

Current Issues in Accounting and Auditing: An Annual Update

AAU4/25/V1-A3

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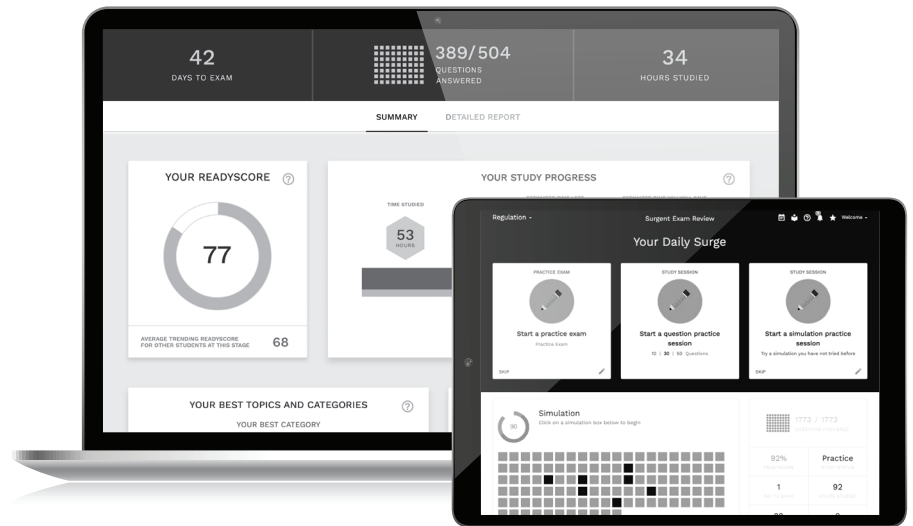
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Table of Contents

Supplement: ASU No. 2025-04

FASB Accounting Standards Updates, Including the Activities of the PCC 1

Recent AICPA, PCAOB, and SEC Activity 2

Updates to the AICPA's Quality Management Standards 3

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NOTES

Supplement: ASU No. 2025-04

<i>I. ASU No. 2025-04, Share-Based Consideration Payable to a Customer</i>	<i>1</i>
A. Reason for issuance	1
B. Entities affected	1
C. Main provisions	1
D. Effective date and transition guidance	2

Supplement:

ASU No. 2025-04

I. ASU No. 2025-04, Share-Based Consideration Payable to a Customer

A. Reason for issuance

FASB issued ASU 2025-04 to resolve diversity in practice and improve the clarity and operability of existing guidance related to share-based consideration (e.g., warrants, options, other equity instruments) granted to customers to incentivize them to purchase goods or services. Stakeholders identified uncertainty in distinguishing between service conditions and performance conditions and noted that existing policy elections for forfeiture accounting delayed revenue recognition in ways that reduced decision usefulness. Additionally, there was inconsistency in how the Topic 606 constraint on variable consideration (which is generally a reduction in revenue) was interpreted in conjunction with share-based consideration.

This ASU aims to ensure that revenue recognition reflects the economic substance of customer awards, especially when vesting is tied to purchase volume or value, and better aligns guidance for these awards with the principles of ASC 606 and ASC 718.

B. Entities affected

This Update applies to all entities, public and private, issuing share-based consideration to customers in the scope of Topic 606.

C. Main provisions

The ASU contains three main provisions within the update.

The ASU redefines the term “performance condition” in the Master Glossary to include vesting targets based on the volume or monetary amount of purchases as follows:

- a. “For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
 - (i) Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s (the customer’s) performance related to the grantor’s own operations (or activities);
 - (ii) The grantee’s purchase (or potential purchase) of the grantor’s goods or services from either the grantor or the grantor’s customers; and/or
 - (iii) A purchase (or potential purchase) of the grantor’s goods or services from either the grantee or the grantee’s customers.

The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer.”

For awards with service conditions, the ASU eliminates the forfeitures-as-they-occur election and instead requires entities to estimate forfeitures.

The amendment further clarifies that the ASC 606 constraint on variable consideration does not apply to share-based customer awards. The grantor is required to only apply Topic 718 to such scenarios.

As a result of the ASU, revenue recognition will no longer be delayed when an entity grants awards that are not expected to vest, allowing a better initial estimate of the transaction price under ASC 606.

D. Effective date and transition guidance

The ASU is effective for all entities for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026. Early adoption is permitted. Modified retrospective (default) or full retrospective adoption is permitted.

“When applying the amendments in this Update on a modified retrospective basis, a grantor should recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period of adoption and should not recast any financial statement information before the period of adoption. A grantor should apply the amendments as of the date of initial application to all share-based consideration payable to a customer.

When applying the amendments in this Update on a retrospective basis, a grantor should recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the earliest period presented. Additionally, an entity that elects to apply the guidance retrospectively should use the actual outcome, if known, of a performance condition or service condition as of the beginning of the annual reporting period of adoption for all prior-period estimates. If actual outcomes are unknown as of the beginning of the annual reporting period of adoption, an entity should use its estimate of the probability of achieving a service condition or performance condition as of the beginning of the annual reporting period of adoption for all prior-period estimates.”

FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objectives	1
I. Introduction	1
II. Key ASUs issued in 2024 and 2025	1
A. ASU No. 2025-03, Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity	1
1. Reason for issuance	1
2. Entities affected	1
3. Main provisions	2
4. Effective date and transition guidance	2
B. ASU No. 2025-02, Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122	2
1. Main provision	2
C. ASU No. 2025-01, Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date	2
1. Main provision	2
D. ASU No. 2024-04, Debt – Debt with Conversion and Other Options (Topic 470-20)	2
1. Reason for issuance	2
2. Entities affected	3
3. Main provisions	3
4. Effective date and transition guidance	3
E. ASU No. 2024-03, Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses	4
1. Reason for issuance	4
2. Entities affected	4
3. Main provisions	4
4. Effective date and transition guidance	4
F. ASU No. 2024-02, Codification Improvements – Amendments to Remove References to the Concepts Statements	5
1. Reason for issuance	5
2. Entities affected	5
3. Main provisions	5
4. Effective date and transition guidance	5
G. ASU No. 2024-01, Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards	5
1. Reason for issuance	5
2. Entities affected	6
3. Main provisions	6
4. Effective date and transition guidance	6
III. Key ASUs issued prior to 2024	6
A. ASU No. 2023-09, Income Taxes (Topic 740): Improvements to Income Tax Disclosures	6
1. Reason for issuance	6
2. Entities affected	6
3. Main provisions	7
4. Effective date	7
B. ASU No. 2023-08, Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)	7
1. Reason for issuance	7
2. Entities affected	7
3. Main provisions	8
4. Effective date	9
C. ASU No. 2023-07, Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures	9
1. Reason for issuance	9

2. Entities affected	9
3. Main provisions	9
4. Effective date	9
D. ASU No. 2023-05, Business Combinations – Joint Venture Formations (Subtopic 805-60)	9
1. Reason for issuance	9
2. Entities affected	10
3. Main provisions	10
4. Effective date	10
E. ASU No. 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method	10
1. Reason for issuance	10
2. Entities affected	10
3. Main provisions	11
4. Effective date	11
F. ASU No. 2022-06, Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848	11
1. Reason for issuance	11
2. Entities affected	12
3. Main provisions	12
4. Effective date	12
G. ASU No. 2022-05, Financial Services – Insurance (Topic 944): Transition for Sold Contracts	12
1. Reason for issuance	12
2. Entities affected	12
3. Main provisions	12
4. Effective date	12
H. ASU No. 2022-03, Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions	13
1. Reason for issuance	13
2. Entities affected	13
3. Main provisions	13
4. Effective date	13
IV. Other ASUs effective in 2025 or beyond	13
V. FASB’s technical agenda	14
A. Framework projects	15
B. Recognition and measurement projects: narrow projects	16
C. Other presentation and disclosure projects	16
VI. FASB Post-Implementation Review Report for ASC 606 – Revenue from Contracts with Customers	16
A. Overview of the PIR process	16
B. PIR timeline and objective	17
C. PIR key activities and stakeholder engagement	17
D. Implementation outcomes	18
E. Impact of ASC 606	18
F. Costs vs. benefits	19
G. Improvements to the standard-setting process	19
VII. What is next?	20
VIII. Update on the FASB’s Private Company Council	20
A. Responsibilities	20
B. Makeup of the PCC	20

FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objectives

After completing this chapter, you should be familiar with:

- Recently issued ASUs of greatest significance to smaller and medium-sized entities;
- Recently issued ASUs impacting SEC registrants and other public entities;
- Items on the FASB's technical agenda; and
- The results and findings of the FASB's Final (Stage 3) Post-Implementation Review (PIR) Report on Topic 606.

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 (ASUs) issued by the FASB in 2025, 2024, and 2023, that are effective in 2025 and beyond. It also covers ASUs issued prior with ongoing significance or application in 2025.

II. Key ASUs issued in 2024 and 2025

A. ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

1. Reason for issuance

The FASB issued ASU 2025-03 to address inconsistencies in the determination of the accounting acquirer in transactions where a variable interest entity (VIE) is acquired. Under prior guidance, the primary beneficiary of a VIE was always considered the accounting acquirer, even when the transaction was effected by exchanging equity interests. Stakeholders raised concerns about lack of comparability between VIE and non-VIE transactions, especially regarding reverse acquisitions and whether a business combination had occurred. The amendments aim to enhance consistency and comparability by allowing the same accounting acquirer assessment factors that are currently required for determining which entity is the accounting acquirer in other acquisition transactions.

2. Entities affected

This Update affects all entities involved in acquisition transactions effected primarily by exchanging equity interests when the legal acquiree is a VIE that meets the definition of a business.

3. Main provisions

The ASU modifies Topic 805 and Topic 810 to require entities to apply the same set of factors (outlined in ASC 805-10-55-12 through 55-15) to determine the accounting acquirer when:

- a. The legal acquiree is a VIE;
- b. The legal acquiree meets the definition of a business; and
- c. The transaction is effected primarily by exchanging equity interests.

Previously, the primary beneficiary was always the acquirer for VIEs; the ASU removes that automatic designation in the specific case of equity exchange transactions. The factors to consider include relative voting rights, governing body composition, senior management continuity, and size of the entities involved. The ASU does not change the accounting for reverse acquisitions or acquisitions where the legal acquiree is not a business.

4. Effective date and transition guidance

ASU 2025-03 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods. Early adoption is permitted at the beginning of any interim or annual reporting period where financial statements have not yet been issued or made available for issuance. The amendments must be applied prospectively to any qualifying acquisition transactions occurring after the initial application date.

B. ASU No. 2025-02, *Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*

1. Main provision

This Update removed the guidance related to the safeguarding of crypto assets initially issued in SAB 121 that was subsequently repealed by SAB 122.

C. ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*

1. Main provision

The amendment in this Update amends the effective date of Update 2024-03 to clarify that all public business entities are required to adopt the guidance in annual reporting periods beginning after December 15, 2026, and interim periods within annual reporting periods beginning after December 15, 2027. Early adoption of ASU 2024-03 is permitted. This ASU is discussed further in the ASU 2024-03 section.

D. ASU No. 2024-04, *Debt – Debt with Conversion and Other Options (Topic 470-20)*

1. Reason for issuance

ASU 2024-04 was issued to address and improve relevance and consistency in the application of the induced conversion guidance under Subtopic 470-20, with the largest focus being on determining if the conversion should be accounted for as an induced conversion or debt extinguishment. Current guidance was found to be inadequate, particularly after the introduction of cash convertible instruments and

changes to accounting for convertible debt instruments with cash conversion features introduced in ASU 2020-06. Current guidance also does not address how the standards should be applied to the settlement of a convertible debt instrument that does not require new equity securities to be issued upon conversion.

The Update seeks to clarify the guidance for determining whether a transaction involving the modification of a convertible debt instrument's terms (particularly a cash convertible instrument) at terms that are different from the original conversion terms should be accounted for as an induced conversion or a debt extinguishment.

2. Entities affected

This Update affects entities, public and private, that settle convertible debt instruments where the conversion privileges have been modified to induce conversion.

3. Main provisions

The main provisions of ASU 2024-04 significantly amend the guidance on induced conversions of convertible debt instruments. The changes include:

- a. **Clarification of inducement offers** – The ASU clarifies that, to account for a settlement of a convertible debt instrument as an induced conversion, the inducement offer must provide the holder with the consideration (in form and amount) that was issuable under the conversion privileges provided in the original terms of the instrument. This clarification addresses ambiguities about whether modifications to terms or the addition of new conversion incentives constitute an induced conversion or a debt extinguishment. The entity must assess this as of the date the conversion offer is accepted by the holder. If, when applying this criterion, the convertible debt instrument had been exchanged or modified (without being deemed substantially different) within the one-year period leading up to the offer acceptance date, an entity should compare the terms provided in the inducement offer with the terms that existed one year before the offer acceptance date.
- b. **Treatment of VWAP modifications** – The ASU specifies that incorporation, elimination, or changes to a volume-weighted average price (VWAP) formula or similar provision do not automatically lead to a debt extinguishment classification. Instead, an entity should assess whether the modified terms preserve the form and amount of the conversion consideration stipulated in the original terms as of the offer acceptance date.
- c. **Applicability to nonconvertible instruments** – The guidance extends to scenarios where a convertible debt instrument is not currently convertible but has a substantive conversion feature at issuance and at the time the inducement offer is accepted.

4. Effective date and transition guidance

ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for all entities that have adopted ASU 2020-06.

Entities may apply the new guidance on a prospective or retrospective basis:

- a. **Prospective application** – Entities apply the amendments to settlements of convertible debt instruments occurring after the effective date of the guidance.
- b. **Retrospective application** – Entities can recast prior periods and recognize a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented or the date the entity adopted the amendments in ASU 2020-06.

E. ASU No. 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*

1. Reason for issuance

ASU 2024-03 was issued in response to feedback from investors and other financial statement users who expressed the need for more detailed information about expenses to better understand an entity's performance, forecast future cash flows, and compare performance across entities. Specific feedback highlighted the importance of disaggregating costs of sales and selling, general, and administrative expenses (SG&A) to better understand an entity's cost structure.

2. Entities affected

The amendments in ASU 2024-03 apply to all public business entities.

3. Main provisions

The main provisions require public business entities to disclose more detailed information about their expenses in the notes to their financial statements. Specifically, entities must:

- a. Disclose the amounts of (a) purchases of inventory, (b) employee compensation, (c) depreciation, (d) intangible asset amortization, and (e) depreciation, depletion, and amortization recognized as part of oil-and gas-producing activities (DD&A) (or other amounts of depletion expense) included in each relevant expense caption. A relevant expense caption is an expense caption presented on the face of the income statement within continuing operations that contains any of the expense categories listed in (a)–(e);
- b. Include certain amounts that are already required to be disclosed under current generally accepted accounting principles (GAAP) in the same disclosure as the other disaggregation requirements;
- c. Disclose a qualitative description of the amounts remaining in relevant expense captions that are not separately disaggregated quantitatively; and
- d. Disclose the total amount of selling expenses and, in annual reporting periods, the entity's definition of selling expenses.

These disclosures are required for both interim and annual reporting periods and aim to enable investors to better understand the components of an entity's expenses, assess performance, and forecast future expenses.

4. Effective date and transition guidance

The FASB removed the initial effective date that was announced in ASU 2024-03. The effective date of ASU 2024-03 was amended shortly after issuance by ASU 2025-01 to correct for a situation where the guidance made it possible for a public business entity to apply the guidance to an interim reporting period prior to applying the guidance to an annual reporting period. Under ASU 2025-01, ASU 2024-03 is effective for public business entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within annual reporting periods beginning after December 15, 2027.

Early adoption is permitted. Entities have the option to apply the amendments either retrospectively to all prior periods presented or prospectively to new or modified transactions after the effective date.

F. ASU No. 2024-02, *Codification Improvements – Amendments to Remove References to the Concepts Statements*

1. Reason for issuance

ASU 2024-02 introduces amendments to the Codification to remove references to various FASB Concepts Statements. This action is part of the FASB's ongoing project to address suggestions from stakeholders for improvements and technical corrections to the Codification, facilitating updates for clarifications, simplifications, and minor improvements. By removing references to Concepts Statements, which are nonauthoritative, the FASB aims to clarify the Codification, correct any unintended applications of guidance, and draw a clear distinction between authoritative and nonauthoritative literature, ensuring that the Codification reflects current GAAP without implying the authoritativeness of the Concepts Statements, which are now removed.

2. Entities affected

The amendments impact various Topics within the Codification and apply to all reporting entities within the scope of the affected accounting guidance.

3. Main provisions

ASU 2024-02 seeks to refine and clarify the Codification by eliminating unnecessary references to nonauthoritative Concepts Statements, thereby enhancing the clarity and application of GAAP for all reporting entities. The main provisions of ASU 2024-02 involve the removal of references to Concepts Statements across a wide range of Codification Topics. These references are often extraneous and not essential for understanding or applying the guidance. In some cases, the references might imply the authoritativeness of Concepts Statements or refer to superseded documents, potentially leading to diverse interpretations. The amendments aim to simplify the Codification, emphasizing the distinction between authoritative guidance and conceptual frameworks that inform the FASB's standard-setting process. This clarification is expected to streamline the application of GAAP by eliminating potential confusion over the role of Concepts Statements in preparing financial statements.

4. Effective date and transition guidance

For public business entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. For all other entities, the amendments apply to fiscal years beginning after December 15, 2025. Early adoption is permitted for entities for any fiscal year or interim period for which financial statements have not yet been issued or made available for issuance. Entities adopting the amendments in an interim period must do so as of the beginning of the fiscal year that includes that interim period. The transition can be applied either prospectively to all new or modified transactions recognized on or after the date of first application or retrospectively to the beginning of the earliest comparative period presented.

G. ASU No. 2024-01, *Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*

1. Reason for issuance

The Financial Accounting Standards Board (FASB) issued ASU 2024-01 to clarify how entities should apply scope guidance in determining whether profits interest and similar awards should be accounted for under Topic 718, *Compensation – Stock Compensation*. This was in response to complexities and

diversity in practice (even for similar fact patterns) identified by the PCC regarding the accounting of profits interest awards, which are used by entities to align compensation with performance and provide participants with future profits and/or equity appreciation. The Update aims to add illustrative examples for clarity and improve consistency in applying GAAP.

2. Entities affected

The amendments affect all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services. Additionally, the amendments that clarify the scope and exceptions section of Topic 718 apply to all entities entering into share-based payment transactions.

3. Main provisions

ASU 2024-01 aims to provide clarity and reduce inconsistencies in how entities account for profits interest and similar awards, ensuring a more standardized approach across different entities and situations. ASU 2024-01 introduces an illustrative example with four fact patterns to demonstrate the application of scope guidance for determining whether a profits interest award falls under Topic 718. These examples focus on key considerations such as whether the award grants the right to equity instruments or cash payments based on the entity's share price, among other conditions. This guidance aims to reduce complexity and practice diversity by providing clear criteria for when profits interest awards should be accounted for under Topic 718. The example is comprehensive, covering cases where the awards are share-based payment arrangements and where they are not, based on various conditions like service requirements, participation in distributions, and settlement terms.

4. Effective date and transition guidance

For public business entities (PBEs), the amendments are effective for annual periods beginning after December 15, 2024, including interim periods within those annual periods. For all other entities, they are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for both interim and annual financial statements not yet issued or available for issuance. Entities can apply the amendments retrospectively to all prior periods presented or prospectively to awards granted or modified after the first application date.

III. Key ASUs issued prior to 2024

A. ASU No. 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*

1. Reason for issuance

This ASU was issued to help investors “better understand an entity’s exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities.” It will allow investors to better assess income tax information that relates to cash flow forecasts and capital allocation decisions and will also aid investors in identifying potential opportunities to increase future cash flows.

2. Entities affected

The ASU affects all entities, public and private, subject to ASC Topic 740.

3. Main provisions

The ASU improves transparency and expands what public and private entities must disclose regarding rate reconciliations, income taxes paid, amounts surrounding the disaggregation of foreign and domestic income before taxes, and income tax expense or benefit from continuing operations disaggregated by foreign, federal, and state. Public entities must disclose specific categories in the rate reconciliation and expand disclosures for all reconciling items that meet a quantitative threshold for items that are greater than or equal to 5 percent of pretax income (loss) by the applicable statutory income rate. Private entities require qualitative, not quantitative, disclosure about categories of reconciling items and tax jurisdictions that result in a “significant difference” between the statutory tax rate and the effective tax rate.

All entities must disclose “the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign taxes.” They also must disclose “the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received).” The ASU also provides that entities must disclose (1) income (or loss) from continuing operations before income tax expense (or benefit), disaggregated between domestic and foreign, and (2) income tax expense (or benefit) from continuing operations disaggregated by federal (national), state, and foreign.

Lastly, the ASU eliminates the requirement for all entities to (1) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made.

4. Effective date

ASU No. 2023-09 is effective for public entities for fiscal years beginning after December 15, 2024; for private entities, the effective date is for fiscal years beginning after December 15, 2025. Early adoption and retrospective application are permitted.

B. ASU No. 2023-08, *Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)*

1. Reason for issuance

This ASU was issued to establish balance sheet, income statement, and statement of cash flow reporting requirements for crypto assets and other intangible assets meeting the FASB's revised definition of a crypto asset. Prior to the release of the ASU, the best recommendation was for crypto assets to be classified as intangible assets subject to impairment testing and carried at cost less impairment. Gain recognition was disallowed. The ASU expands disclosure requirements for reporting holdings in crypto assets.

2. Entities affected

The ASU affects all entities holding or transacting in crypto assets.

3. Main provisions

The ASU establishes financial reporting guidelines for crypto assets. A crypto asset is defined in the standard as an asset that meets all of the following criteria to be in scope of the amendment:

- a. Meets the ASC definition of an intangible asset;
- b. Does not provide the asset holder with enforceable rights to or claims on underlying goods, services, or other assets;
- c. Is created or resides on a distributed ledger based on blockchain or similar technology;
- d. Is secured through cryptography;
- e. Is fungible; and
- f. Is not created by the reporting entity or its related parties.

The ASU establishes that intangible assets meeting the definition of a crypto asset must be reported separately from other intangible assets (further disaggregation by crypto asset is permitted). The asset must be measured and reported at fair value on the balance sheet. Changes resulting from remeasurement go directly to the income statement (or statement of activity) as a gain or loss on change in fair value from intangible assets, reported separately from other gains and losses.

The ASU further establishes disclosure requirements for entities subject to the guidance. Entities must disclose the name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually significant. For crypto assets that are subject to contractual sale restrictions, the fair value of those crypto assets, the nature and remaining duration of the restriction(s), and the circumstances that could cause the restriction(s) to lapse must be disclosed.

Other disclosures include:

- a. A rollforward, in the aggregate, of activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses.
- b. For any dispositions of crypto assets in the reporting period, the difference between the disposal price and the cost basis and a description of the activities that resulted in the dispositions.
- c. If gains and losses are not presented separately, the income statement line item in which those gains and losses are recognized.
- d. The method for determining the cost basis of crypto assets.

Annual reconciliation detailing the activity from the opening to the closing balances of crypto assets, separately listing:

- a. Additions;
- b. Dispositions;
- c. Gains included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net gain from remeasurement as included in net income for the period shall be included in the gains line; and
- d. Losses included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net loss from remeasurement as included in net income for the period shall be included in the losses line.

4. Effective date

ASU No. 2023-08 is effective for all entities for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted for annual and interim financial statements. Entities are required to make a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the period in which the entity adopts the amendment.

C. ASU No. 2023-07, Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures

1. Reason for issuance

This ASU, which only applies to public entities, was issued in response to the FASB's post-implementation review of Statement No. 131. Prior to the ASU, public entities were required to report segment revenue and profit or loss, with limited expense information disclosed. Investors wanted expanded disclosures about a segment's expenses. The ASU expands such expense disclosure requirements and updates guidance on reportable segments, including disclosure of the title and position of the chief operating decision maker (CODM) and significant expenses reported to them.

2. Entities affected

The ASU only applies to public entities subject to segment disclosure requirements.

3. Main provisions

The main provisions of the ASU focus on mandatory disclosure requirements. The public entity must disclose significant segment expenses that are regularly provided to the CODM and included in segment profit or loss. They are required to disclose and break out other segment items not included in the significant expenses, and the other items should be the difference between segment revenue and segment reported profit or loss.

Entities must continue existing reporting requirements under ASC 280. In addition to reporting segment profit and loss that is most consistent under U.S. GAAP, a public entity may report additional profit and loss measures utilized by the CODM. The entity must disclose the title and position of the CODM and describe how they use the identified segment information.

Note that the ASU applies even if the public entity has only one reportable segment.

4. Effective date

ASU No. 2023-07 is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted, and retrospective application is required for all periods presented in the financial statements.

D. ASU No. 2023-05, Business Combinations – Joint Venture Formations (Subtopic 805-60)

1. Reason for issuance

This ASU was issued as an amendment to provide clear guidance on accounting for contributions made to a joint venture, upon formation, in a joint venture's separate financial statements. Prior to the ASU, joint ventures took a diverse approach to measuring contributions at the formation date, with some electing to

account for net asset contributions at fair value and others electing to account for net asset contributions at the venturer's carrying amount. The Update now provides consistent and decision-useful guidance to investors and reduces diversity in joint venture formation accounting.

2. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. Main provisions

The ASU establishes that newly formed joint ventures should initially measure assets and liabilities at fair value as of the formation date (with fair value measurement exceptions that are consistent with business combination guidance). This approach is consistent with the accounting result that would occur if the joint venture was treated as the acquirer of a business and subject to the guidance in FASB ASC Subtopic 850, *Business Combinations*.

Disclosures for joint venture formation should occur in the period in which the formation date occurs. Note that joint venture formation disclosure requirements are different from the requirements for disclosures in a business combination.

4. Effective date

The ASU is effective prospectively for all joint venture formations with a formation date beginning on or after January 1, 2025. Joint ventures formed prior to this date may elect to apply the ASU retrospectively if sufficient information exists. Early adoption is permitted for annual and interim periods for which financial statements have not been issued or made available for issuance, either prospectively or retrospectively.

E. ASU No. 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

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

- a. Tax equity investments that an entity has elected to account for using the proportional amortization method; and/or
- b. 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.

2. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. Main provisions

Entities can elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met:

- a. It is probable that the income tax credits allocable to the tax equity investor will be available;
- b. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project;
- c. 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 non-income-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;
- d. 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; and
- e. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

Furthermore, when a reporting entity makes the referenced election related to the proportional amortization method on a tax-credit-program-by-tax-credit-program basis, the entity should disclose the following:

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

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.

4. Effective date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted.

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

1. 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.

2. 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.

3. 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.

4. Effective date

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

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

1. 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.

2. 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.

3. 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.

4. 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.

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

1. 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.

2. 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.

3. 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:

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

4. Effective date

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

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

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.

IV. Other ASUs effective in 2025 or beyond

The following table details ASUs issued by the FASB prior to 2024 that will become effective for public and nonpublic business entities in 2024 or beyond.

ASU	Title	Summary	Effective Date
ASU No. 2023-06	<i>Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative</i>	Mainly amends requirements surrounding disclosure and presentation of Codification subtopics in an attempt to align SEC mandated disclosures with FASB disclosures. 14 of the SEC's 27 referred disclosures were accepted by the FASB.	The ASU will only become effective if the SEC removes their related disclosure requirements from the regulation by June 30, 2027.
ASU No. 2023-04	<i>Liabilities (Topic 405)</i>	Mainly addresses risks unique to holding customer/client crypto assets, including technological, legal, and regulatory risks. Entities hold these assets on behalf of the users as a part of their platform offering; therefore, the entities are responsible for safeguarding the assets. Such operations present a liability, measured at fair value, to these entities that should be reflected in the financial statements.	Effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years for public business entities. For all other entities, effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.
ASU No. 2018-12	<i>Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts</i>	Changes the accounting model for long-duration insurance contracts.	Years beginning on or after December 15, 2024.

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?

V. 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:

- a. Framework projects (3);
- b. Recognition and measurement: narrow projects (11); and
- c. 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 only one framework project on its agenda: measurement. 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 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:

- a. Fair value measurement; and
- b. Defined benefit plans.

B. Recognition and measurement projects: narrow projects

There are 10 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

- a. Accounting for investments in tax credit structures using the proportional amortization method;
- b. Accounting and disclosure of software costs – Exploring ways to narrow the differences between the current internal use and external use models;
- c. Accounting for environmental credit programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits;
- d. Business combination project; and
- e. Implementation issues related to ASC 606 and ASC 842.

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:

- a. Disaggregation of income statement expenses;
- b. Statement of cash flows targeted improvements; and
- c. 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.

VI. FASB Post-Implementation Review Report for ASC 606 – Revenue from Contracts with Customers

A. Overview of the PIR process

The **Post-Implementation Review (PIR)** process is a comprehensive evaluation conducted by the Financial Accounting Standards Board (FASB) to determine whether a new accounting standard, such as ASC 606, meets its intended objectives. These objectives include providing relevant and reliable financial information to users of financial statements in a manner that justifies the costs of implementation and ongoing compliance. The PIR serves as an essential quality control mechanism embedded in the FASB's standard-setting process and is overseen by the Financial Accounting Foundation (FAF) Board of Trustees.

Objectives of the PIR process for ASC 606 include:

- a. **Determining if ASC 606 fulfills its stated purpose**, specifically evaluating whether it resolves the underlying issues that prompted its development, provides decision-useful information, is operational in practice, and has not resulted in significant unintended consequences;
- b. **Evaluating the implementation and compliance costs**, as well as the benefits realized by various stakeholders, including preparers, investors, and regulators; and

- c. **Gathering feedback to refine the standard-setting process**, particularly regarding effective date selection, coordination with other accounting guidance, and considerations for globally converged standards.

B. PIR timeline and objective

In 2014, ASC 606 was officially issued, marking the culmination of a joint project with the IASB. From 2014 to 2021, Stage 1 of the PIR process was undertaken. Stage 1 focused on monitoring the standard's implementation and providing stakeholder support.

During Stage 1, which occurs before the effective date of the standard, the FASB:

- a. Monitors practice as stakeholders prepare for initial implementation of the standard;
- b. Creates and distributes implementation guidance and other educational material; and
- c. Communicates and performs outreach with stakeholder organizations to generate interest in research activities associated with the standard.

From 2018 to 2024, Stage 2 was undertaken. This stage evaluated the actual costs and benefits of the standard post-implementation. During Stage 2, which begins after the effective date of the final standard and continues for approximately three to five years, the FASB undertakes activities to:

- a. Understand the costs that an entity incurred in applying the standard and the costs that investors and other users incurred in analyzing and interpreting the information in the standard;
- b. Understand the benefits of the standard to investors, entities, and other stakeholders; and
- c. Monitor the ongoing application of the standard.

In 2024, the last stage, Stage 3, was finalized with the publication of the summary report, reflecting a decade of data collection and analysis. In Stage 3, the FASB finalized its final report in written fashion and in a public meeting. The PIR process for ASC 606 stands out due to its scope and duration, reflecting the comprehensive changes introduced and the standard's profound impact across a diverse range of industries.

C. PIR key activities and stakeholder engagement

During the PIR process, FASB engaged with over 2,200 stakeholders, representing a broad and diverse group. As the FASB notes in its final report, "stakeholder feedback is critical to ensure timely support for high-quality implementation of the standard."

They requested and analyzed feedback from the following groups:

- a. **Investors** – Including buy-side and sell-side analysts, accounting analysts, credit rating agency professionals, lenders, and private equity firms.
- b. **Preparers** – Public and private companies, as well as not-for-profit entities, across a wide spectrum of industries and sizes.
- c. **Practitioners** – Representatives from audit and consulting firms at the international, national, and regional levels.
- d. **Other stakeholders** – Academics, state CPA societies, trade organizations, regulators, and other standard setters.

The FASB used a multi-faceted approach to gather feedback. The FASB conducted individual interviews and hosted group discussions; organized advisory group meetings, public roundtables, and stakeholder surveys; delivered webcasts and participated in conferences; and solicited and reviewed comment letters in response to exposure drafts.

As a result, the FASB issued 251 public documents, including detailed Board meeting materials, Transition Resource Group (TRG) memoranda, Exposure Drafts, and Accounting Standards Updates (ASUs). The FASB held 56 public Board meetings to deliberate on feedback and PIR updates and responded to more than 500 technical inquiries, aiding stakeholders in the application of ASC 606.

D. Implementation outcomes

Key achievements of ASC 606 as identified by the PIR process include:

- a. Developing a unified, principles-based revenue recognition model that applies broadly across all industries and transactions;
- b. Introducing comprehensive disclosure requirements, improving investor insight through enhanced revenue disaggregation and qualitative descriptions; and
- c. Achieving global convergence by aligning U.S. GAAP with IFRS 15, reducing inconsistencies for multinational organizations.

E. Impact of ASC 606

Most entities experienced minimal impact on the dollar amount of reported revenues but faced significant efforts to revise internal processes and controls. The FASB believes extensive implementation support was crucial and included TRG meetings, ASUs for clarification, and detailed Q&As.

All entities, regardless of the impact on revenue figures, undertook comprehensive reviews of contracts and revenue recognition practices. These reviews and improvements did lead to challenges.

Although overall feedback on ASC 606 was positive, stakeholders identified several areas that posed difficulties due to the increased need for professional judgment and adaptation to new principles.

Top 10 challenging areas:

1. **Licensing of intellectual property** – Determining the timing of revenue recognition and whether licenses are distinct.
2. **Identification of performance obligations** – Assessing whether promises in a contract are distinct and separable.
3. **Standalone selling price determination** – Estimating prices when not directly observable.
4. **Variable consideration constraint** – Estimating and constraining revenue based on expected outcomes.
5. **Sales/usage-based royalties** – Recognizing revenue tied to customer sales or usage metrics.
6. **Principal vs. agent assessments** – Determining control and gross vs. net presentation.
7. **Consideration payable to a customer** – Accounting for payments made to customers or third parties.
8. **Incremental costs of obtaining a contract** – Capitalization and amortization of contract-related costs.

9. **Short-cycle manufacturing revenue recognition** – Recognizing revenue over time for customized, short-cycle products.
10. **Disclosures** – Meeting the expanded requirements effectively and efficiently.

The causes of these challenges were multifaceted. First, given the complexity of revenue recognition, high levels of judgment and estimation were required, particularly in evaluating performance obligations and transaction pricing. The new standard also represented a fundamental departure from previous guidance (Topic 605), and this necessitated process and system overhauls. Additionally, the emergence of complex and hybrid business models, such as SaaS and bundled service arrangements, increased implementation complexity. Despite these challenges, stakeholders did not advocate for revisions to the core model but recommended additional guidance for specific scenarios in the future.

F. Costs vs. benefits

A key goal of the PIR process is to evaluate implementation and compliance costs relative to the benefits accrued from the standard. The FASB completed this step and identified four key benefits that arose as a result of the standard's implementation. First, investors gained deeper insights into contract structures and revenue recognition policies. Second, investors further benefited from enhanced comparability across entities, industries, and global markets, fostering better investment decisions. In short, the income statement has become more comparable. Third, preparers benefited from improved contract analysis and strengthened internal controls over revenue processes. Lastly, global convergence of standards simplified reporting for multinational entities and reduced discrepancies between GAAP and IFRS, making statements across localities more comparable.

The benefits identified came with three key reported costs. Preparers identified significant implementation costs for system upgrades, staff training, and process changes, especially where industry-specific guidance was eliminated. Investors faced initial learning costs, including model updates and analysis changes, though these were generally one-time costs. Many preparers and practitioners identified ongoing costs related to estimating variable consideration, enhanced disclosures, and maintaining robust controls. Despite these costs, "overall, stakeholders agreed that the benefits of the revenue standard outweigh its costs, especially from a long-term perspective."

G. Improvements to the standard-setting process

Key lessons from the PIR include:

- a. The need for realistic effective date planning, factoring in implementation complexity and stakeholder readiness;
- b. The importance of proactively identifying cross-cutting issues, especially those affecting multiple areas of GAAP;
- c. Recognition that early-stage TRGs could enhance guidance clarity and reduce post-issuance amendments; and
- d. Knowledge that, while beneficial, global convergence introduces added time, cost, and complexity that must be weighed carefully.

As a result, FASB instituted enhanced internal procedures to better forecast timelines and coordinate guidance across standards.

VII. What is next?

The FASB determined that ASC 606 met its core objectives: delivering a robust, consistent, and principles-based revenue recognition framework. The cost-benefit relationship aligned with initial expectations, with long-term benefits justifying the implementation effort. There is no immediate need for standard-setting changes, as ASC 606 is operational and broadly effective. “The staff has not identified any matters that warrant immediate standard-setting action on Topic 606.”

Going forward, the FASB will maintain ongoing support via the Technical Inquiry Service to address emerging questions. The Board will monitor practice developments and consider future agenda items based on evolving needs. Insights from the PIR will be incorporated into the development of future standards and implementation support strategies.

VIII. 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:

- a. 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
- b. 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 chairperson, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC chairperson is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of their 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 Jere G. Shawver, the managing partner for assurance and risk with Baker Tilly, a top 10 U.S. public accounting 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:

- a. Business combination project;
- b. Consolidation/variable interest entity (VIE) projects;
- c. Definition projects;
- d. Disclosure projects;
- e. Financial instruments projects;
- f. Emerging Issues Taskforce (EITF) projects;
- g. FASB's Agenda consultation; and
- h. Implementation issues related to 842.

Discussion question:

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

Recent AICPA, PCAOB, and SEC Activity

Learning objectives	1
I. Overview	1
II. Auditing standards update	2
A. New SASs effective for 2024, 2025, and beyond	2
1. SAS 146 – <i>Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards</i>	3
III. Attestation standards	4
A. Forthcoming standards updates	4
B. Updates to the AICPA Code of Professional Conduct – Nonattest services and other matters	4
C. Other new independence interpretations	4
1. <i>Executive or employee recruiting (ET section 1.295.135)</i>	4
2. <i>Section 529 plans (ET section 1.240.070)</i>	5
3. <i>Determining fees for attest engagements (ET section 1.230.030) and fee dependency (section 1.230.040) interpretations</i>	6
D. Other ethics interpretations effective in 2024 or 2025	7
IV. SEC and PCAOB updates	7
A. SEC update	7
1. <i>Climate disclosures</i>	7
2. <i>Safeguarding crypto assets – SAB 121 and SAB 122</i>	7
B. PCAOB update – 2024 PCAOB inspection results	8
1. <i>Introduction and overview of the PCAOB inspection process</i>	8
2. <i>Notable improvements in audit quality</i>	8
3. <i>Drivers of firm audit improvement</i>	8
4. <i>Enhancements to the inspection approach</i>	9
5. <i>Focus areas and engagement selection</i>	9
6. <i>Common deficiencies in 2024</i>	9
7. <i>Compliance with other PCAOB rules</i>	10
8. <i>Observations on quality control systems</i>	10
9. <i>PCAOB initiatives to promote audit quality</i>	10
10. <i>Final discussion of inspection results</i>	11
C. PCAOB update – New PCAOB guidance	11
1. <i>Quality Control (QC) 1000</i>	11
2. <i>AS 1000 – General Responsibilities of the Auditor in Conducting an Audit</i>	11
3. <i>AS 2310 – The Auditor’s Use of Confirmation</i>	11

Recent AICPA, PCAOB, and SEC Activity

Learning objectives

After completing this chapter, you should be able to:

- Understand recently issued AICPA and PCAOB standards and SEC rulemaking;
- Identify the AICPA's and PCAOB's priorities for 2025;
- Gain familiarity with the standards on the horizon; and
- Gain an understanding of recent PCAOB inspection results and areas of emphasis.

I. Overview

Over time, 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 and has advanced in ways that, even five years ago, 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 U.S. 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 U.S. 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.

Two of the largest and most impactful standards, SAS 142, *Audit Evidence*, and SAS 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, went into effect for December 2022 and 2023 year-ends, respectively. And while they had wide-ranging impacts on the evidence auditors gather, the documentation auditors create, and the risk assessment procedures they perform, these standards have now been in effect for multiple year-ends and are just the law of the land now.

SAS 149 is discussed here. SAS 146 will be discussed in Chapter 4 along with the Quality Management Standards.

As a reminder, SASs 143–145 are effective for December 2023 year-ends. SAS 147 is effective for audits of financial statements for periods beginning on or after June 30, 2023. SAS 148 effective dates are aligned with SAS 142 and SAS 145. 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:

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

II. Auditing standards update

A. New SASs effective for 2024, 2025, and beyond

In addition to those we have discussed above, the following is a summary of other updates that were effective in 2024 or later:

- a. **SAS 147 – *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*:**
 - (i) Clarifies and updates the guidance related to an auditor's inquiries of a predecessor auditor related to engagement acceptance;
 - (ii) After management authorizes the predecessor auditor to respond, auditor is required to ask predecessor auditor about suspected fraud and noncompliance with laws and regulations;
 - (iii) Requires predecessor auditor to respond in a timely matter to inquiries noted above and to state if responses are limited for unusual reasons; and
 - (iv) If auditor accepts the engagement, auditor is required to document the inquiries and responses related to fraud and noncompliance with laws and regulations.
- b. **SAS 148 – *Amendments to AU-C Section 935, Compliance Audits*:**
 - (i) Updates AU-C section 935, *Compliance Audits*, to align with the issuance of SAS 142–145;
 - (ii) Updates requirements of compliance audits related to the auditor's responsibility in applying requirements related to control activities;
 - (iii) Updates guidance and requirements related to identifying and assessing the risk of material noncompliance and its related documentation;
 - (iv) Amendment relating to AU-C section 501 was effective for compliance audits for fiscal periods ending on or after December 15, 2022; and
 - (v) AU-C section 935 has historically discussed that for each of the applicable compliance requirements selected for testing, the auditor is required to perform risk assessment procedures to obtain **a sufficient understanding of the applicable compliance requirements and the entity's internal control over compliance with the applicable compliance requirements**. The amended AU-C section 935 retains this concept and expands it with regard to **control activities**.

- c. SASs effective beyond 2024:
 - (i) 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.

1. SAS 146 – Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards

SAS 146 is an amendment of AU-C 220 and is related to SSARS 26, which amends AR-C sections 60, 70, 80, and 90. It is effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2025. It clarifies that the engagement partner (EP) 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 EP 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 EP were added to reinforce this point:

- a. **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;
- b. **Supporting engagement performance**, including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed; and
- c. **Observing the “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:

- a. 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.
- b. Threats to compliance with relevant ethical requirements.
- c. 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 as well as formal written communications to management and those charged with governance. Further discussions of SAS 146 and SSARS 26 are covered in Chapter 4.

III. Attestation standards

A. Forthcoming standards updates

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.

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

Since its recodification, which was effective in 2014, the AICPA Code of Professional Conduct (Code) had 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, the last few years have seen a litany of changes to the Code. While the expanded NOCLAR guidance was effective beginning in 2023, many threats to independence and changes to existing interpretation have been released since the NOCLAR guidance. As the NOCLAR guidance is now fully implemented, we have moved forward to address the more current guidance and interpretations.

The sections below will cover new PEEC guidance that will be effective in 2025 and 2026, as well as PEEC guidance that was effective in 2024:

- a. ET section 1.295.135:
 - (i) Executive or Employee Recruiting.
- b. ET sections 1.230.030 and 1.230.040:
 - (i) Determining Fees for an Attest Engagement; and
 - (ii) Fee Dependency.
- c. ET section 1.240.070:
 - (i) Section 529 Plans.

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.

C. Other new independence interpretations

1. Executive or employee recruiting (ET section 1.295.135)

Effective January 1, 2026 (early implementation is allowed), after releasing an exposure draft concerning members in public practice performing recruiting services for a key position for an attest client, the PEEC finalized new interpretations to the Code related to recruiting services for attest clients. The recruiting guidance introduced new prohibitions for members performing recruiting services for attest clients.

Specifically, the following actions by a member would represent a threat to independence:

- a. Hiring or terminating the attest client's employees (*item prohibited under previous guidance*);
- b. Advising on the specific terms of employment, remuneration, or related benefits of a particular candidate for a key position;
- c. Searching for or seeking out candidates for key positions;
- d. Undertaking reference checks of prospective candidates for a key position;
- e. Recommending to the attest client only one candidate for consideration for a key position;
- f. Ranking candidates for a key position whether or not using the attest client's criteria;
- g. Negotiating with the candidate on behalf of the attest client; and
- h. Committing the attest client to employee compensation or benefit arrangements.

These prohibitions were in recognition that by performing recruiting services for an attest client self-review, familiarity, undue influence, and management participation threats to independence were all potentially present.

While there are new prohibitions, the new guidance also identifies activities where threats would likely be at an acceptable level, and independence would **not** be impaired:

- a. Recommending or advising on a position description or candidate specifications.
- b. Advising on the general terms of employment, remuneration, or related benefits of a particular position.
- c. Searching for or seeking out candidates for non-key positions using the attest client's criteria, such as required education, skills, or experience.
- d. Reviewing candidate resumes provided by the attest client to identify those who meet the attest client's criteria.
- e. Interviewing candidates and advising on a candidate's competence based on the attest client's criteria for any position.
- f. Recommending to the attest client more than one candidate for any position for consideration based on the attest client's criteria, including providing analysis of how each candidate meets the attest client's criteria. If only one candidate for a non-key position meets the attest client's criteria, the member should apply the "Conceptual Framework for Independence" interpretation [1.210.010] to evaluate whether the threats are at an acceptable level.

2. Section 529 plans (ET section 1.240.070)

Effective May 31, 2025, the PEEC's revised interpretation for ET section 1.240.070, "Section 529 Plans," the *Code of Professional Conduct's* "Independence Rule," becomes effective for members in public practice. The independence interpretation focuses on Section 529 plans. Section 529 plans are tax-beneficial investment vehicles sponsored by institutions of higher education or states. **The plans can be either prepaid tuition plans or savings plans.** The owner of the account can designate themselves as the beneficiary and may change the beneficiary at any time to another individual or previous beneficiary.

Prepaid tuition plan

For prepaid tuition plans, the account owner of such a plan is considered to have a direct financial interest in the plan. If the plan is an attest client, **independence would be impaired** if a covered member is an account owner. However, the account owner **does not have** any financial interest in the underlying investments.

Savings plan

For savings plans, the rules are more nuanced. The account owner of a Section 529 savings plan is considered to have a direct financial interest in the savings plan. Similar to the prepaid tuition plan, if the plan is an attest client, independence would be impaired if a covered member is an account owner. Unlike the tuition plan, the account owner now **has an indirect financial interest** in the plan's underlying investments.

“The account owner has an indirect financial interest in the plan's underlying investments because the account owner's interest in the plan is evidenced by a unit of participation in the plan, which is a municipal fund security, and not shares of the underlying investments. The account owner does not have the ability to control or influence the underlying investments comprising the plan's investment options. When the underlying investments in an account owner's Section 529 savings plan do not include an attest client, there are no threats to independence. When an underlying investment in an account owner's Section 529 savings plan is an attest client, threats to independence may exist if the account owner is a covered member with respect to the underlying investment.”

If the underlying investment in the attest client is material to the covered member, the self-interest threat would not be at an acceptable level, and independence would be impaired unless the covered member deployed one of the following safeguards:

- a. Reallocating plan holdings such that there is no material indirect financial interest in an attest client for which the member is a covered member.
- b. Transferring the account to another sponsor's Section 529 savings plan that does not include a material indirect financial interest in an attest client for which the member is a covered member.
- c. Transferring the account to another account owner who is not subject to the “Independence Rule” [1.200.001].

“The safeguard should be applied as soon as practicable but no later than 30 days after the covered member has knowledge of the material indirect financial interest in the attest client and the right to transfer without a penalty or tax that is significant to the account. If the covered member will incur a penalty or tax that is significant to the account, the covered member may maintain the position in the plan until the safeguard can be applied without significant penalty or tax, provided that the covered member does not participate on the attest engagement team and is not an individual in a position to influence the attest engagement.”

3. Determining fees for attest engagements (ET section 1.230.030) and fee dependency (section 1.230.040) interpretations

Effective January 1, 2025 (early implementation was allowed), after releasing an exposure draft concerning fee dependency and determining fees for an attest engagement, the PEEC finalized new interpretations to the Code related to fees. In determining fees for an attest engagement, ET section 1.230.030 clarifies that fees for an attest engagement are not to be influenced by other services provided to the attest client. The fee should be determined on a standalone basis, not in conjunction with other fees for services provided to the client. The overarching goal of the interpretation is to ensure that other services provided to the client have no influence on the fee charged for the attest engagement.

The “Fee Dependency” interpretation (ET section 1.230.040) addresses the self-interest and undue influence risks that occur when a significant portion of a firm's revenue is derived from a single attest client. If fee dependency remains for five years or more, the firm must put enhanced safeguards in place for the dependent engagement.

To help members identify fee-related independence threats, the PEEC enhanced the “Conceptual Framework for Independence” (ET section 1.210.010) with updated examples of threats. The “Client Affiliates” interpretation (ET section 1.224.010) has also been revised to clarify the affiliates subject to the fee-dependency requirements.

D. Other ethics interpretations effective in 2024 or 2025

In addition to what we discussed above, the PEEC also issued additional updates to the Code in 2024 and 2025. The new updates deal with the following:

- a. Defined compliance audit and compliance audit client. The PEEC issued a revised definition for the term financial statement attest client, effective for compliance audits beginning after June 15, 2023.

Discussion question:

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

IV. SEC and PCAOB updates

A. SEC update

1. Climate disclosures

In March 2024, the Securities and Exchange Commission (SEC) finalized and published its climate disclosure rules for public companies. The rules required companies to disclose climate-related risks and select greenhouse gas emissions. Upon finalizing the rule, the SEC immediately stayed implementation and enforcement of the rule to allow for litigation against the rule to proceed.

In March 2025, the SEC voted to end defense of the ruling in court, effectively killing the ruling. Auditors of public companies will not have to contend with auditing and verifying disclosure of climate-related metrics for the foreseeable future.

2. Safeguarding crypto assets – SAB 121 and SAB 122

Staff Accounting Bulletin (SAB) 121, issued by the SEC staff in March 2022, outlines the staff’s view that public companies – including banks and other financial institutions – that safeguard crypto assets for users must record a liability and a corresponding asset on their balance sheets. Specifically, the entity should recognize a liability to reflect the obligation to safeguard the crypto assets and an asset of equal amount to represent its right to receive reimbursement from the customer for safeguarding those crypto assets. This approach is based on the unique technological, legal, and regulatory risks associated with crypto asset custody, such as the heightened risk of loss due to theft, hacking, or loss of private keys.

The SEC staff also emphasized enhanced disclosure requirements. Entities must provide clear and comprehensive disclosures in their financial statements about the nature and amount of crypto assets held for customers, associated risks, and the accounting policies used. The intent of SAB 121 was to increase transparency for investors by ensuring they understand the risks and responsibilities assumed by custodians of crypto assets, even if the assets are not owned by the custodian. Notably, SAB 121 received considerable pushback at the time it was released.

In 2025, the SEC issued SAB 122, which repealed the interpretive guidance included in SAB 121, Section FF of Topic 5 in the SAB Series entitled “Accounting for Obligations to Safeguard Crypto-Assets an Entity Holds for its Platform Users.” This was the guidance that required a custodian safeguarding crypto assets to record corresponding liabilities and assets for the crypto assets held by the custodian on behalf of a customer. That guidance is no longer SEC rule, effective January 30, 2025.

B. PCAOB update – 2024 PCAOB inspection results

1. Introduction and overview of the PCAOB inspection process

One of the central mechanisms through which the Public Company Accounting Oversight Board (PCAOB) carries out this mission to safeguard the public trust is its comprehensive inspections program, which evaluates registered accounting firms’ compliance with applicable laws, standards, and regulations. In 2024, the PCAOB inspected 171 registered audit firms, reviewing portions of more than 800 public company audits. These inspections provide invaluable insights into the current state of audit quality, the effectiveness of firms’ internal systems, and areas where enhancements are needed.

The PCAOB’s March 2025 Spotlight offers a thorough account of the 2024 inspection cycle. It details both the notable progress made in reducing audit deficiencies and the persistent issues that continue to undermine audit quality. The report also outlines the PCAOB’s evolving inspection approach, areas of focus, observed deficiencies, and the Board’s broader efforts to improve audit quality across the profession. This chapter synthesizes those findings in narrative form for student comprehension and practical application.

2. Notable improvements in audit quality

The most encouraging development in the 2024 inspection cycle was the observed decline in Part I.A deficiency rates. These deficiencies reflect instances where the PCAOB concluded that the audit firm failed to obtain sufficient appropriate audit evidence to support its opinion on the financial statements and/or internal control over financial reporting. In 2024, the aggregate Part I.A deficiency rate across all inspected firms dropped to 39 percent, compared to 46 percent in 2023. The largest and most influential audit firms – particularly those known as the Big Four – showed even greater improvement. Their average deficiency rate decreased to 20 percent, a significant improvement from the previous year’s 26 percent.

Similar trends were observed among U.S. Global Network Firms (GNFs), which reported a decline in deficiencies from 34 percent to 26 percent, and among triennially inspected Non-Affiliated Firms (NAFs), where rates fell from 67 percent to 61 percent. These gains were not just numerical; they reflected substantive changes in firm practices and quality controls, indicating a reversal of the concerning upward trend in audit deficiencies observed following the COVID-19 pandemic.

3. Drivers of firm audit improvement

According to the PCAOB, the improvements observed in 2024 were not coincidental but rather the product of concerted efforts by audit firms. Firms implemented a variety of initiatives aimed at bolstering audit quality. One notable strategy involved increasing the amount of in-person collaboration among audit team members. Many firms instituted policies requiring audit teams to spend a portion of their work week onsite, facilitating real-time supervision and stronger communication.

In addition to increased face-to-face engagement, firms expanded their investment in training, particularly for junior staff, who often perform the foundational elements of the audit. National offices provided enhanced technical support and resources to local engagement teams, offering just-in-time guidance on complex issues. Finally, many firms implemented more rigorous supervision and review protocols, ensuring that critical audit judgments were scrutinized at higher levels within the firm.

4. Enhancements to the inspection approach

In 2024, the PCAOB continued to refine its inspection methodology by employing a more data-driven and risk-based approach. The inspection staff expanded the number of engagements reviewed at annually inspected firms, focusing not only on high-risk engagements but also introducing random selections to enhance unpredictability. The updated procedures ensured more robust and consistent inspections, allowing the PCAOB to make more generalizable observations across firms and sectors.

The PCAOB also placed increased emphasis on evaluating the role of firm culture in promoting audit quality. Recognizing that policies and procedures are only as effective as the environment in which they are executed, the PCAOB began incorporating firm culture assessments into its inspection framework. These included interviews and qualitative analyses aimed at understanding how leadership priorities, incentive structures, and communication practices shape engagement teams' behavior.

5. Focus areas and engagement selection

The selection of audit engagements for inspection was based on a combination of risk-based criteria and randomized selection techniques. This dual strategy was designed to target high-risk audits while also introducing unpredictability into the process. Risk-based selections focused on industries and companies with complex accounting requirements, including entities with Level 3 fair value measurements, substantial digital asset holdings, and significant merger and acquisition activity.

Additionally, the PCAOB's "target team" – a group dedicated to identifying emerging audit risks – reviewed audits involving artificial intelligence, biotech startups, and the use of shared service centers. Once engagements were selected, PCAOB inspectors identified "focus areas" within each audit for deeper analysis. These typically included recurring areas of deficiency, such as revenue recognition, going concern assessments, and the auditor's understanding of the client's environment.

6. Common deficiencies in 2024

The PCAOB continued to observe recurring deficiencies in both the audit of internal control over financial reporting (ICFR) and key financial statement areas. In ICFR audits, frequent issues included poor risk assessment, failure to test key controls, and insufficient evaluation of management review procedures. Engagement teams often neglected to assess the accuracy and completeness of system-generated data, a critical component of control effectiveness. A chart of these deficiencies and select findings is presented in the presentation.

Within financial statement audits, revenue recognition remained the most problematic area. Deficiencies were commonly tied to inadequate testing of disaggregated revenue, insufficient evaluation of data used in revenue correlation analyses, and failures to test assumptions underlying bundled sales transactions. Inventory audits were similarly fraught with issues, including inadequate testing of valuation, existence, and period-end balances.

Other significant deficiencies were observed in the audit of business combinations, where engagement teams often failed to adequately test the valuation of acquired assets or assess contingent considerations. Investment securities presented challenges related to fair value measurements, sampling techniques, and disclosure testing. In audits involving goodwill and intangible assets, firms frequently overlooked indicators of impairment or failed to assess the reasonableness of forecast assumptions. Finally, in the area of allowance for credit losses, firms demonstrated weaknesses in evaluating risk ratings, unallocated reserves, and the completeness of supporting data.

7. Compliance with other PCAOB rules

Beyond audit execution, the PCAOB identified deficiencies related to auditor independence, communications with audit committees, and the proper documentation and disclosure of critical audit matters (CAMs). Several firms failed to adequately communicate the terms of audit engagements, changes to significant risks, or the involvement of other accounting firms. In the area of fraud risk assessment, many auditors did not conduct sufficient journal entry testing or failed to support their rationale for selecting entries to test.

The PCAOB also found that some firms submitted incomplete or inaccurate Form AP filings, which disclose information about audit participants. Instances of noncompliance with independence rules included improper financial or employment relationships and the failure to obtain audit committee preapproval for certain tax services. These issues were particularly prevalent among triennially inspected firms.

8. Observations on quality control systems

While not all quality control (QC) deficiencies are made public, the PCAOB continues to place significant emphasis on evaluating QC systems. These systems are critical to ensuring consistency, competence, and compliance across engagements. In 2024, PCAOB inspections revealed ongoing concerns related to the design and execution of firm-wide QC practices. Many firms exhibited weak monitoring procedures and inconsistent application of audit policies.

The Board is preparing for the implementation of QC 1000 (discussed below), a new standard that will replace the interim QC standards effective December 15, 2025. In anticipation of this transition, inspectors began collecting information on firms' readiness and examining how firms are aligning their practices with the new requirements. The enhanced standard is expected to set a higher bar for firm accountability and quality.

9. PCAOB initiatives to promote audit quality

To further its mission, the PCAOB has initiated several proactive measures. These include publishing inspection reports more rapidly, with 2024 reports for major firms released five months earlier than in previous years. The PCAOB also launched new guidance resources, such as its Spotlight series and "Audit Focus" publications, which offer targeted insights for auditors, especially those working with smaller public companies.

Additionally, the PCAOB has increased its direct engagement with audit committees and smaller firms. This has included forums, feedback initiatives, and the creation of dedicated online resources. One novel area of focus is the relationship between firm culture and audit quality. In late 2024, the PCAOB published a dedicated report on this topic, highlighting the ways in which cultural attributes such as integrity, accountability, and openness influence audit outcomes.

10. Final discussion of inspection results

The PCAOB's 2024 inspections reveal promising signs of progress, particularly among the largest audit firms. Decreases in Part I.A deficiency rates suggest that recent efforts to improve training, supervision, and resource allocation are bearing fruit. Despite the improvements, the presence of recurring deficiencies and systemic QC weaknesses highlights the fact that much work remains. As new standards like QC 1000 take effect this year, and the audit environment becomes increasingly complex, firms must remain vigilant and forward-looking in their commitment to high-quality, investor-focused audits.

C. PCAOB update – New PCAOB guidance

1. Quality Control (QC) 1000

Effective December 15, 2025, the PCAOB is updating its guidance for PCAOB-registered firms. The guidance is similar to the International Standards on Quality Management and the AICPA's System of Quality Management Standards (SQMS). The new guidance creates a new risk-based system of quality management along with the existing mandated standards.

Firms must establish and actively maintain their quality control system, continuously monitor its effectiveness, and take corrective measures when policies or procedures fall short, thereby fostering an ongoing cycle of improvement. The firms must annually evaluate their QC system and report the results of their evaluation to the PCAOB in a new form (Form QC). The form must be certified by key firm personnel.

QC 1000 introduces an external (non-firm personnel) oversight function to firms' systems of quality control. Firms that annually audit more than 100 issuers must establish an external oversight function for their QC system. This external oversight body must have one or more persons who can independently evaluate the QC system at the firm. It will operate similarly to a board of directors.

2. AS 1000 – General Responsibilities of the Auditor in Conducting an Audit

Effective for audits of financial statements for fiscal years beginning on or after December 15, 2024 (and one year later for registered firms with 100 or fewer issuer clients), the modernized standard consolidates and reorganizes existing standards into a single standard. It replaces AS 1001, AS 1005, AS 1010, and AS 1015. While it does not create new principles, it reaffirms some existing principles and expands definitions and guidelines for others. A key technical change in AS 1000 is that it reduces the maximum period for the auditor to assemble a complete and final set of audit documentation from 45 days to 14 days.

3. AS 2310 – The Auditor's Use of Confirmation

Effective for audits of financial statements for fiscal years ending on or after June 15, 2025, the PCAOB has meaningfully updated its confirmation standard for the first time in decades. The standard adopted on an interim basis at its founding, AS 2310, "The Confirmation Process," was originally written in 1992, and had not been updated since then to reflect the new technology and information environment firms are operating in today.

The updated standard moves to a principles-based approach to confirmations to allow for technological advancements and flexibility and removes reference to fax machines and traditional mail.

The standard also clarifies that negative confirmations alone are not sufficient audit evidence for accounts receivable. The auditors must perform other substantive audit procedures if negative confirmations are used. The new standard also reaffirms that the auditor is responsible for maintaining control over the confirmation process and must be the one to select the items to be confirmed, send the confirmation requests, and receive confirmation responses. In modernizing the standard, “the auditor or the confirming party can engage another party as an intermediary to facilitate direct electronic transmission of confirmation requests and responses between the auditor and the confirming party. When using an intermediary for this purpose, the auditor should evaluate the implications on the reliability of confirmation requests and responses.”

AS 2310 also establishes that the auditor should perform audit procedures for cash and cash equivalents held by third parties in addition to accounts receivable. When the auditor determines it is not feasible to obtain audit evidence, the auditor should obtain external audit evidence indirectly by performing other audit procedures.

Updates to the AICPA's Quality Management Standards

Learning objectives	1
I. AICPA's Quality Management Project	1
A. Quality management standards	1
B. Suite of quality management standards	2
1. SQMS 1, A Firm's System of Quality Management	3
2. SQMS 2, Engagement Quality Reviews	17
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	19
4. SQMS 3 – Group Audits	20

Updates to the AICPA's Quality Management Standards

Learning objectives

After completing this chapter, you should be able to:

- Identify key provisions of SQMS 1, SQMS 2, and SQMS 3;
- Recall quality management provisions in SAS 146, SSARS No. 26, and SSAE 23;
- Understand the role of firm leadership in establishing quality management standards; and
- Recall the requirements for engagement quality reviews.

I. 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 comment 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 <i>System of Quality Management</i>	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 <i>Engagement Quality Reviews</i>	Effective for: <ul style="list-style-type: none"> 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 <i>Amendments to QM Sections 10, A Firm's System of Quality Management and 20, Engagement Quality Reviews</i>	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: <ul style="list-style-type: none"> Audits or reviews of financial statements for periods beginning on or after December 15, 2026; and Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2026.
SAS 146 <i>Quality Management for an Engagement</i>	Engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025.
SSARS 26 <i>Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services</i>	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.

B. Suite of quality management standards

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:

- a. Statement on Quality Management Standards 1, *A Firm's System of Quality Management*;
- b. Statement on Quality Management Standards 2, *Engagement Quality Reviews*;
- c. Statement on Quality Management Standards 3, *Amendments to QM Sections 10, A Firm's System of Quality Management, and 20, Engagement Quality Reviews*;
- d. Statement on Auditing Standards No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standard*; and
- e. 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:

- a. Risks to audit quality correlated with audits, reviews, and attestation engagements performed by engagement partners who perform a low volume of such engagements.
- b. A need to improve firm governance and leadership and the culture and tone at the top of the firm.
- c. Consistency issues in the performance of engagements and a lack of focus on planning.
- d. 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.
- e. 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 tailoring 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:

- a. 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.
- b. 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.

The components of the system of quality



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.

One approach to identifying objectives would be by category. The categories to consider are governance and leadership, relevant ethical requirements, acceptance and continuance, engagement performance, resources, information and communication, and monitoring. You will note that many of these objectives are similar to objectives found in the COSO ERM Framework.

The risk assessment process follows three steps:

- a. Understand factors (conditions, events, circumstances, actions, or inactions) that may adversely affect the achievement of the quality objectives.
- b. Consider how and the degree to which the factors may adversely affect the achievement of the quality objectives.
- c. Assess quality risks – An assessed quality risk is one that has a reasonable possibility of occurring and, individually or in combination with other risks, adversely affecting the achievement of one or more quality objectives.

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

Frequent comments from respondents

Where the three steps seem to be straightforward, 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.

As the firm is seeking to identify and assess quality risks to provide a basis for the design and implementation of responses, the firm should obtain an understanding of the conditions, events, circumstances, actions, or inactions that may adversely affect the achievement of the quality objectives. That includes the nature and circumstances of the firm **and** the nature and circumstances of the engagement performed by the firm. The factors of each are addressed in the table below.

Nature and circumstances of the firm	Nature and circumstances of the engagements performed by the firm
Complexity and operating characteristics of the firm	Types of engagements performed by the firm and the reports to be issued
Strategic and operational decisions and actions, business processes, and business model of the firm	Types of entities for which such engagements are undertaken
Characteristics and management style of leadership	How, and the degree to which, the conditions, events, circumstances, actions, or inactions of the firm may adversely affect the achievement of the quality objectives
Resources of the firm, including the resources provided by service providers	
Law, regulation, professional standards, and the environment in which the firm operates	
When a firm belongs to a network, the nature and extent of the network requirements and network services, if any	

Understanding the conditions, events, circumstances, actions, or inactions that lead to quality risks is imperative. Below, we outline examples of such conditions/events.

Example set #1: Understanding the conditions, events, circumstances, actions, or inactions

Conditions, events, circumstances, actions, or inactions	Examples of quality risks that may arise
The firm is a smaller firm with few engagement partners with shared authority.	Governance and leadership component: Engagement performance component: <ul style="list-style-type: none"> • Leadership responsibilities and accountability for quality are not clearly defined and assigned. • Leadership and/or actions and behavior do not promote quality and are not questioned.
The firm recently completed a merger.	Resources component: <ul style="list-style-type: none"> • Technology (smart practice aids) differs between the firms (PPC and Knowledge Coach). • Engagement teams have different sets of required firm workpapers and workpaper templates. Information and communication component: <ul style="list-style-type: none"> • EQR policies differ between the firms.

Example set #1: Assessment of risk

Examples of quality risks that may arise	Assessment of risk
Governance and leadership component: Engagement performance component: <ul style="list-style-type: none"> Leadership responsibilities and accountability for quality are not clearly defined and assigned. Leadership and/or actions and behavior do not promote quality and are not questioned. 	Likelihood (moderate) – The firm has clear-cut lines of authority and responsibility. However, from time to time, when the firm is at its busiest, partners may make decisions without consultation. Impact (moderate) – These situations arise infrequently, but if they should arise, the impact could cause nonconforming engagements or other issues.
Resources component: <ul style="list-style-type: none"> Technology (smart practice aids) differs between the firms (PPC and Knowledge Coach). Engagement teams have different sets of required firm workpapers and workpaper templates. Information and communication component: <ul style="list-style-type: none"> EQR policies differ between the firms. 	Likelihood (high) – Internal inspections have identified differences in practice aids, workpapers, and templates. Impact (high) – Inconsistency has been identified, leading to comment in internal inspection.

Example set #1: Risk response

Examples of quality risks that may arise	Risk responses
Governance and leadership component: Engagement performance component: <ul style="list-style-type: none"> Leadership responsibilities and accountability for quality are not clearly defined and assigned. Leadership and/or actions and behavior do not promote quality and are not questioned. 	<ul style="list-style-type: none"> The firm creates an organizational chart outlining leadership responsibilities. The firm creates policies and procedures that specify independent monitoring of quality risks on a periodic basis and allegations and complaints as they arise. The results are presented to the quality committee for follow-up. Quality is stressed at monthly staff meetings and in engagement team meetings. Quality is identified as a component of performance evaluations.
Resources component: <ul style="list-style-type: none"> Technology (smart practice aids) differs between the firms (PPC and Knowledge Coach). Engagement teams have different sets of required firm workpapers and workpaper templates. Information and communication component: <ul style="list-style-type: none"> EQR policies differ between the firms. 	<ul style="list-style-type: none"> Differing technology, practice aids, required workpapers, and workpaper templates are conformed, and staff are trained on the resulting resources. Follow-up occurs to ensure compliance with the firm-prescribed resources. EQR policies are established to be responsive to all of the firm's circumstances.

Example set #2: Understanding the conditions, events, circumstances, actions, or inactions

Conditions, events, circumstances, actions, or inactions	Examples of quality risks that may arise
The firm has had challenges in retaining managers and senior auditors	Resources component: Information and communication component: Engagement performance: <ul style="list-style-type: none"> Hiring personnel in different parts of the state/country. Extensive use of electronic means to audit.
The firm has recently accepted clients/engagement in new industries (single audits and benefit plans)	Acceptance and continuance component: Resources component: <ul style="list-style-type: none"> Insufficient resources that are skilled in those areas. Lack of familiarity with industry accounting pronouncements, laws, and regulations, etc.

Example set #2: Assessment of risk

Examples of quality risks that may arise	Risk assessment
Resources component: Information and communication: Engagement performance: <ul style="list-style-type: none"> Hiring personnel in different parts of the state/country. Extensive use of electronic means to audit. 	Likelihood (high) – The firm has personnel in several cities across the state, and the offices in different states share audit personnel. Impact (high) – The COVID pandemic resulted in an increase in the amount of remote auditing. Newer audit staff are reluctant to reach out to seniors and managers to discuss issues. This was raised in a staff meeting. There has also been an increase in the amount of correspondence with the client rather than conversations face-to-face.
Acceptance and continuance component: Resources component: <ul style="list-style-type: none"> Insufficient resources that are skilled in those areas. Lack of familiarity with industry accounting pronouncements, laws, and regulations, etc. 	Likelihood (high) – The firm is growing and continuing to take on new clients. These clients, for example, may have benefit plan audits, an area of specialty new to the firm. Impact (moderate) – The firm is part of a network where there is sharing of knowledge and resources related to quality and specific industries.

Example set #2: Risk response

Examples of quality risks that may arise	Risk response
Resources component: Information and communication: Engagement performance: <ul style="list-style-type: none"> Hiring personnel in different parts of the state/country. Extensive use of electronic means to audit. 	<ul style="list-style-type: none"> Team talks are established with regular meetings on Teams to promote a feeling of connection. Supervisory personnel hold regular team meetings on Teams to touch base with staff during engagements. Policies are established to ensure that discussions with management, those charged with governance, and others are held on Teams/Zoom to promote touchpoints with client personnel, especially as they relate to discussions about fraud risks.
Acceptance and continuance component: Resources component: <ul style="list-style-type: none"> Insufficient resources that are skilled in those areas. Lack of familiarity with industry accounting pronouncements, laws, and regulations, etc. 	<ul style="list-style-type: none"> Training is provided for all personnel in new areas. External resources (network and other) are identified to ensure support for the engagement team. The firm joins AICPA quality centers where available in the new areas.

These examples have led many practitioners to ask, “How do I start?” Fortunately, the AICPA has provided a template with generic risks for you to tailor your individual firm and engagement. Second, the IAASB has issued implementation guidance on their SQMS 1- and SQMS 2-equivalent standards. As part of the process was the convergence of standards, this can present a useful tool for your firm seeking to identify an outline. Screenshots of the templates are provided in the slides.

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:

- a. Operational responsibility for the system of quality management; and
- b. Operational responsibility for specific aspects of the system of quality management, including compliance with independence requirements and the monitoring and remediation process.

The new standard represents substantial enhancement to the current requirements in QC 10 while also recognizing the importance of the firm’s strategic decisions and actions. The decisions and actions emphasize those surrounding:

- a. Financial and operational priorities;
- b. Leadership’s ability to influence decisions about firm resources;
- c. Firm’s role in serving the public interest;
- d. Professional ethics, values, and attitudes;
- e. Responsibility of all personnel; and
- f. Strategic decisions and actions.

At the leadership level, a firm demonstrates commitment to quality through its culture. The firm should recognize its role in serving the public interest through the performance of high-quality engagements. The

firm should recognize the importance of professional ethics, values, and attitudes. As recent enforcement actions against firms have shown, the PCAOB and AICPA are placing heightened scrutiny in these areas. The firm should recognize that commitment to quality is the responsibility of **all** personnel.

To demonstrate this commitment, leadership should be responsible for and held accountable for quality. This commitment should be represented through leadership's actions. When assessing the organizational structure, the organizational structure and assignment of roles, responsibilities, and authority should be appropriate to support achievement of the firm's quality objectives. And if deemed otherwise, the organizational structure may require restructuring or reorganizing to achieve the firm's quality objectives.

Component 3: Consideration of relevant ethical requirements – This is consistent with the existing standard but places heightened emphasis on independence generally and in specific areas such as those required by Government Auditing Standards.

Component 4: Acceptance and continuance procedures – This is consistent with the existing standard and recognizes that robust acceptance and continuance procedures are a hallmark of quality management. It also integrates with SAS 146 on engagement quality management. Acceptance and continuance procedures should:

- a. Be based on information obtained about the engagement and the integrity and ethical values of the client;
- b. Reflect the firm's ability to perform the engagement; and
- c. Ensure that financial and operational priorities of the firm do not lead to inappropriate judgments.

Component 5: Engagement performance – The current standard addresses engagement performance. The new standard expands this to focus on leadership and engagement performance in that:

- a. Engagement teams understand and fulfill their professional responsibilities;
- b. The nature, timing, and extent of engagement direction and supervision are appropriate;
- c. Engagement teams exercise appropriate professional judgment and skepticism;
- d. Consultation is undertaken, as necessary;
- e. A process is established for resolving differences of opinion within the engagement team, between the engagement team and the engagement quality reviewer, and between the engagement team and those in the firm's system of quality management; and
- f. Engagement documentation is assembled on a timely basis and in accordance with professional standards.

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

- a. Technological resources; for example, audit tools or IT applications used by the firm for independence monitoring;
- b. Intellectual resources; for example, the firm's methodology, guidance, templates, or tools; and
- c. 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. It also includes ensuring that personnel have the competencies to consistently perform quality engagements and perform activities related to a firm's system of quality management.

- d. Financial resources, including the availability of sufficient financial capital to hire and retain qualified personnel, invest in L&D, engage external experts, and support many of the quality control functions outlined in the standard.

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.

The standard also reflects a change in the operating structures of accounting firms. The engagement team now includes partners and staff performing engagements, **including those from the firm's service delivery centers**. It includes others performing procedures, including component auditors and those from network service providers. It includes an auditor's internal expert (from firm or network firm). However, importantly, **it does not include** individuals providing consultation, EQR, auditor's external expert, individuals in client's internal audit function providing direct assistance, and "referred-to" auditor.

As shown in the table below, the standard intersects with SAS 146 in many areas.

SQMS 1	SAS 146
<p>Engagement team members are assigned to each engagement (the risk is that the appropriate resources are not assigned).</p> <p>Responses at firm level:</p> <ul style="list-style-type: none"> • IT application to track personnel and engagement assignments. • Administrator to manage staff assignments. • Policies and procedures for requesting staff (including busy periods). • Periodic leadership meetings to discuss staff utilization and assignments. • Policies or procedures for addressing issues. 	<p>Engagement partner responsibilities:</p> <ul style="list-style-type: none"> • Follow the firm's policies or procedures for how to request staff. • Check that staff are assigned and consider if sufficient and appropriate – may involve some further liaison with administrator to refine assignments. • If resources are not sufficient/appropriate, take action, including communicating the need for additional or alternative resources.

Under SAS 146, the engagement partner is required to take responsibility for using the resources assigned or made available to the engagement team appropriately, given the nature and circumstances of the engagement. The engagement partner is also required to review, prior to their issuance, formal written communications to management, those charged with governance, or regulatory authorities. When it comes to the engagement partner's responsibilities to the engagement team, the engagement partner must:

- a. Make engagement team aware of relevant ethical requirements;
- b. Make engagement team aware of their responsibilities when breaches arise;
- c. Remain alert for breaches of relevant ethical requirements by the team;
- d. Ensure members of team have appropriate competence and capabilities;
- e. Direct and supervise members of engagement team and review their work;
- f. Take responsibility for engagement team undertaking consultation; and
- g. Inform engagement team of responsibility to cooperate with engagement quality reviewer.

Despite these responsibilities, the engagement partner (EP) does not have to manage engagement resources and quality management alone. The EP may assign certain tasks to others within the engagement while remaining appropriately involved throughout the engagement. For instance, the phrase “take responsibility for...” implies that the engagement partner is permitted to assign the certain activities to experienced team members. However, even if the EP assigns tasks out, when the requirements specify that the engagement partner should do something, **the engagement partner is required to conduct that activity**. In many instances, team members may provide information to the EP, but the task will ultimately remain with the EP.

The standard does recognize that, when one partner is working alone on an engagement, some of the requirements simply will not be able to be followed.

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, making this a new component of quality management. 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.

Objectives surrounding information and communication should address the following:

- a. Obtaining, generating, or using information regarding the system of quality management; and
- b. Communicating such information on a timely basis to those within the firm and to external parties.

When assessing the information and communication objectives, the following considerations should be addressed:

- a. The information system identifies, captures, processes, and maintains relevant and reliable information;
- b. The culture of the firm recognizes and reinforces the responsibility of personnel to effectively exchange information; and
- c. Relevant and reliable information is exchanged throughout the firm, network, and service providers.

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:

- a. How the system is designed;
- b. The nature and circumstances of the firm and the engagements it performs;
- c. The extent of changes to the system; and
- d. 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 a 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.

Designing monitoring activities and establishing remediation procedures

When designing monitoring activities, the firm should consider the size, structure, and organization of the firm, as well as involvement of network participants (if applicable) and the resources to be used. The firm should also consider:

- a. The reasons for the assessments given to quality risk;
- b. The design of the responses;
- c. The design of the firm's risk assessment, monitoring, and remediation processes;
- d. Changes to the firm's system of quality management;
- e. Results of previous monitoring activities; and
- f. Other relevant information.

The design process will likely be an iterative process that is integrated with other systems of quality management components. First, the firm should design and perform monitoring procedures; then they should evaluate findings, identify any deficiencies, and evaluate those identified deficiencies. Next, they should respond to the deficiencies. After the response, those deficiencies should be communicated to the relevant parties, and then the firm should return to design and monitoring. This process will be repeated over and over.

The monitoring process

Inspections of engagements are an important component of the monitoring process. Inspections of engagements are designed to monitor whether an aspect of the system of quality management is designed, implemented, and operating in the manner intended. SQM may include responses that are designed to review engagements while they are in the process of being performed. These may be reviews that are designed to detect failures or shortcomings in the system of quality management so that a quality risk can be prevented from occurring. When performing monitoring activities, the firm may determine that changes to the nature, timing, and extent of the monitoring activities are needed, such as when findings indicate the need for more extensive monitoring activities.

Firms and firms' leadership should consider the following when deciding which engagements to inspect:

- a. Conditions, events, circumstances, actions, or inactions giving rise to the quality risks;
- b. Types of engagements performed by the firm;
- c. Extent of the firm's experience in performing the type of engagement;
- d. Types of entities for which engagements are undertaken;
- e. Entities operating in emerging industries;
- f. Entities operating in industries associated with a high level of complexity or judgment;
- g. Entities operating in an industry that is new to the firm;
- h. Tenure and experience of engagement partners;
- i. Results of previous inspections of completed engagements (by partner);

- j. Complaints or allegations about an engagement partner; and
- k. Results of external inspections, including for each engagement partner.

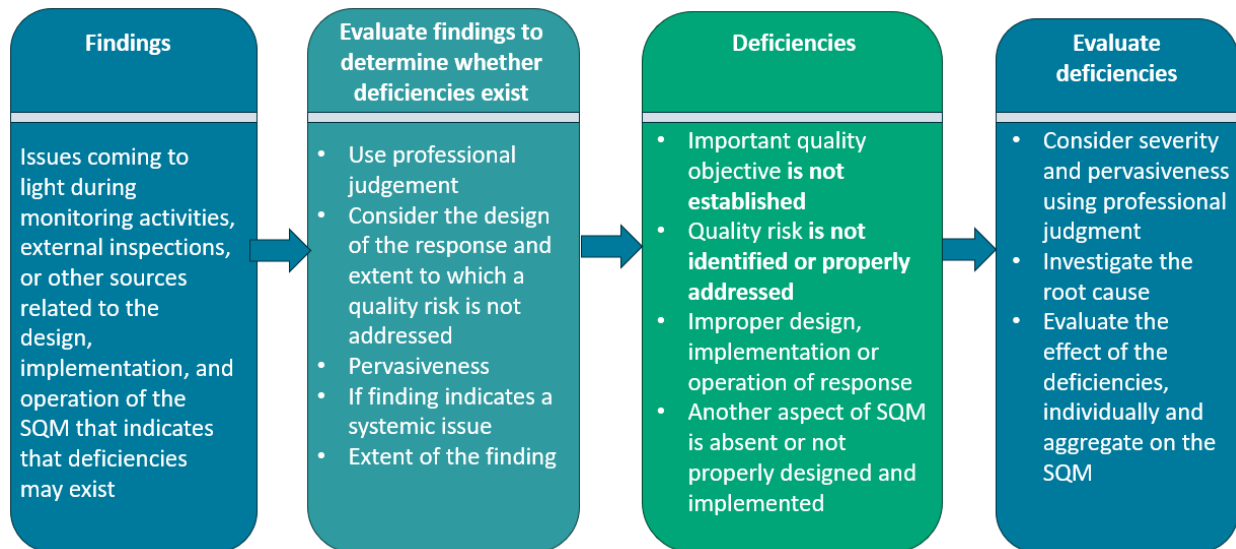
When reporting on the firm's evaluation of the system of quality management, firms should note that peer review definitions of findings and deficiencies are not the same as those outlined in SQMS 1. Findings or deficiencies identified in a firm's system of quality management may not necessarily result in a peer review finding or deficiency. Firms should assess any peer review findings or deficiencies to determine the impact on the firm's evaluation of its system of quality management.

SQMS 1 does not preclude an individual from performing monitoring activities, including inspections of their own compliance with a quality management system. However, self-inspections may be less effective than compliance inspections by another qualified individual. With self-inspections, the firm has a higher risk that noncompliance with policies and procedures will not be detected or reported. The responses that may provide safeguards against self-review include:

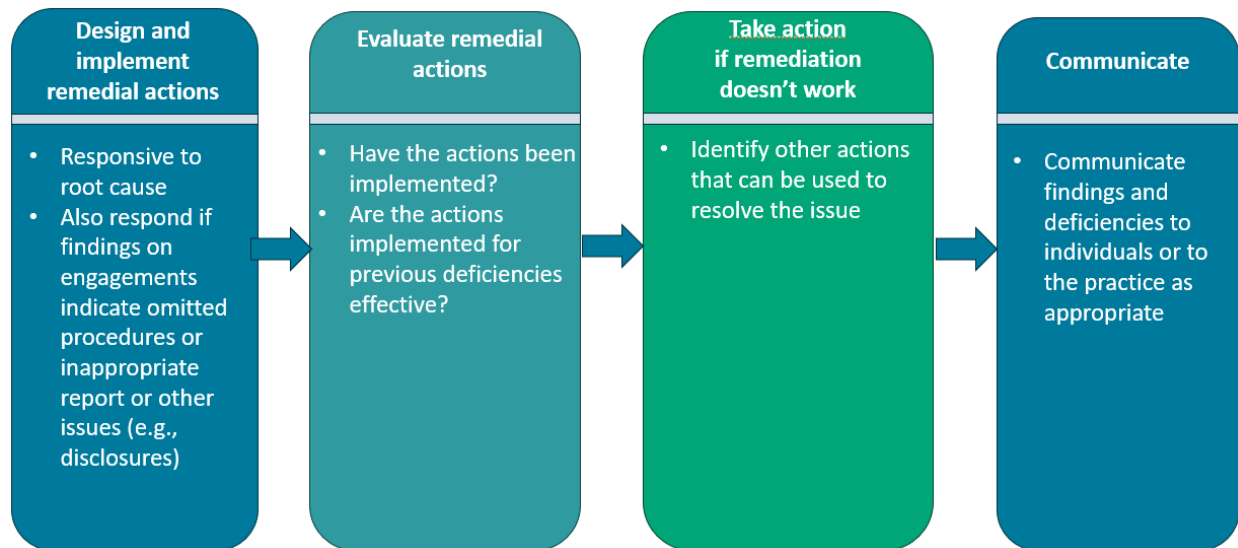
- a. Fostering a commitment to continuing professional education and providing effective training programs so that personnel stay current on accounting, auditing, and quality management standards;
- b. Providing training on how to perform monitoring inspections and requiring the use of peer review or other inspection checklists; and
- c. Requiring the passage of time after the completion of an engagement before self-inspections are performed.

An example flowchart of the monitoring process:

Part A:



Part B:



Engagement quality review

See section 2 in this chapter that discusses the EQR process under SQMS 2.

Evaluating the system of quality management

The individuals assigned ultimate responsibility and accountability for the system of quality management should evaluate the system of quality management **at least annually**, but it can be completed more frequently if a firm desires.

Each year the firm must (1) evaluate SQM as a whole, including all objectives and requirements of the eight component parts discussed in this chapter, and (2) reach conclusions based on the evaluation on the achievement of objectives.

The evaluation should consider:

- a. Severity and pervasiveness of identified deficiencies and effect on SQM;
- b. Whether remedial actions have been designed and implemented and whether remedial actions taken to date of evaluation are effective; and
- c. Whether the effect of identified deficiencies has been appropriately corrected.

Under this evaluation, if identified deficiencies that are severe (including those that are also pervasive) have been appropriately remediated, the individual assigned ultimate responsibility and accountability for SQM may conclude that the system provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

The firm should evaluate the severity and pervasiveness of identified deficiencies by investigating the root causes of the identified deficiencies. In determining the nature, timing, and extent of the procedures to investigate the root causes, the firm should consider the nature of the identified deficiencies and their possible severity. The firm must also evaluate the effect of the identified deficiencies, individually and in aggregate, on the system of quality management.

If the individual with ultimate responsibility and accountability for the SQM reaches a conclusion other than reasonable assurance that quality objectives are achieved, the firm should take prompt and appropriate action. The firm should also communicate with engagement teams and other individuals assigned activities within the system of quality management to the extent that it is relevant to their responsibilities, as well as external parties in accordance with the firm's policies or procedures.

The firm should perform periodic performance evaluations of the individual assigned ultimate responsibility and accountability for SQM and the individual assigned operational responsibility for SQM.

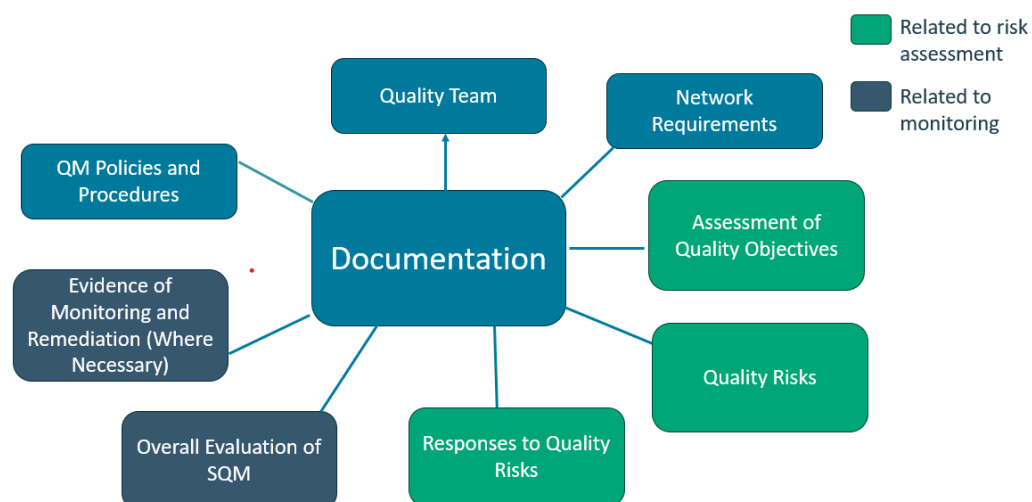
Networks

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.

Network considerations include firm-specific monitoring, monitoring across the network of firms, and firm-identified deficiencies in network requirements.

When documenting networks and network considerations, the documentation should be sufficient to support a consistent understanding of the system by firm personnel, support the consistent implementation and operation of the responses, and provide evidence of the system's design, implementation, and operation to support its evaluation. When preparing the documentation, the firm should consider key individuals and their roles, quality objectives and risks, the firm's response to quality risks, evidence of monitoring, remediation, and communication, and the basis for conclusion on the system's effectiveness.

The documentation should incorporate the following factors:



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. It also integrates with SQMS 1.

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.

The determination of when an engagement quality review is required is part of a firm’s system of quality management. It is an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon. The review is performed within the context of professional standards and legal and regulatory requirements. However, the review is not intended to evaluate whether the entire engagement complies with professional standards.

The engagement quality reviewer **is not** a member of the engagement team. The engagement partner maintains ultimate responsibility for the engagement but is not required to obtain evidence. In establishing the EQR, firm policies should address the engagement quality reviewer’s responsibilities and the timing of their performance, objectivity threats, and the partner’s responsibilities regarding review completion. The firm **may choose**, but is not required, to require a cooling-off period so that engagement partners cannot become EQR for a period of time after they roll off an engagement.

Review performance

In performing the engagement quality review, the reviewer should:

- a. Read and obtain an understanding about information communicated by:
 - (i) The engagement team, related to the engagement and the client; and
 - (ii) The firm, related to its monitoring and remediation process and identified deficiencies.
- b. Discuss with the engagement partner and others significant matters and judgments made in planning, performing, and reporting on the engagement;
- c. Review selected engagement documentation related to significant judgments:
 - (i) Evaluate the basis for the judgments;
 - (ii) Whether the documentation supports the conclusions reached; and
 - (iii) Whether the conclusions are appropriate.
- d. Evaluate whether engagement partner’s evaluation of independence is appropriate;
- e. Determine appropriateness of consultations that have taken place.

Documentation of the review should include:

- a. The name of the engagement quality reviewer and the name of anyone who assisted;
- b. The identification of the engagement documentation reviewed;
- c. The basis for the reviewer's determination whether the requirements of the engagement quality review have been fulfilled;
- d. Notification of whether the review has been satisfactorily completed or not; and
- e. The date of the review.

The report cannot be released until the completion of the engagement quality review.

Review requirements

SQMS 2 requires an engagement quality review for (1) audits or other engagements for which an EQR is required by law or regulation and (2) audits or other engagements for which the firm determines that an EQR is an appropriate response to address one or more quality risks. **Note that the firm may decide there are no engagements that need EQR.**

Under SQMS 2, the firm should establish policies or procedures that address the criteria for eligibility to be appointed an engagement quality reviewer. Policies or procedures should require that the engagement quality reviewer:

- a. Not be a member of the engagement team;
- b. Have the competence and capabilities, including sufficient time and the appropriate authority, to perform the engagement quality review;
- c. Comply with relevant ethical requirements, including those addressing threats to the objectivity and independence of the engagement quality reviewer; and
- d. Comply with provisions of law and regulation, if any, that are relevant to the eligibility of the engagement quality reviewer.

Law or regulation may require an engagement quality review to be performed for audits of entities:

- a. Defined as public interest entities in a particular jurisdiction;
- b. That are governmental organizations or recipients of government funding, or entities with public accountability;
- c. Operating in certain industries (financial institutions such as banks, insurance companies, and pension funds);
- d. Meeting a specified asset threshold; or
- e. Under the management of a court or judicial process.

The firm may use EQR as a response to address one or more quality risks, including:

- a. Engagements that involve a high level of complexity or judgment;
- b. Audits of financial statements for entities operating in an industry that typically has accounting estimates with a high degree of estimation;
- c. Entities with going concern issues;
- d. Assurance engagements that require specialized skills and knowledge in measuring or evaluating the underlying subject matter against the applicable criteria (greenhouse gas);
- e. Audit engagements with recurring internal or external inspection findings;
- f. Engagements with unremediated significant deficiencies in internal control or a material restatement of comparative information in the financial statements;

- g. Engagements for which unusual circumstances have been identified during the firm's acceptance and continuance process (e.g., a new client that had a disagreement with its previous auditor);
- h. Pro forma financial information to be included in a prospectus;
- i. Entities in emerging industries or for which the firm has no previous experience;
- j. Entities for which concerns were expressed in communications from regulators;
- k. Entities that hold a significant amount of assets in a fiduciary capacity for a large number of stakeholders, including financial institutions such as certain banks, insurance companies, and pension funds;
- l. Entities with a high public profile or whose management or owners have a high public profile;
- m. Governmental organizations; and
- n. Engagements with single audits or those under Government Auditing Standards.

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:

- a. **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.
- b. **Supporting engagement performance**, including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed.
- c. **Observing the "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 new requirements related to ethics:

- a. 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.
- b. Threats to compliance with relevant ethical requirements.
- c. 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 as well as formal written communications to management and those charged with governance.

4. SQMS 3 – Group Audits

SQMS 3, *Amendments to QM Sections 10, A Firm's System of Quality Management, and 20, Engagement Quality Reviews*, conforms certain terms to language used in SAS 149 and provides guidance on differentiating between a resource and an information source. The most significant change introduced by SAS 149 is that it provides a risk-based approach to planning and performing a group audit. Current literature requires the group engagement team to identify significant components at which to perform audit work. SAS 149 directs the group auditor to use professional judgment in determining the components at which to perform procedures based on assessed risks. As a result of the standard, certain terminology has changed ("referred-to auditor").