors should be familiar with Appendix E, entitled "Considerations for Understanding IT," which contains a subsection related to identifying IT applications that are subject to risks arising from the use of IT. The highlights of this appendix are presented below:

1. Understand the entity's IT environment, including the nature and extent of information-processing controls.
2. Identify IT applications that the entity relies on for accurate processing and maintaining financial information integrity.
3. Assess the importance of automated controls within the identified IT applications.
    a. If the entity is relying on automated controls or automated calculations within an IT application, it may be more likely that the IT application is subject to risks arising from the use of IT.
4. Determine if the entity has access to source code and the extent of program or configuration changes.
    a. If the entity is able to change the source code and make program changes, this could mean that the IT application is subject to a higher level of risk.
5. Understand the risk of inappropriate access or changes to data.
6. Identify system-generated reports that may be used as audit evidence (AR aging report, inventory valuation report, etc.)

a. If the auditor plans to rely on these reports for audit evidence, the IT application is most likely subject to risks arising from the use of IT.

7. Identify the data sources used by IT applications, such as databases or data warehouses.
    a. It is possible that data warehouses could be IT applications subject to elevated risk.
    b. Other aspects of an IT environment that should be considered are the operating system and the network.
8. Identify IT applications associated with highly automated and paperless transaction processing.
9. Determine the IT applications involved in the processing that are subject to risks arising from the use of IT.

The following table could assist an auditor in determining whether an IT application is subject to risks related to the use of IT.

Less likely to be subject to risks arising from the use of IT	More likely to be subject to risks arising from the use of IT
Standalone applications	Applications are integrated.
Volume of data is not significant	Volume of data is significant.
Application is not complex	Application automatically initiates transactions.
Transactions are supported by original, hard copy documentation	Application is computing complex calculations related to automated entries.
Management does not rely on an application system to process or maintain data	Management relies on an application system to process or maintain data.
Management uses system-generated reports but reconciles the reports back to hard copy documentation and verifies any automated calculations	Management relies on the application system's automated controls.
Management does not rely on automated controls or automated functionality	

Once the IT applications and other aspects of the IT environment have been identified, the auditor is tasked with identifying the risks related to the use of IT and the general IT controls that address these risks. These risks typically revolve around reliance on IT applications that are inaccurately processing data or processing inaccurate data. The table above should also help the auditor identify risks related to IT. Further examples are noted below:

- Unauthorized data access and potential consequences;
- IT personnel with excessive access privileges;
- Unauthorized changes to master files;
- Unauthorized or unaddressed changes in IT applications;
- Inappropriate manual intervention; and
- Data loss or access issues.

The auditor is next required to identify the entity's general IT controls that address the risks previously discussed. These controls will most likely be related to one of the following aspects of an entity's IT environment:

- **Applications** – Controls will depend on the application's functionality and access paths. For example, more complex controls might be needed for highly integrated applications with complex security options compared to applications supporting account balances with transaction-only access.
- **Database** – Controls will address risks related to unauthorized changes to financial reporting information. These risks may be related to direct database access or access to the database through the execution of a script.
- **Operating system** – Controls may be related to unauthorized access. Unauthorized access could result in adding unauthorized users, installing nonapproved software, installing malware, or a number of other unauthorized actions.
- **Network** – Controls might address risks arising from network segmentation, remote access, and authentication. Network controls could be relevant when entity has a significant need for remote access.

SAS 145 application guidance contains examples of general IT controls. These examples are found in the table below.

Overall goal of control activity	Specific goal of control activity	Explanation
Manage access	Authentication	Validate user credentials during access.
	Authorization	Limit user access to job-related information.
	Provisioning	Authorize new users and modify access privileges.
	Deprovisioning	Remove user access upon termination or transfer.
	Privileged access	Control administrative or powerful users' access.
	User-access reviews	Evaluate user access for ongoing authorization.
	Security configuration controls	Restrict access using key configuration settings.
	Physical access	Control physical access to data center and hardware.
Manage program changes	Change-management process	Control design, programming, testing, and migration of changes.
	Segregation of duties	Separate access to make and migrate changes in a production environment.
	Systems development/acquisition	Control initial IT application development or implementation.
	Data conversion	Control data conversion during development, implementation, or upgrades.
Manage IT operations	Job scheduling	Control access to schedule and initiate jobs affecting financial reporting.
	Job monitoring	Monitor financial reporting jobs or programs for successful execution.
	Backup and recovery	Ensure backups of financial data occur and data is accessible for timely recovery.

For each control identified, the auditor:

a. *Evaluates whether the control is designed effectively to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other controls.*

b. *Determines whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.*

The above requirements related to evaluating the design of controls and determining whether the controls have been implemented are not new to AU-C 315 guidance. However, the number of controls included in these assessments will be greater with the implementation of SAS 145. Specifically, the auditor will be required to evaluate IT controls and determine whether IT controls have been implemented. This aligns the guidance with the ASB's goal of enhancing the auditor's focus on an entity's IT environment and the related IT controls. Auditors will no longer be able to audit around an entity's IT system. An entity's IT system will be a central part of the risk assessment process under SAS 145.

Auditors should consider walk-throughs to meet the requirements noted above. Walk-through procedures typically include a combination of inquiry, observation, inspection of relevant documentation, and reperformance controls. A walk-through that follows the above guidelines is normally sufficient to evaluate the design and determine implementation of controls.

As an auditor is likely to spend more time evaluating IT controls under SAS 145, the guidance does provide relief related to automated controls. Although evaluating the design and determining the implementation of controls is not sufficient to test their operating effectiveness, the auditor may use these results as a test of the operating effectiveness for automated controls within the IT environment. If an auditor chooses to utilize the results as noted above, the auditor should be comfortable with general IT controls providing consistent operation of the automated IT controls.

E. Identifying and assessing the risks of material misstatement

SAS 145 aims to improve audit quality by providing additional guidance and clarification to auditors on how to identify and assess risks of material misstatement. The ASB hopes this enhanced guidance will result in better risk assessments, which in turn will lead to improved audit quality. The updated guidance related to identifying and assessing the risks of material misstatement will not result in major changes to audit procedures. SAS 145 instead enhances the guidance by explicitly requiring assessment of inherent risk for identified risks of material misstatement at the assertion level and requiring the auditor to assess control risk at the maximum level if the auditor does not plan to test the operating effectiveness of controls.

1. Assessing inherent risk

The concepts related to inherent risk were discussed earlier in this course; however, auditors are most likely aware of inherent risk. Audit best practices have included assessing inherent risk for many years. SAS 145 enhances the guidance by requiring a separate assessment of inherent risk and control risk.

As introduced in SAS 143, auditors should consider inherent risk on a spectrum. Once again, this is already commonly done in practice. For example, many engagement teams currently assess inherent risk at either a low, medium, or high level. Another option is to assess inherent risk on a scale of 1–10. When making the inherent risk assessment, auditors should consider the intersection of the magnitude and likelihood of material misstatement. In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur based on the related inherent risk factors. The magnitude of a misstatement is based on the qualitative and quantitative aspects of the possible misstatement. Basically, if the misstatement were to occur, what effect would it have at the assertion level?

Considering inherent risk at the intersection of the likelihood and magnitude factors is important. When both the likelihood and magnitude of a possible misstatement are high, inherent risk should be assessed at a high level. However, a risk doesn't need to have both high magnitude and likelihood to be considered higher on the inherent risk spectrum. Instead, the combination of these factors determines the risk's position on the spectrum of inherent risk. Higher inherent risk can result from various combinations, such as a lower likelihood with a very high magnitude. When assessing inherent risk, the auditor is also required to consider the risks of material misstatement at the financial statement level that could affect the assessment of inherent risk for risks of material misstatement at the assertion level.

2. Assessing control risk

The new guidance requires separate assessments of inherent risk and control risk. However, SAS 145 does not indicate a specific method for making risk assessments. Further, it is not required that the auditor conduct a combined assessment of inherent risk and control risk. The auditor should utilize their judgment on how to conduct these assessments.

Under SAS No. 145, when an auditor decides not to test the operating effectiveness of controls, control risk is required to be assessed at the maximum level. This means that the assessment of the risk of material misstatement will be equal to the assessment of inherent risk. Therefore, testing the operating effectiveness of controls will be necessary if the auditor wants to support a control risk assessment below the maximum level.

As a reminder, even if the auditor chooses not to test the operating effectiveness of controls, the evaluation of the design and determination of the implementation of controls is required. If the controls are effectively designed and implemented, the risk assessment procedures could impact the auditor's decision on the nature and timing of substantive procedures to be performed.

For example, if the auditor believes that the controls are well-designed and implemented, they may choose to conduct procedures at an interim date rather than at the period end. The choice of procedures and their timing will depend on the auditor's professional judgment and understanding of the entity's internal control environment, as well as the assessed risks of material misstatement.

F. Documentation

Audit documentation should allow an experienced auditor with no prior knowledge of the audit to comprehend the nature, timing, and extent of the risk assessment procedures, their outcomes, and conclusions. This includes understanding significant professional judgements that were made and the reasons behind them.

SAS 145 preserves audit documentation guidelines from current AU-C 315 guidance and adds the following requirements:

- Documentation of the evaluation of the design of identified controls and determination of whether such controls have been implemented; and
- The rationale for significant judgments made regarding the identified and assessed risks of material misstatement.

The following audit documentation requirements are required under current guidance and will continue to be required with SAS 145:

- The discussion among the engagement team and the significant decisions reached.
  - Best practices will include examples of applying professional skepticism in the engagement team discussion.
- Key elements of the auditor's understanding of the entity, the entity's environment, the applicable financial reporting framework, and the entity's system of internal control. This includes the sources of information from which the auditor's understanding was obtained and the risk assessment procedures performed.
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.
  - Auditors should document their rationale related to the assessment of inherent risk. However, an auditor is not required to document every inherent risk factor that was considered.

G. Other updates within SAS 145

1. Professional skepticism

Professional skepticism is emphasized throughout SAS 145. In general, auditors should always plan and perform an audit with professional skepticism. The AICPA defines professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. Per the updated guidance, the auditor utilizes the understanding of the entity and its environment and the applicable framework to provide a foundation for maintaining professional skepticism during the audit. Professional skepticism should then be applied, at minimum, in the areas noted below per the updated guidance. However, the following sections should not be considered the only areas in which an auditor applies professional skepticism. In all situations where professional skepticism is applied, it is important to document the auditor's thought process and the auditor's actions related to its application.

<u>Risk assessment procedures and related activities</u>
SAS 145 does not change the auditor's fundamental risk assessment procedures. An auditor should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for:

a. The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and
b. The design of further audit procedures in accordance with AU-C section 330.

Further, required risk assessment procedures were not changed with the issuance of SAS 145. The updated guidance does suggest utilizing automated tools and techniques to perform risk assessment procedures on large volumes of data (i.e., the general ledger). Auditors are still expected to conduct the following:

a. Inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
b. Analytical procedures; and
c. Observation and inspection.

SAS 145 explicitly requires an auditor to perform risk assessment procedures that are not biased towards obtaining corroborative audit evidence or biased towards excluding contradictory audit evidence. Though this is typical of how audit risk assessment procedures have been conducted pre-SAS 145, it is now required. The auditor should utilize professional skepticism to assist in this effort. Examples of maintaining professional skepticism in order to minimize the biases noted above include:

- Consider all information that may be used as audit evidence;
- Be aware of information that contradicts what you have previously found, and investigate it further;
- Consider information provided by management and those responsible for governance to determine its accuracy and reliability;
- Be alert to any indicators that suggest the possibility of misstatement due to fraud or error; and
- Review the audit evidence gathered to determine if it supports the assessment of the risks of significant misstatement based on the entity's nature and circumstances.

Engagement team discussion

The engagement team discussion requirements remain the same as pre-SAS 145 and are listed below.

- Engagement partner and key engagement team members should discuss the application of the applicable financial reporting framework and susceptibility of the entity's financial statements to material misstatement.
- The engagement partner should determine what information to communicate to engagement team members not at the discussion.

The ASB does update the guidance by emphasizing the importance of professional skepticism. Maintaining professional skepticism will assist the audit team in identification and assessment of the risks of material misstatement. For example, the engagement leader might discuss the specific areas of the audit that warrant high levels of professional skepticism. In response, more advanced audit team members might be involved in audit procedures related to these areas.

2. Scalability

AU-C 315 currently has application sections labeled "Considerations Specific to Smaller Entities." SAS 145 eliminates these sections; however, much of the content remains with appropriate revisions. In removing these sections, the ASB recognizes that a smaller entity does not necessarily mean a less complex entity. Therefore, the revised application guidance is referred to as "scalability considerations." SAS 145 includes application guidance specific to both less and more complex entities. Although this guidance is helpful to auditors, it should be remembered that the requirements of SAS 145 are applicable to all entities, regardless of their complexity.

As mentioned above, SAS 145 has application guidance related to scalability throughout the standard. This course provides a few examples of how auditors can utilize scalability considerations, but auditors should reference SAS 145 for a full list of the application guidance.

- Depending on their size and complexity, entities may not have formal internal control systems. However, this informality does not exclude an auditor from performing risk assessment procedures. If the entity's internal control system is present and functioning, the auditor can still assess risk by asking questions and using other methods, such as observing processes or checking documents. Examples are noted below:

    - Observing passwords being entered;
    - Observing segregation of duties; and
    - Obtaining an understanding of inventory count controls through direct observation and inquiry even if the controls are not formally documented.
- An engagement partner conducting a team discussion for a complex entity may not discuss all complex issues with the entire team. For example, it might be appropriate for the partner to discuss an entity's use of derivatives with the manager and supervisor that will perform the audit work within that section. The partner could then delegate any further discussion related to the section to the manager.
- In owner-manager entities, the auditor's understanding of monitoring the system of internal control is typically focused on how the owner is directly involved in operations. This would be acceptable for a less complex entity but not for an entity with complex processes and internal controls.
- In a complex entity, understanding the entity's communication typically involves reading policy manuals, financial reporting manuals, board minutes, and other formal documents. However, in a less complex entity, communication may consist of verbal exchanges between employees and the owner-manager.
- Control activities in a less complex entity could be directly applied by management. For example, a single manager checks all credit card purchases on a weekly basis. It would also be expected in a smaller, less complex entity that segregation of duties would not be as profound as in larger, more complex entities.
- Less complex entities may utilize commercial software for their IT purposes. The only IT person on staff could be a simple administrator who grants access to employees and installs vendor-approved updates. In these situations, an auditor could obtain an understanding of the entity's IT environment by doing the following:
    - Understanding the software and its reputation;
    - Understanding whether the client is able to change the source code of the software;
    - Understanding the nature and extent of modifications that have been made to the software; and
    - Understanding whether the data related to financial statement preparation can be directly accessed without using the IT application. The auditor should also understand the volume of data being processed.

3. Stand-back requirement

SAS 145 includes a new "stand-back" requirement related to the evaluation of the completeness of the auditor's identification of significant classes of transactions, account balances, and disclosures. The new guidance is shown below.

<u>Classes of transactions, account balances, and disclosures that are not significant but are material</u>
For material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures, the auditor should evaluate whether the auditor's determination remains appropriate.

Although discussed previously in this course, the definition of significant risk is important to this requirement and is therefore repeated below. Please reference the discussion on significant risk for further context.

Significant risk – An identified risk of material misstatement:

a. 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

b. That is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

This updated guidance will require an auditor to revisit material classes of transactions, account balances, and disclosures after gaining an understanding of the entity and its environment and assessing the risks of material misstatement. The auditor will determine if the decision not to consider these material items as significant is still appropriate. Consistent with previous guidance, materiality is in the context of the financial statements.

Finally, SAS 145 also updated AU-C section 330 to align with the new requirement stated above. AU-C section 330 will require the auditor to perform substantive procedures for each relevant assertion of each <u>significant</u> class of transactions, account balance, and disclosure, regardless of the assessed level of control risk (rather than for all relevant assertions related to each <u>material</u> class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required).

II. Practice exercise and suggested solution

A. Practice exercise

<u>True or False</u>

1. ___SAS 145 requires the auditor to conduct a combined assessment of inherent risk and control risk.

2. ___A main objective of SAS 145 is to improve audit quality through the enhancement of risk assessment procedures.

B. Practice exercise – Suggested solution

1.	**False**. SAS 145 requires separate assessments of inherent risk and control risk but does not require a combined assessment.
2.	**True**. SAS 145 does not fundamentally change the central concepts of audit risk. However, it clarifies and enhances the guidance to improve risk assessment procedures.