

A photograph of a person in a white lab coat sitting at a desk, holding a smartphone. A laptop and a spiral notebook are also on the desk. The image is overlaid with a semi-transparent green rectangle containing the title text.

ACCOUNTING

CONTINUING EDUCATION

Accounting and Auditing Update
(AAU4)

Accounting and Auditing Update

(AAU4)

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Section

1

FASB Update

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- › Apply recently issued Accounting Standard Updates (ASUs)

INTRODUCTION

This section reviews ASUs issued in 2019, and those issued in 2020 to the date of writing this program.

The purpose of this section is to provide an overview of the more recently issued ASUs such that if participants have to apply these new standards, you will have a foundation sufficient to understand the accounting and/or disclosure issues and the reference sources for the material. We also include at the beginning of this section FASB's Technical Agenda to enable you to anticipate the new ASU topics that will be issued in 2020 and beyond.

Due to the fact that FASB has issued a number of new ASUs as Codification Improvements or Transition Relief, this section will provide additional background information supporting the conclusions to help participants understand the purpose of the ASUs.

FASB's TECHNICAL AGENDA

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

1. Framework Projects
2. Recognition and Measurement: Broad Projects
3. Recognition and Measurement: Narrow Projects
4. Presentation and Disclosure Projects
5. Research Projects

As of February 26, 2020, the following are topics included in each of the five project areas.

Framework Projects

Framework projects are designed to improve FASB's basis or foundation for developing future accounting standards. This project is discussed later in this section.

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

Recognition and Measurement: Broad Projects

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

- *Distinguishing Liabilities from Equity (Including Convertible Debt)* – This project's objectives are to reduce the complexity associated with the accounting for financial instruments that have characteristics of both liabilities and equity.
- *Identifiable Intangible Assets and Subsequent Accounting for Goodwill* – The objective of this project is to revisit the subsequent accounting for goodwill and identifiable intangible assets broadly for all entities.

Recognition and Measurement: Narrow Projects

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

- Accounting by a Joint Venture for Non-Monetary Assets Contributed by Investors
- Codification Improvements – Financial Instruments
- Codification Improvements – Financial Instruments-Credit Losses
- Codification Improvements – Hedge Accounting
- Consolidation Reorganization and Targeted Improvements
- Hedging – Last of Layer Method
- Improving the Accounting for Asset Acquisitions and Business Combinations

- PCC Issue No. 2018-01, Practical Expedient to Measure Grant-Date Fair Value of Equity-Classified Share-Based Awards
- Reference Rate Reform: Facilitation of the Effects of the Interbank Offered Rate Transition on Financial Reporting
- Warrant Modifications: Issuers' Accounting for Modifications of Equity Classified Freestanding Call Options That are Not in the Scope of Topic 718
- Revenue Recognition – Contract Modifications of Licenses of Intellectual Property

Presentation and Disclosure Projects

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

- Disclosure Framework: Disclosure Review – Income Taxes
- Disclosure Framework: Disclosure Review – Inventory
- Disclosure Framework: Disclosures – Interim Reporting
- Disclosure Improvements in Response to the SEC's Release on Disclosure Update and Simplification
- Disclosures About Business Entities About Government Assistance
- Financial Performance Reporting – Disaggregation of Performance Reporting – The objective of this project is to improve the decision-usefulness of the income statement through the disaggregation of performance information.
- Not-for-Profit Reporting of Gifts-in-Kind
- Segment Reporting – The objective of this project is to undertake improvements to the segment aggregation criteria and disclosures to provide users with more decision-useful information about the reportable segments of a public entity.
- Simplifying the Balance Sheet Classification of Debt – The objective of this project is to provide guidance that will reduce the cost and complexity of determining the current versus non-current balance sheet classification of debt.

Research Projects

The following research projects are in various stages of completion.

- Disclosure Review – Intangibles, Share-Based Payment, and Foreign Currency
- Financial Performance Reporting: Financial Statements of Not-for-Profit Entities
- Hedge Accounting – Phase 2
- Income Taxes – Backwards Tracing
- Inventory and Cost of Sales
- Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805
- Targeted Improvements to the Statement of Cash Flows
- Variable Interest Entity Related Party Guidance

ASU 2019-01, LEASES (TOPIC 842): CODIFICATION IMPROVEMENTS

Objective

ASU 2016-02 (Topic 842), *Leases*, was issued to increase transparency and comparability among organizations by recognizing lease assets (RoU) and lease payment liabilities on the balance sheet and disclosing essential information about leasing transactions. ASU 2019-01, *Codification Improvements*, is one of six ASUs issued after ASU 2016-02 to improve the application of the ASU by making selected improvements to Topic 842, based on stakeholder feedback.

Background

Subsequent to the issuance of ASU 2016-02 in February 2016, FASB has elected to issue, on a piecemeal basis, ASUs to improve the application of the then new standard. As of this writing, FASB has issued the following additional lease amendments:

- ASU 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842
- ASU 2018-10, Leases (Topic 842): Codification Improvements
- ASU 2018-11, Leases (Topic 842): Targeted Improvements
- ASU 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors

- ASU 2019-01, Leases (Topic 842): Codification Improvements
- ASU 2019-10, Financial Instruments-Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

It would be easier for participants needing current lease accounting guidance for Topic 842 to review the current codification topic rather than trying to apply each of these ASUs individually. Topic 842 has these amendments integrated in the related subtopic areas with the additions and deletions identified.

Stakeholders informed FASB of three additional issues that they were having trouble with when applying Topic 842:

1. Determining the fair value of the underlying asset by lessors that are not manufacturers or dealers
2. Presentation on the statement of cash flows sales-type and direct financing leases cash flows
3. Transition disclosures related to Topic 250, *Accounting Changes and Error Corrections*

Provisions

1. **Determining the fair value of the underlying asset by lessors that are not manufacturers or dealers.** Topic 840, *Leases*, had provided an exception for lessors who are not manufacturers or dealers (generally financial institutions and captive finance companies) for determining the fair value (Topic 820) of leased property – the underlying asset in Topic 842. For those entities, Topic 840 included a fair value exception provision that permitted fair value to be the underlying asset's cost, reflecting any volume or trade discounts that may apply. Topic 842 did not include this exception and applying the definition of fair value in Topic 820 rather than using cost would have required these lessors to expense immediately certain acquisition costs (sales taxes and delivery charges) which were previously capitalized.

ASU 2019-01 reinstates this exception for lessors that are not manufacturers or dealers. These lessors should use their cost, reflecting any volume or trade discounts that may apply, as the fair value of the underlying asset. However, as noted in the ASU, if significant time lapses between the acquisition of the underlying asset and lease commencement, those lessors will be required to apply the definition of fair value (exit price) in Topic 820, *Fair Value Measurements and Disclosures*.

EXAMPLE

If a sales-type lease is entered into by a financial institution because the lease term is for a major part of the economic life of the underlying asset, at initial measurement, the difference between the fair value of the underlying asset and the carrying amount would be zero. The journal entry would appear as follows:

DB: Net Investment in the Lease

DB: Residual Asset

CR: Underlying Asset

If there was a significant time lapse between the acquisition of the underlying asset and lease commencement, assuming an increase in fair value, the journal entry would appear as follows:

DB: Net Investment in the Lease

DB: Residual Asset

CR: Underlying Asset

CR: Gain on Sale

2. **Presentation on the Statement of Cash Flows Sales-Type and Direct Financing Leases.**

Topic 840 did not provide guidance on how principal payments received under leases by lessors from sales-type and direct financing leases should be presented in the Statement of Cash Flows.

Topic 842 includes guidance that requires all lessors to present all cash receipts from leases within operating activities. Topic 942, *Financial Services-Depository and Lending*, though, illustrates presenting principal payments received under leases within investing activities. Consequently, a conflict existed in U.S. GAAP.

ASU 2019-01 requires that financial institutions within the scope of Topic 942 should present all principal payments received under leases within investing activities to better reflect the nature of the transactions.

3. **Transition Interim Disclosures Related to Topic 250, *Accounting Changes and Error***

Corrections. The transition guidance in Topic 842 references the transition disclosure requirements in Topic 250 to explain the accounting change and its impact when adopting a new ASU except for the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted.

As described in Topic 842, transition disclosures do not explicitly exempt reporting entities from applying interim quantitative transition disclosures as described *“In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.”*

As a result, Topic 250 requires similar quantitative disclosure requirements for interim periods and Topic 842 did not provide a similar exemption for these, requiring reporting entities in the year of adoption to provide interim disclosures that are not required for the annual period.

ASU 2019-01 clarifies FASB’s intent by providing a second transition disclosure exception for interim quantitative transition disclosures.

Transition and Effective Date

The transition and effective date provisions for ASU 2019-01 apply to issues 1 and 2 above. They do not apply to issue 3 because the amendments for that issue are to the original transition requirements in Topic 842.

For public business entities, the effective date of these amendments is for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years.

For all other entities, the effective date is for fiscal years beginning after December 15, 2020 (note ASU 2019-10), and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted. *NOTE: As of the date of submission of this course, the FASB has proposed delaying the effective dates for private companies and private nonprofit companies one year to fiscal years beginning after December 15, 2021; and for public nonprofits, the effective date would be pushed back to fiscal years after December 15, 2019.*

ASU 2019-02, ENTERTAINMENT-FILM-OTHER ASSETS-FILM COSTS (SUBTOPIC 926-20) AND ENTERTAINMENT-BROADCASTERS-INTANGIBLES-GOODWILL AND OTHER (SUBTOPIC 920-350): IMPROVEMENTS TO ACCOUNTING FOR COSTS OF FILMS AND LICENSE AGREEMENTS FOR PROGRAM MATERIALS

Objective

To align the cost capitalization guidance for episodic television series with the guidance for films in Subtopic 926-20, *Entertainment-Films-Other Assets-Film Costs*, and also align Subtopic 920-350, *Entertainment-Broadcasters-Intangibles-Goodwill and Other*, which provides guidance for license agreements for program materials, to any changes made to Subtopic 926-20.

NOTE: the FASB Codification has five areas of guidance within the overall topic of Entertainment:

1. Topic 920 – Entertainment-Broadcasters
2. Topic 922 – Entertainment-Cable Television
3. Topic 924 – Entertainment-Casinos
4. Topic 926 – Entertainment-Films
5. Topic 928 – Entertainment-Music

Background

Prior to this ASU, Subtopic 926-20 included different capitalization requirements for film production in the entertainment industry based on the type of content being produced. **For films**, all production costs as specified in Subtopic 926-20 were capitalized. **For episodic television series** though, production costs specified in Subtopic 926-20 were capitalized up to the amount of revenue contracted for each episode in the initial market until persuasive evidence existed that revenue from secondary markets would occur or a reporting entity could demonstrate a history of earning such revenue in that market.

With the increasing use of streaming by these content providers, it has been concluded by FASB that this inconsistency does not provide relevant information for users. The provisions of ASU 2019-02 apply to broadcasters and reporting entities that produce and distribute films and television series through theatrical releases and television as well as streaming services.

Definitions

Before starting with ASU 2019-02's provisions, some definitions are in order.

- **License Agreement.** A typical license agreement for program material (for example: features, specials, series, or cartoons) covers several programs (a package) and grants a television station, group of stations, network, pay television, or cable television system (licensee) the right to broadcast either a specified number or an unlimited number of showings over a maximum period of time (license period) for a specified fee.
- **Exploitation Costs.** All direct costs (including marketing, advertising, publicity, promotion, and other distribution expenses) incurred in connection with the distribution of a film.
- **Film Costs.** Film costs include all direct negative costs incurred in the physical production of a film, as well as allocations of production overhead and capitalized interest in accordance with Topic 835, *Interest*. Examples of direct negative costs include costs of story and scenario; compensation of cast, directors, producers, extras, and miscellaneous staff; costs of set construction and operations, wardrobe, and accessories; costs of sound synchronization; rental facilities on location; and postproduction costs such as music, special effects, and editing.
- **Films.** Feature films, television specials, television series, or similar products (including animated films and television programming) that are sold, licensed, or exhibited, whether produced on film, videotape, digital, or other video recording format.
- **Film Group.** The unit of account used for impairment testing for a film or a license agreement for program material when the film or license agreement is expected to be predominantly monetized with some other films and/or license agreements instead of being predominantly monetized on its own. A film group represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other films and/or license agreements.

- **Operating Cycle.** Presumed to be 12 months. If different than 12 months, this information must be disclosed.
- **Predominant Monetization Strategy.** The conversion of a film, film group, or license agreement into sources of revenue. This can be done on a reporting entity's own platform or through a license agreement in a secondary market.

Provisions

- **Capitalization.** ASU 2019-02 changes U.S. GAAP by aligning the accounting and production costs of episodic television series with the accounting for production costs of films – Subtopic 926-20. Reporting entities will now capitalize all qualifying costs for episodic television series in the same manner that film costs are recorded – capitalized. This should result in more costs capitalized than in legacy GAAP for episodic television series causing reporting entities to more closely monitor potential impairment issues associated with these costs.
- **Impairment.** The ASU requires that a reporting entity test a film or license agreement for impairment at the film group level when the film or license agreement is predominantly monetized with other films and/or license agreements – Subtopic 920-350. This requires that reporting entities determine whether produced content and licensed content should be tested as part of a film group (unit of account) or individually, both using a fair value model.

Once costs are capitalized, ASU 2019-02 requires a reporting entity to determine the predominant monetization strategy for each title. Will the title be monetized on its own or together with other films (film group)? Unamortized film costs should be tested for impairment whenever events or changes in circumstances indicate that the fair value of film predominantly monetized on its own or a film group may be less than its unamortized costs.

Film impairment indicators include:

- An adverse change in the expected performance of a film prior to release
- Actual costs substantially in excess of budgeted costs
- Substantial delays in completion or release schedules
- Changes in release plans, such as a reduction in the initial release pattern
- Insufficient funding or resources to complete the film and to market it effectively
- Actual performance subsequent to release failing to meet expectations set before release due to factors such as:
 1. A significant adverse change in technology, regulatory, legal, economic, or social factors that could affect the public's perception of a film or the availability of a film for future showings

- 2. A significant decrease in the amount of ultimate revenue expected to be recognized
- A change in the predominant monetization strategy of a film resulting in the film being predominantly monetized with other films and/or license agreements

Film group impairment indicators include:

- A significant adverse change in technology, regulatory, legal, economic, or social factors that could affect the fair value of the film group
 - A significant decrease in the number of subscribers or forecasted subscribers or the loss of a major distributor
 - A current-period operating cash flow loss combined with history of operating or cash flow losses or a projection of continuing losses associated with the use or exploitation of a film group
- **Disclosure Requirements.** Increases the transparency of information provided to users about produced and licensed content.

Subtopic 926-20-50 requires the following disclosures for **film costs**:

- The method(s) used in computing amortization
- For impairment, a description of the unit(s) of account used for impairment testing and the method(s) used for determining fair value
- The components of film costs separately for films predominantly monetized on their own and films predominantly monetized with other films and/or license agreements
- The aggregate amortization expenses for each period separately for films predominantly monetized on their own and films predominantly monetized with other films and/or license agreements
- The caption in the income statement where the amortization is recorded
- For completed and not released films, the portion of the costs of completed films that a reporting entity expects to amortize during the next operating cycle separate for films predominantly monetized on their own and for films predominantly monetized with other films and/or license agreements
- For released films, the portion of the costs of released films recognized at the date of the most recent balance sheet that a reporting entity expects to amortize within each of the next three operating cycles separate for films predominantly monetized on their own and for films predominantly monetized with other films and/or license agreements

For impairment amounts recognized for films or film groups, a reporting entity should disclose the following information in the financial statements that include the period in which the impairment is recognized:

1. A general description of the facts and circumstances leading to the impairment
2. The aggregate amount of the impairment losses
3. The caption in the income statement where the impairment losses are recorded
4. If applicable, the segment(s) (public companies) where the impairment losses are recorded

Subtopic 920-350-50 requires the following disclosures for **license agreements for program material**:

- A reporting entity should disclose its methods of accounting for the rights acquired under a license agreement, including, but not limited to, the following method:
 - The method or method(s) used in computing amortization
 - For impairment, a description of the unit(s) of account used for impairment testing and the method(s) used for determining fair value
- The following information should be disclosed for each period when a statement of financial performance is presented:
 - The aggregate amortization expense for the period
 - The caption in the income statement where the amortization is recorded
- For the most recent annual period when a balance sheet is presented, a reporting entity should disclose the portion of the costs of license agreements recognized at the date of the most recent balance sheet that the reporting entity expects to amortize within each of the next three operating cycles.
- For impairment amounts recognized for a license agreement that is not included in a film group, the following information should be disclosed that includes the period when the impairment losses are recognized:
 - A description of the facts and circumstances leading to the impairment
 - The amount of impairment losses
 - The caption in the income statement where the impairment losses are recorded
 - If applicable, the segment(s) (public companies) where the impairment losses are recorded

Transition and Effective Date

For public business entities, ASU 2019-02 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.

For all other entities, ASU 2019-02 is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years.

Early adoption is permitted, including early adoption in an interim period for public business entities for periods for which financial statements have not yet been issued and for all other entities for periods for which financial statements have not yet been made available for issuance.

ASU 2019-02 should be applied prospectively.

ASU 2019-03, NOT-FOR-PROFIT ENTITIES (TOPIC 958): UPDATING THE DEFINITION OF COLLECTIONS

Objective

To align the definition of “collections” in the FASB Codification with the American Alliance of Museums’ (AAM) Code of Ethics for Museums definition.

Background

The definition of collections was changed by the AAM to better reflect the nature of collections which are often held by museums, botanical gardens, libraries, aquariums, arboretums, historic sites, planetariums, zoos, art galleries, nature centers, science centers, technology centers, and some educational, research, and public service organizations.

NOTE: Contributions of works of art, historical treasures, and similar items that are not part of a collection should be recognized as assets and as revenue or gains in the financial statements.

Provisions

A reporting entity need not recognize contributions of works of art, historical treasures, and similar assets if the donated items are added to collections that meet the definition of a collection. ASU 2019-03 changed the definition of collections to the following:

- They are held for public exhibition, education, or research in furtherance of public service rather than financial gain
- They are protected, kept unencumbered, cared for, and preserved
- They are subject to an organizational policy that requires the use of the proceeds from items that are sold for the acquisitions of new collection items, NEW – **the direct care of existing collections**, or both

ASU 2019-03 notes that “the care and preservation of collections was a fundamental element of the basis for permitting entities to not recognize contributed collections.”

The AAM (March 20019) defines **direct care** “as an investment that enhances the life, usefulness, or quality of a museum’s collection.” Thus, when an object is sold, the funds generated should be used to either: replace the object with another that has relevance, importance, or use to the museum’s mission (acquisition) or invest in the existing collections by enhancing their life, usefulness, or quality and thereby ensuring they will continue to benefit the public (direct care).

A collection-holding NFP organization should also **disclose** its organizational policy for the use of proceeds from disposed collection items, including whether those proceeds could be used for acquisition of new collection items, the direct care of existing collections, or both. If the collection-holding NFP allows proceeds from disposed collection items to be used for direct care, the NFP should disclose its definition of direct care.

Transition and Effective Date

ASU 2019-03 is effective for annual financial statements issued for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.

Early adoption is permitted and the ASU should be applied on a prospective basis.

ASU 2019-04, CODIFICATION IMPROVEMENTS TO TOPIC 326, FINANCIAL INSTRUMENTS-CREDIT LOSSES, TOPIC 815, DERIVATIVES AND HEDGING, AND TOPIC 825, FINANCIAL INSTRUMENTS

Objective

Clarify, correct errors, or improve the FASB Codification in the areas of credit losses, derivatives and hedging, and financial instruments.

Background

GAAP defines **financial instruments** as cash, evidence of an ownership interest in an entity, or a contract that does both of the following:

1. Imposes on one entity a contractual obligation to either:
 - Deliver cash or another financial instrument to a second party or
 - Exchange other financial instruments on potentially unfavorable terms with the second entity

2. Conveys to that second party a contractual right to either:
 - Receive cash or another financial instrument from the first entity or
 - Exchange other financial instruments on potentially unfavorable terms with the first entity

FASB has been working on a financial instrument project for over 15 years that has resulted in the following three ASUs:

1. ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, Issued in January 2016.

This ASU changes financial instrument recognition, measurement, presentation, and disclosure requirements for all reporting entities. Its primary changes include the following:

- Reporting entities now have to measure all **equity investments at fair value** with the changes in fair value being reported in net income. This change eliminated legacy GAAP terminology of trading and available-for-sale for equity investments. In legacy GAAP, reporting entities recognized fair value changes in equity investments classified as available for sale through other comprehensive income – this option no longer exists.
 - If a reporting entity has equity investments that do not have a readily determinable fair value and they do not qualify for the net asset value (NAV) practical expedient in Topic 820, *Fair Value Measurement*, ASU 2016-01 provides for a **measurement alternative**. Reporting entities may measure these equity investments at cost, less any impairment, plus/minus changes resulting from observable price changes in orderly transactions for identical or similar investments of the same issuer.
2. ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, Issued in June 2016.

ASU 2016-13 changes how reporting entities account for credit losses for most financial assets including trade receivables that are not measured at fair value through net income. The ASU's objective is to provide financial statement users with more decision-useful information about a reporting entity's expected credit losses on financial assets and other commitments to extend credit.

Topic 825, *Financial Instruments*, also amends fair value option guidance to indicate that a reporting entity "may choose to elect the fair value option for an eligible item only on the date one of the following occurs" – ASU 2016-13 adds the following:

An event that requires an eligible item to be measured at fair value at the time of the event but does not require fair value measurement at each reporting date after that, excluding the recognition of impairment under lower-of-cost-or-market accounting or accounting for securities in accordance with either Topic 321, *Investments-Equity Securities*, or Topic 326, *Credit Losses*.

ASU 2016-13 introduces an impairment model referred to as a **current expected credit loss (CECL) model** that is based on **expected losses** rather than incurred losses. Available-for-sale (AFS) debt securities are excluded from the model's scope and are assessed for impairment under the guidance found in Topic 320, *Investments-Debt and Equity Securities*.

The CECL impairment model considers current economic conditions, past experience, and management's expectations of future economic conditions measuring the expected credit losses over the asset's contractual term.

3. ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities, Issued in August 2017.

ASU 2017-12 requires a reporting entity to **increase risk management economic activity disclosures** and improve **hedging transparency** and understandability. The ASU eliminates the requirement to separately measure and report **hedge ineffectiveness** in certain situations. Instead, for qualifying cash flow and net investment hedges, the total hedge instrument's fair value change will be recorded in other comprehensive income (OCI) and amounts deferred in OCI will be reclassified to earnings in the same income statement line item.

ASU 2017-12 also requires, for fair value and cash flow hedges, reporting entities include in the same income statement line item 1) amounts excluded from hedge effectiveness assessment and 2) the earnings effect of the hedged item. This is regardless of whether these amounts are amortized or recognized immediately in earnings.

Reporting entities are required to assess hedge effectiveness on an ongoing basis. Each assessment must consider whether the hedge has been highly effective (i.e., a retrospective assessment) and is expected to continue to be highly effective (i.e., prospective assessment). The ASU permits reporting entities to assess ongoing hedge effectiveness qualitatively, even for hedging relationships that are not assumed to be perfectly effective if an initial quantitative prospective assessment is performed and demonstrates that the relationship is expected to be highly effective, and at inception, the reporting entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

ASU 2019-04 is issued to clarify certain aspects of accounting for credit losses, hedging activities, and financial instruments. Many of these decisions are a result of the FASB credit losses transition group (TRG) recommendations.

Provisions

The provisions in this ASU are organized within each of the three ASUs described above. Many of the provisions are minor error corrections or provide for accounting policy elections in certain areas. The following is a summary of the principal changes made to each of the three ASUs by ASU 2019-04.

Financial Instruments – Principal Changes Made to ASU 2016-01

- **Health and welfare plans** accounted for following the guidance in Topic 965, *Plan Accounting-Health and Welfare Benefit Plans*, are excluded from the scope of Topic 320, *Investments-Debt and Equity Securities*, and Topic 321, *Investments-Equity Securities*.
- **Non-public entities** are exempted from the fair value disclosure requirements for financial instruments not measured at fair value on the balance sheet.
- Requires that a reporting entity **re-measures** an equity security without readily determinable fair value at fair value when an orderly transaction is identified for an identical or similar investment of the same issuer. The ASU clarifies that the measurement alternative is a non-recurring fair value measurement. In addition, the ASU clarifies that a reporting entity should adhere to the applicable disclosure requirements in Topic 820, *Fair Value Measurement*, for a non-recurring fair value measurement.
- **Transition and Effective Date.** These changes are effective for fiscal years beginning after December 15, 2019, including interim disclosures. Early adoption is permitted in any interim period after issuance of ASU 2019-04 for those entities that have already adopted ASU 2016-01.

Current Expected Credit Losses – Principal Changes Made to ASU 2016-13

- Reporting entities are permitted to measure the allowance for credit losses on accrued interest receivable balances **separately** from other components of the amortized cost basis of associated financial assets.
- Provides an **accounting policy election** not to measure an allowance for credit losses on accrued interest receivable amounts if a reporting entity writes off the uncollectible accrued interest receivable balance in a timely manner and provides adequate disclosures.
- Provides an **accounting policy election** to write off accrued interest amounts by reversing interest income or recognizing credit loss expense, or a combination of both and provides adequate disclosure.
- Provides an **accounting policy election** to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheet.
- Permits a **practical expedient** to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance sheet to meet disclosure requirements.
- For transfers between classifications or categories for loans and debt investments (for example, a transfer of a loan held for sale to a loan held for investment), the ASU requires that a reporting entity **reverse in earnings** any allowance for credit losses or valuation allowance previously measured on a loan or debt security, **reclassify and transfer** the loan or debt security to the new classification or category, and apply the **applicable measurement guidance** in accordance with the new classification or category.

- **Expected recoveries** of amounts previously written off and expected to be written off should be included when estimating the allowance for credit losses for both pools of financial assets and individual financial assets for non-purchased credit-deteriorated (PCD) financial assets. Based on this provision, a reporting entity would be required to include a negative allowance or a basis recovery in the allowance for credit losses for non-PCD financial assets that have been written off. This negative allowance cannot exceed the aggregate amount of previous or expected write offs on the non-PCD asset.
- In the area of **projections** of interest rate environments for variable-rate financial instruments, the ASU permits the use the discounted cash flow method to measure expected credit losses. In addition, a reporting entity that uses projections of future interest rate environments in estimating expected future cash flows should use the same assumptions in determining the effective interest rate used to discount those expected cash flows. Reporting entities should also adjust the effective interest rate to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments.
- Requires that a reporting entity consider the **estimated costs** (undiscounted) to sell if it intends to sell rather than operate the collateral when the reporting entity determines that foreclosure on a financial asset is probable.
- For **extensions and renewal options** (excluding those that are accounted for as derivatives within Topic 815, *Derivatives and Hedging*) that are included in the original or modified contract at the reporting date and are not unconditionally cancelable by the reporting entity, should be considered in determining the contractual term of a financial asset.
- **Transition and Effective Date.** These changes are effective for fiscal years beginning after December 15, 2019, including interim disclosures. Early adoption is permitted in any interim period after issuance of ASU 2019-04 for those entities that have already adopted ASU 2016-13.

Hedging Activities – Principal Changes Made to ASU 2017-12

- **Partial-term fair value hedges** of both interest rate and foreign exchange risk is permitted. The change in fair value of the hedged item can only be measured using an assumed maturity for changes in fair value attributable to interest rate risk.
- A reporting entity may, but is not required to, begin **amortizing a fair value hedge basis adjustment** before the fair value hedging relationship is discontinued. In addition, if a reporting entity elects to amortize the basis adjustment during an outstanding partial-term hedge, that basis adjustment should be fully amortized by the hedged item's assumed maturity date.
- The **amortized cost basis** of a hedged available-for-sale debt security should be disclosed as its carrying amount rather than fair value.

- Non-public reporting entities that are not financial institutions must prepare their analysis to support a designation of any **last-of-layer hedge** at hedge inception.
- States again that **upon transition**, it is permissible to switch from a quantitative approach to assessing hedge effectiveness to a qualitative critical terms method as long as all requirements are met.

Transition and Effective Date

For reporting entities that have not yet adopted ASU 2017-12 as of the issuance date of ASU 2019-04, the effective dates and transition requirements are the same as the effective dates and transition requirements of ASU 2017-12. (For public business entities, ASU 2017-12 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, ASU 2017-12 is effective for fiscal years beginning after December 15, 2020 (note ASU 2019-10), and interim periods within fiscal years beginning after December 15, 2021.)

For reporting entities that have already adopted ASU 2017-12, ASU 2019-04 is effective as of the beginning of the first annual reporting period beginning after the date of issuance of ASU 2019-04. Early adoption is permitted any time after issuance.

ASU 2019-05, FINANCIAL INSTRUMENTS-CREDIT LOSSES (TOPIC 326): TARGETED TRANSITION RELIEF

Objective

Provide transition relief for reporting entities adopting ASU 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

Background

Some reporting entities are planning to elect the fair value option on newly originated or purchased financial assets, although these reporting entities historically have measured similar financial assets at the amortized cost basis. This would cause year-to-year comparability problems for identical or similar financial instruments that are being managed in the same manner. FASB was asked to provide transition relief for these situations.

Provisions

ASU 2019-05 allows for a transition option to irrevocably elect the fair value option for certain financial instruments within the scope of Subtopic 326-20, *Financial Instruments-Credit Losses-Measured at Amortized Cost*, previously measured at amortized cost on an instrument-by-instrument basis.

NOTE: The fair value option does not apply to held-to-maturity debt securities.

Transition and Effective Date

For reporting entities that have not yet adopted ASU 2016-13, the effective date and transition are the same as ASU 2016-13. (For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other public business entities, ASU 2016-13 is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.)

For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, ASU 2016-13 is effective for fiscal years beginning after December 15, 2022 (note ASU 2019-10), and interim periods within those fiscal years.

For reporting entities that have adopted ASU 2016-13, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

ASU 2019-06, *INTANGIBLES-GOODWILL AND OTHER (TOPIC 350)*, *BUSINESS COMBINATIONS (TOPIC 805)*, AND NOT-FOR-PROFIT ENTITIES (TOPIC 958): EXTENDING THE PRIVATE ACCOUNTING ALTERNATIVES ON GOODWILL AND CERTAIN IDENTIFIABLE INTANGIBLE ASSETS TO NOT-FOR-PROFIT ENTITIES

Objective

To reduce the cost and complexity associated with the subsequent accounting for goodwill and the measurement of certain identifiable intangible assets for users of not-for-profit financial statements. ASU 2019-06 extends the scope of the accounting alternatives provided to non-public reporting entities in ASU 2014-02, *Intangibles-Goodwill and Other* (Topic 350): *Accounting for Goodwill*, and ASU 2014-18, *Business Combinations* (Topic 805): *Accounting for Identifiable Intangible Assets in a Business Combination*, to not-for-profit entities.

Background

In 2014, FASB created **accounting alternatives** for non-public entities for the subsequent accounting for goodwill (ASU 2014-02) and for certain identifiable intangible assets acquired in a business combination (ASU 2014-18). The guidance in ASU 2014-02 permits a non-public reporting entity to amortize goodwill on a straight-line basis, generally over 10 years, and to perform a one-step impairment test only when an event indicates that the fair value of the reporting entity or reporting unit may be less than its carrying amount.

The guidance in ASU 2014-18 permits a non-public acquiring company in a business combination to not recognize certain intangibles separately; rather they would become part of the amount recorded as goodwill in the business combination. These intangibles are:

- Customer-related intangible assets not capable of being sold or licensed independently from other assets of the business
- Non-compete agreements

Provisions

ASU 2019-06 extends the accounting alternatives from ASU 2014-02 and ASU 2014-18 to not-for-profit reporting entities.

Transition and Effective Date

ASU 2019-06 is effective upon issuance.

ASU 2019-07, CODIFICATION UPDATES TO SEC SECTIONS

Objective

To update the SEC portion of the FASB Codification(s) to reflect recent changes the SEC made to simplify disclosures, modernize the reporting and disclosure of information by registered investment companies, and other related items.

Background

In 2018, the SEC issued Release No. 33-10532, *Disclosure Update and Simplification*, which amended certain disclosure requirements that had become redundant, outdated, or superseded. In this Release, the SEC also referred certain of its disclosure requirements that overlap with, but require incremental information to, generally accepted accounting principles to the Financial Accounting Standards Board (FASB) for potential incorporation into its Accounting Standards Codification.

Provisions

After considering these referred disclosures, the FASB issued ASU 2019-07. In addition to amendments pursuant to Release No. 33-10532, ASU 2019-07 also amends various Codification SEC paragraphs pursuant to Releases Nos. 33-10231 and 33-10442, *Investment Company Reporting Modernization*. Other miscellaneous updates to agree the Codification to the electronic Code of Federal Regulations also were made.

Transition and Effective Date

ASU 2019-07 is effective upon issuance.

ASU 2019-08, COMPENSATION-STOCK COMPENSATION (TOPIC 718) AND REVENUE FROM CONTRACTS WITH CUSTOMERS (TOPIC 606): CODIFICATION IMPROVEMENTS-SHARE-BASED CONSIDERATION PAYABLE TO A CUSTOMER

Objective

To clarify existing guidance in Topic 606, *Revenue from Contracts with Customers*, that require that share-based payment awards granted to a customer in conjunction with selling goods or services be accounted for under Topic 606.

The clarification is necessary because of perceived diversity in practice because some reporting entities are accounting for share-based payment awards to customers following the guidance in Topic 718, *Compensation-Stock Compensation* (measure at grant date) while other reporting entities are accounting for share-based payment awards to customers following the guidance in Topic 606 (measure at contract inception).

Background

The diversity in practice related to share-based payment awards has existed because the **stock compensation** guidance has always resided in Topic 718 for both employee and non-employee stock awards. Topic 606, as a revenue standard, provides guidance on presentation but it did not provide guidance on measuring share-based payment awards granted to a customer.

Let's review:

FASB Statement No. 123R, *Share-Based Payment* (now Topic 718), was issued in 2004 requiring that compensation expense related to share-based payment transactions be recognized in the financial statements. In 2018, FASB issued ASU 2018-07, *Compensation-Stock Compensation* (Topic 718): *Improvements to Non-Employee Share-Based Payment Accounting*.

With the issuance of ASU 2018-07, the revised objective of Topic 718 is to recognize in the financial statements the goods or services received in exchange for equity instruments granted or liabilities incurred and the related cost to the reporting entity as those goods or services are received. Topic 718 uses the terms **compensation** and **payment** in their broadest sense to refer to the consideration paid for goods or services.

Topic 718 requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. Topic 718 establishes fair value (**or calculated/intrinsic value**) as the measurement objective in accounting for share-based payment arrangements and requires all reporting entities to apply a fair-value-based measurement method in accounting for share-based payment transactions except for equity instruments held by employee stock ownership plans.

The measurement objective for equity instruments awarded to grantees is to estimate the **fair value at the grant date** of the equity instruments that the entity is obligated to issue when grantees have

delivered the good or rendered the service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected volatility at the grant date.

Grant date is the date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers the goods or renders the service.

A share-based payment award becomes **vested** at the date that the grantee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

Reporting entities use valuation models to estimate the fair value of stock options. Two of those models are:

1. Black-Scholes-Merton Model
2. Lattice Model

The **Black-Scholes-Merton Model** consist of five inputs designed to estimate the fair value of stock options. Those five inputs include:

1. Exercise price
2. Price of the underlying common stock security
3. Term of the option
4. Volatility of the price of the underlying common stock security
5. Risk-free interest rate

NOTE: Volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

The **Lattice Model** produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument.

Topic 718 refers the issue of share-based consideration payable to customers to Topic 606, which before the issuance of ASU 2019-08, did not have measurement and recognition guidance for these types of arrangements.

Provisions

ASU 2019-08 clarifies (Topic 606-10-32-25A) that share-based consideration payable to a customer should be measured and recognized under stock compensation guidance found in Topic 718. This results in share-based sales incentives payable to a customer reflected as a **reduction in the transaction price** (in accordance with Topic 606) on the basis of the grant date fair value-based measure following the guidance in Topic 718 for both equity and liability classified share-based awards.

The **grant date** is the date at which a grantor (supplier) and a grantee (customer) reach a mutual understanding of the key terms and conditions of a share-based payment award. The classification and subsequent measurement of the award are subject to the guidance in Topic 718 unless the share-based payment award is subsequently modified and the grantee is no longer a customer.

ASU 2019-08 indicates that the practical expedient available for **non-public reporting entities** to estimate the expected term when valuing share-based options or similar awards is applicable for share-based awards granted to customers. If a non-public reporting entity elects to apply the practical expedient, it can do so if the share-based award has all of the following characteristics:

- The share-based award is granted at the money.
- The grantee has only a limited time to exercise the award (typically 30 to 90 days) once the grantee no longer provides goods, terminates service, or ceases to be a customer.
- The grantee can only exercise the award. The grantee cannot sell or hedge the award.
- The award does not include a market condition.

In addition, non-public reporting entities should initially and subsequently measure liability classified share-based awards to customers at fair value. Use of the intrinsic method is not permitted when measuring the fair value of share-based awards payable to a customer, unless the share-based awards are issued to a customer in exchange for distinct goods or services.

EXAMPLE

Share-Based Sales Incentive Issued for Each Customer Purchase

On January 1, 20X1, Company A executes a one-year Master Supply Agreement (MSA) with Customer B to sell and deliver custom product XYZ. Enforceable rights and obligations will exist once Customer B issues a purchase order for custom product XYZ. Based on Topic 606, a contract only exists when a purchase order is received.

Each custom product XYZ is priced at \$5,000 and Company A agrees to grant Customer B 100 fully vested stock shares of A's common stock as a sales incentive for each custom product XYZ purchased. The share-based sales incentive is not in exchange for distinct goods or services. During 20X1, Customer B issues three separate purchase orders, each for one custom product XYZ on February 1, June 1, and October 1. On the same day Company A receives each purchase order, it transfers control of each custom product XYZ and also issues 100 shares of A's common stock to Customer B.

The fair value of Company A's common stock is \$10 per share on January 1, 20X1 and appreciates during 20X1 as follows:

January 1, 20X1	\$10
February 1, 20X1	\$11
June 1, 20X1	\$12
October 1, 20X1	\$13

Prior to ASU 2019-08, many companies would have accounted for this transaction as a reduction in the transaction price measured on the date(s) each separate contract existed. The measurement incentive awards would have been:

February 1, 20X1	$\$11 * 100 \text{ shares} = \$1,100$
June 1, 20X1	$\$12 * 100 \text{ shares} = \$1,200$
October 1, 20X1	$\$13 * 100 \text{ shares} = \$1,300$

Following the guidance in ASU 2019-08, Company A will measure the share-based sales incentive issued to Customer B on January 1, 20X1, at the grant date fair value of the awards (each 100 shares at \$10 = \$1,000).

February 1, 20X1	$\text{Revenue } \$5,000 - \$1,000 = \$4,000$
June 1, 20X1	$\text{Revenue } \$5,000 - \$1,000 = \$4,000$
October 1, 20X1	$\text{Revenue } \$5,000 - \$1,000 = \$4,000$

If the incentive share-based award is not modified, there is no accounting change recognized to the value of the award(s) because the measurement date is the grant date.

Transition and Effective Date

For reporting entities that have adopted ASU 2018-07, ASU 2019-08 is effective for public business entities in fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other reporting entities, the ASU is effective in fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

ASU 2019-09, FINANCIAL SERVICES INSURANCE (TOPIC 944): EFFECTIVE DATE

Objective

Apply FASB's new effective date philosophy for new ASUs, staggering effective dates between large public companies and all other reporting entities.

Background

In 2018, FASB issued ASU 2018-12, *Financial Services-Insurance* (Topic 944): *Targeted Improvements to the Accounting for Long-Duration Contracts*. This ASU made targeted changes to improve, simplify, and enhance the financial reporting requirements for long-duration contracts issued by insurance companies. ASU 2018-12 made these targeted improvements in the following areas:

1. Liability for future policy benefits – Liability for future policy benefits was originally locked at contract inception and held constant over the term of the contract. This ASU requires reporting entities to review original assumptions and make updates to its expected cash flows on an annual basis, at a minimum. In addition, the ASU requires that an insurance reporting entity utilizes an upper-medium grade (low-credit risk) fixed-income instrument yield that maximizes the use of observable market inputs in order to discount future expected cash flows.
2. Market risk benefits – Prior to ASU 2018-12, two measurement models existed: 1) a fair value model and 2) an insurance accrual model. This ASU changed to one method an insurance reporting entity can use, that is, requiring that an insurance reporting entity measure market risks associated with deposit contracts at fair value. Any change in fair value that is related to a change in the instrument-specific credit risk is required to be reported in other comprehensive income.
3. Deferred acquisition costs – Prior to ASU 2018-12, amortization was complex with multiple methods in existence. This ASU simplified amortization of deferred acquisition costs and other balances in proportion to premiums, gross profits, or gross margins.

ASU 2018-12 was effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. For all other reporting entities, ASU 2018-12 was effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

Provisions

ASU 2019-09 defers the effective date of ASU 2018-12 for all reporting entities.

For public business entities, ASU 2018-12 is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other reporting entities, ASU 2018-12 is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years after December 15, 2024.

Early adoption is permitted.

ASU 2019-10, FINANCIAL INSTRUMENTS-CREDIT LOSSES (TOPIC 326), DERIVATIVES AND HEDGING (TOPIC 825), AND LEASES (TOPIC 842): EFFECTIVE DATES

Objective

Apply FASB's new effective date philosophy for new ASU's, staggering effective dates between large public companies and all other reporting entities.

Background

FASB is issuing this ASU to apply the change in philosophy to the effective dates for the following three ASUs:

1. ASU 2016-13, *Financial Instruments-Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*
2. ASU 2017-12, *Derivatives and Hedging* (Topic 815): *Targeted Improvements to Accounting for Hedging Activities*
3. ASU 2016-02, *Leases* (Topic 842)

Provisions

1. ASU 2016-13: For public business entities, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other reporting entities, the ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.
2. ASU 2017-12: For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other reporting entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.
3. ASU 2016-02: For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other reporting entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

ASU 2019-11, CODIFICATION IMPROVEMENTS TO TOPIC 326, FINANCIAL INSTRUMENTS-CREDIT LOSSES

Objective

To clarify or address stakeholders' specific issues and concerns about certain aspects of ASU 2016-13, *Financial Instruments-Credit Losses*.

Background

Similar to ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*, ASU 2019-11 improves the FASB Codification guidance in the area of credit losses for items brought to FASB's attention by stakeholders.

Provisions

Issue 1: Expected Recoveries for Purchased Financial Assets with Credit Deterioration (PCD)

ASU 2019-11 clarifies that the allowance for credit losses for PCD financial assets should include in the allowance for credit losses expected recoveries of amounts previously written off and expected to be written off by the reporting entity and should not exceed the aggregate cost basis previously written off and expected to be written off by a reporting entity.

This provision permits negative allowance on PCD financial assets. As noted in the ASU, the phrase "negative allowance" is used to describe situations where a reporting entity determines that it will recover the amortized cost basis, or a portion of that basis, after a write off and that basis recovery is included in the allowance for credit losses through a negative allowance. These situations often are a result of a reporting entity applying regulatory charge-off policies that are generally based on delinquency status.

EXAMPLE

Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration (PCD) with No Change in Credit Conditions

This example is Example 18 from ASU 2019-11 illustrating how, for PCD financial assets, reporting entities should include in the allowance for credit losses expected recoveries of amounts previously written off and expected to be written off.

Bank Q purchases a portfolio of loans with a par amount of \$10 million for \$2 million. At acquisition, Bank Q expects to collect \$2.5 million on the loan portfolio. Bank Q estimates expected credit losses using a method other than a discounted cash flow method. The acquisition-date journal entry is as follows:

DB: Loan-par amount	\$10,000,000	
CR: Loan-non-credit discount		\$500,000
CR: Allowance for credit losses		\$7,500,000
CR: Cash		\$2,000,000

After acquisition, Bank Q determines that each loan is deemed uncollectible on an individual unit-of-account basis and, therefore, writes off the loan portfolio. The following journal entries are recorded:

DB: Provision expense	\$2,000,000	
CR: Allowance for credit losses		\$2,000,000
DB: Allowance for credit losses	\$9,500,000	
DB: Loan-non-credit discount	\$500,000	
CR: Loans-par amount		\$10,000,000

Although deemed uncollectible on an individual basis, when grouped together, the group is expected to have some recoveries on an aggregate basis. Therefore, Bank Q records a negative allowance. Because Bank Q's expectation of credit conditions has not changed since acquisition, the expected recoveries of \$2.5 million must not result in the acceleration of the non-credit discount that existed immediately before being written off. Therefore, the following journal entry is recorded:

DB: Allowance for credit losses	\$2,000,000	
CR: Provision expense		\$2,000,000

EXAMPLE

Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration (PCD) After a Change in Credit Conditions

This example is Example 19 from ASU 2019-11 illustrating, for PCD financial assets, the accounting for a negative allowance after a change in credit conditions.

Assume the same facts from Example 18, Bank Q subsequently determines that a change in credit conditions has occurred and expects to collect an additional \$600,000 (for a total of \$3.1 million) on the group of loans. Because Bank Q's expectation of credit conditions has changed and it is determining the amount that it expects to collect using a method other than a discounted cash flow method, the expected recoveries of \$3.1 million would be reduced by the non-credit discount of \$0.5 million (that has not been accreted). This would result in Bank Q having an overall negative allowance of \$2.6 million. Therefore, the following journal entry is recorded:

DB: Allowance for credit losses	\$600,000	
CR: Provision expense		\$600,000

Issue 2: Transition Relief for Troubled Debt Restructurings

The ASU provides an accounting policy election to adjust the effective interest rate on existing troubled debt restructurings using prepayment assumptions on the date of adopting ASU 2016-13 rather than the prepayment assumptions in effect immediately before the restructuring.

Issue 3: Disclosures Related to Accrued Interest Receivables

As noted previously when discussing ASU 2019-04, ASU 2019-04 included the following provisions related to accrued interest receivables:

- Reporting entities are permitted to measure the allowance for credit losses on accrued interest receivable balances **separately** from other components of the amortized cost basis of associated financial assets.
- Provides an **accounting policy election** not to measure an allowance for credit losses on accrued interest receivable amounts if a reporting entity writes off the uncollectible accrued interest receivable balance in a timely manner and provides adequate disclosures.
- Provides an **accounting policy election** to write off accrued interest amounts by reversing interest income or recognizing credit loss expense, or a combination of both and provides adequate disclosure.
- Provides an **accounting policy election** to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheet.
- Permits a **practical expedient** to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet disclosure requirements.

ASU 2019-11 extends the disclosure relief above for accrued interest receivable balances when accounting for available-for-sale debt securities.

Issue 4: Financial Assets Secured by Collateral Maintenance Provisions

Topic 326 permits a **practical expedient for financial assets secured by collateral maintenance provisions** allowing reporting entities to measure the estimate of expected credit losses by comparing the amortized cost basis of a financial asset and the fair value of the collateral securing the financial asset as of the reporting date. ASU 2019-11 clarifies that a reporting entity should assess whether it reasonable expects that the borrower will be able to continually replenish collateral securing the financial asset to apply the practical expedient.

ASU 2019-11 also clarifies that reporting entities applying the practical expedient should estimate expected credit losses for any difference between the amount of the amortized cost basis that is greater than the fair value of the collateral securing the financial asset. The ASU notes that a reporting entity may determine that the expectation of non-payment for the amount of the amortized cost basis equal to the fair value of the collateral securing the financial asset is zero.

Transition and Effective Date

For reporting entities that have not yet adopted ASU 2016-13, the effective date and transition requirements are the same as the effective dates and transition requirements in ASU 2016-13.

For reporting entities that have adopted ASU 2016-13, ASU 2019-11 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

ASU 2019-12, *SIMPLIFYING THE ACCOUNTING FOR INCOME TAXES* (TOPIC 740)

Objective

ASU 2019-12 is part of FASB's Simplification Initiative designed to make narrow-scope simplifications and improvements to issued accounting topics through a series of short-term projects. This ASU is intended to improve and maintain the usefulness of tax information reported to users while reducing costs and complexity in financial reporting.

Background

As stated above, ASU 2019-12 is designed to simplify the accounting for income taxes by improving and maintaining the usefulness of tax information reported to users while reducing costs and complexity in financial reporting.

NOTE: As part of FASB's Disclosure Framework project, an Income Tax Exposure Draft was issued in 2016, and after much deliberation, a second Income Tax Exposure Draft is expected to be issued in 2020. This second Exposure Draft will change the disclosure requirements for income taxes when finalized.

Provisions

Accounting for Franchise Taxes

Certain tax jurisdictions calculate franchise taxes by using the greater of two tax computations: 1) based on income taxes and 2) based on items other than income. ASU 2019-12 reduces complexity in calculating deferred taxes in this area by requiring reporting entities to account for this tax by calculating the amount based on income first and then account for any remaining amount as a non-income-based tax. In the period of adoption for ASU 2019-12, reporting entities may have to re-measure its related deferred tax assets and liabilities.

Transactions Directly between a Taxpayer and a Government

Certain tax jurisdictions permit corporate taxpayers to elect a step-up in the tax basis of the reporting entity's assets in exchange for a current tax payment or for other considerations. Prior guidance in Topic 740 prohibited accounting recognition of a deferred tax asset for a subsequent step-up in the

tax basis of goodwill that is related to the portion of prior goodwill when a deferred tax liability was not previously recognized, except when the newly deductible goodwill amount exceeds the remaining balance of book goodwill.

Feedback received by FASB suggested that in some situations, applying the above guidance did not represent the overall economics of the transaction because the reporting entity has exchanged one asset for another asset but is not able to recognize the second asset received.

To address this issue, ASU 2019-12 changes the prior guidance in Topic 740 by requiring a reporting entity to determine whether a step-up in the tax basis of goodwill relates to the business combination when goodwill was originally recognized or whether it relates to a separate transaction. In situations when the tax basis relates to the business combination, no deferred tax asset would be recorded for the increase in basis except to the extent that the newly deductible goodwill amount exceeds the remaining balance of book goodwill.

In situations when the tax basis step-up relates to a **separate transaction**, a deferred tax asset would be recorded for the entire amount of the newly created tax goodwill. Factors that may indicate that the step-up in tax basis relates to a separate transaction include, but are not limited, to the following:

- A significant lapse in time between the transactions has occurred.
- The tax basis in the newly created goodwill is not the direct result of settlement of liabilities recorded in connection with the acquisition.
- The step-up in tax basis is based on a valuation of the goodwill or the business that was performed as of a date after the business combination.
- The transaction resulting in the step-up in tax basis requires more than a simple tax election.
- The reporting entity incurs a cash tax cost or sacrifices existing tax attributes to achieve the step-up in tax basis.
- The transaction resulting in the step-up in tax basis was not contemplated at the time of the business combination.

Allocation of Consolidated Tax Expense to Separate Financial Statements of Members

The ASU notes that a reporting entity is **not required** to allocate the consolidated tax to legal entities that are not subject to tax. However, a reporting entity may elect to allocate the consolidated tax to legal entities that are both not subject to tax and disregarded by the taxing authority.

This election is not required for all members of a group that files a consolidated tax return; that is, the election may be made for individual members of the group that files a consolidated tax return. The reporting entity should not make this election to allocate the consolidated amount of tax for legal entities that are partnerships or are other pass-through entities that are not wholly owned.

A reporting entity that is both not subject to tax and disregarded by the taxing authority that elects to include the allocated amount of tax in its separately issued financial statements should disclose that fact and provide the following disclosures:

- The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented.
- The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.

Removal of Topic 740 Exceptions

ASU 2019-12 further simplifies the accounting for income taxes by removing the following exceptions in Topic 740:

- Exception to the incremental approach for intra-period tax allocation when there is a loss from continuing operations and income or a gain from other items – for example, discontinued operations or other comprehensive income
- Exception to the requirement to recognize a deferred tax liability for equity method investments when a foreign subsidiary becomes an equity method investment
- Exception to the ability not to recognize a deferred tax liability for a foreign subsidiary when a foreign equity method investment becomes a subsidiary
- Exception to the general methodology for calculating income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year

Transition and Effective Date

ASU 2019-12 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.

For all other entities, ASU 2019-12 is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

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

Objective

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

Background

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

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

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

- The contract is entered into to purchase securities that will be accounted for under either Topic 320, *Investments-Debt and Equity Securities*, or Topic 321.
- The contract's terms require physical settlement of the contract by delivery of the securities.
- The contract is not a derivative instrument otherwise subject to the guidance in Topic 815.
- The contract, if a purchased option, has no intrinsic value at acquisition.

Provisions

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

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

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

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

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

Transition and Effective Date

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

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

Early adoption is permitted.

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

Objective

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

Background

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

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

Provisions

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

1. Measuring current expected credit losses
2. Development, governance, and documentation of a systematic methodology for determining its allowance for credit losses
3. Documenting the results of a systematic methodology
4. Validating a systematic methodology

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

At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting Topic 842, Leases, for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. These dates are consistent with the effective dates for Topic 842 as amended in ASU 2019-10, Financial Instruments-Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates.

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

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

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

Transition and Effective Date

ASU 2020-02 is effective upon issuance.

ASU 2020-03, CODIFICATION IMPROVEMENTS TO FINANCIAL INSTRUMENTS

Objective

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

Background

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

Provisions

Issue 1: Fair Value Option Disclosures

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

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

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

- Management's reasons for electing a fair value option for each eligible item or group of similar eligible items

- If the fair value option is elected for some but not all eligible items within a group of similar eligible items, both of the following:
 1. A description of those similar items and the reasons for partial election
 2. Information to enable users to understand how the group of similar items relates to individual line items on the statement of financial position
- For each line item in the balance sheet that includes an item or items for which the fair value option has been elected, both of the following:
 1. Information to enable users to understand how each line item in the balance sheet relates to major classes of assets and liabilities presented in accordance with the fair value disclosure requirements of Topic 820
 2. The aggregate carrying amount of items included in each line item in the balance sheet that are not eligible for the fair value option, if any
- The difference between the aggregate fair value and the aggregate unpaid principal balance of each of the following:
 1. Loans and long-term receivables (other than securities subject to Topic 320) that have contractual principal amounts and for which the fair value option has been elected
 2. Long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected
- For loans held as assets for which the fair value option has been elected, all of the following:
 1. The aggregate fair value of loans that are 90 days or more past due
 2. If the entity's policy is to recognize interest income separately from other changes in fair value, the aggregate fair value of loans in non-accrual status
 3. The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in non-accrual status, or both
- For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, the information required by Topic 323, *Investments-Equity Method and Joint Ventures*.

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

- For each line item in the statement of financial position, the amounts of gains and losses from fair value changes included in earnings during the period and in which line in the income statement those gains and losses are reported. This subtopic does not preclude an entity from meeting this requirement by disclosing amounts of gains and losses that include amounts of gains

and losses for other items measured at fair value, such as items required to be measured at fair value.

- A description of how interest and dividends are measured and where they are reported in the income statement. This subtopic does not address the methods used for recognizing and measuring the amount of dividend income, interest income, and interest expense for items for which the fair value option has been elected.
- For loans and other receivables held as assets, both of the following:
 1. The estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk
 2. How the gains or losses attributable to changes in instrument-specific credit risk were determined
- For liabilities, all of the following about the effects of the instrument-specific credit risk and changes in it:
 1. The amount of change, during the period and cumulatively, of the fair value of the liability that is attributable to changes in the instrument-specific credit risk
 2. How the gains and losses attributable to changes in instrument-specific credit risk were determined
 3. If a liability is settled during the period, the amount, if any, recognized in other comprehensive income that was recognized in net income at settlement

Other Required Disclosures

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

Issue 2: Applicability of Portfolio Exception in Topic 820, Fair Value Measurement, to Non-Financial Items

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

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

Issue 3: Disclosures for Depository and Lending Institutions

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

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

ASU 2020-03 provides this cross-reference.

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

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

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

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

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

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

Effective Date

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

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

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

Objectives

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

Background

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

FASB notes that LIBOR transition is impacted by the significant volume of outstanding contracts, and other arrangements, such as debt agreements, lease agreements, and derivative instruments, which will be modified to replace references to discontinued rates with references to replacement rates. For accounting purposes, these contract modifications are required to be evaluated in determining whether these modifications result in the **establishment of new contracts or the continuation of existing contracts**.

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

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

Provisions

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

ASU 2020-04 provides **optional expedients and exceptions** for applying GAAP to contract modifications and hedging relationships, subject to meeting certain criteria that reference LIBOR or

another rate that is expected to be discontinued. If a debt agreement or lease agreement has to be changed to use a new interest rate, the modification would be accounted for as a continuation of the contract rather than the establishment of a new contract.

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

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

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

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

- Modifications of contracts within the scope of Topics 310, *Receivables*, and 470, *Debt*, should be accounted for by prospectively adjusting the effective interest rate in the contract
- Modifications of contracts within the scope of Topic 842, *Leases*, should be accounted for as a continuation of the existing contracts with no reassessments of the lease classification and the discount rate or re-measurements of lease payments that otherwise would be required under those topics for modifications not accounted for as a separate contract
- Modifications of contracts do not require a reporting entity to reassess its original conclusion about whether that contract contains embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract following the guidance in Topic 815, *Derivatives and Hedging*

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

Effective Date and Transition

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

ASUs EFFECTIVE IN 2020

For Public Business Entities

- ASU 2016-13, *Financial Instruments-Credit Losses* (Topic 326)
- ASU 2017-04, *Intangibles-Goodwill and Other* (Topic 350): *Simplifying the Test for Goodwill Impairment*

- ASU 2018-13, *Fair Value Measurement* (Topic 820): *Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement*
- ASU 2018-14, *Compensation-Retirement Benefits-Defined Benefit Plans-General* (Subtopic 715-20): *Disclosure Framework-Changes to the Disclosure Requirements for Defined Benefit Plans*
- ASU 2018-15, *Intangibles-Goodwill and Other-Internal Use Software* (Subtopic 350-40): *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract*
- ASU 2018-17, *Consolidation* (Topic 810): *Targeted Improvements to Related Party Guidance for Variable Interest Entities*
- ASU 2018-18, *Collaborative Arrangements* (Topic 808): *Clarifying the Interaction Between Topic 808 and Topic 605*
- ASU 2018-19, *Codification Improvements to Topic 326: Financial Instruments-Credit Losses*
- ASU 2019-01, *Leases* (Topic 842): *Codification Improvements*
- ASU 2019-02, *Entertainment-Films-Other Assets-Film Costs* (Subtopic 920-350): *Improvements to Accounting for Costs of Films and License Agreements for Program Materials*
- ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments* – The amendments to ASU 2016-01 and ASU 2016-13 are effective for fiscal years and interim periods beginning after December 15, 2019
- ASU 2019-05, *Financial Instruments-Credit Losses* (Topic 326): *Targeted Transition Relief*
- ASU 2019-08, *Codification Improvements-Share-Based Consideration Payable to a Customer*
- ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*
- ASU 2020-02, *Financial Instruments-Credit Losses (Topic 326) and Leases (Topic 842) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)*
- ASU 2020-03, *Codification Improvements to Financial Instruments* (in part)
- ASU 2020-04, *Reference Rate Reform* (Topic 848): *Facilitation of the Effects of Reference Rate Reform on Financial Reporting*

For Non-Public Business Entities

- ASU 2017-08, *Receivables and Other Costs* (Subtopic 310-20): *Premium Amortization on Purchased Callable Debt Securities*
- ASU 2017-11, *Earnings Per Share* (Topic 260); *Distinguishing Liabilities from Equity* (Topic 480); *Derivatives and Hedging* (Topic 815): *(Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Non-public Entities and Certain Mandatorily Redeemable Non-controlling Interests with a Scope Exception*
- ASU 2018-07, *Compensation-Stock Compensation* (Topic 718): *Improvements to Non-Employee Share-Based Payment Accounting*
- ASU 2018-08, *Not-for-Profit Entities* (Topic 958): *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*
- ASU 2018-13, *Fair Value Measurement* (Topic 820): *Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement*
- ASU 2018-16, *Derivatives and Hedging* (Topic 815): *Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*
- ASU 2019-03, *Not-for-Profit Entities* (Topic 958): *Updating the Definition of Collections*
- ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments* – The amendments to ASU 2016-01 are effective for fiscal years and interim periods beginning after December 15, 2019
- ASU 2019-08, *Codification Improvements-Share-Based Consideration Payable to a Customer*
- ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments-Credit Losses*
- ASU 2020-04, *Reference Rate Reform* (Topic 848): *Facilitation of the Effects of Reference Rate Reform on Financial Reporting*

Section

2

AICPA Update – Auditing

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- › Identify and describe technology changes affecting accounting and auditing
- › Identify and describe recently issued SASs (audit standards)
- › Describe recent audit issues and how these issues are being addressed
- › Refer to report illustrations for recently issued standards

INTRODUCTION

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

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

1. The Auditing Standards Board (ASB) promulgates the audit standards for non-public entities in the United States known as Statements on Auditing Standards (SAS).
2. The ASB also promulgates the Statements on Standards for Attestation Engagements (SSAE).

3. The AICPA Forensic and Valuation Services Executive Committee (FVS Executive Committee) promulgates the Statement on Standards for Forensic Services (SSFS).
4. The Professional Ethics Executive Committee (PEEC) issues interpretations of the Code of Professional Conduct.

Examples of a Few of the Changes

The ASB has completed a suite of standards related to auditor reporting as part of its project to converge, to the extent possible, U.S. standards with both international standards and standards promulgated by the Public Company Accounting Oversight Board (PCAOB). It will be imperative that CPA firms and practitioners evaluate the impact of the new standards on their audit practice as not only are auditor report letter language and form change, there are significant changes to definitions, new required procedures, and disclosures.

These changes are the most significant since the risk assessment suite of standards were issued in 2006. In fact, the risk assessment approach will need to be revised to ensure that the new requirements are incorporated in the firm's approach.

The ASB issued SAS 138 and SSAE 20, which amended the description of the Concept of Materiality. The revised description of materiality for both concludes that:

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

As this course is being written in March 2020, it is not possible to exactly predict the contents of the Exposure Drafts or any final new standards that will result from the completion of these projects. Topics to be covered in this section include:

- Challenges to the Future of Audits – The Future is Now
- Technology Affecting Accounting and Auditing
- AICPA Audit Quality Initiative Update
- Peer Review – Risk Assessment – A Continuing Issue
- Peer Review – Other Issues
- Audit Issues Implementing the New Revenue and Lease Accounting Standards
- Statements on Standards for Audit Update
- Proposed Statements on Standards for Audit
- Statement on Standards for Attestation Engagements Update

- Statement on Standards for Forensic Accounting (NEW)
- Ethics Update

CHALLENGES TO THE FUTURE OF AUDITS – THE FUTURE IS NOW

To meet the challenges in the ever-changing environment of financial reporting and audits of the future, in November 2019, the AICPA proposed a **strategic plan** to guide the ASB's work for the next three years. The plan has five strategic initiatives:

1. ASB will continue to converge its standards with the International Auditing and Assurance Standards Board while trying to reduce the differences with the Public Company Accounting Oversight Board.
2. Seek input and feedback from stakeholders in setting its agenda in developing high quality standards and guidance.
3. Operate more strategically.
4. Consider the changing environment by monitoring the development and use of technologies to consider if its standards remain fit for the purpose.
5. Help practitioners understand and consistently apply standards for the effective implementation and application of standards.

The ASB believes strongly that audit standards should be set to meet the public interests. The proposed strategic plan should help practitioners effectively and efficiently provide high-quality audit and attestation services to non-issuers while considering the current global economic environment and the manner in which business is conducted.

The future **key drivers** in auditing will likely be:

- **Technology** – The Internet of Things-Artificial Intelligence (AI) data driven audits will modify the ability for technology to allow time for more analysis with less focus on routine tasks that will be automated. It is conceivable that audits will be on 100% of a population as opposed to samples of a population.
- **Methodology** – Rethink the audit process of how the audit is conducted by integrating robust and current technology.
- **Standards** – The evolution of standards must keep up with the process of future audits. The strategic plan of the ASB should address this issue.
- **New Skills** – New skills the audit professional will need to be proficient in are data analytics and integration. Since routine tasks will be automated, there will more time for critical analysis.

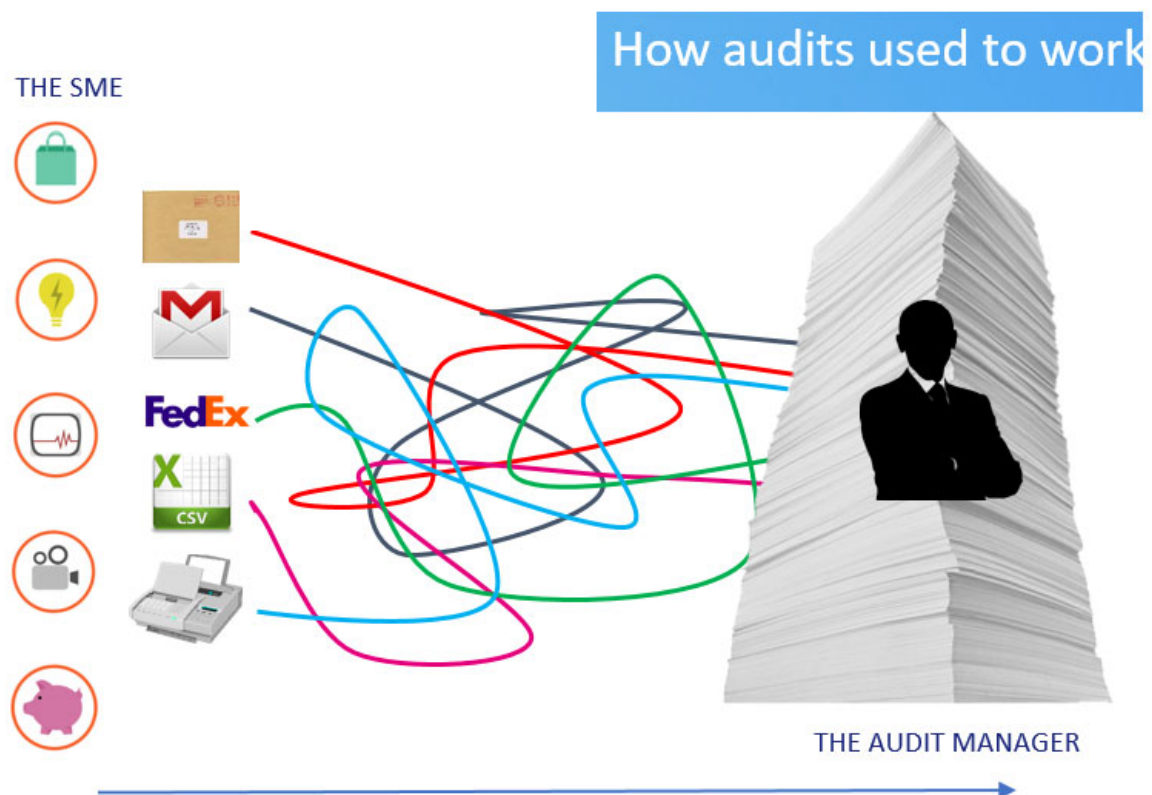
TECHNOLOGY CHANGES AFFECTING ACCOUNTING AND AUDITING

Use of Data Analytics in Audits

In the auditing profession, the process of how audits are performed is being reimagined. We are starting to recognize (and soon will require) the advantages of more in-depth skills required to understand and analyze IT systems succinctly and test controls over the computer systems that have automated controls versus manual internal controls. Historically, sampling risk has been accepted for paper controls. With the use of technology, testing can be applied on an entire population, which will result in a 100% test with the audit focusing on outliers and anomalies.

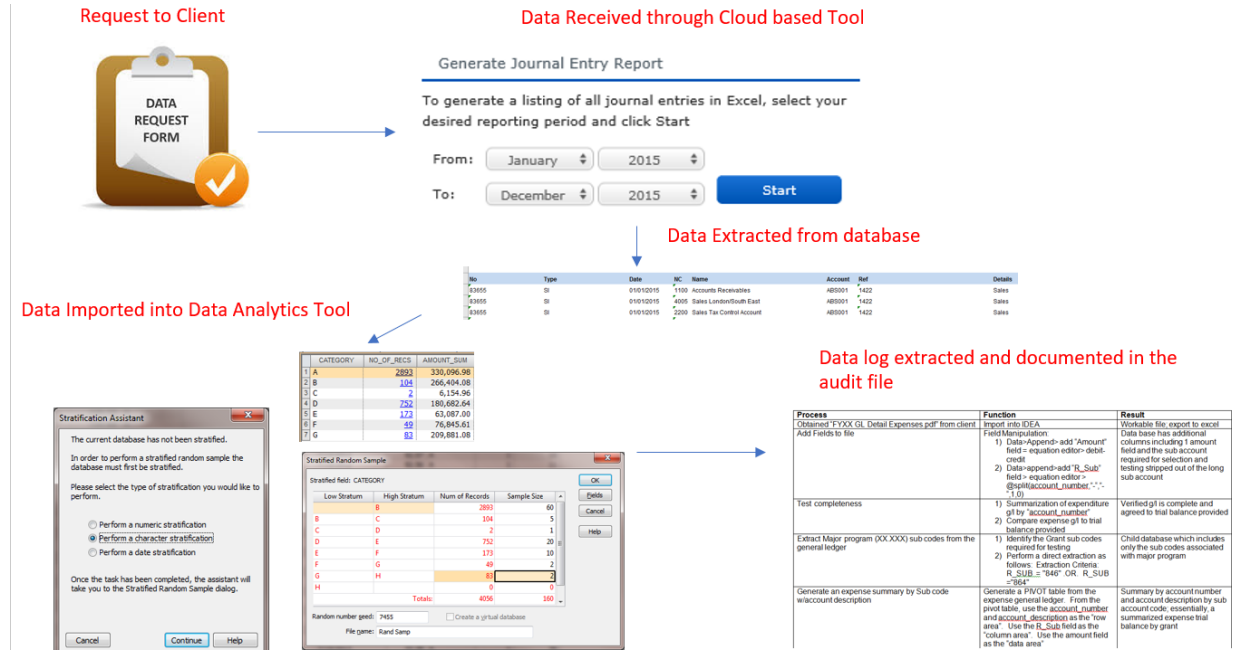
This can create some trepidation that when an error is identified, current audit standards would suggest that all errors should be investigated. The concern is that the audit standards have not yet been updated for these relatively new advancements in technology; however, the Accounting Standards Board strategic plan for the next few years and the proposed NASBA and AICPA new licensing model will virtually eliminate these constraints. Below are current initiatives to address these concerns.

The Audits of Yesterday and Today



* Image extracted from Validis.com

The Audits of Tomorrow But Should Be Today



Core Concepts in Data Analytics

Big Data

Big data involves the acquisition, extraction, and analysis of large data sets. A large data set is considered big data if it has one or more of the following characteristics: **high volume, high velocity, or high variety** (3 Vs). When Twitter launched in 2006, on average there are 350 million tweets sent per day. By the spring of 2018, a trillion tweets had been sent in the history of the platform ranging from images, text, video, and audio. Twitter's tweets are good examples of the "3 V's" of "volume, velocity, and variety" of big data.³

The six Vs of big data

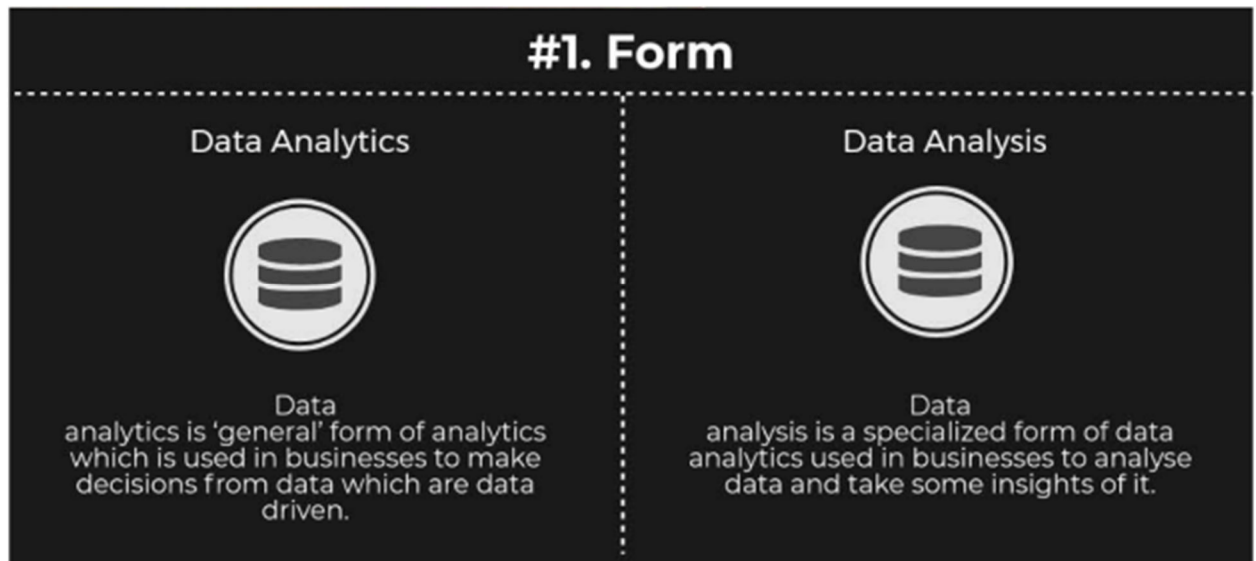
Big data is a collection of data from various sources, often characterized by what's become known as the 3Vs: *volume, variety and velocity*. Over time, other Vs have been added to descriptions of big data:

VOLUME	VARIETY	VELOCITY	VERACITY	VALUE	VARIABILITY
The amount of data from myriad sources.	The types of data: structured, semi-structured, unstructured.	The speed at which big data is generated.	The degree to which big data can be trusted.	The business value of the data collected.	The ways in which the big data can be used and formatted.
					

[<https://searchdatamanagement.techtarget.com/definition/big-data>]

³ "How Do We Define 'Big Data' And Just What Counts as A 'Big Data' Analysis?", Kalev Leetaru (2019), <https://www.forbes.com/sites/kalevleetaru/2019/01/09/how-do-we-define-big-data-and-just-what-counts-as-a-big-data-analysis/#6a06c7f91b66>

Data Analytics



[<https://www.educba.com/data-analytics-vs-data-analysis/>]

The terms like data analytics and data analysis are used interchangeably. Data analytics is a process of reviewing, cleaning, transforming, and modeling data with the objective of utilizing the data to make informed decisions supported by the data.⁴

Types of Data Analytics/Analysis

- Descriptive. Descriptive analytics is a first stage of data processing and is a summary of historical data. Descriptive analytics uses data mining (searching) and aggregation (gathering) techniques to provide answers about the past.⁵
- Diagnostic. Diagnostic analytics is a type of analytics that examines the data to answer the question of “Why.” This process involves activities such as data discovery, mining, and discovering correlations.⁶
- Predictive. Predictive analytics employs the use of statistical analysis and forecasting to predict the future.⁷
- Prescriptive. Prescriptive analytics involves finding the best course of action for a given circumstance.⁸

⁴ <https://www.investopedia.com/terms/d/data-analytics.asp>

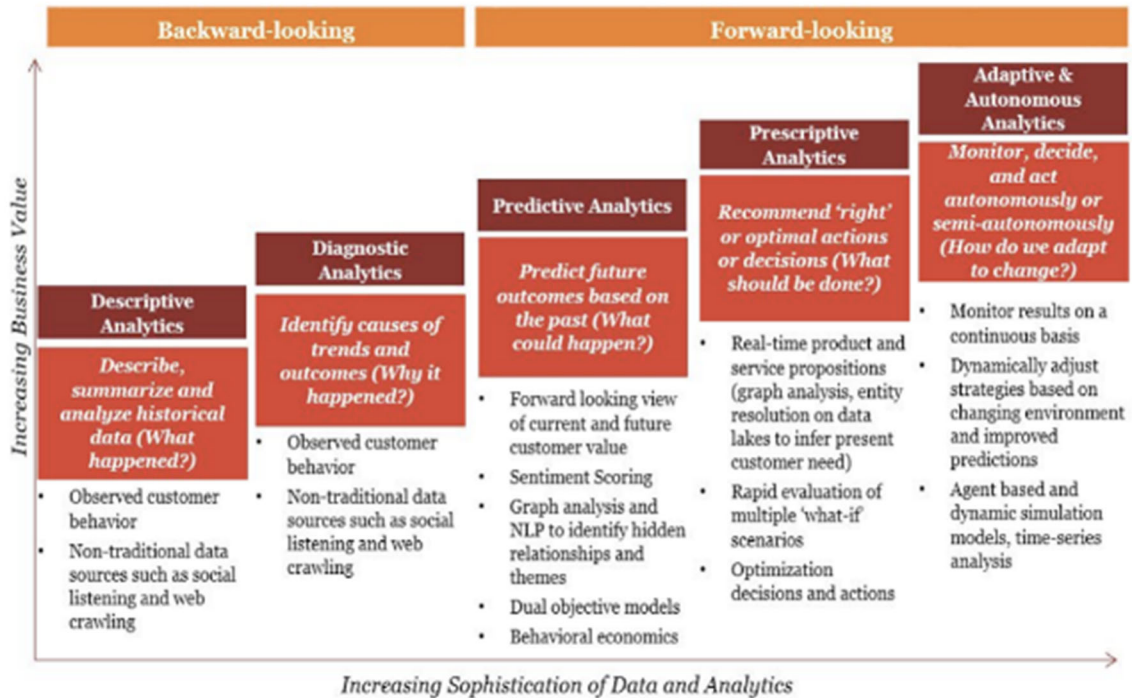
⁵ “4 Types of Data” (2017), Thomas Maydon, <https://www.kdnuggets.com/2017/07/4-types-data-analytics.html>

⁶ “4 Types of Data” (2017), Thomas Maydon, <https://www.kdnuggets.com/2017/07/4-types-data-analytics.html>

⁷ “4 Types of Data” (2017), Thomas Maydon, <https://www.kdnuggets.com/2017/07/4-types-data-analytics.html>

⁸ “4 Types of Data” (2017), Thomas Maydon, <https://www.kdnuggets.com/2017/07/4-types-data-analytics.html>

- Adaptive. Adaptive analytics is a form of predictive analytics that augments decision-making techniques with deep learning adaptive models in order to improve predictions.⁹



[<https://towardsdatascience.com/your-smarter-analytics-strategy-97fb3a1c1b1f>]

Data Analysts

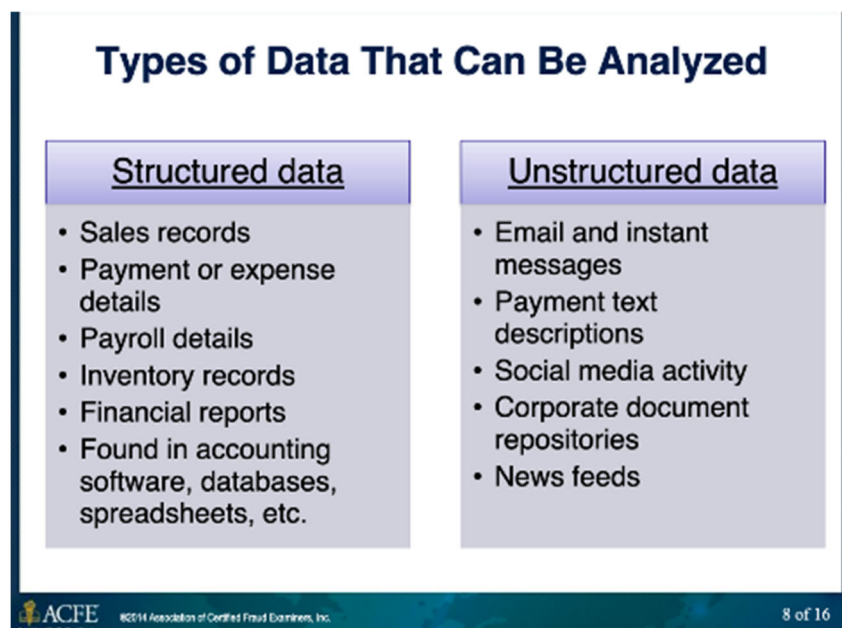
Data analysts turn large data sets into insights and patterns to discover trends. Data analysts work in a wide range of industries such as healthcare, education, retail, and government—collecting data and looking for patterns within that data to uncover trends that can be used to make decisions and recommendations.¹⁰

Most organizations have a treasure trove of data. Data analytics empowers these organizations to make the best use of that data for other purposes including process improvement. Although technology is not necessarily a part of data analytics, it certainly makes the process a lot more efficient and effective. The use of technology in the data analytics process though ideal is nonetheless tedious and costly in most instances. In this section, we will explore the steps in the data analytics process.

⁹ "Adaptive Analytics: Big Data for Small Business", Parnell Woodard (2018), https://data-analytics.cioreview.com/vendor/2018/adaptive_analytics

¹⁰ "How Much Do Data Analysts Make? Salary, Demand, and Defining Skills of the Industry", Kristin Burnham (2019), <https://www.northeastern.edu/graduate/blog/how-much-do-data-analysts-make/>

1. **Business Problem (Case).** The first step in the data analytics process is defining the purpose of the project. During this phase, a business case is developed outlining: the objectives, time, and budget necessary to meet the business' objectives.¹¹
2. **Identify/Collect Data Sources.** The next step involves searching for and or identifying data sources. Most large businesses have tons of data including research, customer, and employee data.¹² This step may involve mapping data across the organization to find viable sources of data.¹³
3. **Select Data.** Once the data is determined to be viable for use in analytics, other stakeholders may be required in the decision to use particular data sets.¹⁴ Global regulations including data privacy and employment laws may restrict the purchase and/or use of certain types of data for alternate purposes. Generally, publicly available data have the least restrictions.¹⁵
4. **Process Data.**



[https://www.acfe.com/uploadedFiles/ACFE_Website/Content/review/da/01-Introduction-to-Data-Analytics.pdf]

¹¹ “5 Steps of the Data Analysis Process”, Devin Pickell (2019), <https://learn.g2.com/data-analysis-process>

¹² “5 Steps of the Data Analysis Process”, Devin Pickell (2019), <https://learn.g2.com/data-analysis-process>

¹³ “Advanced Data Analytics for IT Auditors”, Spiros Alexiou, Ph.D., CISA (2016), <https://www.isaca.org/Journal/archives/2016/volume-6/Pages/advanced-data-analytics-for-it-auditors.aspx>

¹⁴ “Big Data Privacy is a Bigger Issue Than You Think”, John Weathington (2017), <https://www.techrepublic.com/article/big-data-privacy-is-a-bigger-issue-than-you-think/>

¹⁵ “Solving Real-World Problems Using Data Science”, Naman Doshi (2018), <https://towardsdatascience.com/solving-real-world-problem-using-data-science-e2236159a1a9>

At this phase, the data is organized for analysis.¹⁶ Processing may require also structuring the data as required for the relevant analysis tools. For example, the data might have to be placed into rows and columns in a table within a database, spreadsheet, or application.¹⁷

1. **Clean.** Processed and organized data may contain duplicate, incomplete, or erroneous information. The purpose of data cleaning is to correct and prevent errors.¹⁸
2. **Analysis.** Once the data that is processed, organized, and cleaned, it is ready for analysis. Various techniques are used to analyze, interpret, and derive conclusions based on the requirements. During this phase, data visualization models may be used to examine the data in graphical format and obtain additional insights.¹⁹
3. **Decision Making.** The final phase includes reporting on the results of the data analysis. The report should be sufficient to support informed decisions and further action. The feedback from users may result in additional analysis.²⁰

VISUALIZATIONS AND DASHBOARDS

Excel

Microsoft Excel is frequently used for data analysis. Excel offers basic operations reviewing and reading data into Excel using various data formats, organization, and manipulation.²¹ R and Python are more useful for large data sets.²²

¹⁶ Data Analysis – Process, https://www.tutorialspoint.com/excel_data_analysis/data_analysis_process.htm

¹⁷ Data Analysis – Process, https://www.tutorialspoint.com/excel_data_analysis/data_analysis_process.htm

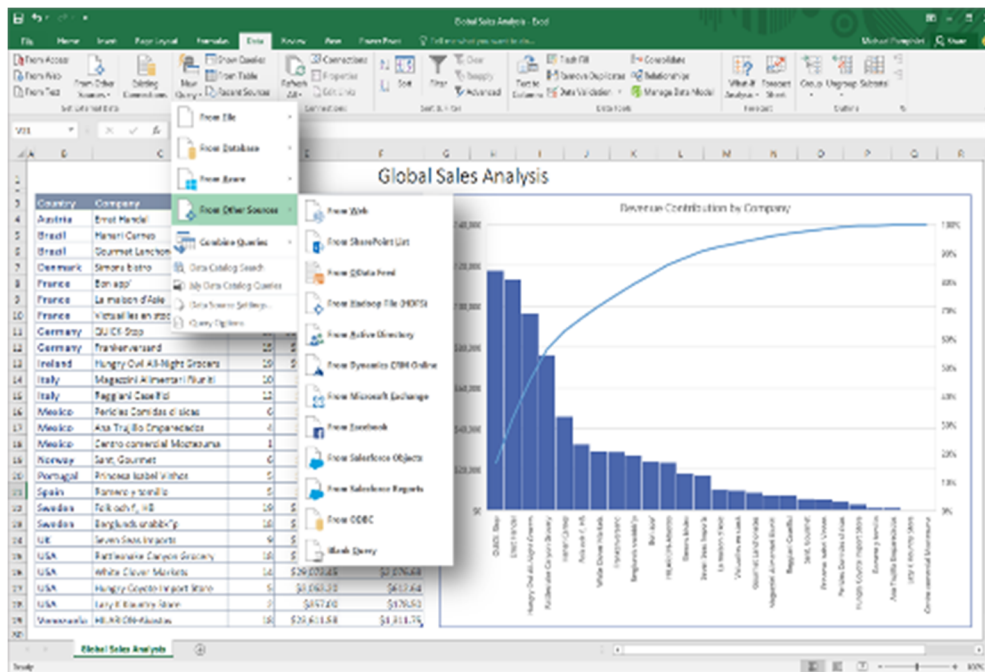
¹⁸ Data Analysis – Process, https://www.tutorialspoint.com/excel_data_analysis/data_analysis_process.htm

¹⁹ Data Analysis – Process, https://www.tutorialspoint.com/excel_data_analysis/data_analysis_process.htm

²⁰ Data Analysis – Process, https://www.tutorialspoint.com/excel_data_analysis/data_analysis_process.htm

²¹ “15 Excel Data Analysis Functions You Need to Know”, <https://excelwithbusiness.com/blog/15-excel-data-analysis-functions-you-need-to-know/>

²² “Simple Yet Powerful Excel Tricks for Analyzing Data”, Sunil Ray (2015), <https://www.analyticsvidhya.com/blog/2015/11/excel-tips-tricks-data-analysis/>

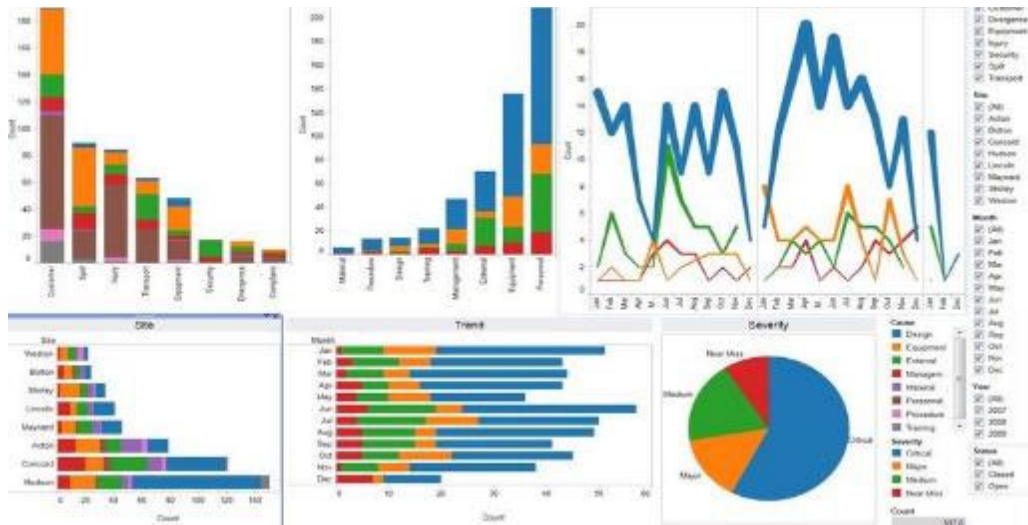


Tableau

Tableau is a data visualization tool used in data science and business intelligence. Tableau provides insightful and colorful visualizations in an interactive and impactful way.²³

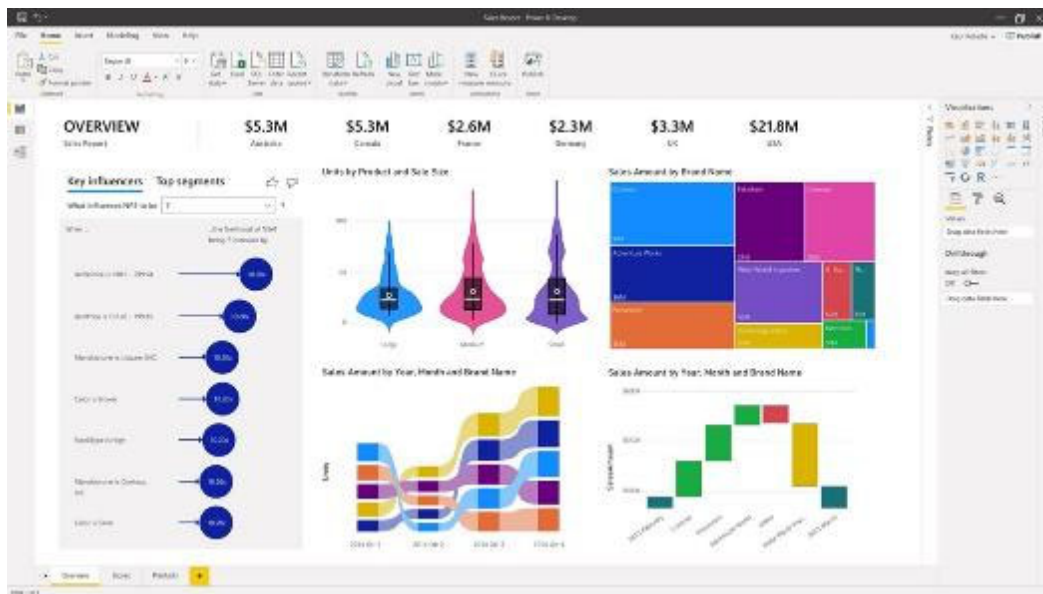


²³ "Tableau", Duke Digital Humanities, 2020, <https://digitalhumanities.duke.edu/tools/tableau>



Power BI

Power BI is a cloud-based business analytics service offered by Microsoft. Similar to Tableau, Power BI can be used to create visualizations and analyze data.²⁴



²⁴ "Data Visualization with Power BI", Parul Pandrey (2019), <https://www.datacamp.com/community/tutorials/data-visualisation-powerbi>

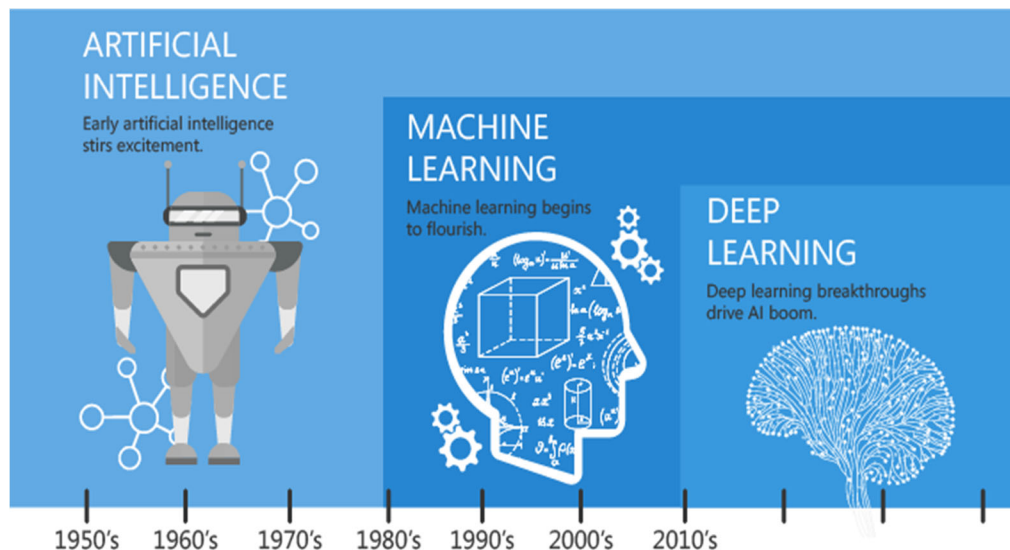
Differences Between Visualization Software

	Power BI	Qlik Sense	Tableau
Visualization Capabilities	Easy-to-use Platform	Self-service Analytics Tool	Perfect Graphics and Visualization Capabilities
Advances Analytics Capabilities	Supports R Language-Based Visualizations	Does not support R or Python-based objects.	Provides fully integrated support for R and Python
Cloud Capability	Compatible with Microsoft Azure	Offers a SaaS cloud product	Compatible with robust cloud platforms like, Azure, AWS etc
Big Data Integration	Places the solution above Tableau and Qlik	Lets you access and manage all your data, big and small, within a single environment	Connect to nearly any data repository, ranging from MS Excel to Hadoop clusters
Storage Limits	10GB cloud storage	500GB of cloud storage	100GB data storage

[<https://data-flair.training/blogs/bi-tool-for-big-data-visualization/>]

ARTIFICIAL INTELLIGENCE

Artificial intelligence (AI) involves the use of machines, robots, or systems to simulate human intelligence, functions, and actions normally done by humans. AI can be used to build applications or supplement application features with machine or deep learning capabilities.²⁵

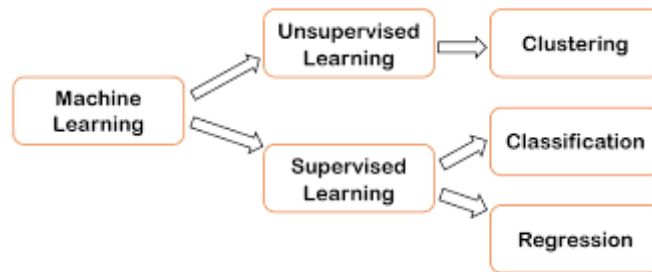


[<https://hackernoon.com/difference-between-artificial-intelligence-machine-learning-and-deep-learning-1pcv3zeg>]

²⁵ Best Artificial Intelligence Software, <https://www.g2.com/categories/artificial-intelligence>

MACHINE LEARNING

The most common subset of AI is machine learning (ML). In ML computers, software and devices perform cognitive functions similar to the human brain. ML essentially is the piece that teaches the computer how to think and the reactions to those thoughts manifests itself through AI.²⁶



[<https://dzone.com/articles/machine-learning-and-artificial-intelligence-1>]

Deep Learning

Deep learning (DL) is a subset of ML. While machine learning requires guidance in order to perform tasks, DL process completes tasks without any interference. ML is the reasoning behind the technique and DL is the implementation piece.²⁷

Algorithms

An algorithm is essentially a step-by-step guide for solving a problem or accomplishing some end result.²⁸ Algorithms are not exclusive to AI. An ML algorithm provides the instructions to the computer telling it what to do next with an “or,” “and,” or “not” statement captured in programming codes. When linked together, these algorithms can be used to do things like break down and automate sorting tasks. Here are some use cases for AI algorithms:

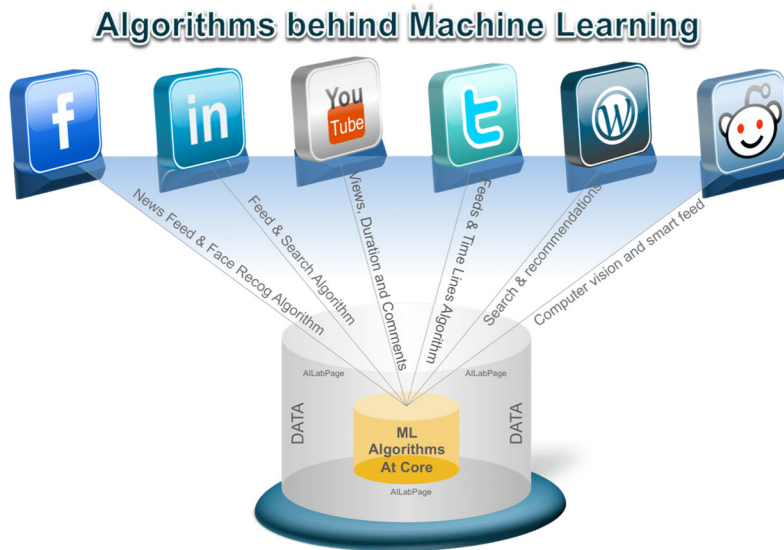
- Motion detection do not require sensors thanks to algorithms;
- Facebook’s algorithms know what marketing to display; and
- Google’s algorithm knows news to display.²⁹

²⁶ “9 Applications of Machine Learning from Day-to-Day Life”, Daffoldi Software (2017), <https://medium.com/app-affairs/9-applications-of-machine-learning-from-day-to-day-life-112a47a429d0>

²⁷ “Difference Between Artificial Intelligence, Machine Learning, and Deep Learning,” Nikhil Gupta (2019), <https://hackernoon.com/difference-between-artificial-intelligence-machine-learning-and-deep-learning-1pcv3zeg>

²⁸ <https://www.merriam-webster.com/dictionary/algorithm>

²⁹ “A Beginner’s Guide to AI: Algorithms,” Tristan Greene (2018), <https://thenextweb.com/artificial-intelligence/2018/08/02/a-beginners-guide-to-ai-algorithms/>



[<https://vinodsblog.com/2018/10/29/how-machine-learning-algorithms-works-an-overview/>]

AI CHARACTERISTICS

Automation

Contrary to popular belief, AI does not eliminate jobs. AI works as a tool to complete mundane tasks and frees humans to work on more pressing matters.³⁰

Predictive Capabilities

With AI, the computer or the software can perform a task or produce an outcome based on what it assumes is correct.³¹

Intelligent Decision Making

ML eliminates guesswork from critical decision making by providing analytical proof and predicted outcomes. This functionality removes human error and provides users with the information necessary to support the decisions made.³²

Personalization

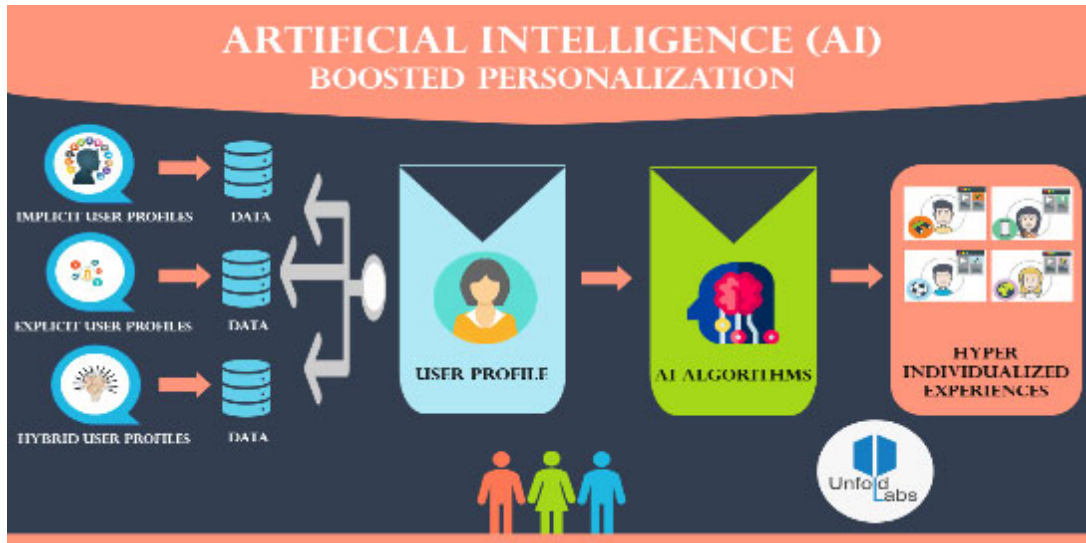
Engineers use ML algorithms to create high-level personalization in order to provide users with unique experiences. For example, personalization is achieved by creating applications that recognize users' preferences based on their behavior and interactions. This allows the application to make

³⁰ Best Artificial Intelligence Software, <https://www.g2.com/categories/artificial-intelligence>

³¹ Id. at 80

³² Id. at 80

recommendations to the users. Good examples of this are the recommendations both Netflix and YouTube make based on your viewing history.³³



[<https://medium.com/@Unfoldlabs/ai-driven-personalization-6dc9c47c1418>]

Communication/Chatbots

Chatbots are one of the more common ways that AI software is utilized. Chatbots are often used to automate customer experience. Organizations use chatbots to determine the nature and severity of a customer request or interaction. The chatbot can interpret the customer requests and direct the customer to the next steps or put them in touch with the right person. Chatbots can also be used for virtual assistants.³⁴

³³ Id. at 80

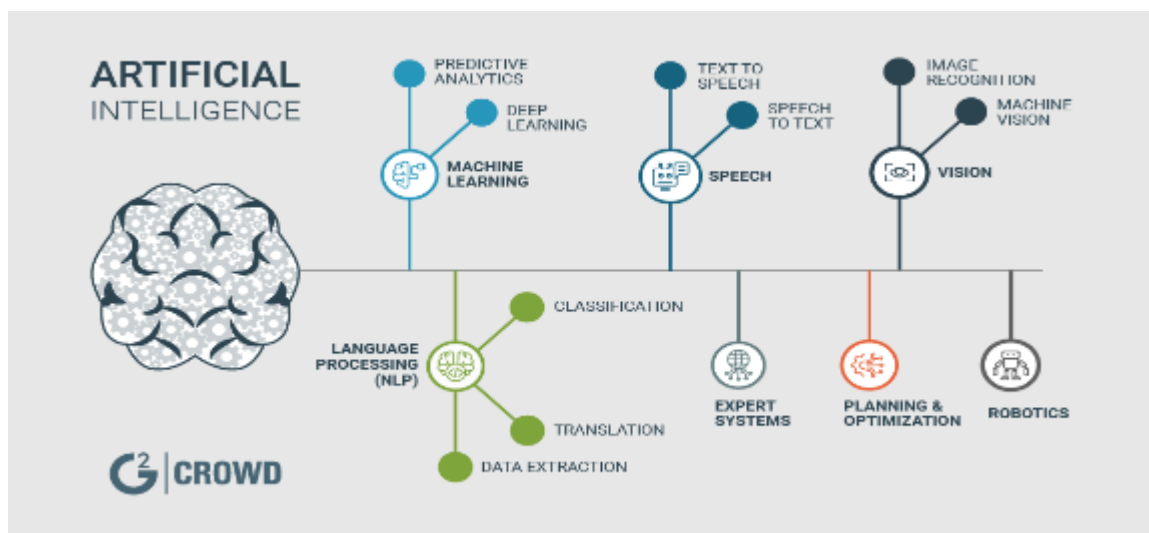
³⁴ Best Artificial Intelligence Software, <https://www.g2.com/categories/artificial-intelligence>



[<https://newsroom.mastercard.com/press-releases/mastercard-makes-commerce-more-conversational-with-launch-of-chatbots-for-banks-and-merchants/>]

Search Engine

Google and other search engines use ML to improve search results. Every time a user executes a search, the algorithms determine how you respond to the results.



[<https://www.g2.com/categories/artificial-intelligence>]

COMPUTER-AIDED AUDIT TOOLS (“CAAT”)³⁵

Computer-aided audit tools (“CAAT”) are packages designed for data analysis. CAATs are typically used to analyze and manipulate data. In the context of accounting, CAATs are additionally used to compare both financial and non-financial data. CAATs are also typically used to streamline audit process.³⁶

CAAT Features

Audit functions that are normally performed manually can now be standardized by accounting/CAAT software. Once the data is verified using a CAAT system, the data is retained so it can be reused in the audit process to identify errors and segregate transactions within accounts. CAATs generate both customized reports of the findings and produce a standard audit trail consistent with Generally Accepted Accounting Principles (GAAP).³⁷

The use of data analytics in CAATs is useful to:

- Identify anomalies;
- Spot patterns and risk indicators;
- Analyze datasets instead of population samples;
- Analyze data from disparate datasets; and
- Discover multiple systems or locations of data.³⁸

Common CAAT Software

Idea

IDEA® software is a powerful and comprehensive data analysis tool that allows professionals to gather evidence, discover trends, assess risk, and provide the business intelligence needed to make informed decisions from multiple data sources.³⁹

³⁵ <https://www.auditnet.org/audit-library/computer-assisted-audit-tools-and-techniques-caatt>

³⁶ A Guide to Computer Assisted Audit Techniques (2006),
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Audit_Program/Resource/caat.pdf

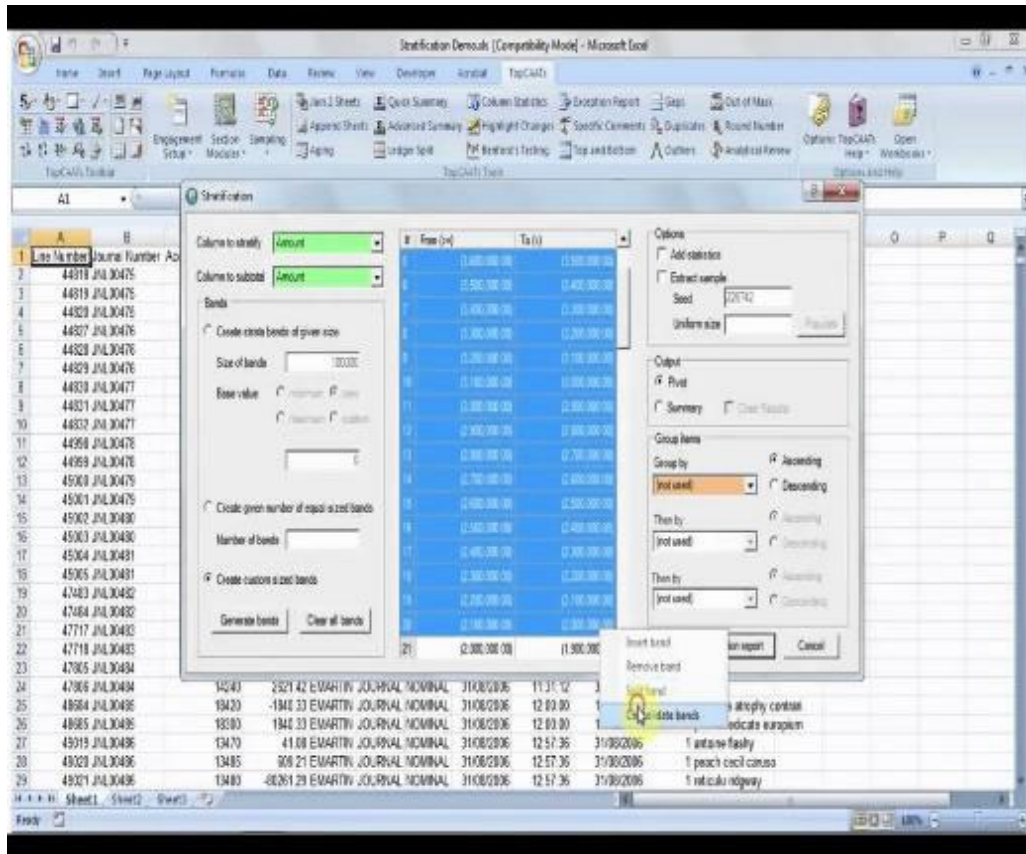
³⁷ A Guide to Computer Assisted Audit Techniques (2006),
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Audit_Program/Resource/caat.pdf

³⁸ <http://www.bcccpa.com/cpe-presentations/CAATs1.pdf>

³⁹ <https://www.audimation.com/wp-content/uploads/2019/12/caseware-idea-product-sheet.pdf>

TeamMate

TeamMate Analytics is widely used by sole practitioners and Big 4 accounting firms. Teammate offers a suite of more than 150 CAATs that assist auditors with performing data analysis and delivering significant value within their organizations, internal, and/or external clients.⁴⁰



⁴⁰ <http://www.teammatesolutions.com/data-analytics.aspx>

ACL Analytics

ACL's audit analytics suite of software products offers data extraction, analysis, and fraud detection features. ACL offers comprehensive audits to identify errors, fraud, and anomalies in support of regulatory, operational, compliance, and efficiencies.⁴¹



The screenshot shows the ACL Analytics application window titled "Sample Project.ACL - ACL Analytics". The interface includes a menu bar (File, Edit, Data, Analyze, Sampling, Applications, Tools, Server, Window, Help), a toolbar, a Navigator pane on the left, a Command Line pane, a data table, and a status bar at the bottom.

Numbered Callouts:

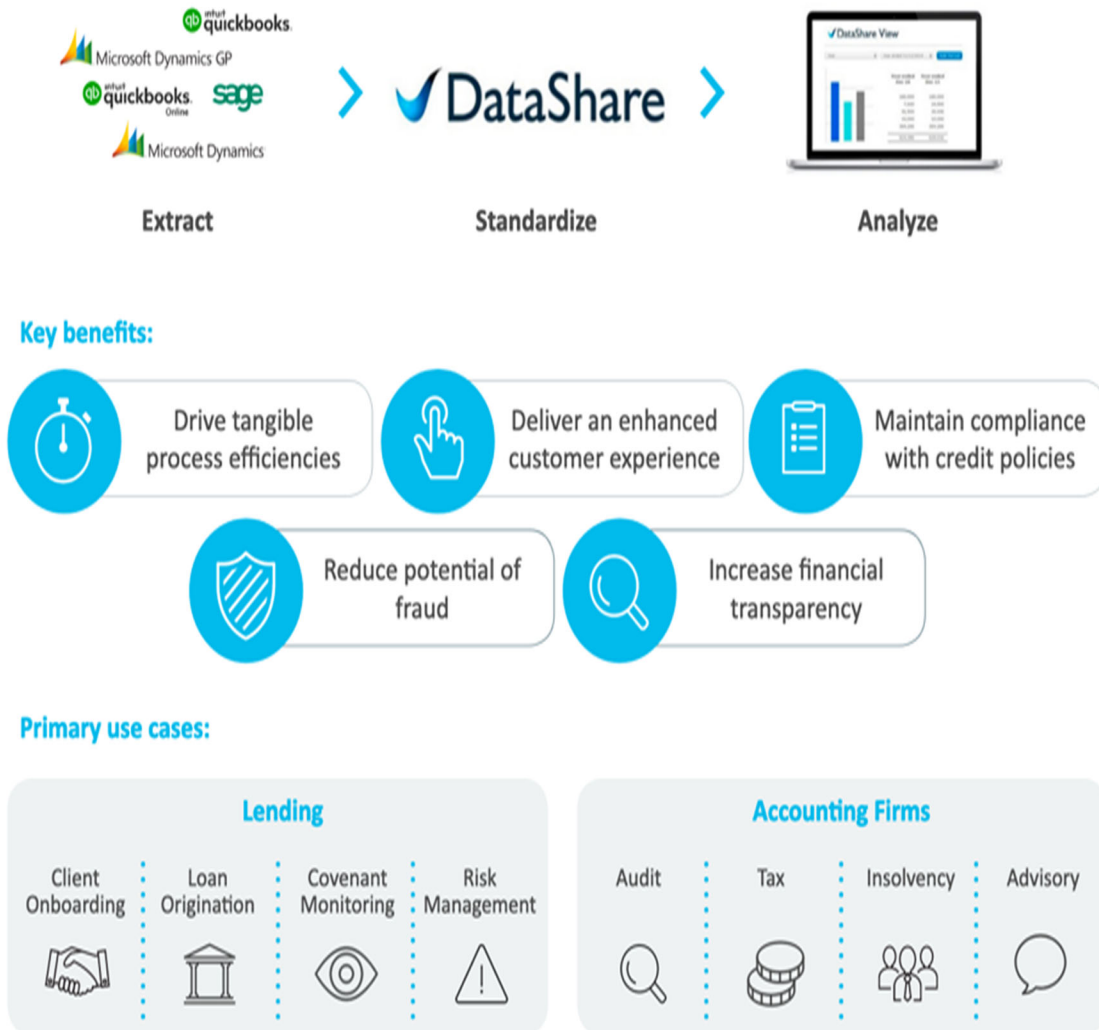
- 1: Application title bar
- 2: File menu
- 3: Toolbar
- 4: Navigator pane (Sample Project.ACL tree)
- 5: Command Line input field
- 6: Filter dropdown menu (Due Date >= '20140101')
- 7: Index dropdown menu (None)
- 8: Data table (Invoices_2014)
- 9: Status bar (Records: 7/772 Global Filter: Due Date >= '20140101')

	Cust Number	Invoice Date	Due Date	Ref No	Trans Type	Trans Amount
1	795401	29/04/2014	29/05/2014	205605	CN	(474.70)
2	795401	24/06/2014	24/07/2014	206300	BN	225.87
6	518008	28/01/2014	27/02/2014	212334	CN	(12.23)
7	784647	28/01/2014	27/02/2014	212297	BN	737.36
8	518008	17/02/2014	19/03/2014	212592	CN	(37.15)
9	501657	09/03/2014	08/04/2014	212824	BN	1,524.32
11	230575	06/04/2014	06/05/2014	213052	BN	8.85
12	516372	19/04/2014	19/05/2014	213133	CN	(212.56)
13	516372	19/04/2014	19/05/2014	213134	CN	(76.01)
14	516372	19/04/2014	19/05/2014	213135	CN	(121.11)
15	516372	19/04/2014	19/05/2014	213136	CN	(80.74)
16	516372	19/04/2014	19/05/2014	213137	CN	(74.97)
17	516372	19/04/2014	19/05/2014	213138	CN	(10.70)
18	516372	19/04/2014	19/05/2014	213139	CN	(80.74)
19	516372	19/04/2014	19/05/2014	213151	CN	(12.81)
20	516372	26/04/2014	26/05/2014	213204	CN	(18.34)
21	836004	26/04/2014	26/05/2014	213194	CN	2,151.72
22	836004	26/04/2014	26/05/2014	213184	BN	1,469.77
23	812465	30/04/2014	08/08/2014	213227	BN	3,582.98
24	836004	06/05/2014	05/06/2014	213240	BN	475.99
25	478604	07/05/2014	06/06/2014	213256	BN	251.81
26	065003	10/05/2014	08/08/2014	213248	BN	874.97
27	516372	10/05/2014	09/06/2014	213285	CN	(80.74)
28	262001	12/05/2014	11/06/2014	213290	BN	1,666.32
29	262001	12/05/2014	11/06/2014	213293	BN	998.19

⁴¹ https://help.highbond.com/tech_briefs/ax/ax_54x_tech_brief.pdf

Validis

Validis is an interactive database that enables small and medium enterprises (SMEs) to share financial data history directly from the software in a standard format. Validis can be used to speed up loan decisions, initiate audits, and foster business intelligence.⁴²



⁴² https://validis.com/wp-content/uploads/2019/08/US-DataShare-2pp_Ext-Mar191.pdf

MindBridge

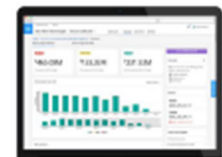
MindBridge AI Auditor was the world's first AI-powered financial auditing solution. MindBridge offers the following features:

- **Analytics:** Improving testing and audit planning using AI-driven insights through the client's dataset, such as monthly sales and cost of goods sold
- **Journal Entry Testing:** Performing faster, complete, and comprehensive testing of the client's general ledger
- **Search:** Extraction of transaction details within a general ledger, notwithstanding the level of flagged risk
- **Risk Identification:** Identifying high-risk vendors by analyzing the standalone risk of invoices⁴³

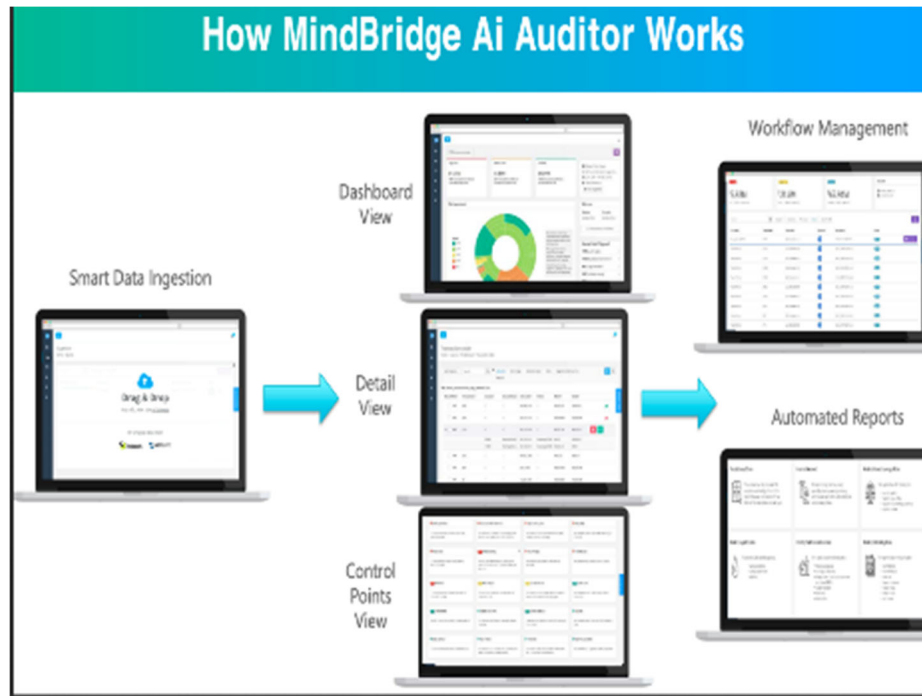


MindBridge AI Auditor: “The Solution”

- Uses Artificial Intelligence AND Machine Learning.
- Purpose built for Accounting industry and exceeding standards.
- Detects Anomalies, Irregularities, and Outliers in Financial Data that are missed with the human eye or a rules based analytics solution
- An Extensible AI platform to support Audit & Assurance, Forensics, Advisory Services, etc.
- Speed, Ease of Use, Granularity & Completeness
- Greater Insight, Cost Savings and Risk Reduction / Assurance



⁴³ Doeren Mayhew Improves audit Engagements Using AI, MindBridge, <https://www.mindbridge.ai/wp-content/uploads/2019/10/MindBridge-AiAuditor-CaseStudy-DoerenMayhew.pdf>



[<https://s3.amazonaws.com/primeglobal-assets/downloads/MindBridge-PPT-PrimeGlobal-August-23-2018-Final.pdf?mtime=20180904145053>]

PRIVATE COMPANY/SOLE PRACTITIONERS

Clients are unique, with different goals and values. CPAs are now incorporating data analytics in their practice to better serve their clients. Many CAAT and tax software aggregate client data, show patterns, and irregularities. Data analytics can help CPAs discover multiple opportunities and provide value to clients through various strategies. Three main areas where analytics can be instrumental in client services are:

1. Risk analysis,
2. Fraud detection, and
3. Cyber security.

Risk Analysis

There are risks associated with investors, customers, employees, competitors, or regulators. Organizations want to make sure they identify, prioritize, and monitor risks. Organizations can leverage customer data, lending trends, insurance results, and algorithms to develop risk-scoring models.⁴⁴

In more mature organizations, analytics is used to measure risk in one unified system and offering management insights on identifying, viewing, understanding, and managing risk. Risk analytics can be leveraged to integrate this data into a single, unified view, gather valuable information, and enable actionable insights.⁴⁵



[<https://activewizards.com/blog/top-7-data-science-use-cases-in-finance/>]

Here is a step-by-step process for applying data analytics to risk assessments and controls:

1. Identify and list risks;
2. Identify your risks and define your key risk indicators (KRIs);
3. Connect all of your data sources and automate testing;
4. Track patterns, analyze trends, and spot emerging risks; and
5. Report results.⁴⁶

⁴⁴ "Top 7 Data Science Use Cases in Finance," <https://activewizards.com/blog/top-7-data-science-use-cases-in-finance/>

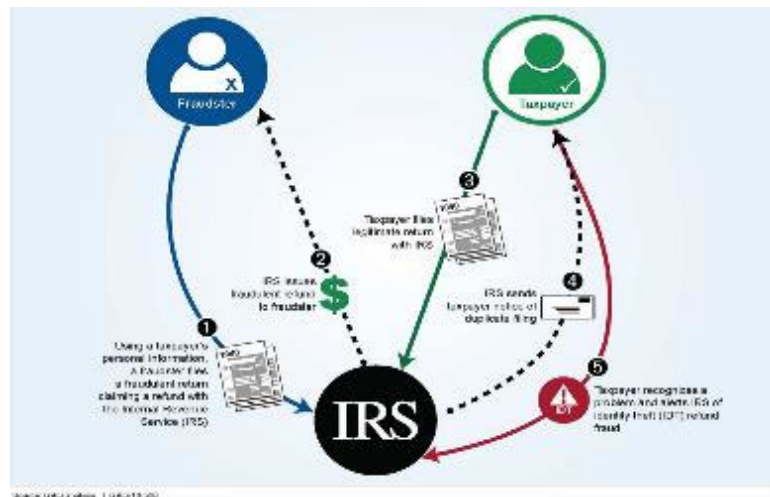
⁴⁵ "Risk Analytics: The Three-Minute Guide," Deloitte (2012), <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Deloitte-Analytics/dttl-analytics-us-da-oriskanalytics3minguide.pdf>

⁴⁶ "6 Steps to Start Using Data Analytics for Risk Assessments," (2019), <https://www.wegalvanize.com/risk/data-analytics-risk-assessments/>

Fraud Detection

AI is being used to prevent healthcare, specifically Medicare, fraud. The healthcare industry is able to use the large datasets available to the medical industry and ML to train and analyze refill patterns for individuals, pharmacies, and regions. Irregularities are flagged for human investigation.⁴⁷

In 2009, the IRS began implementing the Return Review Program (RRP). RRP is an AI engine that interacts with the tax processing system and scans for potential identity theft and fraud.⁴⁸



Retailers like Amazon, Best Buy, and L.L. Bean use data analytics to review customer returns and determine if fraud is involved.⁴⁹



⁴⁷ "Machine Learning in Analytics to Limit Healthcare Fraud," David A. Teich, (2018), <https://www.forbes.com/sites/davidteich/2018/11/27/machine-learning-in-analytics-to-limit-healthcare-fraud/#9b94e0f381cb>

⁴⁸ The Return Review Program Increases Fraud Detection; However, Full Retirement of the Electronic Fraud Detection System Will Be Delayed, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (2017), <https://www.treasury.gov/tigta/auditreports/2017reports/201720080fr.pdf>

⁴⁹ "How Data Analytics Can Assist in Fraud Detection," Kayla Matthews (2019), <https://www.kdnuggets.com/2019/11/data-analytics-assist-fraud-detection.html>

CYBERSECURITY

Cyber threats are on the rise. Security breaches result in both financial and reputational harm for organizations.⁵⁰

The best way to mitigate security risks is to prevent them in the first place and that is where analytics comes into play. Analytics can be used to detect and prevent security breaches. Unlike traditional security information event management (SIEM) systems, those powered with analytics provide real-time security alerts.⁵¹

NOTE: The material following in this section is taken directly from the AICPA and its Auditing Standards Board, the AICPA's Forensic and Valuation Services Executive Committee, and the AICPA's Professional Ethics Executive Committee.

AICPA AUDIT QUALITY INITIATIVE UPDATE

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

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

The following issues have been addressed by the end of 2019:

- The CPA examination has been updated.
- Audit reports have been revised to reflect significant aspects of an audit.
- Data analytics and emerging technologies utilized in the audit process are continually being explored.

⁵⁰ Big Data Security Analytics: A Weapon Against Rising Cyber Security Attacks? [Video & Infographic], <https://bi-survey.com/big-data-security-analytics>

⁵¹ Big Data Security Analytics: A Weapon Against Rising Cyber Security Attacks? [Video & Infographic], <https://bi-survey.com/big-data-security-analytics>

- Projects underway include process mining, visualization, and multi-dimensional audit data selection.
- Peer review has been revamped to be more robust to address recurring issues, while becoming more consistent in the peer review process.

Proposed Model for Licensure Changes

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

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

1. Common core level of competencies
 - a. Accounting
 - b. Audit
 - c. Tax
 - d. Technology
2. Second level of competencies that would involve more in-depth skills and knowledge of one of three disciplines:
 - a. Business reporting analysis
 - b. Information systems and controls
 - c. Tax compliance and planning

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

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

- Principle #1: The CPA profession must adapt quickly due to the technological disruptions in areas such as data analytics, robotics, artificial intelligence, and more. As such, the competencies, services, and attitudes of CPAs need to continually evolve in order to protect the public interest.
- Principle #2: The CPA profession and state boards of accountancy recognize that technological and analytical expertise are essential to performing assurance work, as well as the other services that are currently, or will be in the future, core to professional accounting.

- Principle #3: The CPA profession and state boards of accountancy acknowledge that sustaining the profession and continued public protection require rethinking initial licensure requirements.
- Principle #4: The profession, and therefore entry into the profession, must be redesigned to attract individuals with technological and analytical expertise. This includes non-CPA professionals whose technology and analytics skills are critical to the performance of assurance and other core services, as well as non-accounting major students. All must demonstrate minimum required competencies necessary to perform professional accounting services as a CPA.
- Principle #5: The changes must be rapid, transformational, and substantive without negatively impacting candidates currently in the pipeline.

EBP Audit Quality

The Department of Labor (DOL) periodically performs reviews of a sizable sample of audits to evaluate the quality of the audit work. Over the years, the AICPA has responded to the DOL findings in several ways. However, the most recent examination of our work on EBP audits based on the 2011 audit filings revealed that, past efforts notwithstanding, the quality of EBP audit work needs additional improvement.

The DOL reviewed 400 of the 80,000+ audits filed with the DOL for 2011 and issued a report in 2014 that was highly critical of the profession. The AICPA did its own due diligence to substantiate the DOL findings. The AICPA agreed with DOL findings. The DOL put forth 11 suggestions for how to improve EBP audit quality.

PRACTICE NOTE

Going into detail about those suggestions is beyond the scope of this program. The DOL report is available on the DOL website using the following link for those interested in more details.

<https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/assessing-the-quality-of-employee-benefit-plan-audits-report.pdf>

The AICPA responses to the DOL reports over the years included the formation of the AICPA EBP Audit Quality Center. Responses to the most recent DOL report include:

- The promulgation of proposed audit standard SAS 13X which is discussed later in this section, and
- Modifications to peer review which are also discussed later in this section.

Of course, it is the hope of the AICPA that these steps will improve EBP audit quality.

Government Audit Quality

Just to be sure we are all on the same page, the **Yellow Book**, produced by the Government Accounting Office (GAO), is used by auditors of government entities, entities that receive government awards, and other audit organizations performing Yellow Book audits (single audits). It outlines the requirements for audit reports, professional qualifications for auditors, and audit organization quality control. Auditors of federal, state, and local government programs use these standards to perform their audits and produce their reports.

The 2018 revision of the Yellow Book is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020 and for performance audits beginning on or after July 1, 2019. Early implementation is not permitted.

Yellow Book audits require the auditor to possess significant specialized knowledge to perform the audit properly. The AICPA Government Audit Quality Center (GAQC) represents a significant undertaking to help improve audit quality in this area of our practice.

New Government Review Program

Every six years beginning in 2018, a federal agency designated by the Office of Management and Budget (OMB) will lead a government-wide project to determine the quality of single audits by providing a “statistically reliable estimate of the extent that single audits conform to applicable requirements, standards, and procedures.” The reviewing agency will then make recommendations to address any audit quality issues, which could include changes to applicable audit requirements, standards, and procedures. The results must be public. The purpose is to see if quality has improved in single audits especially where there were single audit deficiencies identified in the President’s Council on Integrity and Efficiency (PCIE) 2017 study.

The AICPA performed its own governmental audit quality project in 2016. For that project, 87 engagements were selected for review by subject matter experts. Of the 87, 41 were single audits.

No. of single audits performed by partner annually	Non-conformity percentage
1	68%
2 to 10	44%
11 or more	25%

The results also showed that among Government Audit Quality Center (GAQC) members, the non-conformity rate was 32% versus 58% for those that were not members. This situation prompted the AICPA to require more training for peer reviewers and to devote internal efforts to screening single audit reports.

Unlike the DOL, when deficiencies are noted by the OMB government reviewers, the OMB reviewer has the authority to sanction the audit firm, i.e., the audit firm may be subject to suspension from

performing single audits, additional oversight in the form of pre-issuance reviews of single audit engagements, and additional continuing professional education.

The AICPA provides helpful tools and templates for practitioners that belong to the GAQC to help improve audit quality. These practice aids can be accessed by GAQC members on the AICPA's website.

Deficiencies identified in the AICPA's governmental audit quality project include:

- **Risk Assessments.** Risk assessments were not performed for every major program. The AICPA is placing a priority on ensuring that risk assessments are properly performed not only for financial statement audits, as discussed earlier, but also for compliance audits. The guidance provides considerations for the reviewer to use when evaluating the firm's compliance with risk assessment standards and instructs the state Peer Review Program Report Acceptance Bodies to require implementation plans and corrective action when "findings for further consideration" are identified.

The main issue identified here is the fact that risk assessments must be performed at the major program and compliance requirement level. Reviewers are seeing far too many instances where there are no risks identified. If this is truly the case, the auditor should ensure the documentation is in the workpapers to support such a conclusion. **Linkage** is also an issue that has been identified. When a risk is identified, there should be an action step that is designed to bring the risk down to a sufficiently low level. This could include altering the nature, timing, and extent of procedures or increasing the level of supervisory review.

- **Direct and Material Compliance Requirements.** Auditors are not properly documenting why they consider certain compliance requirements not to be direct and material. This is a significant concern because a compliance requirement is not tested when it is not considered direct and material. The auditor should document why the requirement is not considered direct and material.

EXAMPLE

Procurement is not considered to be a direct and material compliance requirement for major program XYZ because materiality is \$50,000 for the program and 95% of program expenditures are payroll related.

EXAMPLE

Eligibility is not considered to be a direct and material compliance requirement. The state (state pass-through entity) selects the beneficiaries to receive service and the not-for-profit has no discretion.

EXAMPLE

Program income is not considered to be a direct and material compliance requirement. The amount of program income was \$6,000 and materiality for this program is \$75,000.

- **Internal Control Over Compliance.** Auditors are not testing internal controls at the entity level. Frequently, auditors will make affirmative statements such as the “board reviews the financial statements before they are released” or “management sets the tone about the necessity to follow all compliance requirements and takes corrective action when issues are noted.” Although these are good controls, the affirmative statement by itself does not serve as a test of controls. Documentation should include what the auditor observed, who s/he spoke with about the control, and other evidence such as review of documents.
-

EXAMPLE

An auditor identified the control “management sets the tone about the necessity to follow all compliance requirements and takes corrective action when issues are noted” and documented the following:

“I spoke with both the Executive Director and the CFO concerning proper adherence to compliance requirements by client personnel involved in working with federal programs. I was provided with an agenda to the monthly grant staff meetings where concerns were raised and discussed, and corrective action planned. I noted that when there was a concern raised, the next month the minutes of the meeting showed a report on corrective action. I spoke with two of the grant accounting staff and they corroborated this information. I believe that the control is appropriately designed, implemented, and effective.”

Control activities were identified and tested, but it was hard to distinguish between them and the compliance tests in dual purpose testing. There appear to be two main causes of this deficiency: First, the auditor is identifying what they believe is a control, but it is really a substantive or compliance test, and second, the attributes are worded in such a way that it is not possible to tell one from the other.

EXAMPLE

An auditor documented the following about allowable cost:

- a. Cost is allowable under the terms of the Uniform Guidance (Section 200.403)
- b. Cost was approved by a member of the grant accounting staff who has knowledge of the grant and allowable cost
- c. Traced and agreed the amount per the invoice to the federal report requesting reimbursement
- d. Noted two signatures on the check
- e. Traced and agreed the amount of the expenditure to the general ledger

Of the items identified above, the only one that is clearly an internal control is item b, because it identifies a client action designed to prevent, detect, or correct misstatement on a timely basis.

Item a is a compliance test because it involves the auditor's conclusion as to the allowability of a cost based on the Uniform Guidance criteria.

Items c and e are substantive tests that illustrate that two numbers agree. If the step was performed by client personnel and there was documentation to support it, then this could be a test of controls. As it is, it appears the auditor is doing the test.

Item d is a substantive test that illustrates that there are two signatures on a check. These signatures are evident, but if it was a properly designed internal control, client personnel would be performing an action to ensure that the support is present for the expenditure before the check is signed.

Other internal control issues identified were that controls tested did not link back to controls identified in earlier steps and control weaknesses identified during the internal control assessment were not identified as significant deficiencies or material weaknesses. Note that control deficiencies are not always significant deficiencies or material weaknesses, but they need to be evaluated to determine whether individually or in the aggregate they rise to that level.

PEER REVIEW

Risk-Based Auditing – A Continuing Issue

For peer review, risk-based auditing is a continuing issue that needs to be reviewed by firms, especially in light of the significant changes made by the auditing standards issued in 2019 (SAS 134, 135, 136, 137, 138, 139) and the many proposed new exposure drafts for audit. The risk assessment model is not replaced, rather it is enhanced and more robust with more required proceeds, documentation, and changes in definitions of what will constitute a presumed risk that must be addressed.

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

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

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

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

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

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

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

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

1. Perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. These procedures include:
 - a. Making inquiries of management and other members of the client team who may have information that can assist in identifying risks of material misstatement due to fraud or error
 - b. Performing both financial and non-financial analytical procedures to assist in understanding the client and its environment, and to identify areas that may present risks of material misstatement due to fraud or error
 - c. Assessing prior experience with the audit client and audit procedures performed in prior audits, as well as the relevancy of information obtained, particularly if the intent is to use that information for purposes of the current period audit. This may require the auditor to conduct certain audit procedures (such as walkthroughs of relevant systems) in order to determine whether or not changes have occurred that may affect the relevancy of the information previously obtained
2. Facilitate discussions among the audit engagement team regarding the susceptibility of the audit client's financial statements to material misstatement due to errors or fraud
3. Develop an understanding of the audit client, its environment, and internal controls relevant to the audit. "Understanding" internal control relevant to the audit means understanding the design of the systems of controls, and whether the controls have been implemented (D&I). Performing walkthroughs of significant accounting processes by tracing transactions through accounting

process steps from the initiation of a transaction through its posting to the appropriate general ledger accounts confirms that controls are implemented as designed.

4. Identify the risk of material misstatement due to fraud or error at both the financial statement and relevant assertion levels (i.e., assertion risks). Revisions to this risk assessment should be made during the course of the audit where additional audit evidence, or new information obtained, produces inconsistencies with the audit evidence upon which the auditor originally based the assessment.
5. Identify the accounting processes that include assertion risks
6. Identify the key controls within the accounting processes
7. Assess the risk of material misstatement identified as high, moderate, or low. Ensure that significant and fraud risks are identified.
8. Develop tailored audit procedures linked to the risks of material misstatement identified. Note that this is a critical step in the audit planning process, which is necessary to reduce these risks.
9. Document key aspects of the risk assessment process including:
 - a. Significant decisions reached in engagement team discussions, as well as timing of those discussions, and audit team members who participated in those discussions;
 - b. Key elements associated with obtaining an understanding of the audit client, its environment, internal control components, sources from which the understanding was obtained, and the risk assessment procedures performed;
 - c. Identified and assessed risks of material misstatement at both the financial statement and relevant assertion levels; and
 - d. Risks and controls related to those risks that require special audit consideration (i.e., fraud risk, risks associated with significant related party transactions, economic and accounting matters, etc.).

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

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

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

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

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

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

1. Internal Control – 40% of identified issues related to failure to gain an understanding of internal control when identifying the client's risks
2. No Linkage of Risks Identified to Procedures Performed – 24% of issues related to auditors not linking their risk assessments to their audit responses
3. Insufficient Risk Assessment – 14% of issues related to incomplete or non-existent risk assessment
4. Improper Control Risk – 13% of issues related to auditors assessing control risk as less than high without appropriately testing internal controls

Other Peer Review Findings

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

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

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

■ Single Audit Engagements:

- Missed major program resulting from an improper risk assessment
- Improper clustering of programs
- Failure to meet the coverage percentage
- Improper calculation of type A/B threshold
- Inadequate testing of controls over compliance
- Schedule of Expenditures of Federal Awards (SEFA) not properly added
- Language in auditor report not consistent with AU-C 265 (communicating internal control matters) or AU-C 935 (compliance audits)
- Missing required footnotes for SEFA

■ Employee Benefit Plan Audit Engagements:

- Participant data – failure to test eligibility, allocations, or forfeitures
- Inadequate or failure to document understanding of internal control
- No audit work performed on contributions
- Failure to test elective deferrals on payroll audit procedures
- Failure to test year-end investment values
- No testing on benefit payments
- Reducing sample sizes to levels that are too low

Auditors, for **2020-2021 peer reviews**, should focus on the following areas:

- a. Firm's system of quality control
- b. Independence potential impairments and documentation
- c. Implementation of new standards; especially, revenue recognition
- d. Recurring deficiencies in audits and review engagements
- e. Other matters including cybersecurity, omitted procedures, and adequate documentation

AUDIT ISSUES IN IMPLEMENTING THE NEW REVENUE AND LEASE ACCOUNTING STANDARDS

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

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

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

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

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

- How business and accounting processes (procedures) have changed
- Systems that have been developed to accumulate data from these processes
- Change in controls to support the systems
- Considerations of the use of estimates (principle-based standard)
- Required new and expanded qualitative and quantitative disclosures

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

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

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

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

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

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

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

NOTE TO PARTICIPANTS

Implementation of the lease accounting and credit loss standards over the next couple of years will present many similar auditing risks. As the implementation date for the lease standard is upon us, let's focus on it for a moment.

Audit Issues for Consideration in Implementing the New Leases Standard – Topic 842, Leases

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

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

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

In any case, there are challenges for auditors presented by the new lease standard. Experience tells us that most, if not all, of the participants at our CPE programs are focused on leasing from the lessee

perspective more so than from the lessor perspective. Accordingly, we will focus on the issues facing an auditor of an entity that is a lessee. The issues include:

- Considering whether management will be biased in favor of keeping the right-to-use asset and related liability artificially low
- Determining that management is following an allowable implementation method and properly applying elected practical expedients
- Determining if there is a lease, particularly for leases that might be embedded in contracts not labeled as a lease
- Determining if the lease is a finance or operating lease
- Determining if there are non-lease components and how management has allocated payment amounts, or if management elected not to make such an allocation
- Determining the appropriate lease term
- Determining the appropriate interest rate to use to calculate the present value of the liability
- Determining that variable consideration is handled properly
- Determining that the lease payments are properly accounted for as rent, or interest and principal, and that amortization of the related assets is calculated appropriately
- Determining that required disclosures are included in the notes to the financial statements

AUDITING STANDARDS (SASs) ISSUED IN 2019/2020

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

Introduction

SAS 134 was issued in May 2019 to improve the transparency and relevance of the communication in the auditor's report. Generally accepted auditing standards (GAAS) will now be more consistent with the International Auditing Standards (IAS).

SAS 134 addresses the auditor's responsibility to form an opinion on the financial statements. This SAS also discusses the auditor's responsibilities and the form and content of the auditor's report when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary, and when additional communications are necessary in the auditor's report.

Effective Date

The standard is effective for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time.

Changes

The new reporting standard has several significant changes to the form and content of the auditor's report.

SAS 134 supersedes the following sections:

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

SAS 134 adds new AU-C Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

SAS 134 is the first major overhaul of auditor reporting standards since the issuance of SAS 122, *Clarification and Recodification*. SAS 134 amends the following sections of SAS 122:

- Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*
- Section 210, *Terms of Engagement*
- Section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*
- Section 230, *Audit Documentation*
- Section 240, *Consideration of Fraud in a Financial Statement Audit*
- Section 260, *The Auditor's Communication with Those Charged with Governance*
- Section 300, *Planning an Audit*
- Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- Section 320, *Materiality in Planning and Performing an Audit*

- Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- Section 450, *Evaluation of Misstatements Identified During the Audit*
- Section 510, *Opening Balances – Initial Audit Engagements, Including Pre-audit Engagements*
- Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- Section 600, *Special Considerations – Audits of Group Financial Statements Including the Work of Component Auditors*
- Section 910, *Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country*

SAS 134 also amends SAS 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

Practitioners should pay particular attention to the following:

- The auditor's report is moved to the first section of the report.
- The Basis for the Opinion section follows the report.
- The Basis for the Opinion section is new and more focused on the obligations relating to independence and clarifies that there are ethical requirements of the audit engagement.
- The section related to auditor's responsibilities is revised particularly as it relates to communications with those charged with governance. The section should be headed as "Auditor's Responsibilities for the Audit of the Financial Statements."
- Improved reporting specific to the going concern issue is required. Management and the auditor's responsibilities are evaluating and considering the conditions that give rise to the reporting entity's ability to continue as a going concern. AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, now includes a separate section when substantial doubt exists.
- Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, has been added to address key audit matters (KAM). In determining, communicating, and documenting KAMs, a framework has been developed.
- KAMs are not required by the standard, but when engaged to communicate KAMs in the auditor's report, the framework must be utilized.

Changes in Management's Responsibility

Focuses on the evaluation by management of going concern:

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

This focus by management's evaluation will require:

1. identification of conditions and events that could impact the reporting entity's ability to continue as a going concern.
2. how the conditions and events are addressed.
3. a conclusion by management as to the probability that the entity can mitigate and reduce to an acceptable level the effect these conditions would have on the financial conditions for a period of time.

Changes in Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, an auditor must:

- exercise professional judgment and maintain **professional skepticism** throughout the audit.
- identify and assess the risks of material misstatement of the financial statements, whether due to **fraud or error**, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the reporting entity's internal control. Accordingly, no such opinion is expressed.

- evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as **evaluate the overall presentation** of the financial statements.
- conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the reporting entity’s ability to continue as a going concern for a reasonable period of time. **Notice focus on auditor’s responsibilities for going concern evaluation that is made by management.**

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

EXHIBIT – ILLUSTRATIONS OF AUDITOR’S REPORTS ON FINANCIAL STATEMENTS

Illustration 1: An Auditor’s Report on Comparative Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Audit of a complete set of general-purpose financial statements (comparative). The audit is not a group audit.
- Management is responsible for the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in AU-C Section 210, Terms of Engagement.
- The auditor has concluded that an unmodified (that is, “clean”) opinion is appropriate based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time in accordance with AU-C Section 570, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern.
- The auditor has not been engaged to communicate key audit matters.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statement⁵²

Opinion

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

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

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute

⁵² The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

assurance, and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.⁵³
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

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

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature of the auditor's firm]

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

[Date of the auditor's report]

⁵³ In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed."

Illustration 2: An Auditor's Report on Comparative Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America, Including Communication of Key Audit Matters

Circumstances include the following:

- Audit of a complete set of general-purpose financial statements (comparative). The audit is not a group audit.
- Management is responsible for the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in AU-C Section 210, *Terms of Engagement*.
- The auditor has concluded that an unmodified (that is, "clean") opinion is appropriate based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in accordance with AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor **has been engaged** to communicate key audit matters.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements⁵⁴

Opinion

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

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

Basis for Opinion

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

Key Audit Matters

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were most significant in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with Section 701, Communicating Key Audit Matters in the Independent Auditor's Report, of this SAS]

Responsibilities of Management for the Financial Statements

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

⁵⁴ The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

1. Exercise professional judgment and maintain professional skepticism throughout the audit.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
 - Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.⁵⁵
 - Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
 - Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

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

⁵⁵ In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed."

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature of the auditor's firm]

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

[Date of the auditor's report]

Illustration 3: An Auditor's Report on Financial Statements for a Single Year Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Audit of a complete set of general-purpose financial statements (single year). The audit is not a group audit.
- Management is responsible for the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in AU-C Section 210, *Terms of Engagement*.
- The auditor has concluded that an unmodified (that is, "clean") opinion is appropriate based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in accordance with AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor **has not been engaged** to communicate key audit matters.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements⁵⁶

Opinion

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

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

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute

⁵⁶ The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

assurance, and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.⁵⁷
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

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

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature of the auditor's firm]

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

[Date of the auditor's report]

⁵⁷ In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed."

Illustration 4: An Auditor's Report on Financial Statements for a Single Year Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America When Comparative Summarized Financial Information Derived from Audited Financial Statements for the Prior Year Is Presented

Circumstances include the following:

- Audit of a complete set of general-purpose financial statements (single year). The audit is not a group audit.
- Prior year summarized comparative financial information derived from audited financial statements is presented.
- Management is responsible for the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in AU-C Section 210, *Terms of Engagement*.
- The auditor has concluded that an unmodified (that is, "clean") opinion is appropriate based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in accordance with AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor **has not been engaged** to communicate key audit matters.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements⁵⁸

Opinion

We have audited the financial statements of XYZ Not-for-Profit Organization, which comprise the statement of financial position as of September 30, 20X1, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of XYZ Not-for-Profit Organization and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

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

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Not-for-Profit Organization's ability to continue as a going concern for *[insert the time period set by the applicable financial reporting framework]*.

⁵⁸ The subtitle "Report on the Audit of the Financial Statements" is unnecessary in circumstances in which the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

1. Exercise professional judgment and maintain professional skepticism throughout the audit.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
 - Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of XYZ Not-for-Profit Organization's internal control. Accordingly, no such opinion is expressed.⁵⁹
 - Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
 - Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Not-for-Profit Organization's ability to continue as a going concern for a reasonable period of time.

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

⁵⁹ In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed."

Report on Summarized Comparative Information

We have previously audited XYZ Not-for-Profit Organization's 20X0 financial statements, and we expressed an unmodified audit opinion on those audited financial statements in our report dated December 15, 20X0. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 20X0, is consistent, in all material respects, with the audited financial statements from which it has been derived.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature of the auditor's firm]

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

[Date of the auditor's report]

CONSIDERATION OF AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN

AU-C Section 570 changes include circumstances when:

1. Use of the going concern basis of accounting is appropriate **but** conditions and events have been identified.

If the auditor concludes that substantial doubt about the reporting entity's ability to continue as a going concern remains, the auditor should include *a separate section* in the auditor's report with the heading *"Substantial Doubt About the Entity's Ability to Continue as a Going Concern"* that includes the following:

- a. Focus on the note in the financial statements that discloses
 - the conditions or events identified,
 - management's plans that deal with these conditions,
 - that these conditions indicate that substantial doubt exists about the entity's ability to continue as a going concern, and
 - the period of time considered reasonable.
2. If adequate disclosure about a reporting entity's ability to continue as a going concern **is not made** in the financial statements, the auditor should:
 - a. Express a qualified opinion or adverse opinion in accordance with Section 705, *Modifications to the Opinion in the Independent Auditor's Report*.
 - b. In the "Basis for Qualified (Adverse) Opinion" section of the auditor's report, state that:
 - Substantial doubt exists about the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter, or
 - Substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans, but the financial statements do not adequately disclose this matter.

EXHIBIT—ILLUSTRATIONS OF AUDITOR’S REPORTS RELATING TO GOING CONCERN

Illustration 1: An Auditor’s Report Containing an Unmodified Opinion and Includes a Going Concern Section When Management Is Required under the Applicable Financial Reporting Framework to Include a Statement in the Notes to the Financial Statements That Conditions or Events Have Been Identified and Substantial Doubt Exists and Disclosure in the Financial Statements Is Adequate

The following circumstances are assumed:

- Audit of a complete set of financial statements prepared in accordance with FASB Accounting Standards Codification (ASC).
- The audit is not a group audit.
- The auditor has concluded that an unmodified opinion is appropriate.
- The auditor has concluded that substantial doubt remains and the disclosures of the conditions and management’s plans are adequate.
- Management is required to disclose in the notes to the financial statements that conditions or events have been identified and substantial doubt exists.

Independent Auditor's Report

To the Shareholders of ABC Company

Report on the Audit of the Financial Statements

Going Concern section is presented immediately after the Basis for Opinion of the Auditor's Report section.

Substantial Doubt about the Company's Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations, has a net capital deficiency, and has stated that substantial doubt exists about the Company's ability to continue as a going concern.

Management's evaluation of the events and conditions and management's plans regarding these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Illustration 2—An Auditor’s Report Containing an Unmodified Opinion and Includes an Emphasis-of-Matter Paragraph Because Substantial Doubt Has Been Alleviated

The following circumstances are assumed:

- Audit of a complete set of financial statements prepared in accordance with FASB ASC.
- The audit is not a group audit.
- Management has disclosed conditions, when aggregated, that raise substantial doubt about the entity’s ability to continue as a going concern.
- Management has disclosed its evaluation of the significance of those conditions in relation to the entity’s ability to meet its obligations.
- Management has disclosed that the substantial doubt about the entity’s ability to continue as a going concern has been alleviated by management’s plans.
- The auditor has concluded that management’s disclosures are adequate.

Independent Auditor's Report

To the Shareholders of ABC Company

Report on the Audit of the Financial Statements

Emphasis-of-Matter

As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note X. Our opinion is not modified with respect to this matter.

COMMUNICATING KEY AUDIT MATTERS

AU-C Section 701 has been added to provide guidance on the auditor's responsibility to communicate key audit matters (KAMs) in the auditor's report **when the auditor is engaged** to do so. It addresses the auditor's judgment about:

- a. What to communicate in the auditor's report
- b. The form and content of such communication

However, it **does not require** the communication of KAMs. In circumstances where an adverse or qualified opinion is issued, AU-C Section 705 prohibits the auditor from communicating KAMs except in cases where it is required to be reported by law or regulation.

What Would Constitute KAMs?

KAMs are described as those matters that are **the most significant** in the current period audit of the financial statements. Of the matters communicated with those charged with governance, professional judgment of the auditor will determine which of these matters are the most significant.

While the auditor is not required to update KAMs from a prior audit, reviewing those matters might provide insight in the current audit period and the matters may be a continuing KAM.

The process the auditor should consider might include the following:

- Choose from matters communicated with those charged with governance
- Of those matters, determine if any have required significant attention in performing the audit
- From that group of matters, the auditor would identify those that were the most significant
- Consider matters throughout the audit

KAMs are circumstances that required significant auditor attention. This could include the following:

- Requiring the auditor to change audit strategy
- Reallocating resources
- Extent of the effort required by senior personnel
- Requiring expertise of specialized area of accounting

For example:

- Complex areas where auditor is challenged to obtain sufficient appropriate audit evidence:
 - Acquisition of intangible assets
 - Hedging transactions
 - Implementation of new standard
 - Related party transactions
- Areas that required significant judgments where auditor is challenged in forming an opinion on the financial statements:
 - Investments
 - Inventory
 - Fraud risk
 - Regulatory changes
 - Fair value

NOTE: Consider that many items may include matters that are relevant to the audit but may not be required to be disclosed. Examples might include the following:

- How would the implementation of a new IT system or even a significant change to the current system affect the audit attention on the strategy?
- Would modifying a system for implementation of revenue affect the fraud risk factor of revenue recognition?
- Would the identification of significant risks require more specialized expertise?

Caution: A lengthy list of KAMs is not the objective, only those matters that are the most significant.

Communicating KAMs in the auditor's report is done in the context of forming an opinion on the financial statements as a whole. It **does not** mitigate or provide a substitute for the following:

- a. Required disclosures in the financial statements
- b. Any disclosure that would achieve fair presentation
- c. The auditor expressing a modified opinion when required to do so by AU-C Section 705, *Modifications to the Opinion in the Independent Auditor's Report*

- d. For reporting in accordance with AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- e. A separate opinion on individual matters

Determining KAMs

In determining the matters to be communicated with those charged with governance, the matters that required significant auditor attention in performing the audit should be considered, including the following:

- a. Areas of higher assessed risk of material misstatement
- b. Areas of significant risks that were identified
- c. Areas that involved significant management judgment, including accounting estimates
- d. Effect on the audit of significant events or transactions that occurred
- e. The matters that were determined to be the most significant

Each key audit matter in the “Key Audit Matters” section should include a reference to any related disclosures and address the following:

- a. Why the matter was determined to be a KAM. For example:
 - Describe the factors the auditor considered
 - Describe why the matter required significant auditor attention
 - Identify unique circumstances related to an industry
 - Changes in the business model or strategy
 - New or emerging accounting policies
- b. How the matter was addressed in the audit.

Communicating KAMs

A separate section in the Auditor's Report titled “Key Audit Matters” should be placed in a prominent location in close proximity to the Opinion and Basis of Opinion sections.

Opinion

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

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

Basis for Opinion

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

Key Audit Matters

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole and, in forming our opinion thereon, we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with Section 701, Communicating Key Audit Matters in the Independent Auditor's Report, of this SAS]

In communicating to those charged with governance, the auditor should:

- a. Describe each KAM
- b. Use an appropriate subheading for each KAM under the heading "Key Audit Matters"

The introductory language in the KAM section of the auditor's report should state the following:

- a. KAMs that, in the auditor's professional judgment, were of most significance.
- b. The auditor does not provide a separate opinion on these matters as these matters were addressed in the context of the audit as a whole and in forming the auditor's opinion.

Key Audit Matters Not a Substitute for Expressing a Modified Opinion

AU-C Section 705 prohibits the auditor from communicating KAMs when the auditor expresses an adverse opinion or disclaims an opinion on the financial statements.

Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report

The auditor should describe each KAM in the auditor's report unless either:

- a. law or regulation precludes the disclosure of the matter, or
- b. the auditor determines that the matter should not be communicated in the auditor's report as the adverse consequences would outweigh the public interest benefits.

However, this would not apply should the information about the matter be available outside the entity.

Interaction between Descriptions of Key Audit Matters and Other Elements Required to Be Included in the Auditor's Report

When a qualified opinion or substantial doubt exists about an entity's ability to continue as a going concern, these matters are, by their nature, KAMs. Neither of these circumstances should be described in the "Key Audit Matters" section of the auditor's report. In these circumstances, the auditor should:

- a. Report on these matters in accordance with other AU-C sections.
- b. Include a reference to the "Basis for Qualified Opinion" or "Going Concern" section in the "Key Audit Matters" section.

Communication with Those Charged with Governance of Key Audit Matters

The auditor should communicate the following with those charged with governance:

- a. Those matters the auditor has determined to be the KAMs
- b. That the auditor has determined that there are no KAMs to communicate

NOTE: If there are no KAMs to communicate, or the only KAMs communicated are those matters of a qualified opinion or going concern, a statement should be included under "Key Audit Matters"

that the auditor has determined that there are no KAMs to be communicated. The following language could be used:

Key Audit Matters

Except for the matter described in the “Basis for Qualified Opinion” section of Going Concern section, we have determined that there are no (other) key audit matters to communicate in our report.

Other Presentation Issues

Present “Key Audit Matters” section in the Auditor’s Report close to the “Opinion” and “Basis for Opinion” sections.

Comparative statements should describe matters that relate to only the most current period under audit; however, could refer to any period covered by the financial statements.

How the Matter Was Addressed in the Audit

The detail included in the report to describe how the KAM was addressed in the audit is judgment by the auditor and may describe the following elements:

- The auditor’s approach to address the matter
- A brief overview of procedures performed
- Result of the auditor’s procedures
- Any relevant observations with respect to the matter
- Disclosures in the financial statements, if any
- Does not contain or imply discrete opinions on separate elements of the financial statements

Documentation

Audit documentation should include the following:

- Matters that required significant auditor attention
- The rationale for determination of a key audit matter
- The rationale for determination that there are no KAMs to communicate
- The rationale for the determination not to communicate in the auditor’s report a matter determined to be a key audit matter

■ Conclusions reached include determining the following:

- The KAMs to be communicated
- The KAMs that will not be communicated
- That there are no KAMs to be communicated

Examples for Discussion

Auditing Standard No. 3101, PCAOB's new auditor reporting model, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*, was effective for the fiscal years ending on or after December 15, 2017. The auditor reporting model is similar to requirements in SAS 134 for non-public entity auditors. PCAOB requires critical audit matters (CAMs) to be disclosed in the auditor's report for audit years that end on or after June 30, 2019 for large accelerated filers or December 15, 2020 for other companies. CAMs required for public entities are similar to KAMs for non-public entities (although not required unless engaged to report). Therefore, the following companies have been selected to illustrate issues that are anticipated to be CAMs between both groups of auditors.

FORD MOTOR COMPANY

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Ford Motor Company

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheet of Ford Motor Company and its subsidiaries (the "Company") as of December 31, 2019 and 2018, and the related consolidated statements of income, of comprehensive income, of equity and of cash flows for each of the three years in the period ended December 31, 2019, including the related notes and financial statement schedule listed in the index appearing under Item 15(a)(2) (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control – Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control – Integrated Framework* (2013) issued by the COSO.

Changes in Accounting Principles

As discussed in Notes 1 and 3 to the consolidated financial statements, the Company changed its method for reporting early termination losses related to customer defaults on Ford Credit's vehicles subject to operating leases and the manner in which it accounts for leases, respectively, in 2019.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on the Company's consolidated financial statements and on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the consolidated financial statements that were communicated or required to be communicated to the audit committee and that (i) relate to accounts or disclosures that are material to the consolidated financial statements and (ii) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial

statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Consumer Collective Allowance for Credit Losses

As described in Note 11 to the consolidated financial statements, the Company had consumer finance receivables of \$73,560 million collectively evaluated for impairment, for which an allowance of \$478 million was recorded as of December 31, 2019. The consumer collective allowance for credit losses represents the estimate of the probable credit loss inherent in consumer finance receivables as of the balance sheet date. Management estimates the allowance for credit losses on consumer receivables using a combination of measurement models (collective loss-to-receivables and loss projection models) and management judgment. The key assumptions used in the process of estimating the consumer collective allowance for credit losses are frequency, loss severity, and loss emergence period. After establishing the collective and specific allowance for credit losses, if management believes the allowance does not reflect all losses inherent in the portfolio due to changes in recent economic trends and conditions, or other relevant factors, an adjustment is made based on management judgment.

The principal considerations for our determination that performing procedures relating to the consumer collective allowance for credit losses is a critical audit matter are there was significant judgment by management in determining the consumer collective allowance for credit losses, including the frequency, loss severity, and loss emergence period assumptions, which led to a high degree of auditor judgment, subjectivity, and effort in performing procedures over these assumptions. In addition, the audit effort involved the use of professionals with specialized skill and knowledge to assist in performing procedures and evaluating the audit evidence obtained from these procedures.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls related to management's consumer collective allowance for credit losses estimation process. These procedures also included, among others, testing management's process for determining the consumer collective allowance for credit losses, including evaluating the appropriateness of the models used to estimate the allowance, the reasonableness of management's frequency, loss severity, and loss emergence period assumptions, and testing the completeness and accuracy of underlying data supporting the assumptions and models. Additionally, the procedures included the involvement of professionals with specialized skill and knowledge to assist in evaluating the appropriateness of the models.

Defined Benefit Pension Plan Obligations and Benefit Cost

As described in Note 18 to the consolidated financial statements, the Company has defined pension benefit obligations of \$81,045 million (comprised of \$45,672 million and \$35,373 million for its U.S. plans and non-U.S. plans, respectively) as of December 31, 2019, and pre-tax net periodic benefit cost ("benefit cost") of \$1,890 million (comprised of \$(706) million of benefit income and \$2,596 million of benefit cost for its U.S. plans and non-U.S. plans, respectively) for the year ended December 31, 2019. Management re-measures defined benefit pension plan obligations at least annually as of December 31 based on the present value of projected future benefit payments for all participants for services rendered to date. Actuarial gains and losses resulting from plan re-measurement are recognized in net periodic benefit cost in the period of the re-measurement. The measurement of projected future benefits is dependent on the provisions of each specific plan, demographics of the group covered by the plan, and other key measurement assumptions including the discount rate and the average rate of increase in compensation. The assumptions used to determine the benefit cost include discount rate-service cost, effective interest rate on benefit obligation, expected long-term rate of return on assets, and average rate of increase in compensation.

The principal considerations for our determination that performing procedures relating to defined benefit pension plan obligations and benefit cost is a critical audit matter are there was significant judgment by management when developing assumptions used in the estimation of the defined benefit pension

obligations and benefit cost, which led to a high degree of auditor judgment, subjectivity, and effort in performing procedures to evaluate the significant assumptions. In addition to the demographics of the group covered by the plan, significant assumptions include the discount rate and the average rate of increase in compensation used in determining the benefit obligation and the discount rate-service cost, the effective interest rate on benefit obligation, and the average rate of increase in compensation used in determining the benefit cost. In addition, the audit effort involved the use of professionals with specialized skill and knowledge to assist in performing these procedures and evaluating the audit evidence obtained from these procedures.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls relating to the determination of the defined benefit pension plan obligations and benefit cost. These procedures also included, among others, evaluating the Company's historical experience and expectations of future experience to evaluate the reasonableness of the average rate of increase in compensation. Additionally, professionals with specialized skill and knowledge were used to assist in the evaluation of the appropriateness of the actuarial model, as well as the reasonableness of significant assumptions including demographics of the group covered by the plan, the discount rate used in determining the benefit obligation and the discount rate-service cost and the effective interest rate on benefit obligation used in determining the benefit cost.

Warranty and Field Service Actions Accrual (United States)

As described in Note 27 to the consolidated financial statements, the Company recorded an accrual for estimated future warranty and field service action costs, net of estimated supplier recoveries ("warranty accrual"), of \$5,702 million as of December 31, 2019, of which the United States comprises a significant portion. Management accrues the estimated cost of both base warranty coverages and field service actions at the time of sale. Management establishes their estimate of base warranty obligations using a patterned estimation model, using historical information regarding the nature, frequency, and average cost of claims for each vehicle line by model year. Management establishes their estimates of field service action obligations using a patterned estimation model, using historical information regarding the nature, frequency, severity, and average cost of claims for each model year.

The principal considerations for our determination that performing procedures relating to the warranty accrual for the United States is a critical audit matter are there was significant judgment by management in the estimation of the accrual and development of the patterned estimation model, which led to a high degree of auditor judgment, subjectivity, and effort in performing procedures to evaluate the estimation model and significant assumptions, including the frequency and average cost of claims. In addition, the audit effort involved the use of professionals with specialized skill and knowledge to assist in performing these procedures and evaluating the audit evidence obtained from these procedures.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls related to the estimate of the warranty accrual for the United States. These procedures also included, among others, evaluating the reasonableness of significant assumptions used by management to develop the warranty accrual for the United States, including the frequency and average cost of claims, in part by considering the historical experience of the Company. Additionally, professionals with specialized skill and knowledge were used to assist in the evaluation of the appropriateness of the model as well as the reasonableness of certain significant assumptions.

MICROSOFT CORPORATION

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of Microsoft Corporation

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the “Company”) as of June 30, 2019 and 2018, the related consolidated statements of income, comprehensive income, stockholders’ equity, and cash flows, for each of the three years in the period ended June 30, 2019, and the related notes (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2019, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of June 30, 2019, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 1, 2019, expressed an unqualified opinion on the Company’s internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current-period audit of the financial statements that were communicated or required to be communicated to the Company’s Audit Committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Revenue Recognition — Refer to Note 1 to the Financial Statements

Critical Audit Matter Description

The Company recognizes revenue upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. The Company offers customers the ability to acquire multiple licenses of software products and services, including cloud-based services, in its customer agreements through its volume licensing programs.

Significant judgment is exercised by the Company in determining revenue recognition for these customer agreements, and includes the following:

- Determination of whether products and services are considered distinct performance obligations that should be accounted for separately versus together, such as software licenses and related services that are sold with cloud-based services.
- Determination of stand-alone selling prices for each distinct performance obligation and for products and services that are not sold separately.
- The pattern of delivery (i.e., timing of when revenue is recognized) for each distinct performance obligation.
- Estimation of variable consideration when determining the amount of revenue to recognize (e.g., customer credits, incentives, and in certain instances, estimation of customer usage of products and services).

Given these factors, the related audit effort in evaluating management's judgments in determining revenue recognition for these customer agreements was extensive and required a high degree of auditor judgment.

How the Critical Audit Matter Was Addressed in the Audit

Our principal audit procedures related to the Company's revenue recognition for these customer agreements included the following:

- We tested the effectiveness of internal controls related to the identification of distinct performance obligations, the determination of the timing of revenue recognition, and the estimation of variable consideration.
- We evaluated management's significant accounting policies related to these customer agreements for reasonableness.
- We selected a sample of customer agreements and performed the following procedures:
 - Obtained and read contract source documents for each selection, including master agreements, and other documents that were part of the agreement.
 - Tested management's identification of significant terms for completeness, including the identification of distinct performance obligations and variable consideration.
 - Assessed the terms in the customer agreement and evaluated the appropriateness of management's application of their accounting policies, along with their use of estimates, in the determination of revenue recognition conclusions.
- We evaluated the reasonableness of management's estimate of stand-alone selling prices for products and services that are not sold separately.
- We tested the mathematical accuracy of management's calculations of revenue and the associated timing of revenue recognized in the financial statements.

Income Taxes — Uncertain Tax Positions — Refer to Note 12 to the Financial Statements

Critical Audit Matter Description

The Company's long-term income taxes liability includes uncertain tax positions related to transfer pricing issues that remain unresolved with the Internal Revenue Service ("IRS"). The Company remains under IRS audit, or subject to IRS audit, for tax years subsequent to 2003. While the Company has settled a portion of the IRS audits, resolution of the remaining matters could have a material impact on the Company's financial statements.

Conclusions on recognizing and measuring uncertain tax positions involve significant estimates and management judgment and include complex considerations of the Internal Revenue Code, related regulations, tax case laws, and prior-year audit settlements. Given the complexity and the subjective nature of the transfer pricing issues that remain unresolved with the IRS, evaluating management's estimates relating to their determination of uncertain tax positions required extensive audit effort and a high degree of auditor judgment, including involvement of our tax specialists.

How the Critical Audit Matter Was Addressed in the Audit

Our principal audit procedures to evaluate management's estimates of uncertain tax positions related to unresolved transfer pricing issues included the following:

- We evaluated the appropriateness and consistency of management's methods and assumptions used in the identification, recognition, measurement, and disclosure of uncertain tax positions, which included testing the effectiveness of the related internal controls.
- We read and evaluated management's documentation, including relevant accounting policies and information obtained by management from outside tax specialists that detailed the basis of the uncertain tax positions.
- We tested the reasonableness of management's judgments regarding the future resolution of the uncertain tax positions, including an evaluation of the technical merits of the uncertain tax positions.
- For those uncertain tax positions that had not been effectively settled, we evaluated whether management had appropriately considered new information that could significantly change the recognition, measurement or disclosure of the uncertain tax positions.
- We evaluated the reasonableness of management's estimates by considering how tax law, including statutes, regulations and case law, impacted management's judgments.

SAS 135 – Omnibus Statement on Auditing Standards – 2019

Introduction

The omnibus statement was issued by the Auditing Standards Board (ASB) in conjunction with SAS 134 to align ASB guidance more closely with the Public Company Accounting Oversight Board (PCAOB). While amending multiple sections, the primary focus was on amending the following:

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

Effective Date

The standard is effective for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time.

Significant Changes

AU-C Section 260, The Auditor's Communication with Those Charged with Governance

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

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

Audit documentation should include a copy or summary of management's communication provided to those charged with governance.

Application material has been added as guidance in:

- Communication of the possible implication of uncorrected misstatements
- Communication of complaints or concerns about accounting or auditing matters (that came to the attention of the auditor)
- Documentation of the communication

AU-C Section 550, Related Parties

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

- Understanding of the entity and its environment
- Assessing the risks of material misstatement
- Performing audit procedures to respond to the risks
- Evaluating the audit evidence obtained
- Consideration of fraud related to risk of misstatements

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

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

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

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

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

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

- Has the reporting entity properly identified its related party relationships and transactions?
- To identify these relationships and transactions, has the auditor included procedures to test the accuracy and completeness?

- Have procedures on balances with affiliated entities been considered as of concurrent dates such as:
 - Has the underlying documentation been read to determine that terms and information are consistent with explanations and another audit evidence?
 - Has authorization been consistent with policies and procedures?
 - Has the transaction been accounted for properly?
 - Has adequate disclosure been made?

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

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

Consideration of fraud related to risk of misstatements notes that fraudulent financial reporting often involves **management override of controls** that otherwise may appear to be operating effectively. The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the reporting entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include the following:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business purpose of these transactions
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value
- Engaging in complex transactions with related parties, such as entities formed to accomplish specific purposes, that are structured to misrepresent the financial position or financial performance of the entity

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

Changes to AU-C Section 240 include redefining *Significant Unusual Transactions* as:

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

Other changes include:

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

SAS 136 – Forming an Opinion and Reporting of Employee Benefit Plans Subject to ERISA

Introduction

In July 2019, the AICPA Auditing Standards Board issued SAS 136 in the continuing effort to improve the communication value of the auditor's report for ERISA plan financial statements. The Department of Labor (DOL) has long advocated for increased transparency in reporting standards when management elects to exclude from the audit certain investment information held and certified by a qualified institution, which is permitted by ERISA. The redesign of the auditor's report should make it easier to understand and more relevant which will lead to improved employee benefit plan (EBP) audit quality.

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

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

AU-C Section 703 amends:

- SAS No. 119, as amended [AICPA, Professional Standards, AU-C Section 725];
- Various sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended [AICPA, Professional Standards, AU-C Sections 220, 240, 330, 450, 501, 510, 540, 550, 560, 580, and 708];
- SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* [AICPA, Professional Standards, AU-C Section 570];
- Section 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*;
- Section 240, *Consideration of Fraud in a Financial Statement Audit*;
- Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*;
- Section 450, *Evaluation of Misstatements Identified During the Audit*;
- Section 510, *Opening Balances – Initial Audit Engagements, Including Pre-audit Engagements*;
- Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*;

Effective Date

The standard is effective for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time. Upon initial implementation of the SAS, transitional implementation reporting guidance is provided in Exhibit B of the standard, "Implementation Guidance for ERISA Section 103(a)(3)(C) Audits." This guidance can be found at <https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/sas-136.pdf>.

What's Different?

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

Form and Content

Practitioners should pay particular attention to:

- The Scope and Nature of ERISA Section 103(a)(3)(C) Audit Section is presented first.
- The Auditor's Opinion section follows the Scope and Nature section.
- The Basis for the Opinion section follows the Auditor's Opinion section.
- The Basis for the Opinion section is new and more focused on the obligations relating to independence and clarifies that there are ethical requirements of the audit engagement.
- The section related to auditor's responsibilities is revised particularly as it relates to communications with those charged with governance. The section should be headed as "Auditor's Responsibilities for the Audit of the Financial Statements." It makes clear that the

ERISA Section 103(a)(3)(C) audit does not include the certified investment information with the exception of certain procedures.

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

Note to practitioners: Firm methodologies and engagement team training will need to be reviewed when implementing this standard. In addition, users should be educated on the new form and content of the auditor's report.

Illustration 1 — An Auditor's Report on Financial Statements for a Defined Contribution Retirement Plan Subject to ERISA

Circumstances include:

- Audit of complete set of financial statements
- Management is responsible for the preparation of financial statements with GAAP
- Unmodified opinion
- No conditions that raise substantial doubt about continuing as a going concern
- Auditor has not been engaged to communicate key audit matters
- Report on ERISA required supplemental schedules is presented
- Form and content are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA

Independent Auditor's Report

[Appropriate Addressee]

Opinion

We have audited the financial statements of ABC 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), which comprise the statements of net assets available for benefits as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the net assets available for benefits of ABC 401(k) Plan as of December 31, 20X2 and 20X1, and the changes in its net assets available for benefits for the year ended December 31, 20X2, in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

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

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

Other Matter - Supplemental Schedules Required by ERISA

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

the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS.

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

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

[Signature of the auditor's firm]

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

[Date of the auditor's report]

Illustration 2 — An Auditor's Report on Financial Statements for a Defined Benefit Pension Plan Subject to ERISA

Circumstances include:

- Audit of complete set of financial statements
- Information regarding the actuarial present value of accumulated plan benefits and changes is presented in separate statements within the financial statements
- Management is responsible for the preparation of financial statements with GAAP
- Unmodified opinion
- No conditions that raise substantial doubt about continuing as a going concern
- Auditor has not been engaged to communicate key audit matters
- The report on the ERISA required supplemental schedules is presented as an other-matter paragraph
- Form and content are presented in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA

Independent Auditor's Report

[Appropriate Addressee]

Opinion

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

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

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

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

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

Other Matter – Supplemental Schedules Required by ERISA

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

the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS.

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

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

[Signature of the auditor's firm]

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

[Date of the auditor's report]

Illustration 3 — An Auditor’s Report on Financial Statements for a Defined Contribution Retirement Plan Subject to ERISA When Management Elects an ERISA Section 103(a)(3)(C) Audit

Circumstances include:

- Management has elected an ERISA Section 103(a)(3)(C) audit
- Auditor performed an ERISA Section 103(a)(3)(C) audit of complete set of financial statements
- Management is responsible for the preparation of financial statements with GAAP
- No limitations on the scope of the audit and auditor has not identified any material misstatements of the ERISA plan financial statements
- No conditions that raise substantial doubt about continuing as a going concern
- Auditor has not been engaged to communicate key audit matters
- The report on the ERISA required supplemental schedules is presented as an other-matter paragraph
- Form and content are presented in conformity with the Department of Labor’s Rules and Regulations for Reporting and Disclosure under ERISA except for the information in the supplemental schedules agreed to/derived from the certified investment information
- The information in the supplemental schedules related to assets held and certified to by a qualified institution agreed to/derived from the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C)

Independent Auditor's Report

[Appropriate Addressee]

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

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

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

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

Opinion

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

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

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the

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

Responsibilities of Management for the Financial Statements

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

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ABC 401(k) Plan's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC 401(k) Plan's ability to continue as a going concern for a reasonable period of time.

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

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

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

Other Matter – Supplemental Schedules Required by ERISA

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

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

In our opinion:

- The form and content of the supplemental schedules, other than the information in the supplemental schedules that agreed to or is derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.
- The information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

[Signature of the auditor's firm]

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

[Date of the auditor's report]

Engagement Acceptance

AU-C Section 210, *Terms of Engagement*, requires the auditor to have an agreement with management that management acknowledges and understands its responsibility for the following:

- Maintaining a current plan instrument, including all plan amendments
- Administering the plan in conformity with the plan provisions and determine that:
 - Plan's transactions that are presented and disclosed in the ERISA plan financial statements comply with the plan provisions
 - Sufficient records are maintained in conformity with the plan provisions such that each participant's benefits due or which may become due are correctly determined
- When an election is made by management for an ERISA Section 103(a)(3)(C) audit determining if:
 - An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances
 - The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8
 - The certification meets the requirements in 29 CFR 2520.103-5
 - The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework

The auditor should inquire of management or those charged with governance (when electing to have an ERISA Section 103(a)(3)(C) audit) about the following:

- How management determined that the entity preparing and certifying the investment information is a qualified institution
- Prior to the dating of the auditor's report, provide to the auditor a draft of Form 5500 that is substantially complete

AU-C Section 250 Auditor Responsibilities

As part of the auditor's responsibilities in accordance with AU-C Section 250 relating to the plan's tax status, the auditor should consider whether management has performed the relevant IRC compliance tests, including:

- Discrimination testing
- Corrected or intends to correct failure

Audit Risk Assessment and Response

AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The auditor's responsibility to identify and assess the risks of material misstatement includes understanding the entity and its environment, as well as the entity's internal control. To understand the plan and identify and perform audit procedures that are responsive to assessed risks requires an adequate understanding of the plan instrument. In performing the risk assessment procedures, the auditor should perform the following:

- Obtain and read the most current plan instrument, including any amendments, to gain an understanding of the entity
- Consider relevant plan provisions that affect the risk of material misstatement at the relevant assertion level for
 - classes of transactions,
 - account balances, and
 - disclosures.

If the auditor does not consider it necessary to test any relevant plan provisions, the considerations in reaching the conclusion not to test the provisions must be documented in accordance with AU-C Section 230, *Audit Documentation*.

Prohibited Transactions

Should the auditor become aware that the plan has entered into a prohibited transaction with a party in interest, and the prohibited transaction has not been properly reported in the applicable ERISA-required supplemental schedule, the auditor should discuss the matter with management. In the event that management does not revise the ERISA-required schedule, a discussion of the matter with those charged with governance and the following should be considered:

- If the effect of the prohibited transaction is material to the financial statement as a whole, the auditor should modify the auditor's opinion on the ERISA-required supplemental schedule.
- If the effect of the prohibited transaction is not material, the auditor should include additional discussion in the other-matter paragraph in the auditor's report on the ERISA-required supplemental schedules describing the prohibited transaction.
- If the prohibited transaction is considered a related party transaction and not properly disclosed in the notes to the ERISA plan financial statements, the auditor should modify the auditor's opinion on the financial statements in accordance with AU-C Section 705 as a departure from the applicable financial reporting framework.

Reportable Findings

If items are identified that are not in accordance with the criteria specified (for example, not in accordance with the plan instrument), the auditor should evaluate whether the matters are reportable findings.

One or more of the following matters should be considered reportable findings:

- An identified or suspected non-compliance with laws or regulations in accordance with AU-C Section 250
- An audit finding that is significant and relevant regarding the responsibility of those charged with governance to oversee the financial reporting process in accordance with AU-C Section 260
- An indication of deficiencies in internal control that have been identified during the audit but that have not been communicated to management which are of sufficient importance to merit management's attention in accordance with AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*

Reportable Findings Should Be Communicated in Writing on a Timely Basis to Those Charged with Governance

The communication should be included with the required communication in accordance with AU-C Sections 250, 260, or 265, either in a separate section or other communications. The written communication should include the following:

- A description of the reportable finding
- Sufficient information to enable those charged with governance and management to understand the context of the communication
- An explanation of the potential effects of the reportable findings on the financial statements or to the plan

NOTE: The auditor **should not** issue a written communication stating that no reportable findings were identified.

ERISA Section 103(a)(3)(C) Audit Procedures

Management's election to have an ERISA Section 103(a)(3)(C) audit requires the auditor to evaluate management's assessment as to whether the entity issuing the certification is a qualified institution. Management should provide sufficient information that supports their determination that the entity preparing and certifying the investment information is a qualified institution.

The auditor should:

- Identify which investment information is certified
- Perform the following procedures on the certified investment information:
 - Read the certification
 - Compare the certified investment information to:
 - The related information presented
 - The information disclosed in the ERISA plan financial statements
 - The ERISA-required supplemental schedules
- Identify which investment information is not certified
- Perform the following procedures on uncertified investment information:
 - On financial information
 - Disclosures

For all audits of ERISA plan financial statements, including an ERISA Section 103(a)(3)(C) audit, the auditor should perform the procedures necessary to become satisfied that received and disbursed amounts (for example, employer or employee contributions and benefit payments) reported by the trustee or custodian were determined in accordance with the plan provisions.

Written Representations

The following written representations from management in an audit of ERISA plan financial statements should be requested:

- That management has provided the most current plan instrument, including all plan amendments
- Acknowledgement of its responsibility for administering the plan and determining that the plan's transactions that are presented and disclosed in the ERISA plan financial statements are in conformity with the plan's provisions, including maintaining sufficient records with respect to each of the participants to determine the benefits due or which may become due to such participants
- When management elects to have an ERISA Section 103(a)(3)(C) audit, acknowledgement that management's election of the ERISA Section 103(a)(3)(C) audit does not affect its responsibility for the financial statements and for determining whether:
 - An ERISA Section 103(a)(3)(C) audit is permissible under the circumstances,

- The investment information is prepared and certified by a qualified institution as described in 29 CFR 2520.103-8,
- The certification meets the requirements in 29 CFR 2520.103-5, and
- The certified investment information is appropriately measured, presented, and disclosed in accordance with the applicable financial reporting framework

Considerations for Form 5500, Annual Return

Prior to dating the auditor's report, the Form 5500 should be obtained and read by the auditor. The auditor should read the draft Form 5500 in order to:

- identify material inconsistencies with the audited ERISA plan financial statements.
- communicate with those charged with governance the auditor's responsibility with respect to Form 5500.
- communicate the procedures performed relating to Form 5500.
- communicate the results of the procedures performed related to the Form 5500.

Transition – Implementation Guidance for ERISA Section 103(a)(3)(C) Audits

The following illustration contains example reports for when the auditor has adopted this SAS for the first time and is performing an ERISA Section 103(a)(3)(C) audit for the current year and updating their audit from the prior year.

Auditor's Reports on Financial Statements for a Defined Contribution Retirement Plan Subject to ERISA When Management Elects an ERISA Section 103(a)(3)(C) Audit in the Current Year (2021) and the Auditor Disclaimed an Opinion on the Financial Statements in the Prior Year (2020)

Circumstances include the following:

- Management elected an ERISA Section 103(a)(3)(C) audit for the 2020 plan financial statements, as permitted by Code of Federal Regulations (CFR), *Labor*, Title 29, Section 2520.103-8, of the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.⁶⁰

⁶⁰ Although not as common, an ERISA Section 103(a)(3)(C) audit may relate to the audit of a 103-12 entity as permitted by 29 CFR 2520.103-12. Accordingly, the wording in this illustrative report may need to be revised to fit the circumstances of the engagement.

- The audit is for a complete set of general-purpose financial statements for a 401(k) plan subject to ERISA that is presenting comparative statements of net assets available for benefits and a single-year statement of changes in net assets available for benefits.
- The auditor performed an ERISA Section 103(a)(3)(C) audit as of and for the year ended December 31, 2021.
- The auditor disclaimed an opinion on the prior year financial statements (for the year ended December 31, 2020).
- The auditor is issuing **two separate reports**.
- Management is responsible for the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America, as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in AU-C Section 210, *Terms of Engagement*.
- There are no limitations on the scope of the audit for the current year, and the auditor has not identified any material misstatements of the ERISA plan financial statements in accordance with AU-C Section 705, *Modifications to the Opinion in the Independent Auditor's Report*.
- The auditor has concluded that the ERISA Section 103(a)(3)(C) report is appropriate as of and for the year ended December 31, 2021 based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time in accordance with AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor **has not been engaged** to communicate **key audit matters**.
- The report on the ERISA-required supplemental schedules is presented as an other-matter paragraph for the year ended December 31, 2021.

Independent Auditor's Report

[Appropriate Addressee]

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

We have performed an audit of the financial statements of ABC 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), as permitted by ERISA Section 103(a)(3)(C) (ERISA Section 103(a)(3)(C) audit). The financial statements comprise the statement of net assets available for benefits as of December 31, 2021, and the related statement of changes in net assets available for benefits for the year then ended, and the related notes to the financial statements.

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

Management has obtained a certification from a qualified institution as of and for the year ended December 31, 2021, stating that the certified investment information, as described in Note X to the financial statements, is complete and accurate.⁶¹

Opinion

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

- The amounts and disclosures in the financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America.
- The information in the financial statements related to assets held by⁶² and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

⁶¹ If the note to the financial statements does not identify the names of the qualified certifying institutions and periods covered, then such information may be included in the auditor's report.

⁶² This sentence may need to be modified when the certification is provided by an insurance entity, which provides benefits under the plan or holds plan assets.

Basis for Opinion

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

Responsibilities of Management for the Financial Statements

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

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

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

Auditor's Responsibilities for the Audit of the Financial Statements

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

In performing an audit in accordance with GAAS, we:

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

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

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

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

Other Matter – Supplemental Schedules Required by ERISA

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

other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with GAAS. For information included in the supplemental schedules that agreed to or is derived from the certified investment information, we compared such information to the related certified investment information.

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

In our opinion,

- the form and content of the supplemental schedules, other than the information in the supplemental schedules that is agreed to or derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.
- the information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

[Signature of the auditor's firm]

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

[Date of the auditor's report]

Independent Auditor's Report

[Appropriate Addressee]

We were engaged to audit the accompanying statement of net assets available for benefits of ABC 401(k) Plan, as of December 31, 2019, and the related notes to the financial statement.

Management's Responsibility for the Financial Statement

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

Auditor's Responsibility

Our responsibility is to express an opinion on the 2019 financial statement based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee of the Plan, except for comparing such information with the related information included in the financial statement. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 2019 that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the 2019 financial statement. Accordingly, we do not express an opinion on the 2019 financial statement.

**Report on Form and Content in Compliance with DOL Rules and Regulations for 2019
Financial Statement**

The form and content of the information included in the 2019 financial statement, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of the auditor's firm]

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

[Date of the auditor's report]

SAS 137 – The Auditor’s Responsibilities Relating to Other Information Included in Annual Reports

Introduction

SAS 137 addresses the responsibility of the auditor related to other information included in an annual report. The information could be financial or non-financial information. The standard is expected to reduce diversity in practice and improve transparency related to the auditor’s responsibilities for other information and documents that are within the scope of the standard. The standard requires the auditor to read and consider consistency with the financial statements or the knowledge the auditor has obtained in the audit of the financial statements which might indicate a material misstatement of the financial statements or the other information.

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

Effective Date

The SAS will be effective for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time.

Changes

Supersedes SAS 118, *Other Information in Documents Containing Audited Financial Statements*, as amended AU-C 720. Amends:

- SAS 119, *Supplementary Information in Relation to the Financial Statements as a Whole*
- SAS 120, *Required Supplementary Information*
- SAS 122, *Clarification and Recodification*
 - Section 210, Terms of Engagement
 - Section 230, Audit Documentation
 - Section 260, The Auditor’s Communication with Those Charged with Governance
 - Section 450, Evaluation of Misstatements Identified During the Audit
 - Section 600, Special Considerations-Audits of Group Financial Statements
 - Section 810, Engagements to Report on Summary Financial Statements
- SAS 133, *Auditor Involvement with Exempt Offering Documents*

- SAS 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
 - Section 700, Forming an Opinion and Reporting on Financial Statements
 - Section 705, Modification to the Opinion in the Independent Auditor's Report
 - Section 706, Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report

SAS 137 does not:

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

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

- Management report, management commentary, or operating and financial review or similar reports by those charged with governance (for example, a director's report)
- Chairman's statement
- Corporate governance statement
- Management's internal control and risk assessment reports
- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data
- Tables, charts, or graphs containing extracts of the financial statements

- A disclosure providing greater detail about a balance or account shown in the financial statements
- Descriptions of the financial results, such as “Total research and development expense”

Requirements of the auditor:

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

Reading and considering the other information for the following:

- Whether a material inconsistency exists between the financial statements and the other information
- Comparing selected amounts or other items in the other information to the financial statements
- If a material inconsistency exists between the auditor’s knowledge and the other information
- Existence of a material misstatement of fact or other information that is misleading

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

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

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

Reporting

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

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

Documentation

Required documentation includes:

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

EXHIBIT — ILLUSTRATIONS OF OTHER INFORMATION SECTIONS TO BE INCLUDED IN AUDITOR’S REPORTS RELATING TO OTHER INFORMATION INCLUDED IN THE ANNUAL REPORT

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

Other Information [Included in the Annual Report]

Management is responsible for the other information *[included in the annual report]*. The other information comprises the *[information included in the annual report]*⁶³ but does not include the financial statements and our auditor’s report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

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

⁶³ A more specific description of the other information, such as “the management report and chairman’s statement,” may be used to identify the other information.

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

Other Information [Included in the Annual Report]

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

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

SAS 138 – Amendments to the Description of the Concept of Materiality

Provisions

In December 2019, the ASB of the AICPA issued Statement of Auditing Standard (SAS) No. 138, *Amendments to the Description of the Concept of Materiality*, that amended various sections of AU-C in an attempt to eliminate inconsistencies between the AICPA professional standards and the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators. The revised definition is now aligned with the Financial Accounting Standards Board (FASB) and consistent with the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB) as well as the PCAOB and the SEC.

The description has been revised as follows:

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

SAS 138 amends:

- SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, as amended*
 - Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards* [AICPA, Professional Standards, AU-C Section 200];
 - Section 320, *Materiality in Planning and Performing an Audit* [AICPA, Professional Standards, AU-C Section 320];

- Section 450, *Evaluation of Misstatements Identified During the Audit* [AICPA, Professional Standards, AU-C Section 450]; and
- Section 600, *Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)* [AICPA, Professional Standards, AU-C Section 600]
- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, as amended
 - Section 700, *Forming an Opinion and Reporting on Financial Statements* [AICPA, Professional Standards, AU-C Section 700]
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* [AICPA, Professional Standards, AU-C Section 703]

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

Effective date for the standard will be for periods ending on or after December 15, 2021.

SAS 139 – Amendments to AU-C Sections 800, 805, and 810

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

Changes from SAS 134 are in the following sections:

- Section 800, *Special Considerations-Special Purpose Frameworks*
- Section 805, *Special Considerations-Specific Elements, Accounts, or Items*
- Section 810, *Summary Financial Statements*
- Reflects guidance in new SAS 136 and 137

There are three areas of particular concern:

1. Section 800 is amended to require a statement in the audit report when the financial statements are prepared on a regulatory or contractual basis of accounting or any other basis and the use is restricted that alerts the user to the fact the financial statements may not be suitable for another purpose other than the intended purpose. In lieu of the report letter, there should be reference to the note to the financial statements with the required information of the purpose of the financial statements.

2. Section 805 adds factors to consider when reporting on a single financial statement or a specific element of a financial statement.
3. Section 810 includes application paragraphs when the auditor's report includes communication about key audit matters that the auditor is not required to describe the individual key audit matters in the auditor's report on the summary financial statements.

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

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

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

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

- Based on the audit evidence obtained, conclude whether, in the auditor's judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- When such substantial doubt exists, evaluate the adequacy of the financial statement disclosures.
- The SAS will be effective for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time.

SAS 140 – Amendments to AU-C Sections 725, 730, 930, 935, and 940

In April 2020, the Auditing Standards Board issued SAS 140 that conforms sections to coincide with the codification sections for recently issued standards on Auditor Reporting and the Auditor's Responsibilities in SAS 134 and related to the Auditor's Responsibilities Relating to Other Information included in Annual Reports SAS 137. Other significant revisions were revisions to AU-C 930, 935, and 940. AU-C Sections 725 and 730 were aligned with SAS 137 on reporting on supplementary information. SAS 140 amends the following:

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

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

Illustration: A Review Report on Interim Financial Information

Circumstances include the following:

- A review of interim financial information presented as a complete set of financial statements, including disclosures

Independent Auditor's Review Report

[Appropriate Addressee]

Results of Review of Interim Financial Information

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

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

Basis for Review Results

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

Responsibilities of Management for the Interim Financial Information

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

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

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

Illustration: Combined Report on Compliance With Applicable Requirements and Internal Control Over Compliance (Unmodified Opinion on Compliance, No Material Weaknesses, or Significant Deficiencies in Internal Control Over Compliance Identified)

The AICPA Audit Guide Government Auditing Standards and Single Audits contains illustrative language for other types of reports, including reports containing qualified or adverse opinions on compliance with either material weaknesses in internal control over compliance, significant deficiencies in internal control over compliance, or both identified.

Independent Auditor's Report

[Addressee]

Report on Compliance

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

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

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

Basis for Opinion

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

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

Responsibilities of Management for Compliance

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

Auditor's Responsibilities for the Audit of Compliance

Our objectives are to obtain reasonable assurance about whether material noncompliance with the compliance requirements referred to occurred, whether due to fraud or error, and express an opinion on Example Entity's compliance based on our audit. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS, Government Auditing Standards, and *[insert the name of the governmental audit*

requirement or program-specific audit guide] will always detect material noncompliance when it exists. The risk of not detecting material noncompliance resulting from fraud is higher than for that resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Noncompliance with the compliance requirements referred to above is considered material if there is a substantial likelihood that, individually or in the aggregate, it would influence the judgment made by a reasonable user of the report on compliance about Example Entity's compliance with the requirements of the government program as a whole.

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

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

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

Report on Internal Control Over Compliance

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

Our consideration of internal control over compliance was for the limited purpose described in the Auditor's Responsibilities for the Audit of Compliance section above and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or

significant deficiencies in internal control over compliance. Given these limitations, during our audit we did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, material weaknesses or significant deficiencies in internal control over compliance may exist that have not been identified.

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

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

[Signature of the auditor's firm]

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

[Date of the auditor's report]

AU-C Section 940 revisions include changes to the reporting requirement related to audits of internal control over financial reporting that is integrated with an audit of financial statements as follows:

- Should a separate report on internal control over financial report be issued, there will be a required paragraph to be placed within:
 - a. The Opinion section following the opinion paragraph that references to the report on internal control over financial reporting, and
 - b. The Opinion on Internal Control over Financial Reporting section following the opinion paragraph in the ICFR report that references the report on the financial statements.

Changes the requirements on how to report when issuing an adverse opinion or disclaiming an opinion when there is a scope limitation.

- When management includes additional information in management's report or a document containing management's report and the related auditor's report.

In circumstances where the auditor is required to report on supplementary information or required supplementary information, AU-C Sections 725 and 730 have been amended to require reporting in a separate section of the auditor's report as opposed to in an other-matter paragraph.

The effective date will be for periods ending on or after December 15, 2021. Reviews of interim financial information will be effective for interim periods of fiscal years beginning on or after December 15, 2021. Early implementation is permitted; however, the ASB expects that SAS Nos. 134-140 be implemented at the same time.

PROPOSED STATEMENTS ON STANDARDS FOR AUDIT

Proposal Addressing Audit Evidence

This proposed Statement on Auditing Standards identifies what is included as audit evidence and addresses how an auditor evaluates information that is to be used as audit evidence. Attribution will be set for information that considers how to assist the auditor in exercising professional skepticism. The proposal in conjunction with other AU-C sections is to be considered specifically in applying AU-C Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which requires a conclusion by the auditor as to whether sufficient appropriate audit evidence has been obtained that provides a basis for the opinion. The conclusion related to adequate audit evidence, even though a professional judgment, includes evaluating the following:

1. Is the assessment of the risks of material misstatement at the financial statement and the assertion level appropriate?
2. Is the audit evidence in accordance with the auditing standards?

The expected effective date is for audits for periods beginning on or after December 15, 2021.

Proposed Standard for Auditing Accounting Estimates and Related Disclosures Which Encourages Auditors to Exercise Professional Skepticism

This proposal is part of the AICPA's *Enhancing Audit Quality Initiative*. The standard would identify the various aspects of management estimates, which will address one of the major challenges for audits. Auditors will be able to focus their efforts on unique aspects like subjectivity and estimation uncertainty. This focus is intended to improve the effectiveness of the procedures performed by the audit related to management estimates in general. To assist auditors in appropriately addressing the complex situations that come about from current, new accounting standards is the purpose of this standard related to estimates and related disclosures and to focus the auditor on factors like estimate uncertainty and potential management bias. The proposed changes are believed to encourage auditors to exercise professional skepticism.

Proposed Statement on Communication with Predecessor Auditor Regarding Fraud and Non-Compliance with Laws and Regulations

Requires that the auditor inquire of the predecessor auditor regarding identified or suspected fraud and matters involving non-compliance with laws and regulations when considering whether to accept an engagement. Specific inquiries would include:

1. Identified or suspected fraud involving:
 - Management
 - Employees with significant roles in internal control
 - Others where a fraud could result in a material misstatement
2. Matters involving noncompliance with laws and regulations that come to the auditor's attention

STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS

SSAE No. 19 – Agreed-Upon Procedures Engagements

Introduction

Statement on Standards for Attestation Engagements (SSAE) No. 19, *Agreed-Upon Procedures Engagements*, was issued in December 2019, by the Auditing Standards Board.

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

position, but SSAE removes the requirement to obtain an assertion. The standard will affect the current guidance as follows:

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

Agreed-upon procedures engagements involve three parties:

1. Engaging party – the party engaging the practitioner to perform the engagement (client)
2. Responsible party – the party responsible for the subject matter
3. Specified party – the intended user(s) of the practitioner’s written report

Effective Date

SSAE 19 will be effective for agreed-upon procedures reports that will be dated on or after July 15, 2021. Early implementation is allowed.

Key Changes

The standard provides flexibility to the practitioner performing agreed-upon procedures in several ways:

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

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

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

EXHIBIT – ILLUSTRATIVE PRACTITIONER’S AGREED-UPON PROCEDURES REPORTS

The illustrative practitioners’ agreed-upon procedures reports in this exhibit meet the applicable reporting requirements in SSAE 19. A practitioner may use alternative language in drafting an agreed-upon procedures report, provided that the language meets the applicable requirements in SSAE 19.

Illustration 1: Practitioner’s Agreed-Upon Procedures Report Related to a Statement of Investment Performance Statistics

Circumstances include the following:

- The engaging party is the responsible party.
- The practitioner has assisted in the development of the procedures.
- No party other than the engaging party has agreed to the procedures and acknowledged that the procedures are appropriate for their purposes.

Independent Accountant's Report

[Appropriate Addressee]

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

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

The procedures and the associated findings are as follows:

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

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

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

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

[Signature of the practitioner's firm]

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

[Date of the practitioner's report]

Illustration 2: Practitioner's Agreed-Upon Procedures Report Related to Cash and Accounts Receivable

Circumstances include the following:

- The engaging party is not the responsible party.
- Other than the engaging party, no other party has agreed to the procedures and acknowledged that the procedures are appropriate for their purposes.

Independent Accountant's Report

[Appropriate Addressee]

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

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

Cash

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

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

We found no exceptions as a result of the procedures.

Accounts Receivable

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

We found no exceptions as a result of the procedures.

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

We found no exceptions as a result of the procedures.

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

We found no exceptions as a result of the procedures.

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

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

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

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

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

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

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

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

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

[Signature of the practitioner's firm]

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

[Date of the practitioner's report]

Illustration 3: Practitioner's Agreed-Upon Procedures Report in Connection with Claims of Creditors

Circumstances include the following:

- The engaging party is the responsible party.
- The engaging party and one specified party have prescribed the procedures for the practitioner to perform. The engaging party and the specified party have both agreed to the procedures and have acknowledged that the procedures are appropriate for the intended purpose of the engagement and their purposes, respectively.

The practitioner has determined to disclose in the agreed-upon procedures report that the specified party has agreed to and acknowledged that the procedures are appropriate for their purposes.

- The practitioner has determined to restrict the use of the agreed-upon procedures report to the parties that prescribed the procedures.

Independent Accountant's Report

[Appropriate Addressee]

We have performed the procedures enumerated below on *[identify the subject matter, for example, the claims of creditors of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A]*. *[The responsible party, for example, XYZ Company]* is responsible for *[the subject matter]*.

[The engaging party, for example, XYZ Company] has agreed to and acknowledged that the procedures performed are appropriate to meet the intended purpose of *[identify the intended purpose of the engagement, for example, assisting users in understanding the claims of creditors of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A]*. Additionally, *[identify the other party or parties that has or have agreed to and acknowledged that the procedures performed are appropriate to meet their purposes, for example, the Trustee of XYZ Company]* has agreed to and acknowledged that the procedures performed are appropriate to meet for their purposes. This report may not be suitable for any other purpose. The procedures performed may not address all the items of interest to a user of this report and may not meet the needs of all users of this report and, as such, users are responsible for determining whether the procedures performed are appropriate for their purposes.

The procedures and associated findings are as follows:

1. Obtained the general ledger and the accounts payable trial balance as of May 31, 20XX, from XYZ Company. Compared the total of the accounts payable trial balance to the total accounts payable balance in general ledger account 450.

The total of the accounts payable trial balance agreed with the total accounts payable balance in the general ledger account number 450.

2. Obtained the claim form submitted by creditors in support of the amounts claimed from XYZ Company. Compared the creditor name and amounts from the claim form to the respective name and amounts shown in the accounts payable trial balance obtained in procedure 1. For any differences identified, requested XYZ Company to provide supporting detail. Compared such identified differences to the supporting detail provided.

All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were agreed to *[describe supporting detail]*.

3. Using the claim form obtained in procedure 2, compared the name and amount to invoices, and if applicable, receiving reports, provided by XYZ Company.

No exceptions were found as a result of this procedure.

We were engaged by *[the engaging party, for example, XYZ Company]* to perform this agreed-upon procedures engagement and conducted our engagement in accordance with attestation standards established by the AICPA. We were not engaged to and did not conduct an examination or review engagement, the objective of which would be the expression of an opinion or conclusion, respectively, on *[identify the subject matter, for example, the claims of creditors of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A]*. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

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

This report is intended solely for the information and use of *[identify the specified parties, for example, XYZ Company and the Trustee of XYZ Company]*, and is not intended to be, and should not be, used by anyone other than these specified parties.

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

[Signature of the practitioner's firm]

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

[Date of the practitioner's report]

Illustration 4: Practitioner's Agreed-Upon Procedures Report in Which Procedures Are Specified in Regulation

Circumstances include the following:

- The engaging party has agreed to the procedures and acknowledged that the procedures are appropriate for the intended purpose of the engagement.
- The procedures are prescribed in regulation.
- The practitioner has determined to restrict the use of the agreed-upon procedures report to the engaging party and the regulator.

Independent Accountant's Report

[Appropriate Addressee]

We have performed the procedures enumerated below on *[identify the subject matter, for example, the financial accounts of the engaging party during the year ended December 31, 20XX]*. *[The responsible party]* is responsible for *[the subject matter]*.

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

The procedures and the associated findings are as follows:

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

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

We are required to be independent of *[the responsible party]* and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our agreed-upon procedures engagement.

This report is intended solely for the information and use of *[identify the specified parties, for example, the engaging party and the State of XXX]*, and is not intended to be, and should not be, used by anyone other than these specified parties.

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

[Signature of the practitioner's firm]

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

[Date of the practitioner's report]

SSAE 20 – Amendments to the Description of the Concept of Materiality

Introduction

The Auditing Standards Board issued Statement on Standards for Attestation Engagements No. 20, *Amendments to the Description of the Concept of Materiality* in December 2019. While the concept of materiality is not new, the standard clarifies and provides additional guidance related to the consideration of materiality in attestation engagements.

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

1. AT-C Section 205 – *Examination Engagements*
2. AT-C Section 210 – *Review Engagements*

Effective Date

The amendment is effective for examination and review reports dated on or after December 15, 2020.

Changes in Definition

NOTE: **Materiality** is defined as:

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

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

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

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

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

STATEMENT ON STANDARDS FOR FORENSIC SERVICES NO. 1

Introduction

The first Statement on Standards for Forensic Services (SSFS No. 1) was issued by the AICPA Forensic and Valuation Services Executive Committee, which is designed by the FVS Executive Committee as a body to establish professional standards under the “Compliance with Standards Rule” ET 1.310.001 of the AICPA’s Code of Professional Conduct.

Definition

Forensic is defined, in the standard, as “Used in, or suitable to, courts of law or public debate.” The forensic accounting services generally involve the application of investigative skills and specialized knowledge to collect, analyze, and evaluate certain evidential matter and to ineptly communicate findings.

The standard has been issued to provide consistency and quality of practice by AICPA members. Standards are established for the following engagements:

- **Litigation** which is an actual or potential legal or regulatory proceeding. It is not limited to formal litigation but incorporates alternative dispute resolution forums.
- **Investigation** is a matter conducted in response to specific concerns of wrongdoing in which the member is engaged to perform procedures to collect, analyze, evaluate, or interpret certain evidential matter to assist the stakeholders in reaching a conclusion on the merits of the concerns.

NOTE: The statement does not apply to audit, review, compilation, attestation, or tax services. Also, should a member be engaged by a party in a litigation engagement to provide expert opinions, the work cannot be performed under AT Section 201, Agreed-Upon Procedures (AUP) Standards. However, should the member be engaged by the trier of fact and/or both sides of a dispute jointly, the results may be reported under AUP standards and this statement may also apply.

For example, a member may provide data analysis services in a client engagement that does not constitute a litigation or investigation engagement. This statement would not apply. If, however, the same services were performed in a client engagement that does constitute a litigation or investigation engagement, this standard would apply.

The standard does require an understanding with the clients, which can be written or verbal, related to:

1. Responsibilities of both parties
2. Scope of services to be performed

3. Limitation of services to be performed
4. Any significant change in circumstances during the engagement, the understanding should be modified

The member is also required to comply with the general standards rule in the Code of Conduct related to the following:

- Professional competence
- Due professional care
- Planning and supervision
- Sufficient relevant data

Prohibited arrangements:

1. Contingency fees arrangements
2. Opining on fraud or other legal determinations (unless the member is the trier-of-fact)

Effective date for forensic services is for new engagements accepted on or after January 1, 2020. Early application is permissible.

ETHICS UPDATE

Interpretations

The AICPA Professional Ethics Division issued revised ethics interpretations addressing two ethics interpretations in 2019:

1. State and Local Government Client Affiliates which:
 - Clarifies examples for state and local government entities
 - Changes the language to refer to “financial statement attest client” rather than state and local government entities
 - Clarifies the definitions of “investor” and “investment”
 - Clarifies conditions that create threats to independence
 - Effective for years beginning after December 15, 2020
2. Information Systems Services for an attest client when member provides non-attest services:
 - a. Addresses self-review threats

- b. Management participation threats
- c. Identifies specific conditions when independence may be impaired
- d. Effective January 1, 2021 with early implementation allowed

The AICPA Professional Ethics Division, also, issued responses to member inquiries concerning various topics related to non-attest services: Since these FAQs are not considered authoritative guidance, members should refer to the General Requirements for Performing “Non-Attest Services” ET Section 1.295.040 as well as the “Conceptual Framework for Independence” ET Section 1.210.010. Members should also consider other standard-setters or regulatory bodies that may apply. Questions responded to include the following:

- 1. Routine activities
- 2. Period of impairment
- 3. Suitable skill, knowledge, and/or experience
- 4. Documentation requirements
- 5. Bookkeeping services
- 6. Controllorship services
- 7. Tax services
- 8. Information technology services
- 9. Appraisal, valuation, and actuarial services
- 10. Training services
- 11. Project management services
- 12. Cybersecurity services
- 13. Hosting services

NOTES

Section

3

AICPA Update – SSARS

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- › Identify changes to SSARS engagements as a result of the issuance of SSARS 21, *Clarification and Recodification*
- › Apply SSARS requirements found in recently issued SSARS 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*, to accounting and review service issues such as engagement terms, independence, reporting, and documentation

SSARS 21 – CLARIFICATION AND RECODIFICATION

SSARS 21 was issued in 2014 and was effective for periods ended after December 15, 2015. It replaced all previous SSARS standards. SSARS 21, as amended, comprises four sections:

1. AR-C Section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*
2. AR-C Section 70, *Preparation of Financial Statements*
3. AR-C Section 80, *Compilation Engagements*
4. AR-C Section 90, *Review of Financial Statements*

SSARS 21 has been covered in previous FASB and AICPA Update programs, but due to the amendments issued in to SSARS 21 by SSARS 25 in February 2020, we thought it would be useful to identify the major changes to SSARS engagements made by SSARS 21:

- Incorporates the AICPA **Clarity Drafting Conventions**, similar to those previously applied to auditing standards.
- Introduces a new level of service called **preparation**. This is a non-attest service where the accountant prepares, but does not report or provide any assurance on the financial statements.

- Includes **revisions to the compilation and review standards**, mostly affecting reports and engagement letters.
- **Management-use-only** compilation engagement has been eliminated, so that all compilation engagements will include a report.
- **Revises guidance on the circumstances that determine the type of service provided.** The type of service is dependent on what the accountant was engaged to do.
- **Requires a signed engagement letter** for all engagements covered by SSARS 21, including preparation engagements.

Recent SSARS 21 Practice Issues

Introduction

The Accounting and Review Services Committee (ARSC) is the AICPA's senior committee for preparations, compilations, or reviews, and is designated to issue pronouncements in connection with the unaudited financial statements of non-public entities. Its mission is to develop and communicate performance and reporting standards and practice guidance to enable accountants of non-issuers to provide high quality, objective preparation, compilation and review services in the best interests of the profession and the users of prepared, compiled, and reviewed financial statements, with the ultimate purpose of serving the public interest.

SSARS – Preparation, Compilation, and Review

This section discusses questions or issues that have arisen since the issuance of SSARS 21. SSARS 21 clarified and revised the standards for reviews, compilations and engagements to prepare financial statements.

Questions have been asked of the ARSC concerning preparation (no assurance engagement), independence, and non-attest services. The following addresses each of these concerns.

Preparation Services

The state of SSARS engagements has been evolving since the issuance of SSARS 21 and the creation of the **preparation service**. SSARS 21 addresses review, compilation, and preparation engagements for non-public reporting entities, which are the core bread and butter engagements for the smaller CPA firm/practitioner.

With the establishment of the new non-attest service – preparation engagement, SSARS established a **no assurance, no verification, and no reporting service**. However, there has been the recognition of an inherent trap concerning the accountant's responsibility spelled out in the **Code of Professional Conduct** Sections 0.300.020 (Responsibilities), .030 (The Public Interest), .040 (Integrity), .050 (Objectivity and Independence), and .060 (Due Care). The exercise of professional responsibilities mandates an inherent integrity in the work product.

While there is no verification or report association in a preparation engagement, **due care** in the Code of Conduct's provisions prohibits the accountant from associating with recklessness or a work product that could be misleading or misstated, suggesting that not reading the financial statements may violate the due care provisions of the Code of Conduct. An engagement established to allow an extension of bookkeeping or write-up accounting services without applying professional judgment may be fundamentally prohibited by the Code of Conduct.

Because of this apparent conflict, the ARSC continues to make smaller, contextual, and interpretive changes through annual resource guides rather than the issuance of clarifying or correcting changes in the form of new SSARS standards. For example:

The AICPA issues, annually, a *Guide – Preparation, Compilation, and Review Engagements* that constitutes an interpretive publication issued under the authority of the ARSC. "Pursuant to AR-C Section 60, *General Principles for Engagements Performed in Accordance With Statements for Accounting and Review Services*, an accountant should consider applicable interpretive publications in the performance of his or her engagement in accordance with SSARS. If the accountant does not apply the guidance in this interpretive publication, the accountant should document how the requirements of SSARS were complied with in the circumstances addressed by such guidance." Accordingly, the referenced guide is considered authoritative.

As a result, the ARSC has "tightened" CPA responsibilities and interpretations over the past four years with annual "Guides." While the issuance of SSARS 21's guidance for the preparation service had fairly simple requirements and applicability, subsequent reassessment clarifications in these guides appear to have added complications while trying to address the apparent ethics conflict.

For example, the initial SSARS 21 established that all standards were engagement driven. That is, an accountant was only responsible for a preparation services if they had been engaged or were hired to prepare. If the accountant was not hired to prepare, and then prepares and presents the financial statements to the client, then it was simply a bookkeeping engagement. Subsequently, ARSC re-clarified the "engagement driven" approach and indicated that "hired" or "engaged" means **expected deliverables** – that is, if the client expected to get a financial statement when the engagement was completed, then that constituted being hired or engaged.

Recently, the ARSC again re-clarified the preparation engagement by referencing the **output presentation format**. The 2018 AICPA *Guide to Preparation, Compilation, and Review Engagements* provides this new clarifying guidance:

"To be engaged does not mean to obtain an engagement letter. Instead, it is what the accountant is hired to do, regardless of whether it is specified in the engagement letter. The engagement letter is then a required procedure after the accountant has been engaged. The understanding with the entity as to what the accountant is engaged (i.e., hired) to do is paramount in determining whether AR-C Section 70, Preparation of Financial Statements, applies.

As part of the accountant's bookkeeping services, the accountant may provide certain financial presentations to the client (e.g., a trial balance) that do not constitute a financial statement. As such, while the accountant may apply—adapted as necessary—the provisions of AR-C Section 70 to the preparation of a trial balance, the accountant is not required to do so.”

The implication is that if financial reporting information has the characteristics and appearance of a financial statement, AR-C Section 70 will most likely apply. If the characteristics and appearance were more along the lines of a trial balance or general ledger listing, then it would likely be outside the scope of AR-C Section 70.

Further, the Guide indicates or clarifies that an accountant in public practice who provides a client with controllership, outsourced CFO, or other management services, and is engaged to prepare or provide financial statements as a part of those controllership, CFO, or management services, the accountant would be subject to AR-C Section 70.

Another problem pertains to the **legend** on each financial statement to be provided alerting any users of financial statements that no assurance is provided. The primary alert is a legend that must be included on each and every page of the financial statements in a preparation engagement. However, SSARS 21 provided an alternative whereby if management did not wish to include the legend on each page, this new alternative was permitted – an accountant's disclaimer report. After a year or two, the ARSC re-clarified this alternative by stating:

The issuance of a disclaimer is intended to be used when the accountant is engaged to prepare financial statements but either cannot include the required legend on each page of the financial statements or there is another reason that the inclusion of the legend is not practical. For example, if the accountant is engaged to prepare financial statements but management's software is not compatible with the inclusion of a legend, the accountant can perform the preparation engagement and issue the disclaimer. However, if at the time of the engagement the intent is that the accountant will issue a report to be used by management or third parties, the accountant would likely perform a compilation engagement on the financial statements that the accountant prepared.

These changes in the various guides suggest that conclusions accountants reached when SSARS 21 was first applied may not be correct today. As the examples above indicate, there has been an increase in the accountant's responsibilities associated with preparation services.

Independence

Independence is threatened in two critical areas: 1) the **preparation of financial statements**, in whole or in part, is a non-attest service subject to threat assessment under ET 1.295, *Non-Attest Services*, and 2) the matter of the **application of a financial reporting framework, and management's responsibilities** relating to it becomes a significant professional judgment area as to whether the owners, management, or the “designee” representative truly have the skills, knowledge, and/or expertise to even accept responsibility for the financial reporting framework.

The independence challenge in these areas is that ARSC has elected not to provide any guidance in the form of assertion, interpretation, or conclusion with regards to matters of professional ethics; the AICPA's Professional Ethics Executive Committee (PEEC) has provided guidance that relies principally on the accountant's professional assessment and judgment. However, the accountant who performs reviews, compilations, and/or preparation engagements and participates in the **peer review process** will have those assessments and judgments evaluated, considered, and possibly challenged by peer reviewers. At this stage of the process, an adverse determination pertaining to the documentation or conclusion reached by the reporting accountant could result in a significant violation if the "Independence Rule" has been deemed to have been violated, resulting in not only a peer review finding, but possibly an "act discreditable" assessment.

Non-Attest Services

The AICPA Professional Ethics Division has published some matters for reference and consideration in the *Frequently Asked Questions: Non-attest Services Questions Guide*. The following three questions from this document demonstrate the extent of the accountant's professional assessment and judgment on a situation-by-situation basis that may not necessarily provide a "safe harbor" for the accountant:

Q: A member is engaged to perform an attest service for a client that records all transactions on a cash basis in its general ledger. During the engagement process, the member identifies all appropriate journal entries required to convert the client's general ledger to an accrual basis and prepares the financial statements, including footnotes, on the accrual basis in order to conform to U.S. generally accepted accounting principles (GAAP). The client reviews the entries and financial statements, including all footnote disclosures, and understands the impact these entries have on the financial statements. As part of the management representation letter, the client acknowledges responsibility for the financial statements and footnotes. Would these services be considered non-attest bookkeeping services subject to the interpretations of the "Non-attest Services" subtopic?

A: If the engagement covers periods beginning on or after December 15, 2014, then providing these services will be considered non-attest services subject to the interpretations of the Non-attest Services subtopic including the "General Requirements for Performing Non-attest Services" interpretation.

Q: How can a member be satisfied that the attest client designee understands the non-attest services performed and the resulting work product?

A: Members are expected to use their professional judgment and experience to recognize which individuals designated by the attest client are able to fulfill the client responsibilities that are set forth in the interpretation. Through interaction with the owner(s) or employees of the attest client, experienced practitioners should be able to assess whether the individual designated by the attest client possesses the skill, knowledge, and/or experience necessary to effectively oversee the non-attest service.

Q: What factors should a member consider in determining whether the individual designated by the attest client to oversee the non-attest service possesses suitable skill, knowledge, and/or experience?

A: In assessing whether the individual designated by the attest client has suitable skills, knowledge, and/or experience to oversee a non-attest service, the member might consider the following factors that pertain to the individual's:

- Understanding of the nature of the service
- Knowledge of the attest client's operations
- Knowledge of the attest client's industry
- General business knowledge
- Level of education
- Position at the attest client

Some factors may be given more weight than others, depending on the nature of the service. For example, although the level of education attained by the individual can be one indicator of his or her skills and/or knowledge, it is not necessarily true that the more formal education the individual possesses, the more able he or she would be to oversee the non-attest service. If the individual understands the nature of the service and possesses a sufficient knowledge of the attest client's business and industry, he or she may have the skills, knowledge, and/or experience to oversee the service, regardless of the level of education that he or she possesses. For example, most small business owners know their company's operations and financial position better than anyone, and they understand the services they need from the member and what those services are intended to accomplish. Because they are the owners of the business, they regularly make important decisions about all matters affecting their business. Accordingly, members might conclude that those individuals would possess the necessary skills, knowledge, and/or experience to understand the services being performed, make any management decisions, and determine whether the results of the services meet the agreed-upon specifications.

SSARS 25 - MATERIALITY IN A REVIEW OF FINANCIAL STATEMENTS AND ADVERSE CONCLUSIONS

Introduction

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

SSARS 25 aligns ARSC engagements closer to the International Standards for Review Engagements (ISRE 2400 – Engagements to Review Historical Financial Statements). The ARSC's objective is to converge as closely as possible with the ISRE to allow engagements to be performed and reported on in accordance with both sets of standards. It is anticipated that less confusion about the level of assurance being given will result.

SSARS concepts, such as materiality, will also align with generally accepted auditing standards (GAAS).

NOTE: There should not be significant change in practice for those practitioners that have been performing ARSC engagements appropriately using current standards, but should result in less diversity in practice.

Effective Date

Effective date will be for financial statement with periods ending on or after December 15, 2021. Early implementation will be allowed.

The standard will amend SSARS 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, as amended in the following sections:

- Section 60, General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services [AICPA, Professional Standards, AR-C Section 60]
- Section 70, Preparation of Financial Statements [AICPA, Professional Standards, AR-C Section 70]
- Section 80, Compilation Engagements [AICPA, Professional Standards, AR-C Section 80]
- Section 90, Review of Financial Statements [AICPA, Professional Standards, AR-C Section 90]

CHANGES IN DEFINITIONS WITHIN SSARS

- **Financial Reporting Framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.
- **Applicable Financial Reporting Framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.
- **Fair Presentation Framework.-** Refers to the financial reporting framework that requires compliance with the requirements of the framework and does one of the following:
 1. Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework.
 2. Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements.

A financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgment in the two bullets above is not a fair presentation framework.

- **Reasonable Period of Time.** The period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable).
- **Review Evidence.** Information used by the accountant to provide a reasonable basis for obtaining limited assurance. Review evidence includes both information contained in the accounting records underlying the financial statements and other information, which primarily consists of the results of analytical procedures and inquiries. Sufficiency of review evidence is the measure of the quantity of review evidence. Appropriateness of review evidence is the measure of the quality of review evidence, that is, its relevance and reliability in providing support for the conclusions on which the accountant's review report is based.
- **Inquiry.** Inquiry consists of seeking information of knowledgeable persons within or outside the entity.
- **Limited Assurance.** A level of assurance that is less than the reasonable assurance obtained in an audit engagement but is at an acceptable level as the basis for the conclusion expressed in the accountant's review report.
- **Unmodified Conclusion.** The accountant should express an unmodified conclusion in the accountant's review report on the financial statements as a whole when the accountant has obtained limited assurance to be able to conclude that nothing has come to the accountant's attention that causes the accountant to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.
- When the accountant expresses an unmodified conclusion, the accountant should, unless required by law or regulation, use the following language:

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements for them to be in accordance with [the applicable financial reporting framework].
- **Modified Conclusion.** The accountant should express a modified conclusion in the accountant's review report on the financial statements as a whole when the accountant determines, based on the procedures performed and the review evidence obtained, that the financial statements are materially misstated resulting in a qualified conclusion or an adverse conclusion.
- **Pervasive.** A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements. Pervasive effects on the financial statements are those that, in the accountant's judgment:
 - are not confined to specific elements, accounts, or items of the financial statements,

- if so confined, represent or could represent a substantial portion of the financial statements, or
 - with regard to disclosures, are fundamental to users' understanding of the financial statements.
- **Qualified Conclusion.** When the accountant concludes that the effects of the matter or matters giving rise to the modification are material but not pervasive to the financial statements.
 - **Adverse Conclusion.** When the effects of the matter or matters giving rise to the modification are both material and pervasive to the financial statements.

SSARS 25 CHANGES

General Principles – AR-C Section 60

- Principle changes in Section 60 are in definitions related to the **applicable financial reporting framework** used by a client to prepare its financial statements.
- These changed definitions are designed to emphasize the requirements for an acceptable financial reporting framework when an accountant provides accounting and review services to clients.

Preparation of Financial Statements – AR-C Section 70

- The primary change in Section 70 addresses financial statements that **omit substantially all the disclosures** required by the applicable financial reporting framework, requiring that the accountant disclose the omission of disclosures either in the financial statements or in an accompanying disclaimer.
- Additionally, it emphasizes that financial statements may be misleading if the applicable financial reporting framework includes the premise that the financial statements are prepared on the **going concern basis** and undisclosed uncertainties exist regarding the reporting entity's ability to continue as a going concern.

Compilation Engagements – AR-C Section 80

- Additional **compilation report guidance** is provided for regulatory or the contractual basis of accounting and for alerting users in the accountant's compilation report when special purpose framework financial statements are presented, that these financial statements are prepared in accordance with a special purpose framework, and that the basis of accounting is a basis other than generally accepted accounting principles (GAAP).

Review of Financial Statements – AR-C Section 90

- The review definition is modified from the accountant providing “limited assurance” that the financial statements are free from material misstatement to now “**expressing a conclusion**” that the reporting entity’s financial statements are free from material misstatement.
- The accountant now obtains **limited assurance** in order to express a conclusion in the review report.
- Related to expressing a conclusion, the accountant may reach a “**modified conclusion**” which is a qualified conclusion or an adverse conclusion.
- A **qualified conclusion** is reached when the accountant concludes that the effects of the matter or matters, giving rise to this modification, are material but not pervasive to the financial statements.
- An **adverse conclusion** is reached when the effects of the matter or matters, giving rise to this modification, are both material and pervasive to the financial statements.
- As a result of “expressing a conclusion,” the review **report language** changes to reflect the conclusion reached.
- The accountant is required to determine **materiality** for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.
- Further, the accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.
- Consistent with the increased emphasis on materiality, the accountant, when **designing and performing analytical procedures and inquiries**, should address 1) all material items in the financial statements, including disclosures, and 2) areas in the financial statements where the accountant believes there are increased risks of material misstatement.
- **Additional review guidance** is included in SSARS 25 in the areas of related parties, fraud and non-compliance with laws and regulations, and going concern.
- **Examples of transactions, events, or matters** the accountant should inquire about are included in SSARS 25.

The primary changes resulting from the issuance of SSARS 25 are in AR-C Section 90, *Review of Financial Statements*. The following provides more explanatory information related to the changes made by SSARS 25 to review engagements.

SSARS 25 – Review Engagements

In a review of financial statements, the accountant expresses a conclusion regarding the entity's financial statements in accordance with an applicable financial reporting framework. The accountant's conclusion is based on the accountant obtaining limited assurance. The accountant's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion.

The accountant performs primarily analytical procedures and inquiries to obtain sufficient appropriate review evidence as the basis for a conclusion on the financial statements as a whole, expressed in accordance with the requirements of this section.

If the accountant becomes aware of a matter that causes the accountant to believe the financial statements may be materially misstated, the accountant designs and performs additional procedures, as the accountant considers necessary in the circumstances, to be able to conclude on the financial statements in accordance with this section.

In conducting a review of financial statements, the **objectives of the accountant** are to:

- a. Obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.
- b. Report on the financial statements as a whole and communicate, as required by AR-C 90.

The accountant should **inquire** of members of management who have responsibility for financial and accounting matters concerning the financial statements, and **others within the reporting entity**, as appropriate, related to whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied, including how management determined that significant accounting estimates are reasonable in the circumstances.

- a. The identification of related parties and related party transactions, including the purpose of those transactions.
- b. Whether there are significant, unusual, or complex transactions, events, or matters that have affected or may affect the entity's financial statements, including the following:
 - Significant changes in the entity's business activities or operations
 - Significant changes to the terms of contracts that materially affect the entity's financial statements, including terms of finance and debt contracts or covenants
 - Significant journal entries or other adjustments to the financial statements
 - Significant transactions occurring or recognized during the period, particularly those in the last several days of the reporting period

- The status of any uncorrected misstatements identified during the previous review (that is, whether adjustments were recorded subsequent to the periods covered by the prior review and, if adjustments were recorded, the amounts recorded and period in which such adjustments were recorded)
 - Effects or possible implications for the entity of transactions or relationships with related parties
 - Matters about which questions have arisen in the course of applying the review procedures
 - The existence of any actual, suspected, or alleged fraud or non-compliance with laws and regulations
 - Non-compliance with provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations
 - Whether management has identified and addressed events subsequent to the date of the financial statements that require adjustment of, or disclosure in, the financial statements
- c. The basis for management's assessment of the entity's ability to continue as a going concern
 - d. Whether there are events or conditions that appear to cast doubt on the entity's ability to continue as a going concern
 - e. Material commitments, contractual obligations, or contingencies that have affected or may affect the entity's financial statements, including disclosures
 - f. Material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration
 - g. Communications from regulatory agencies, if applicable
 - h. Any litigation, claims, and assessments that existed at the date of the balance sheet being reported on and during the period from the balance sheet date to the date of management's response to the accountant's inquiry
 - i. Actions taken at meetings of stockholders, the board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements
 - j. Any other matters that the accountant may consider necessary

Materiality in a Review of Financial Statements

The accountant should **determine materiality** for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.

The accountant should **revise materiality** for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.

In obtaining **sufficient appropriate review evidence** as the basis for a conclusion on the financial statements as a whole, the accountant should design and perform the analytical procedures and inquiries to address the following:

- a. **All material items** in the financial statements, including disclosures
- b. Areas in the financial statements where the accountant believes there are **increased risks** of material misstatements

Evaluating Review Evidence Obtained from the Procedures Performed

If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant's attention is incorrect, incomplete, or otherwise unsatisfactory, the accountant should:

- a. request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and
- b. consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be materially misstated.

The accountant should evaluate whether sufficient appropriate review evidence has been obtained from the procedures performed and, if **sufficient appropriate review evidence has not been obtained from the procedures performed**, the accountant should perform other procedures that are necessary in the circumstances to be able to form a conclusion on the financial statements.

If the accountant is not able to obtain sufficient appropriate review evidence to form a conclusion, the accountant should withdraw from the engagement.

When the accountant expresses a **qualified conclusion** on the financial statements because of a material misstatement, the accountant should, unless otherwise required by law or regulation, use the following language:

Based on my (our) review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in

order for them to be in accordance with [the applicable financial reporting framework].

When the accountant expresses an **adverse conclusion** on the financial statements, the accountant should, unless otherwise required by law or regulation, use the following language:

Based on my (our) review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with [the applicable financial reporting framework].

In the **basis for conclusion paragraph**, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the accountant should do the following:

Describe and quantify the financial effects of the misstatement if the material misstatement relates to specific amounts in the financial statements (including quantitative disclosures) and the effects of the departure on the financial statements have been determined by management or are known to the accountant as a result of the accountant's procedures.

1. If the effects of the departure have not been determined by management or are not known to the accountant as a result of the accountant's procedures, the accountant is not required to determine the effects of the departure; however, in such circumstances, the accountant should state in the report that such determination has not been made by management.
2. Explain how disclosures are misstated if the material misstatement relates to narrative disclosures.
3. Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. The accountant should include the omitted disclosures when practicable to do so.

NOTE: An adverse conclusion relating to a specific matter described in the basis for modification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the accountant's conclusion. In instances in which other identified matters would have otherwise required a modification of the accountant's conclusion, the disclosure of such other matters of which the accountant is aware may be relevant to users of the financial statements.

Consideration of the Applicable Financial Reporting Framework in Relation to the Financial Statements

In forming the conclusion on the financial statements, the accountant should do the following:

- Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

- Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:
 - The terminology used in the financial statements, including the title of each financial statement, is appropriate;
 - The financial statements adequately disclose the significant accounting policies selected and applied;
 - The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
 - Accounting estimates made by management appear reasonable;
 - The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and
 - The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements.

The accountant should consider the impact of the following:

- Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole
- Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments

The accountant's consideration should also include the following:

- The overall presentation, structure, and content of the financial statements
- Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation

Review Documentation

The extent and type of documentation in a review file is a matter of professional judgment. However, verbal explanations in and of themselves are not sufficient to support the work performed or the conclusions reached. The documentation should be sufficient to demonstrate the work performed. Documentation provides evidence that their review was performed in accordance with professional standards and supports the accountant's conclusion. This should include (review) evidence of:

- The nature, timing, extent, and results of the work performed such as inquiry, analytical, or other procedures;

- The review evidence obtained from the review procedures performed and the accountant's conclusion formed on the basis of that review evidence;
- The source of the review evidence; and
- Significant matters arising during the review, the accountant's conclusions reached, and significant professional judgments made in reaching those conclusions.

An accountant can include any additional documentation that the accountant believes is appropriate. AR-C Section 90 states the accountant's documentation should include the following:

- An engagement letter
- A copy of the review report issued and the financial statements
- Analytical procedures performed, including documentation of:
 - The expectation, if not self-evident, and the factors considered in their development;
 - The results of comparing the results of the procedure performed to the general ledger. For example, calculating a gross margin would not be sufficient unless it was compared to prior periods or an industry standard; and
 - Management's explanations if the procedures differ significantly from expectations.
- Any additional review procedures performed in response to significant unexpected differences and the results of these procedures
- The results of significant inquiries
- Any significant findings or issues
- Significant unusual matters
- Any verbal or written communication of fraud or illegal acts
- Communications with management regarding the accountant's expectation to include emphasis-of-matter or other-matter paragraph(s) in the accountant's review report
- Communication with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters
- If, in the course of the engagement, the accountant identified information that is inconsistent with the accountant's findings regarding significant matters affecting the financial statements, how the inconsistency was addressed

- Communications with other accountants that have audited or reviewed the financial statements of significant components
- A signed representation letter

NOTE: While SSARS 25 does not explicitly state that **materiality** should be documented in a review, there is now an explicit requirement for the accountant to determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. When determining and using materiality in a review engagement, the accountant must document materiality in order to reach a review conclusion. The accountant's conclusion states the following:

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance the applicable financial reporting framework.

In documenting the nature, timing, and extent of procedures performed, the accountant should document the following:

- Who performed the work and the date such work was completed
- Who reviewed the work performed for the purpose of quality control for the engagement and the date and extent of the review

In addition to the above, Kaplan suggests the following additional documentation be included:

- That the accountant has knowledge of the client's business and industry
- A trial balance that bridges the general ledger to the financial statements
- Indication that there are no material modifications required to the financial statements
- A work program, if required by firm policy
- A disclosure checklist, if required by firm policy
- Any consultation performed. Consultation would include discussion with firm personnel, technical research, etc.

EXHIBIT – ILLUSTRATIONS OF ACCOUNTANT REVIEW REPORTS ON FINANCIAL STATEMENTS ARE PROVIDED TO ASSIST IN COMPLYING WITH THE REQUIREMENTS OF UPDATED AR-C SECTION 90

Illustration 1 – An Accountant’s Review Report on Comparative Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America When a Review Has Been Performed for Both Periods

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be **independent** of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Accountant's Conclusion

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 2 – An Accountant’s Review Report on Single Year Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

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

Accountant's Conclusion

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 3 — An Accountant's Review Report on Single Year Financial Statements Prepared in Accordance with the Tax Basis of Accounting

Circumstances include the following:

- Review of a complete set of financial statements (single year).
- The financial statements are of a partnership and prepared in accordance with the basis of accounting the partnership uses for **income tax purposes** (that is, a special purpose framework).
- Management has a choice of financial reporting frameworks.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Partnership, which comprise the statement of assets, liabilities, and partners' capital – tax basis as of December 31, 20XX, and the related statements of revenue and expenses – tax basis, and partners' capital – tax basis for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (partners') financial data and making inquiries of partnership management (partners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management (Partners) is (are) responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting the partnership uses for income tax purposes; this includes determining that the basis of accounting the partnership uses for income tax purposes is an acceptable basis for the preparation of financial statements in the circumstances. Management (Partners) is (are) also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with the basis of accounting the partnership uses for income tax purposes. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Partnership and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our review.

Accountant's Conclusion

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the basis of accounting the partnership uses for income tax purposes.

Basis of Accounting

I (We) draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared in accordance with the basis of accounting the partnership uses for income tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our conclusion is not modified with respect to this matter.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 4 — An Accountant’s Review Report on Interim Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of interim financial statements for the period ended September 30, 20XX, and for the three and nine months then ended.
- The interim financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- The accountant appropriately performs the engagement in accordance with SSARSs (AU-C Section 930, Interim Financial Information, is not applicable).

Independent Accountant's Review Report⁶⁴

[Appropriate Addressee]

I (We) have reviewed the accompanying interim financial statements of XYZ Company, which comprise the balance sheet as of September 30, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the three and nine months then ended, and the related notes to the interim financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the interim financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the interim financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

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

Accountant's Conclusion

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying interim financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

⁶⁴ All AU-C sections can be found in AICPA Professional Standards.

Illustration 5 — An Accountant’s Review Report on Comparative Financial Statements Disclosing a Departure from Accounting Principles Generally Accepted in the United States of America

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements contain a departure from accounting principles generally accepted in the United States of America.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

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

Basis for Qualified Conclusion

As disclosed in Note X to these financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this

departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined.

or

As disclosed in Note X to these financial statements, the company has adopted *[description of newly adopted method]*, whereas it previously used *[description of previous method]*. Although the *[description of newly adopted method]* is in accordance with accounting principles generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by FASB Accounting Standards Codification 250, Accounting Changes and Error Corrections.

Qualified Conclusion

Based on my (our) reviews, except for effect of the matter described in the Basis for Qualified Conclusion paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

Illustration 6 — An Accountant’s Review Report on Single Year Financial Statements Prepared in Accordance with Accounting Principles Generally Accepted in the United States of America Containing an Adverse Conclusion Due to a Misstatement of the Financial Statements That Is Both Material and Pervasive to the Financial Statements

Circumstances include the following:

- Review of a complete set of comparative financial statements.
- The financial statements contain a departure from accounting principles generally accepted in the United States of America that is both material and pervasive to the financial statements due to no consolidation of a subsidiary.

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

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

Basis for Adverse Conclusion

As disclosed in Note X to these financial statements, the Company has not consolidated the financial statements of subsidiary ABC Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Conclusion

Based on my (our) review, due to the significance of the matter described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

Coronavirus Appendix – Potential Financial Reporting Impact/Consequences

INTRODUCTION

At the time of this writing, March 25, 2020, the country is pretty much in an economic lockdown due to the coronavirus. As a result, significant financial reporting consequences are a likely possibility in a variety of accounting and disclosure areas. Reporting entities and their auditors/accountants will need to be alert for the economic and financial impact of the actions taken by both the federal and state governments to curtail the coronavirus. This Appendix addresses some of these financial reporting impacts/consequences to serve as a memory jogger for practitioners and reporting entities to consider when preparing their 2019 and 2020 financial statements.

To highlight the significance of these financial reporting impacts/consequences, please review the following J&J Snack Foods press release issued on March 22, 2020 and summarized in the Courier-Post on March 24, 2020:⁶⁵

J&J Snack Foods Corp. has predicted that the impact of the coronavirus on its finances will be worse than originally predicted.

The Pennsauken N.J. firm on Sunday said government shutdown orders have closed or curtailed foodservice venues that account for about two-thirds of its \$1.2 billion in annual revenue. J&J on March 12th had estimated the virus would affect only about one-third of its revenues. J&J sells soft pretzels, frozen beverages, and other snacks.

The Company's initial statement predicted it would lose sales in part due to "anticipated lower attendance and traffic" at foodservice venues like schools, stadiums, movie theaters, and amusement parks.

J&J's new statement says the financial impact has increased due to government-ordered shutdowns "over the past 10 days". The shutdowns are intended to curb the spread of the virus by reducing interactions between people.

⁶⁵ <https://www.courierpostonline.com/story/news/2020/03/23/jandj-snack-foods-pennsauken-coronavirus-gerald-shreiber/2897900001/>

In its statement, J&J said it expects higher sales at grocery stores, and other retailers, but that the overall impact will be “decidedly negative”. The Company which previously reported record sales for 48 years, said it could not estimate the financial impact but predicted that it would be “material.”

SUBSEQUENT EVENTS

Topic 855, Subsequent Events, discusses the two types of subsequent events that can impact financial statements and disclosures:

1. An event or transaction occurring after the balance sheet date but before financial statements are issued (or available to be issued) that confirms a fact that existed at the balance sheet date. These events are called **recognized subsequent events** because they are recorded in the accounts. The key is that the event must be the culmination of conditions that existed on or before the balance sheet date.
2. An event or transaction occurring after the balance sheet date but before the financial statements are issued (or available to be issued) that relates to events occurring after the balance sheet date. These events are called **non-recognized subsequent events**. Such events would not cause a change in the accounts but, if material, are disclosed in the notes.

The potential economic and financial impact of the coronavirus meets the criteria to be a non-recognized subsequent event that will **require disclosure** for financial reporting periods ending before January 20, 2020, the date the virus became known. Those required disclosures include:

A reporting entity should disclose the following:

- The nature of the event
- An estimate of its financial effect, or a statement that such an estimate cannot be made

If the non-recognized subsequent event (coronavirus) has a significant impact/consequence on the reporting entity’s financial statements, the reporting entity should also consider supplementing the historical financial statements with pro forma financial data. Such data should give effect to the event as if it had occurred on the balance sheet date. In some situations, a reporting entity should also consider presenting pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

REVENUE

In Topic 606, Revenue from Contracts with Customers, a contract with a customer does not exist if it is probable that the reporting entity will not collect substantially all of the consideration to which it will be entitled – assessing probability is made based on the customer’s ability and intent to pay the amounts when due. If a significant change in facts and circumstances takes place after the sale has been recognized, such as the customer being unable to pay due to the consequences of the coronavirus, the contract may no longer be probable of collection, and therefore, a customer contract no longer exists. If that is the case, the reporting

entity cannot recognize the revenue from the transaction. According to 606-210-25-5, at the point for which substantial doubt about collectability exists, it should be reviewed as to whether a contract exists according to 606-10-25-1. If it is determined that a contract no longer exists, then no future revenue should be recognized and the existing receivable should be reviewed for impairment either according to Topic 310 or Subtopic 326-20.

Topic 606 defines **variable consideration** as the amount of consideration to which a selling entity will eventually become entitled that may be uncertain in whole or in part due to:

- Potential returns, allowances, rebates, refunds, discounts, or other credits to the customer's account
- Performance incentives, penalties, or price concessions
- Consideration contingent on the occurrence or non-occurrence of a future event

A reporting entity must include in the transaction price some or all of an amount of variable consideration that is estimated to the extent that it is **probable** that there will not be a significant reversal in the amount of cumulative revenue recognized when the uncertainty associated with the variable consideration is subsequently resolved.

Due to the coronavirus, variable consideration may have to be reassessed in future reporting periods. At the end of each reporting period, the estimated transaction price (including any variable consideration) should be updated to present any changes in circumstances. Any changes that have occurred should be accounted for as a change in the transaction prices as a change in estimate.

RECEIVABLE IMPAIRMENTS (CREDIT LOSSES)

Topic 310, Receivables, addresses measurement, presentation, and disclosure requirements for financing receivables, including trade receivables, and loans receivable. Topic 450, Contingencies, addresses losses from uncollectible receivables.

ASU 2016-13, *Financial Instruments – Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*, was issued to provide financial statement users with more decision-useful information about a reporting entity's 1) **expected credit losses** on financial assets and 2) other commitments to extend credit. ASU 2016-13 is effective for public business entities for fiscal years beginning after December 15, 2019. Early adoption is permitted.

The scope of Topic 326 includes:

- Loans receivable
- Debt securities
- Trade receivables
- Net investment in leases

- Off-balance sheet credit exposure
- Reinsurance receivables

2019 Financial Statements

If a public reporting entity adopts ASU 2016-13 earlier than 2020, the related current expected credit loss (CECL) framework should be applied for estimating credit losses in 2019 financial statements. If ASU 2016-13 is not early adopted, Topic 310, Receivables, applies for the recognition of impairments for receivables that may result from the coronavirus in 2019 public company financial statements. For 2020 reporting periods, ASU 2016-13 applies to public business entities and unless a non-public reporting entity early adopts ASU 2016-13 in 2020, Topic 310 will apply.

Assuming Topic 310, Receivables, and Topic 450, Contingencies, applies for both public and non-public reporting entities for 2019 financial statements, an estimated loss from a loss contingency (such as impaired receivables due to the coronavirus) should be accrued by a charge to income if both of the following conditions are met:

1. Information available before the financial statements are issued or available to be issued indicates that it is **probable** that a receivable had been impaired, and
2. The amount of the loss can be reasonably estimated

Disclosure of the impairment should be made if there is at least a **reasonable possibility** that a loss or an additional loss may have been incurred.

Disclosure of an impairment loss arising after the date of the reporting entity's financial statements but before those financial statements are issued may be necessary to keep the financial statements from being misleading if a loss accrual is not required. If disclosure is deemed necessary, the financial statements should include both of the following:

- The nature of the impairment loss
- An estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made

2020 Financial Statements

Public business entities are required to apply ASU 2016-13's credit loss guidance to their 2020 financial statements. This guidance requires public business entities to record a current expected credit loss (CECL) (if any) for receivables measured at amortized cost or net realizable value over the receivables' life. Because this is a forward-looking measurement, it is based on forecasts of future economic conditions. The CECL model requires if losses exist, the carrying value of the receivable should equal its amortized cost minus an allowance for credit losses, that is, the amount expected to be collected. In estimating credit losses, all relevant information should be considered:

- Past events

- Current conditions
- Reasonable, supportable forecasts

NOTE: The *Coronavirus Aid, Relief, and Economic Security Act* passed in March of 2020, provides financial institutions optional temporary relief from troubled debt restructurings and impairment accounting requirements for certain loan modifications related to the coronavirus. A financial institution may elect to suspend the application of Topic 310's guidance for troubled debt restructurings and loan impairments.

In addition, the Act also provides optional temporary relief to insured depository institutions from compliance with Topic 326's guidance for credit loss accounting when estimating allowances for credit losses.

VALUATION OF INVENTORY

Topic 330, Inventory, states the basis of accounting for inventories is cost. According to Topic 330, costs for inventory purposes may be determined under one of several cost flow assumptions including FIFO, average, or LIFO. The primary objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

FIFO and average cost basis inventory is subsequently measured at the lower of cost or **net realizable value**. LIFO is subsequently measured at the lower of cost or market. Reduced demand for inventory due to the coronavirus may require loss recognition.

FAIR VALUE MEASUREMENTS

Fair value is defined in Topic 820, Fair Value Measurement, as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date.

When the market approach is used for fair value measurements, the approach uses observable prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. It includes observable market prices, as well as business valuation models such as earnings multiples. The effects of the coronavirus are causing market volatility that may impact the measurement date for fair value measurements. Assuming this volatility is based on orderly transactions, market prices should be recognized in the financial statements at the measurement date.

Significant fair value disclosures are also required reflecting the valuation techniques utilized for the fair value measurements.

GOODWILL IMPAIRMENTS

Goodwill and indefinite-lived intangibles are not currently amortized for public entities, so their original cost remains on the balance sheet indefinitely. As a result, an impairment of value is of greater concern over time, and Topic 350, Intangibles-Goodwill and Other, requires that the possibility of impairment be addressed at least annually (more often if there are **triggering events**).

Note that a simplified alternative approach for goodwill is now available to non-public entities since the issuance of ASU 2014-02, Accounting for Goodwill. This alternative results in goodwill being amortized and tested for impairment only when there are **triggering events**.

Topic 350 permits a qualitative analysis to be performed to determine if goodwill is impaired. This qualitative analysis first evaluates **qualitative events and circumstances** to conclude whether it is **more likely than not** (“MLTN”) that the reporting unit’s carrying value exceeds its fair value. If this qualitative assessment results in a conclusion that it is not MLTN, then a quantitative impairment test based on quantitative data is not required. This approach is an option rather than a requirement and may be used in some reporting periods but not others. A reporting entity can always choose to go directly to the **quantitative** test and forego performing this qualitative analysis. Conversely, when the quantitative test is employed, the qualitative analysis need not also be performed.

Rather than prescribe a methodology or “bright line” cutoffs for the qualitative analysis, it provides a **list of potential adverse events and circumstances** that should be considered to assess the likelihood that the carrying value of a reporting unit exceeds its fair value, and then describes in general terms how they should be weighted in terms of their significance, combined with factual data from prior periods or any other relevant data, and examined in conjunction with positive or mitigating factors to form an MLTN conclusion.

Potential Adverse Events and Circumstances

- Macroeconomic factors – deterioration in general economic conditions, access to capital, or foreign exchange rates, or other changes in equity and credit markets
- Industry/market factors – increased competition, industry downturn, change in the market for a company’s products or services, decline in market-dependent multiples or metrics affecting valuation, adverse regulatory actions
- Cost factors – increased costs for materials, labor, etc., that adversely affect profitability or cash flows
- Financial performance – negative or declining cash flows, declines in actual or projected revenue or earnings compared with actual and projected results for prior periods
- Entity-specific – changes in management or key personnel, strategy, or customer base; litigation; consideration of filing for bankruptcy

- Assets – actual or contemplated major disposals; significant asset classes tested for impairment due to triggering events, recognition of goodwill impairments in subsidiaries of the reporting unit
- Share price – sustained decrease in share price (on a standalone basis or in relation to comparable companies)

All of these factors can be impacted by the economic or financial results of the coronavirus and the coronavirus should be considered a **triggering event** for goodwill impairment testing.

For each goodwill impairment loss recognized, Topic 350 requires the following **disclosures**:

- A description of the facts and circumstances leading to the impairment
- The amount of the impairment loss and the method of determining the fair value of the associated reporting unit
- If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons therefor and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss
- The caption in the Income Statement or the Statement of Activities in which the impairment loss is aggregated
- If applicable, the segment in which the impaired intangible asset is reported

PROPERTY, PLANT, AND EQUIPMENT IMPAIRMENTS

Topic 360, Property, Plant, and Equipment, impairment tests are performed on depreciated (or amortized) assets that are held and used only upon the occurrence of **triggering events** that suggest the assets may be impaired. When performed, the tests are "cash-flow based," i.e., impairment exists when carrying values exceed undiscounted cash flows expected from those assets during their remaining economic life.

This approach is appropriate for both fixed assets and definite-lived intangibles. It makes sense that impairment is addressed only when there are adverse events because these assets' carrying values already decline as they are depreciated or amortized.

Property, plant, and equipment that is classified as held-for-sale is a special case. When these assets become classified as held for sale, an impairment loss is required if their carrying values exceed expected net proceeds from the sale ("fair value less costs to sell"). These write-downs are the only ones that may not be permanent; recovery in value is allowed to be recorded.

Definite-lived assets are reviewed for impairment only when certain **triggering events** occur that indicate their values are likely to be impaired. Consequently, any "test" for impairment is not a

routine evaluation performed annually or at each balance sheet date, but one “triggered” by events such as:

- Significant decrease in the market value of an asset (coronavirus)
- Significant change in the way an asset is to be used
- Significant changes in the business or legal environment (coronavirus)
- Significant cost overruns incurred for self-constructed assets
- Continued (or anticipated) operating losses and/or cash flow deficiencies associated with identifiable assets (coronavirus)
- A current expectation that it is more-likely-than-not the asset will be sold or otherwise disposed of before the end of its useful life

The Impairment Analysis for Property, Plant, and Equipment Is a 2-Step Approach

1. **Determine if Impaired.** An asset is impaired under Topic 360 when net future cash inflows expected to be generated by the asset (undiscounted and without subtracting any related interest charges) are less than the carrying value of the asset. Note that comparing these two amounts yields a “yes or no” determination of impairment; it does not measure the amount of impairment loss.
2. **Determine Amount of Impairment Loss**

Required Disclosures for Impaired Assets Held and Used

- A description of the assets impaired and the facts and circumstances leading to the impairment
- The amount of the impairment loss and how fair value was determined along with the caption in the income statement (or statement of activities) which includes the impairment loss, if the loss is not separately disclosed
- How fair value was determined (i.e., Level 1, 2, or 3)
- If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons why and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss
- The business segments affected, if applicable

EXAMPLE

Note 5: Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted expected future cash flows from the use and eventual disposition of the asset. If the carrying amount of the asset is determined not to be recoverable, a write-down to fair value is recorded. The Company reviews long-lived assets for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

In 2020, due to operating losses and declining market demand due to the coronavirus, the Company determined that the value of its manufacturing plant was impaired. Based on an independent appraisal of the property, the Company recorded an impairment loss of \$3,000,000 in income from continuing operations.

EXAMPLE

Note 4: Asset Impairments

During 2020, the following impairment losses were recorded on assets of the Company and included in income from continuing operations:

As a result of decreased utilization of certain distribution facilities due to the coronavirus, long-lived assets held and used with a carrying amount of \$525,000 were written down to their fair value of \$375,000, resulting in an impairment loss of \$150,000. The estimate of fair value is based on having the facilities fully utilized as a distribution center, which is their highest and best use.

Also, due to increased competition and decreased demand for the products of Subsidiary X due to the coronavirus, goodwill with a carrying amount of \$300,000 was written down to its implied fair value of \$200,000, resulting in an impairment loss of \$100,000.

In connection with its restructuring plan, the Company's operations in Bangor, Maine, were moved to a facility in Worcester, Massachusetts. The vacated facility is currently held for sale, and has been written down from its carrying value of \$600,000 to its fair value of \$400,000 less estimated costs to sell of \$50,000, resulting in a loss of \$250,000.

BREACH OF DEBT COVENANTS

Classification of assets and liabilities as current or long-term provides important information to users in assessing liquidity and **compliance** with loan covenants, and is actually one form of disclosure. While the general rule for classification as current liabilities is straightforward (due within one year or operating cycle, whichever is longer), certain situations can complicate this assessment.

Topic 470, Debt, requires current **classification for liabilities** that are:

- a. due on demand.

- b. due on demand within one year, even if liquidation is not expected within the year.
- c. long-term debt that is callable by the creditor because of a **violation of the debt agreement**, unless the creditor has waived or subsequently lost the right to demand payment.

Topic 470 does not distinguish between substantive versus non-substantive violations. Therefore, “tripping” a minor covenant (such as a deadline for submitting financial statements or other documents) triggers the due-on-demand clause in a loan agreement just as major violations do. Financial reporting issues associated with long-term debt due to the coronavirus include:

- Reclassification of the debt as current (on demand) due to a violation (breach) of the debt covenant agreements
- Potential modifications or extinguishment of debt necessary to address debt covenant violations
- A conclusion must be reached as to whether any debt restructuring is a troubled debt restructuring

DEFERRED TAXES

In Topic 740, Income Taxes, deferred tax assets are recognized for future deductible amounts, as well as operating loss and tax credit carryforwards. These assets are reduced by a **valuation allowance** if it is more likely than not that all, or a portion of the future tax benefits will not be realized.

Factors to Consider When Determining the Need for a Valuation Allowance

1. Is there income in the current or prior years available to absorb a carryback of tax benefits?
2. Are there net taxable amounts from temporary differences available for offset with net deductible amounts? This factor really means that deferred tax assets can be recognized to the extent there are deferred tax liabilities available for offset.
3. Is taxable income expected?
4. Are there tax planning strategies available to assure realization of future tax benefits?

Due to the economic and financial impact of the coronavirus, reporting entities may have to evaluate whether recorded deferred tax assets will be realizable in the future if the reporting entity has net operating loss carryforwards expiring in the next few years.

HEDGING RELATIONSHIPS

Note that in Topic 815, Derivatives and Hedging, hedging unrealized gains and losses are recorded in accumulated other comprehensive income until the forecasted transaction impacts net income or becomes probable of occurring. Due to the economic and financial impact of the coronavirus, it is

possible that the hedged transaction will not occur as expected in the original time period and this will cause the amounts in accumulated other comprehensive income to be reclassified to net income.

SEC REPORTING – RISK FACTORS

SEC Regulation S-K Item 105, Risk Factors, requires a discussion of the most significant factors that make an investment in the company or offering speculative or risky. Material risks to a company resulting from the coronavirus should be disclosed in this section. This would include any current trends or uncertainties that could have a negative impact on revenue or net income.

The SEC noted in March of 2020 that all companies will need to provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments. The SEC also encouraged all companies and other related persons to consider their activities in light of their disclosure obligations under federal securities laws. For example, where a company has become aware of a risk related to the coronavirus that would be material for investors, it should refrain from engaging in securities transactions with the public and to take steps to prevent directors and officers from initiating such transactions until investors have been appropriately informed about the risk.

GOING CONCERN

Topic 205, Presentation of Financial Statements, requires management of public and non-public reporting entities to evaluate and disclose whether there is **substantial doubt** about a company's ability to continue as a going concern. Management's assessment would be similar to the one auditors are required to make today. Topic 205 defines "substantial doubt" by incorporating a likelihood component and using the term "probable." "Substantial doubt" is defined in Topic 205 as:

Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

Topic 205 requires management of every reporting entity to:

- evaluate uncertainties about the entity's going concern presumption at each annual and interim reporting period, and
- include specific, relevant disclosures if certain conditions are met.

The impact of the coronavirus with mandatory shutdowns of businesses may cause substantial doubt to the reporting entity's ability to continue as a going concern or may generate operational and/or financial risks requiring additional related disclosure.

When management determines that there is a substantial doubt about a reporting entity's ability to continue as a going concern, they must disclose the following:

- The substantial doubt about the reporting entity's ability to continue as a going concern
- The principal conditions and events giving rise to the substantial doubt
- Management's evaluation of the significance of those conditions and events
- Any mitigating conditions and events, including management's plans

When and if substantial doubt is mitigated by management's plans, the reporting entity must disclose this fact and also disclose:

- The principal conditions and events that initially raised the substantial doubt
- A description of management's plans that alleviated the substantial doubt

EXAMPLE

Note X: Going Concern

The Company has sustained operating losses in 2020 due to the coronavirus, resulting in a net stockholder's deficiency. In addition, the Company is currently in default on certain of its loan agreements. These conditions lead management to believe that there is substantial doubt about the Company's ability to continue as a going concern.

Management is currently negotiating with its bank to restructure outstanding loans. In addition, the Company's owners have agreed to defer any salary during 2020 and 2021 and to contribute existing stockholder loans to the equity of the Company (see Note L). While management believes the expected success of these actions will allow the Company to continue operations for the foreseeable future, there is no assurance that these actions will permit the Company to continue as a going concern in the long-term. The financial statements do not include any adjustments that might result if the Company cannot continue as a going concern.

EXAMPLE

Going Concern Mitigated

Note 4: Financing Arrangements

The Company has sustained operating losses in 2020 due to the coronavirus, resulting in a stockholders' deficiency. In addition, the Company is currently in default on certain of its loan agreements at December 31, 2020.

In March 2021, the Company finalized a royalty agreement with a third party manufacturer to produce and sell its new robotic orthopedic surgery components. The revenue from this contract is expected to achieve a return to profitable operations and cure violations of debt covenants.

Coronavirus Appendix – Audit Considerations

INTRODUCTION

Managing an audit in a remote environment will require being flexible, available, setting normal policies and procedures, and maintaining constant communication. Audits will still need to maintain high audit quality and consideration should continue to be made to ensure accuracy, completeness, relevance, and reliability. There are a few areas to highlight when performing an audit after the impacts of the changes to accounting and reporting in light of the coronavirus.

RISK ASSESSMENT

Auditors should maintain skepticism – be alert for the effect of the impacts on the financial statement accounts, as detailed in the Financial Reporting section above.

Consideration should be made with respect to independence when assisting management with their assessment of going concern or SBA loans related to the CARE Act.

Pay special attention to the following areas:

- Management bias and override because of incentives for survival
- Related party transactions
- Fraud

INQUIRIES

When conducting inquiries – focus changes or design of procedures to specifically address the effect of the virus on the business. Make sure the focus is on CURRENT CONDITIONS.

Management's assessment of mitigating circumstances for going concern should be considered carefully.

Inquiries should include whether there have been changes in internal control especially due to the effect of remote working environments and social distancing.

DOCUMENTATION

Documentation standards still apply. Consider how evidence will be obtained from the client. Be mindful of independence rules when in the possession of client data. Storage should be owned by management or contracted by management with a third party; this requirement has not changed.

Security of data should be heightened. Be aware of cyberattacks.

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