2022 Accounting & Auditing Update

(AAU4)

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2022 ACCOUNTING & AUDITING UPDATE (AAU4)

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Unit

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 2021 as of the date of writing this program.

The purpose of this section is to provide an overview of the more recently issued ASUs such that if participants have to apply these new standards, you will have a foundation sufficient to understand the accounting and/or disclosure issues and the reference sources for the material. We also include at the beginning of this section FASB's Technical Agenda to enable you to anticipate the new ASU topics that will be issued in 2022 and beyond.

FASB'S TECHNICAL AGENDA

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

1. Recognition and Measurement: Broad Projects

1. Recognition and Measurement: Narrow Projects

2. Presentation and Disclosure Projects

3. Framework Projects

4. Research Projects

5. Post-Implementation Projects

As of March 5, 2022, the following are topics included in each of the five project areas.

Recognition & 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.

- 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 reporting entities.

Recognition & Measurement: Narrow Projects

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

- Codification Improvements (Next Phase)
- Codification Improvements—Amendments to Remove References to the Concepts Statements
- Codification Improvements—Financial Instruments—Credit Losses (Vintage Disclosure: Gross Writeoffs and Gross Recoveries)
- Codification Improvements—Hedge Accounting
- Consolidation Reorganization and Targeted Improvements
- Distinguishing Liabilities from Equity Phase 2
- EITF 21-A, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method
- Fair Value Hedging—Portfolio Layer Method
- Fair Value Measurement of Equity Securities Subject to Contractual Sales Restrictions
- Financial Instruments—Credit Losses (Topic 326)—Acquired Financial Assets
- Financial Instruments—Credit Losses (Topic 326)—Targeted Improvements to the Accounting for Troubled Debt Restructuring for Creditors
- Improving the Accounting for Asset Acquisitions and Business Combinations
- Joint Venture Formations
- Leases (Topic 842)—Lease Modifications
- Reference Rate Reform—Deferral of the Sunset Date of Topic 848
- Reference Rate Reform—Fair Value Hedging

Presentation & Disclosure Projects

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

- Disaggregation—Income Statement Expenses
- Disclosure Framework: Disclosure Review—Income Taxes
- Disclosure Framework: Disclosures—Interim Reporting
- Disclosure Improvements in Response to the SEC's Release on Disclosure Update and Simplification
- Disclosure of Supplier Finance Program Obligations
- Segment Reporting

Framework Projects

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

- Conceptual Framework—Measurement

Research Projects

The following research projects are in various stages of completion.

- Accounting for and the Disclosure of Intangibles
- Accounting for Exchange—Traded Digital Assets and Commodities
- Accounting for Financial Instruments with Environmental, Social, and Governance (ESG) Linked Features and Regulatory Credits
- Accounting for Government Grants, Invitation to Comment
- Agenda Consulting
- Hedge Accounting—Phase 2

Post-Implementation Projects

- Credit Losses
- Leases
- Revenue Recognition

LEASES

ASU 2016-02, *Leases* (Topic 842)

Since the effective date of ASU 2016-02, *Leases*, for non-public reporting entities is for periods beginning after December 15, 2021, we begin this year's FASB Update with an overview of Topic 842.

Objective

The FASB issued ASU 2016-02, *Leases*, as amended (Topic 842), to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

The **core principle** of Topic 842 is that a reporting entity should recognize assets and liabilities arising from a lease. A lessee will recognize a liability to make lease payments and a right-of-use (RoU) asset representing its right to use the leased asset for the lease term. Our focus in this sub-section is leasing from the lessee's perspective.

Scope

According to Topic 842, a lease conveys the right to control the use of an identified property, plant, and equipment (an identified asset) for a period of time in exchange for consideration. A reporting entity should apply Topic 842 to all leases, including subleases. Topic 842 does not apply to the following:

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

A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to extend the lease term or purchase the underlying asset that the lessee is reasonably certain to exercise.

Note: "Reasonably certain" is defined as a high degree of confidence (for example, 85% to 90%) that an event will take place.

The lessee has an accounting policy option to recognize payments on a short-term lease on a straight-line basis over the lease term. If the accounting policy option is elected, short-term leases would not be reflected on the lessee's statement of financial position—policy note disclosure is required.

Lease Definition—Contract

A lease is a contract or part of a contract that conveys the right to control the use of an identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A contract is (or contains) a lease when the following two criteria are met:

1. The contract explicitly or implicitly specifies the use of an identifiable asset:
   – Asset is physically distinct
   – Lessor does not have any substitution rights. A protective right defines the scope of the lessee's right of use within applicable laws and regulations but does not, in isolation, prevent the lessee (customer) from having the right to direct the use of the asset.
2. The lessee (customer) controls the use of the asset for that period of use:
   – The lessee has the right to obtain substantially all of the economic benefits from use of an identified asset, and
   – The lessee has the right to direct the use of the identified asset during the period of use. Note that the period of time can be expressed in months or years or it can be expressed in terms of the amount of use of the identified assets such as production units

Examples of decision-making rights that would normally grant the right to direct how and for what purpose an asset is used include the following:

- The right to change the type of output that is produced by the asset
- The right to change when the output is produced
- The right to change where the output is produced
- The right to change whether the output is produced and the quantity of that output

At the inception of a contract, a reporting entity must determine whether the contract is or contains a lease. If the lessee has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term. In identifying the asset, the lessor must not have substantive substitution rights for the identified asset; meaning the lessor has no practical ability to substitute or would not benefit from substituting. An entity would reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

Lease Classification

According to Topic 842, a reporting entity must classify each lease component within a lease contract at the commencement date. A reporting entity should not reassess this lease classification after the commencement date unless the lease contract is modified and the modification is not accounted for as a separate contract. However, the lessee is required to reassess this lease classification after the commencement date if there is a change in the lease term or a change in the assessment as to whether the lessee is reasonably certain or not to exercise an option to purchase the underlying asset.

A lessee will **classify** a lease as a **finance lease and a lessor will classify a lease as a sales-type lease** when the lease contract meets any of the following criteria at the lease commencement date. This criterion classifies a lease based on whether the lease contract effectively reflects a purchase of the underlying asset:

- The lease **transfers ownership** of the underlying asset to the lessee by the end of the lease term

- The lease grants the lessee an **option to purchase the underlying asset** that the lessee is reasonably certain (probable) to exercise

- The lease term is for the **major part** (legacy GAAP 75%) of the remaining economic life of the underlying asset—note that if the commencement date falls at or near the end of the economic life of the underlying asset, this specific criterion should not be used for purposes of classifying the lease

  – If a single lease component contains the right to use more than one underlying asset, the reporting entity should consider the remaining economic life of the predominant asset in the lease component for the purpose of applying this criterion

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments, **equals or exceeds substantially all of the fair value** (legacy GAAP 90%) of the underlying asset

- The underlying asset is of such a **specialized nature** that it is expected to have no alternative use to the lessor at the end of the lease term

When **none of the criteria for a finance lease are met**, a lessee classifies the lease as an operating lease. When none of the criteria for a sales-type lease are met, a lessor will classify the lease as either a direct financing lease or an operating lease. The lessor will classify the lease as an operating lease unless both of the following criteria are met:

- The present value of the sum of the lease payments and any residual value guarantee by the lessee that is not already reflected in the lease payments and/or any other third-party guarantee unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset, and

- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee

When both of the above criteria are met, a lessor must classify the lease as a direct financing lease.

Note: The reason it is important to determine the lease classification of a lease is because the subsequent accounting for a lessee is based on the lease classification (pattern of expense measurement and recognition) and for a lessor, the initial and subsequent measurement is based on whether the lease is classified as a sales-type lease, direct financing lease or an operating lease.

Lessee Initial Measurement

At the lease commencement date, a lessee should recognize in the statement of financial position both of the following:

- A **lease payment liability** based on the present value of the lease payments, discounted using the discount rate for the lease, and

- A **right-of-use (RoU) asset** representing the lessee's right to use the underlying asset for the lease term.

EXAMPLE

Initial Measurement

DB: Right-of-Use Asset	XX	
CR: Lease Payment Liability		XX

When calculating the lease payment liability, if the rate implicit in the lease is not readily determinable, the lessee will use its incremental borrowing rate for borrowings of the similar amounts and terms. A lessee may use a single discount rate to apply to a portfolio of leases, assuming the result would not be significantly different than individual lease discount rates.

Note: Non-public reporting entities are permitted an accounting policy election to use a risk-free discount rate for the lease (normally the federal funds rate).

The RoU asset and the lease payment liability may not be the same on commencement, nor throughout the lease term, because the RoU asset is calculated as the amount of the initial measurement of the lease payment liability plus payments made by a lessee to the lessor at or before the lease commencement date minus any lease incentives the lessee received from the lessor and any initial direct costs incurred by the lessee.

When initially measuring the **lease payment liability** at the commencement date, the lease payments consist of the following payments relating to the use of the underlying asset during the lease term:

- **Fixed payments**, including in substance fixed payments, less any lease incentives paid or payable to the lessee.
- **Variable lease payments** that depend on an index or rate, initially measured using the index or rate at the commencement date.
- The **exercise price of an option** to purchase the underlying asset if the lessee is reasonably certain to exercise this option.
- **Payments for penalties for terminating the lease** if the lease term reflects the lessee exercising the option to terminate the lease.
- **Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.** These fees are not included in the fair value assessment of the underlying asset for purposes of determining fair value for lease classification purposes.
- For the lessee only, amounts probable of being owed by the lessee under **residual value guarantees**.

From the **lessee's perspective**, to determine whether a lease is a finance lease or an operating lease, we must evaluate the lease classification criteria presented earlier in this section. The following example evaluates these classification criteria to make the lease classification decision.

EXAMPLE

Finance Lease—Subsequent Measurement

ABC Lessee enters into a five-year equipment lease (no renewal options) with Lessor Inc. with annual lease payments of $24,000. The economic life of the equipment is 7 years and its fair value is $150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1st of each year. The rate implicit in the lease is 6 percent. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term.

Using the five lease classification criteria, we can determine whether this lease is a finance or operating lease:

1. Transfer of ownership—Ownership does not transfer to the lessee
2. Option to purchase the underlying asset—The lease does not contain a purchase option
3. Lease term is for the major part of the remaining economic life of the underlying asset—Five-year lease term is a major part of the economic life of the asset (5/7 = 71%)
4. Present value of the sum of the lease payments and any residual value guarantee amounts to substantially all of the fair value of the underlying asset—Present value of 5 payments of $24,000 at 6% is $107,163. This is approximately 71% of the fair value of the leased asset and is not substantially all of the fair value of the underlying asset
5. Underlying asset is of such a specialized nature—There is no indication that this equipment is of a specialized nature

Based on this analysis, the lease term is for a major part of the economic life of the asset, and therefore, this lease is a finance lease.

1/1 Year 1:

DB:	RoU Asset	$107,163	
CR:	Lease Payment Liability		$107,163
DB:	Lease Payment Liability	$24,000	
CR:	Cash		$24,000

Subsequent Measurement—Finance Lease

The lease payment liability is increased by recognizing periodic interest on the lease liability and decreased by payments made during the lease periods. The RoU asset is amortized on a straight-line basis from the commencement date to the earlier of the end of the lease term or the useful life of the RoU asset. The RoU asset is reduced by accumulated amortization and any impairment losses based on reassessment requirements. If the RoU asset will be transferred to the lessee at the end of the lease term or it is reasonably certain that the lessee will exercise a purchase option for the RoU asset, then the RoU asset's amortization period should be to the end of the useful life of the RoU asset.

EXAMPLE

ABC Lessee enters into a five-year equipment finance lease (no renewal options) with Lessor Inc. with annual lease payments of $24,000. The economic life of the equipment is six years and its fair value is $150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1. The rate implicit in the lease is 6%. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term.

Operating Lease—Subsequent Measurement

Year 1:

January 1

DB: RoU Asset	$107,163	
CR: Lease Payment Liability		$107,163
(Present value of 5 payments of $24,000 at 6% is $107,163)		
DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000
DB: Lease Amortization Expense	$21,433	
CR: RoU Asset		$21,433
(RoU asset of $107,163 / 5 = $21,432.60)		

December 31

DB: Interest Expense	$4,990	
CR: Lease Payment Liability		$4,990
(Lease payment liability of $107,163 – $24,000 payment = $83,163 × 6% = $4,990)		

Year 2:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000
DB: Lease Amortization Expense	$21,432	
CR: RoU Asset		$21,432

December 31

DB: Lease Expense	$3,849	
CR: Lease Payment Liability		$3,849

Year 3:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000
DB: Lease Amortization Expense	$21,433	
CR: RoU Asset		$21,433

December 31

DB: Interest Expense	$2,640	
CR: Lease Payment Liability		$2,640

Year 4:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000
DB: Lease Amortization Expense	$21,432	
CR: RoU Asset		$21,432

December 31

DB: Interest Expense	$1,358	
CR: Lease Payment Liability		$1,358

Year 5:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000
DB: Lease Amortization Expense	$21,432	
CR: RoU Asset		$21,432

Subsequent Measurement—Operating Lease

As stated previously, when none of the criteria for a finance lease are met, the lease is classified as an operating lease. The lessee recognizes a right-of-use (RoU) asset and a lease payment liability in the statement of financial position in the same manner as a finance lease. The lessee though, in an operating lease, will recognize a **single lease cost**, calculated so that the undiscounted cost of the lease is allocated over the lease term, generally on a straight-line basis. This is accomplished by amortizing the lease liability on an effective interest basis and then amortizing the RoU asset by adjusting (plugging) the lease asset's amortization to arrive at a constant lease expense amount.

Stated differently, the lease payment liability is reduced over time by recognizing the present value of the remaining lease payments not yet paid. The initial RoU asset balance is reduced by periodically adjusting the amortization of the RoU asset by the effective interest on the lease payment liability to arrive at a constant straight-line expense amount. As with finance leases, the RoU asset may also be impacted by any prepaid or accrued expenses, the remaining balance of any lease incentives received, unamortized initial direct costs or any impairment.

For clarity purposes, Topic 842-20-25-6a, *Recognition*, states the following as it relates to operating lease recognition:

> *A single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern which benefit is expected to be derived from the right to use the underlying asset unless the right of use asset has been impaired.*

EXAMPLE

Note 7—Leases

ABC Lessee enters into a five-year equipment lease (no renewal options) with Lessor Inc. with annual lease payments of $24,000. The economic life of the equipment is 10 years and its fair value is $150,000. There is no purchase option available, there is not a residual value guarantee made by the lessee, and the payments are due annually on January 1. The rate implicit in the lease is 6%. There are no other payments associated with this lease. The equipment will be returned to Lessor Inc. at the end of the five-year lease term. None of the five finance lease criteria are met; therefore, the lease is an operating lease.

Year 1:

January 1

DB: RoU Asset	$107,163	
CR: Lease Payment Liability		$107,163

(Present value of 5 payments of $24,000 at 6% is $107,163)

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000

December 31

DB: Lease Expense	$24,000	
CR: Lease Payment Liability		$4,990
CR: Accumulated Amortization		$19,010

[The lease payment liability is increased by calculating the effective interest ($107,163 – $24,000 = $83,163 × 6% = $4,990).]

The reduction in the RoU asset is calculated by subtracting the effective interest ($4,990) from the required straight-line expense amount ($24,000) = $19,010.

Year 2:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000

December 31

DB: Lease Expense	$24,000	
CR: Lease Payment Liability		$3,849
CR: Accumulated Amortization		$20,151

[The lease payment liability is increased by calculating the effective interest ($107,163 – $24,000 – $19,010 = $64,153 × 6% = $3,849).]

The reduction in the RoU asset is calculated by subtracting the effective interest ($3,849) from the required straight-line expense amount ($24,000) = $20,151.

Year 3:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000

December 31

DB: Lease Expense	$24,000	
CR: Lease Payment Liability		$2,640
CR: Accumulated Amortization		$21,360

[The lease payment liability is increased by calculating the effective interest ($107,163 – $24,000 – $19,010 – $20,151 = $44,002 × 6% = $2,640).]

The reduction in the RoU asset is calculated by subtracting the effective interest ($2,640) from the required straight-line expense amount ($24,000) = $21,360.

Year 4:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000

December 31

DB: Lease Expense	$24,000	
CR: Lease Payment Liability		$1,359
CR: Accumulated Amortization		$22,641

[The lease payment liability is increased by calculating the effective interest ($107,163 – $24,000 – $19,010 – $20,151 – $21,360) = $22,642 × 6% = $1,359).]

The reduction in the RoU asset is calculated by subtracting the effective interest ($1,359) from the required straight-line expense amount ($24,000) = $22,641.

Year 5:

January 1

DB: Lease Payment Liability	$24,000	
CR: Cash		$24,000

December 31

DB: Lease Expense	$24,000	
CR: Accumulated Amortization		$24,000

Note: Each year, the credit to the RoU asset (amortization) gets larger. This is the only way to achieve a straight-line lease expense while the interest decreases each year on the lease payment liability.

Lessee Disclosures

The objective of the disclosure requirements in Topic 842, *Leases*, is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. These disclosures will be both qualitative and quantitative:

1. Information about the nature of the entity's leases, including:
   - A general description of its leases
   - The basis, terms and conditions on which variable lease payments are determined
   - The existence and terms of any options to extend or terminate the leases
   - Narrative disclosure about options that are recognized as part of its RoU assets and lease payment liabilities and those that are not
   - The existence, terms and conditions any residual value guarantees provided by the lessee
   - Any restrictions or covenants imposed by leases (e.g., dividends, additional financial obligations, etc.)
   - If the entity has subleases, the entity should identify the information relating to subleases as indicated above

2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction of the underlying asset.

3. Information about significant **assumptions and judgments** made in applying Topic 842, which may include the following:

   - The determination of whether a contract contains a lease
   - The allocation of the consideration in a contract between lease and non-lease components
   - The determination of the discount rate for the lease

4. In addition, for each period in the financial statements, a lessee must disclose the following amounts relating to a **lessee's total lease cost**. These amounts include both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other GAAP, and the cash flows arising from lease transactions:

   - **Finance lease cost** segregated between the amortization of the RoU assets and the interest on the lease liabilities
   - **Operating lease cost** including its amortization allocation, variable lease payments, and impairments (if any)
   - **Short-term lease cost** excluding expenses relating to leases of one month or less
   - **Variable lease cost** not included in the lease liability in the period in which those obligations are incurred
   - **Sublease income** disclosed on a gross basis, separate from the finance or operating lease expense
   - **Net gain or loss** recognized from any sale and leaseback transactions
   - **Amounts segregated** between those for finance and operating leases for the following items:
     - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
     - Supplemental non-cash information on lease liabilities arising from RoU assets
     - Weighted-average remaining lease terms
     - Weighted-average discount rates

5. A **maturity analysis** of the lessee's finance lease liabilities and its operating lease liabilities, separately, presenting the undiscounted cash flows on an annual basis for a minimum of five years and a total of the amounts for the remaining years. The lessee should present a reconciliation of the undiscounted cash flows to the financial lease and operating lease liabilities recognized in the statement of financial position.

6. Other lessee disclosures, include:

   - Lease transactions between related parties
   - If the lessee elects the accounting policy option for short-term leases, the lessee must disclose that fact
   - If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, the lessee must disclose that fact and the amount of its short-term lease commitments
   - A lessee that elects the practical expedient on not separating lease components from non-lease components must disclose its accounting policy election and which class or classes of the underlying assets it has elected to apply the practical expedient
   - Main terms and conditions of any sales-leaseback transactions

EXAMPLE—LESSEE DISCLOSURE

We lease retail stores in shopping centers, office facilities, warehouses, computers, and transportation equipment. Variable lease payments are included in most retail store leases based on the achievement of certain sales targets. These variable lease payments are recognized as lease expense when and if the targets are achieved. Most retail store, office facilities and warehouse leases have options to extend the lease terms as well as options to terminate the leases. Lease termination clauses include penalties for early termination.

40% of the retail stores, office facilities, and warehouse leases include options to extend the lease terms and these amounts are included in the Company's right-of-use assets and lease payment liabilities. 60% of the retail stores, office facilities, and warehouse leases do not have options to extend the lease terms. As a matter of Company policy, we do not provide any residual value guarantees to lessors' assets that we lease. Any restrictions or performance covenants imposed by lessors are limited to certain debt and income metrics and the Company is in full compliance with these restrictions and performance covenants. Subleases entered into by the Company are immaterial to operations.

We are a party to the construction of two shopping malls, one in Phoenix, Arizona, and one in Atlanta, Georgia. These shopping malls are expected to be completed and open for business in 20X7. We will be the lead tenant in both malls and have signed long-term leases for 20 years each to occupy 110,000 square feet in the Phoenix location and 125,000 square feet in the Atlanta location. Once these leases commence, we will have significant rights and financial obligations throughout the 20 years of these leases.

Based on Topic 842, Leases, we have established policies and procedures to assist the Company in determining whether a contract contains a lease, we separate non-lease components from lease components in our lease contracts and account for non-lease components based on other U.S. GAAP. Lease components in our lease contracts are accounted for following the guidance in Topic 842 for the capitalization of long-term leases. Discount rates used in our capitalization policies are the discount rates implicit in our lease contracts as established through negotiation with our lessors. Based on the length of a lease contract, as well as any variable lease payments, these discount rates currently range from 6% to 10%.

	20X9	20X8
Lease cost:		
Finance lease cost:		
Amortization of right-of-use assets	$ XXX	$ XXX
Interest on lease	XXX	XXX
Total finance lease cost	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$ XXX	$ XXX
Other information:		
Gain/(loss) on sale-leaseback transactions, net	$ XXX	$ XXX
Cash paid for amounts included in lease liabilities:		
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Total cash paid	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term (in years)—finance leases	XX	XX
Weighted-average remaining lease term (in years)—operating leases	XX	XX
Weighted-average discount rate (percent)—finance leases	XX	XX
Weighted-average discount rate (percent)—operating leases	XX	XX

Maturity Analysis		
	Finance Lease Liabilities	Operating Lease Liabilities
20XX	$XX	$XXX
21XY	XX	XXX
20XZ	X	XX
20XA	X	XX
20XB	XX	XXX
Total Undiscounted Cash Flows	$XXX	$X,XXX
Interest at a Weighted Average Rate of 7.4%	(XX)	(XXX)
Lease Payment Liabilities	$XXX	$X,XXX

Dollars in millions except per share amounts

AT&T 2020 ANNUAL REPORT NOTE 8—LEASES

NOTE 8. LEASES

We have operating and finance leases for certain facilities and equipment used in our operations. Our leases generally have remaining lease terms of up to 15 years. Some of our real estate operating leases contain renewal options that may be exercised, and some of our leases include options to terminate the leases within one year.

We have recognized a right-of-use asset for both operating and finance leases, and a corresponding lease liability that represents the present value of our obligation to make payments over the lease term. The present value of the lease payments is calculated using the incremental borrowing rate for operating and finance leases, which was determined using a portfolio approach based on the rate of interest that we would have to pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term. We use the unsecured borrowing rate and risk-adjust that rate to approximate a collateralized rate in the currency of the lease, which will be updated on a quarterly basis for measurement of new lease liabilities.

The components of lease expense were as follows:

	2020	2019
Operating lease cost	**$5,896**	$5,684
Finance lease cost:		
Amortization of right-of-use assets	**$ 287**	$ 271
Interest on lease obligation	**156**	169
Total finance lease cost	**$ 443**	$ 440

The following table provides supplemental cash flows information related to leases:

	2020	2019
Cash Flows from Operating Activities		
Cash paid for amounts included in lease obligations:		
Operating cash flows from operating leases	**$4,852**	$4,583
Supplemental Lease Cash Flow Disclosures		
Operating lease right-of-use assets obtained in exchange for new operating lease obligations	**$5,270**	$7,818

The following tables set forth supplemental balance sheet information related to leases at December 31:

	2020	2019
Operating Leases		
Operating lease right-of-use assets	**$24,714**	$24,039
Accounts payable and accrued liabilities	**$ 3,537**	$ 3,451
Operating lease obligation	**22,202**	21,804
Total operating lease obligation	**$25,739**	$25,255
Finance Leases		
Property, plant and equipment, at cost	**$ 3,586**	$ 3,534
Accumulated depreciation and amortization	**(1,361)**	(1,296)
Property, plant and equipment, net	**$ 2,225**	$ 2,238
Current portion of long-term debt	**$ 189**	$ 162
Long-term debt	**1,847**	1,872
Total finance lease obligation	**$ 2,036**	$ 2,034

	2020	2019
Weighted-Average Remaining Lease Term (years)		
Operating leases	**8.5**	8.4
Finance leases	**9.9**	10.3
Weighted-Average Discount Rate		
Operating leases	**4.1%**	4.2%
Finance leases	**8.1%**	8.4%

The following table provides the expected future minimum maturities of lease obligations:

	Operating Leases	Finance Leases
2021	**$ 4,808**	**$ 350**
2022	**4,527**	**333**
2023	**4,094**	**300**
2024	**3,560**	**276**
2025	**2,904**	**272**
Thereafter	**11,230**	**1,609**
Total lease payments	**31,123**	**3,140**
Less: imputed interest	**(5,384)**	**(1,104)**
Total	**$25,739**	**$ 2,036**

APPLE 2020 ANNUAL REPORT NOTE 12—LEASES

Note 12 – Leases

The Company has lease arrangements for certain equipment and facilities, including retail, corporate, manufacturing and data center space. These leases typically have original terms not exceeding 10 years and generally contain multi-year renewal options, some of which are reasonably certain of exercise. The Company's lease arrangements may contain both lease and non-lease components. The Company has elected to combine and account for lease and non-lease components as a single lease component for leases of retail, corporate, and data center facilities.

Payments under the Company's lease arrangements may be fixed or variable, and variable lease payments are primarily based on purchases of output of the underlying leased assets. Lease costs associated with fixed payments on the Company's operating leases were $1.5 billion for 2020. Lease costs associated with variable payments on the Company's leases were $9.3 billion for 2020. Rent expense for operating leases, as previously reported under former lease accounting standards, was $1.3 billion and $1.2 billion in 2019 and 2018, respectively.

For 2020, the Company made $1.5 billion of fixed cash payments related to operating leases. Non-cash activities involving ROU assets obtained in exchange for lease liabilities were $10.5 billion for 2020, including the impact of adopting the new leases standard in the first quarter of 2020.

The following table shows ROU assets and lease liabilities, and the associated financial statement line items, as of September 26, 2020 (in millions):

Lease-Related Assets and Liabilities	Financial Statement Line Items	2020
Right-of-use assets:		
Operating leases	Other non-current assets	$ 8,570
Finance leases	Property, plant and equipment, net	629
Total right-of-use assets		$ 9,199
Lease liabilities:		
Operating leases	Other current liabilities	$ 1,436
	Other non-current liabilities	7,745
Finance leases	Other current liabilities	24
	Other non-current liabilities	637
Total lease liabilities		$ 9,842

Lease liability maturities as of September 26, 2020, are as follows (in millions):

	Operating Leases	Finance Leases	Total
2021	$ 1,493	$ 43	$ 1,536
2022	1,461	43	1,504
2023	1,317	54	1,371
2024	1,068	30	1,098
2025	960	25	985
Thereafter	3,845	895	4,740
Total undiscounted liabilities	10,144	1,090	11,234
Less: Imputed interest	(963)	(429)	(1,392)
Total lease liabilities	$ 9,181	$ 661	$ 9,842

The weighted-average remaining lease term and discount rate related to the Company's lease liabilities as of September 26, 2020 were 10.3 years and 2.0%, respectively. The discount rates are generally based on estimates of the Company's incremental borrowing rate, as the discount rates implicit in the Company's leases cannot be readily determined.

As of September 26, 2020, the Company had $1.7 billion of future payments under additional leases, primarily for corporate facilities and retail space, that had not yet commenced. These leases will commence between 2021 and 2022, with lease terms ranging from 1 year to 20 years.

ASU 2021-05, Leases (Topic 842): *Lessors—Certain Leases with Variable Lease Payments*

Objective

ASU 2021-05 is part of FASB's post-implementation review of Topic 842, *Leases*. Including ASU 2021-05, FASB has issued the following seven ASU amendments on leases:

- ASU 2018-01—Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842
- ASU 2018-10—Codification Improvements to Topic 842, Leases
- 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 2021-05—Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments
- ASU 2021-09—Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities

Background

Topic 842 requires that a lessor determine whether a lease should be classified as a sales-type lease or a direct financing lease on the lease commencement date. Following Topic 842, a lessor is not permitted to estimate most variable lease payments in recording the initial lease transaction and must exclude variable payments that are not estimated and do not depend on a reference rate or a rate from the lease receivable.

Subsequently, those excluded variable lease payments are recognized entirely as lease income when the changes in facts and circumstances on which the variable lease payments are based occur. As a result, the net investment in the lease for a sales-type lease or a direct financing lease with variable payments that do not depend on a reference index or rate may be less than the carrying amount of the underlying asset derecognized at the date of the lease commencement.

When this occurs, the lessor must recognize a selling loss at the lease commencement date (day one loss) even if the lessor expects the lease contract to be profitable overall.

Provisions

To minimize the potential impact of a lessor having to recognize a day one loss in the circumstances above, ASU 2021-05 requires lessors to classify and account for a lease with variable lease payments that do not depend on a reference index or rate as an **operating lease** if both of the following criteria are met:

1. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with Topic 842

2. The lessor would have otherwise recognized a day one loss

Following operating lease guidance, the lessor does not derecognize the underlying asset in the lease but continues to recognize the measurement and impairment guidance found in Topic 360, *Property, Plant & Equipment*.

Effective Date

- ASU 2012-05 is effective for public business entities for fiscal years beginning after December 15, 2021 and interim periods within those fiscal years.

- ASU 2021-05 is effective for all other reporting entities for fiscal years beginning after December 15, 2022.

ASU 2021-09, *Discount Rate for Lessees That Are Not Public Business Entities* (Topic 842)

Objective

To provide lessees that are not public business entities with more flexibility in how they determine the discount rate for their leases and make the risk-free rate election to reduce their initial adoption and ongoing implementation costs associated with Topic 842, *Leases*.

Background

The lease payment liability in Topic 842 is measured by using an appropriate discount rate to calculate the present value of future lease payments. The discount rate is defined in Topic 842 as the rate implicit in the lease unless that rate cannot be readily determined—if this is the case, the lessee is required to use its incremental borrowing rate. The "Day 1" lease payment liability is the present value of the lease's remaining lease payments plus any amounts probable of being owed by the lessee under a residual value guarantee.

A practical expedient exists in Topic 842 applying only to non-public business entities. A non-public business entity can elect to use a risk-free rate (e.g., U.S. Treasury bill rate) to discount the lease payments **for all leases** and avoid the more complicated risk-adjusted discount rate, its incremental borrowing rate. This results in the reporting entity recording a larger asset and liability on its balance sheet.

During FASB's post implementation review of Topic 842, it was noted that many private companies were reluctant to use the risk-free rate election because it caused the recording of RoU assets and lease payment liabilities to be larger than what they would be if the rate implicit in the lease or the incremental borrowing rate was used. It was also noted that the use of the risk-free rate could cause a finance lease classification to occur when otherwise the lease would be classified as an operating lease.

Provisions

ASU 2021-09 permits non-public business entities that are lessees to make the risk-free election by class of underlying assets (not all leases). A reporting entity that makes the risk-free rate election is required to disclose which asset classes it has elected to apply the risk-free rate.

Additionally, ASU 2021-09 requires that when the rate implicit in the lease is readily determinable for any individual lease, the lessee must use that rate rather than a risk-free rate or an incremental borrowing rate, regardless of whether it has made the risk-free rate election for other leases.

Effective Date

- Topic 842 becomes effective for non-public business entities for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.
- Reporting entities that have not early adopted Topic 842 as of November 11, 2021 are required to adopt ASU 2021-09 at the same time that they adopt Topic 842.
- Reporting entities that have adopted Topic 842 as of November 11, 2021 are required to adopt ASU 2021-09 for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

REMAINING ACCOUNTING STANDARD UPDATES

ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* & ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*

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.

Further, the SEC on December 7, 2021 issued *SEC Staff Statement on LIBOR Transition-Key Considerations for Market Participants*. In this Statement, the SEC includes Disclosure Considerations for Public Companies and Asset Backed Securities Issuers. As noted in the Statement:

> *The federal securities laws are designed to elicit disclosure of timely, comprehensive, and accurate information about risks and events that a reasonable investor would consider important to an investment decision. It is important that companies keep investors informed about their progress toward LIBOR risk identification and mitigation, and the anticipated impact on the company, if material. A number of existing rules or regulations may require disclosure related to the expected discontinuation of LIBOR, including rules and regulations related to disclosure of risk factors, management's discussion and analysis, board risk oversight, and financial statements. Issuers of registered asset-backed securities also should consider relevant disclosure requirements under Regulation AB, as well as appropriate disclosures regarding the potential impacts of the LIBOR transition on investors in those securities. To provide meaningful insight to investors about the status of their identification and mitigation efforts, including significant matters yet to be addressed, companies should consider providing detailed and specific disclosure, rather than general statements about the progress of the company's transition efforts to date.*
>
> *The staff encourages companies to provide qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past December 31, 2021 or June 30, 2023, as applicable, to provide context for the status of the company's transition efforts and the related risks. For example, companies with material risk related to outstanding debt with inadequate fallback provisions should consider disclosing how much debt will be outstanding after the relevant cessation date and the steps the company is taking address the situation, such as renegotiating contracts or refinancing the obligations. To the extent that a company has or is taking steps to identify and assess LIBOR exposure and mitigate material risks or potential impacts of the transition, the company should consider providing investors insight into what the company has done, what steps remain, and the timeline for further efforts. Banking regulators have provided guidance to their regulated entities encouraging those banks "to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021." Companies subject to such supervisory guidance should consider providing detailed disclosure about their transition efforts and the impact of the efforts on the company, if material.*
>
> *In general, companies generally include disclosures about the LIBOR transition as part of risk factors, recent developments, MD&A and/or quantitative and qualitative disclosures about market risk. To the extent a company provides this disclosure in response to more than one disclosure requirement within a filing, consider providing a cross-reference or otherwise summarizing or tying the information together so an investor has a complete and clear view of the company's plan for the discontinuation of LIBOR, the status of the company's efforts, and the related risks and impacts. The staff expects*

disclosures to evolve over time as companies provide updates to reflect transition efforts and the broader market and regulatory landscape. For further information about disclosure considerations, companies are encouraged to refer to the July 2019 Staff Statement as they prepare their disclosures to investors about the LIBOR transition and its potential impact on their businesses.

Provisions—ASU 2020-04

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.

Provisions—ASU 2021-01

Derivative instruments that use certain interest rate indexes for determining variable cash flows and for valuation and other purposes are also transiting to alternative reference rates. Changes in interest rates used for margining, discounting, or contract-price alignment for derivative instruments are being implemented as part of the market wide transition to new reference rates—Discounting Transition. ASU 2021-01 clarifies the scope of Topic 848 to explain that derivatives affected by the discounted transition are explicitly eligible for certain optional expedients and exceptions established in Topic 848.

Further, FASB clarified that a receive-variable-rate, pay-variable-rate cross currency interest rate swap may be considered an eligible hedging instrument in a net investment hedge if both legs of the swap do not have the same repricing intervals and dates as a result of reference rate reform.

Effective Date & Transition

ASU 2020-04 and ASU 2021-01 are effective for all reporting entities upon issuance.

ASU 2021-02, *Franchisors—Revenue from Contracts with Customers* (Subtopic 952-606)

Objective

FASB decided to issue this ASU to address the issues raised by stakeholders who expressed concerns about the level of effort required to account for pre-opening services provided by private company franchisors. The specific issue is the cost and complexity of applying Topic 606, *Revenue from Contracts with Customers*, to determine the amount and timing of revenue recognition for initial franchise fees.

Provisions

ASU 2021-02 includes amendments that introduce a practical expedient for franchisors that are not public business entities allowing them to account for pre-opening services provided to a franchisee as distinct from the franchise license if the services are consistent with those included in a predefined list within the guidance. Additionally, an accounting policy election can be made to recognize the pre-opening services as a single performance obligation.

Pre-opening services include:

- Assistance in the selection of a site
- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation
- Training of the franchisee's personnel or the franchisee
- Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping
- Bookkeeping, information technology, and advisory services, including settling up the franchisee's records, and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business
- Inspection, testing, and other quality control programs

A franchisor may account for pre-opening services as a single performance obligation by:

- Simplifying Step 2 of the revenue recognition model—identify performance obligations—by providing a list of acceptable services
- Leveraging existing concept of initial services, with some modifications
- Retaining standalone selling price guidance

Franchisors that elect the practical expedient will be required to determine whether the pre-opening services are distinct from one another unless it makes the accounting policy election to account for the services as a single performance obligation.

Effective Date

If a reporting entity has not yet adopted Topic 606, the existing transition provisions and effective date of Topic 606 are required—effective for annual reporting periods beginning after December 15, 2019

If a reporting entity has already adopted Topic 606, this ASU is effective for annual periods beginning after December 15, 2020. This guidance should be applied retrospectively to the date Topic 606 was adopted.

Early application is permitted.

ASU 2021-03, *Intangibles—Goodwill & Other* (Topic 350)

Objective

FASB decided to issue ASU 2021-03 in response to stakeholders' concerns about the cost and complexity of performing a goodwill triggering event evaluation during the reporting period (at an interim date), rather than completing the analysis as of the end of the reporting period (year-end), and the relevance of the triggering event evaluation (in 2021 due to the coronavirus, for example) with the financial information reported to and used by stakeholders (users).

Provisions

The amendments in ASU 2021-03 provide private companies and not-for-profit entities with an accounting alternative to perform the goodwill impairment triggering event evaluation as required in Subtopic 350-20 as of the end of the reporting period, whether the reporting period is an interim or annual period. A reporting entity that elects this alternative is not required to monitor for goodwill impairment triggering events during the reporting period but, instead, should evaluate the facts and circumstances as of the end of each reporting period to determine whether a triggering event exists and, if so, whether it is more likely than not that goodwill is impaired.

A reporting entity that does not elect the accounting alternative for amortizing goodwill and that performs its annual impairment test as of a date other than the annual reporting date should perform a triggering event evaluation only as of the end of the reporting period. The amendments in ASU 2021-03 do not require incremental disclosures beyond the existing requirements in Topic 235, *Notes to Financial Statements*, and Subtopic 350-20.

Effective Date

ASU 2021-03 is effective on a prospective basis for fiscal years beginning after December 15, 2019. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance as of March 30, 2021. A reporting entity should not retroactively adopt ASU 2021-03 for interim financial statements already issued in the year of adoption.

ASU 2021-03 also includes an unconditional one-time option for reporting entities to adopt the alternative prospectively after its effective date without assessing preferability under Topic 250, *Accounting Changes and Error Corrections*.

ASU 2021-04, *Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options* (Subtopic 815-40)

Objective

Clarify and reduce diversity in an issuer's accounting for modification or exchanges of freestanding equity-classified written call options (warrants) that remain equity classified after the modification or exchange.

According to the ASU, stakeholders requested that FASB provide guidance that will clarify whether an issuer should account for a modification or an exchange of a freestanding equity classified written call option that remains equity classified after modification or exchange as:

1. An adjustment to equity and, if so, the related earnings per share (EPS) effects, if any or

2. An expense and, if so, the manner and pattern of recognition

Note: The provisions of this ASU do not apply to warrants that are modified to compensate for goods or services within the scope of Topic 718, *Compensation-Stock Compensation*.

Provisions

The ASU requires that due to a modification or exchange of an equity classified freestanding written call option with a resulting change in fair value, the following guidance applies to a call option that is not within the scope of another Topic:

- A reporting entity should treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option that remains equity classified after the modification or exchange as an exchange of the original instrument for a new instrument

- Measurement is based on the following:

  - Modification or exchange of a debt instrument as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged

- For all other modifications or exchanges, as the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged

- Recognition is based on the following:

  - A reporting entity should recognize the effect of a modification or exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange on the basis of the substance of the transaction, in the same manner as if cash had been paid as consideration

  - If a financing transaction to raise equity, the increase in fair value should be recognized as an equity issuance cost

  - If a financing transaction to raise or modify debt, the increase in fair value is recognized as debt issuance cost

  - If other modifications unrelated to equity or debt financings, or other exchange transactions not within the scope of another Topic, the increase in fair value should be recognized as a dividend—the dividend is an adjustment to net income or loss in computing basic EPS

  - In a multiple-element transaction involving both debt financing and equity financing, the total fair value effect of the modification should be allocated to the respective elements in the transaction

Effective Date

- ASU 2021-04 is effective for all reporting entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years.

- A reporting entity should apply ASU 2021-04 prospectively to modifications or exchanges occurring on or after December 15, 2021.

ASU-2021-06, *Amendments to SEC Paragraphs Pursuant to SEC Final Rule Release No. 33-10786, Amendments to Financial Disclosures About Acquired and Disposed Businesses & No. 33-10835, Update of Statistical Disclosures for Bank & Savings & Loan Registrants* (Topics 205, 942 & 946)

Objective

This ASU amends various SEC paragraphs in the FASB Codification pursuant to the issuance of SEC Release No. 33-10786, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, and SEC Release No. 33-10835, *Update of Statistical Disclosures for Bank and Savings and Loans Registrants*.

Provisions

SEC Release No. 33-10786

- Topic 205, *Presentation of Financial Statements—Overall*—Minor cross reference amendments were made

- Topic 946, *Financial Services—Investment Companies—Overall*—Corrective edits are made to certain definitions—Affiliate, Value, Balance Sheets, Qualified Assets, and Swing Pricing. Additional edits are made to the topic *Financial Statements of Funds Acquired or to Be Acquired* to provide consistency with Regulation S-X Rule 6-11.

SEC Release No. 33-10835

- Topic 942, *Financial Services—Depository and Lending—Overall*—Topic 942 is amended to state "The consolidated financial statements filed for bank holding companies, savings and loan holding companies, and financial statements of banks and savings and loan associations, must apply the guidance" in Regulation S-X Rule 901, *Application of Rules 9-01 to 9-07*.

- Topic 942, *Financial Services—Depository and Lending—Balance Sheet*—Certain items are deleted from Topic 942 based on the amendments to Regulation S-X Rule 903, *Balance Sheets*. Additionally, certain terms are defined—Associate, Executive Officers, Immediate Family, and Ordinary Course of Business.

Effective Date

Effective upon issuance.

ASU 2021-07, *Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards* (Topic 718)

Objective

Simplify the calculation of fair value for private companies when private companies issue share option awards or upon the modification of existing awards for its employees or non-employees.

Background

When companies determine the grant-date fair value of share-option awards in accordance with Topic 718, *Compensation-Stock Compensation*, they are required to determine the grant-date fair value of those awards by using a valuation technique such as an option-pricing model.

An example option pricing model is the Black-Scholes Model. The inputs in the Black-Scholes Model are:

- Current stock price—Determining the current stock price is more difficult for private companies because private company equity shares often are not actively traded, and thus, observable market prices for these shares or similar shares do not exist.

- Exercise price
- Expected term
- Risk-free rate
- Volatility
- Dividend yield

The Private Company Council (PCC) is the primary advisory body to the FASB on private company matters. The PCC decided that the concerns expressed by many private company constituents about the cost and complexity of determining the current stock price input in accordance with existing GAAP indicated that a change to the guidance (Topic 718) for private companies was warranted.

Provisions

The primary provision of ASU 2021-07 is permitting the use of a **practical expedient** for private companies (non-public) to determine the current price input for equity-classified share-based awards issued to both employees and non-employees using the **reasonable application of a reasonable valuation method**. The characteristics of this method are the same as the characteristics used in Section 409A of the U.S. Internal Revenue Code to describe the reasonable application of a reasonable valuation method for income tax purposes.

The share value calculated using the practical expedient may be used for a period of 12 months from the measurement date, unless information that may materially affect the value of the non-public entity (for example, the resolution of material litigation, the issuance of a patent) becomes available. Reporting entities that elect to apply the practical expedient must disclose that fact.

The practical expedient is not available for liability-classified awards.

ASU 2021-07 describes the **characteristics of the reasonable application of a reasonable valuation method**:

1. The date on which the valuation's reasonableness is evaluated is the measurement date

2. The following factors should be considered in a reasonable valuation:

   - The value of the tangible and intangible assets of the reporting entity
   - The present value of the anticipated future cash flows of the reporting entity
   - The market value of stock or equity interests in similar reporting entities engaged in trades or businesses substantially similar to those engaged in by the reporting entity for which stock is to be valued
   - Recent arms-length transactions involving the sale or transfer of the stock or equity interests of the reporting entity

- Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the reporting entity, its stockholders, or its creditors

- The entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes

3. The scope of the information to be considered in a reasonable valuation is all information material to the value of the reporting entity

4. The following criteria must be met for the use of a previously calculated value to be considered reasonable:

   - The value is updated for any information available after the date of calculation that may materially affect the value of the reporting entity

   - The value is calculated no more than 12 months earlier than the date for which the value is being used

The ASU notes that "it is expected that an **independent appraisal** will often be the method used by a non-public reporting entity electing to use the practical expedient because of:

- The presumption of reasonableness associated with that method for tax purposes, and

- The requirements associated with, and limiting the availability of, other methods that achieve the presumption of reasonableness"

Note: Independent appraisals generally consist of the following:

- Market Approach—The market approach is a valuation method used to determine the appraisal value of a business, intangible asset, business ownership interest, or security by considering the market prices of comparable assets or businesses that have been sold recently or those that are still available—price-related indicators like sales, book values, and price-to-earnings are usually utilized

- Income Approach—Divides annual net operating income or annual operating cash flows by the capitalization rate. The capitalization rate is a blended rate of return on the blended capital of a business including its debt and equity components

- Asset Approach—The principal method used in the asset approach is the Adjusted Net Asset Method. This method is used to value a business on the basis of the difference between the fair market value of its assets and its liabilities

- Under this method, the assets are adjusted from book value to fair market value, and the total adjusted assets are then reduced by recorded and unrecorded liabilities

Effective Date

- The practical expedient in ASU 2021-07 is effective prospectively for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022

- Early application, including application in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of October 25, 2021

ASU 2021-08, *Accounting for Contract Assets & Contract Liabilities from Contracts with Customers* (Topic 805)

Objective

To improve the accounting for acquired revenue contracts with customers in a business combination by addressing diversity in practice and inconsistence related to the following:

- Recognition of an acquired contract liability

- Payment terms and their effect on subsequent revenue recognized by the acquirer

Background

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. The objective of the Topic 805, *Business Combinations*, is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects.

Topic 805 requires that acquisitions be recorded based on their **fair values**. Under this guidance, the acquirer in a business combination must identify and determine fair value for all identifiable assets acquired, liabilities assumed, and non-controlling interests, as well as consideration paid at the acquisition date.

Topic 606, *Revenue from Contracts with Customers*, though requires that contract assets and contract liabilities be recognized based on the revenue recognition guidance in Topic 606. A contract asset is a reporting entity's right to consideration in exchange for goods or services that the reporting entity has transferred to a customer when that right is conditioned on something other than the passage of time. A contract liability is a reporting entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer or the payment is due but the transfer has not yet been completed.

Measuring Selected Assets & Liabilities Acquired at Fair Value

In a business combination, the acquirer must consider all identifiable assets acquired and liabilities assumed, regardless of whether they are or are not included in the acquiree's financial statements. The following examples illustrate the factors that should be considered in evaluating the fair value of assets and liabilities.

- **Accounts Receivable**—In GAAP financial statements, accounts receivable are carried at cost less an allowance for credit losses. If the receivables are short-term in nature, the carrying value is not discounted for the time value of money. However, the fair value of the receivables is the price that market participants would be willing to pay for them. Market participants would typically take the following factors into consideration:

  – The creditworthiness of the debtors

  – Desired profit for entering into the transaction

  If there is a market for identical or similar receivables, then determining fair value using Level 1 or Level 2 inputs would be appropriate. If no market exists, then discounting the contractual amounts of the receivables for credit risk and profit margin using Level 3 inputs would be appropriate.

- **Finished Goods or Merchandise Inventory**—Fair value would be determined by using either a retail price to customers in a retail market or a wholesale price to retailers in a wholesale market. The price in the wholesale market would then be adjusted upwards or downwards for the condition of the merchandise, location, and the required efforts for the wholesaler to complete the sale to a retail customer. Theoretically, the two values should be the same.

- **Raw Materials or Work in Process Inventory**—Fair value would be determined by using either replacement cost or the retail selling price adjusted for the costs of completing and delivering the merchandise to the retail buyer. The latter would require both Level 2 and Level 3 inputs. The former would require Level 2 inputs. If a manufacturer were to sell in-process goods to other manufactures as raw materials or finished goods to end users, the acquirer would have to look to the principal or most advantages market available to them.

- **Machinery and Equipment**—The fair value should incorporate highest and best use in a similar business environment. The following approaches could be used to determine fair value:

  – **Market Approach**—This would be based on appraisals, including delivery and installation, when an active market for used machinery and equipment exists.

  – **Income Approach**—This could be used if the asset(s) could be used on a standalone basis or information could be obtained regarding lease terms of comparable equipment. The value would be based on estimated cash flows generated from the asset(s).

  – **Cost Approach**—This would be the delivered, installed cost of a new machine adjusted for "wear and tear."

  The acquirer would have to determine which of the three approaches—and which specific value under that approach—is most representative of the assets' fair value.

- **Land**—Again, the fair value should assume that market participants would put the land to its highest and best use. For example, assume a company holds vacant land for the purpose of future expansion of its office space, but the site could be developed for residential housing. The company has no intention of selling or developing the land.

  Under this scenario, the fair value would be based on the higher of the value of the two uses: (a) the in-use value as expanded office space, or (b) the in-exchange value, assuming it would be sold for residential development. The valuation under either scenario may require inputs from Levels 1, 2 or 3.

- **Intangible Assets in General**—Under Topic 805, all identifiable intangibles should be separately recognized when either of the following applies:

  - They arise from contractual or other legal rights, regardless of whether such rights are transferable or separable from the entity or other rights or obligations.

  - They are separable, i.e., they can be separated from the entity and sold, licensed, transferred, rented, or exchanged—either on a standalone basis or with related contracts, assets, or liabilities—regardless of any intent to do so.

  These rules are designed to ensure that intangibles that should be separately valued and recorded are not "lumped in" with goodwill.

- **Software**—Typically, generic operating software is licensed to a particular user. If the license can be transferred to a market participant or the reporting entity would continue to use it, then it would be valued at its current fair value. However, if the license cannot be transferred and the software would no longer be used by the reporting entity, it would have no value.

- **Liabilities**—A liability is valued based on what market participants would have to be paid in order to assume the liability. This value is typically determined by discounting the contractual cash stream associated with the liability. It may also include a profit margin for the assuming party.

  Additionally, the discount rate would take into consideration the credit risk of the debtor. For example, if the reporting entity has an AAA credit rating, the discount rate would be less than one with a BBB rating. Thus, if the credit rating of the acquirer differs from that of the acquiree, the fair value of the assumed debt could differ from its previous carrying value.

  In the absence of a quoted price for the identical liability in an active market, the reporting entity may measure the fair value of the liability at the amount that it would receive as proceeds if it were to issue that liability at the measurement date.

Provisions

As noted above, under current GAAP, an acquirer generally recognizes assets acquired and liabilities assumed in a business combination, including contract assets and contract liabilities arising from revenue contracts with customers, at fair value on the acquisition date. FASB has concluded that it is unclear how an acquirer should evaluate whether to recognize a contract liability (deferred revenue) from a revenue contract with a customer acquired in a business combination after Topic 606, *Revenue from Contracts with Customers*, is adopted. Additionally, it was identified that under current practice, the timing of payment of a revenue contract may subsequently affect the post-acquisition revenue recognized by the acquirer.

To address the conflicting guidance in Topic 805 and Topic 606, ASU 2021-08 requires reporting entities (acquirers) to **apply Topic 606 to measure contract assets and contract liabilities in a business combination**. This adds an exception to the fair value guidance in Topic 805.

Effective Date

- For public business entities, the amendments are effective for fiscal years beginning after December 15th, 2022, including interim periods within those fiscal years.
- For all other reporting entities, the amendments are effective for fiscal years beginning after December 15th, 2023, including interim periods within those fiscal years.
- ASU 2021-08 should be applied prospectively to business combinations occurring on or after the effective dates. Early adoption is permitted.

ASU 2021-10, *Disclosures by Business Entities About Government Assistance* (Topic 832)

Objective

To increase the transparency of government assistance including the disclosure of the types of assistance, a reporting entity's accounting for the assistance and the effect of the assistance on a reporting entity's financial statements.

Background

Requiring disclosures about government assistance in the notes to financial statements will provide comparable and transparent information to investors and other financial statement users to enable them to understand a reporting entity's financial results for future cash flows.

Provisions

ASU 2021-10 creates a new FASB Codification Topic—Topic 832, *Government Assistance*.

ASU 2021-10 requires the following annual disclosures by business entities about transactions with a government that are accounted for by applying a grant or contribution accounting model by analogy:

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

Effective Date

- ASU 2021-10 is effective for all reporting entities within the scope for financial statements issued for annual periods beginning after December 15, 2021.
- Early application is permitted.

- A reporting entity should apply ASU 2021-10 either prospectively to all transactions that are reflected in financial statements at the date of initial application and new transactions that are entered into after the date of initial application or retrospectively to those transactions.

FASB Staff Educational Paper, *Intersection of Environmental, Social & Governance Matters with Financial Accounting Standards*

Introduction

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

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

The UN World Commission on Environment and Development defines sustainability as development that meets the needs of the present without compromising the ability of future generations to meet their own needs. The Commission's focus is about promoting prosperity and economic growth (profit) while protecting the planet and people across three interconnected core elements (ESGs):

1. Environmental
2. Social
3. Governance

Environmental

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

Metrics can include:

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

Social

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

Metrics can include:

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

Governance

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

Metrics can include:

- Board oversite of high-risk issues such as climate
- Executive compensation
- Number of minority directors
- Anti-corruption programs and activities
- Tax transparency

The United States Securities & Exchange Commission (SEC)

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

1. Investors require reliable, material ESG information upon which to base investment and voting decisions
2. Issuers should directly provide material information to the market relating to ESG issues used by investors to make investment and voting decisions
3. Requiring material ESG disclosures will level the playing field among issuers

4. Ensure the flow of capital to U.S. markets and to U.S. issuers of all sizes

5. The U.S. should take the lead on disclosure of material ESG disclosures

FASB Staff Educational Paper—March 21, 2021

Purpose

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

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

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

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

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

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

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

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

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

FASB EFFECTIVE DATES

Public Companies—2022

- ASU 2021-01, *Reference Rate Reform*
- ASU 2021-04, *Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (Subtopic 815-40)*
- ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*
- ASU 2021-06, *Amendments to SEC Paragraphs Pursuant to SEC Final Rule Release No. 33-10786, Amendments to Financial Disclosures About Acquired and Disposed Businesses, and No. 33-10385, Update of Statistical Disclosures for Bank and Savings and Loan Registrants (Topics 205, 942, and 946)*
- ASU 2021-10, *Disclosures by Business Entities about Government Assistance (Topic 832)*

Non-Public Companies—2021

- ASU 2021-01, *Reference Rate Reform Scope*
- ASU 2021-02, *Franchisors—Revenue from Contracts with Customers: Practical Expedient*
- ASU 2021-04, *Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (Subtopic 815-40)*
- ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*
- ASU 2021-07, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers (Topic 805)*
- ASU 2021-09, *Discount Rate for Lessees That Are Not Public Business Entities (Topic 842)*
- ASU 2021-10, *Disclosures by Business Entities about Government Assistance (Topic 832)*

NOTES

Unit

2

Special Purpose Acquisition Companies (SPACs)

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- **Define** SPACs, including their advantages and disadvantages.
- **Identify** SEC reporting requirements for SPAC acquisitions.

INTRODUCTION

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

According to the SEC:

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

A SPAC transaction can include the following steps:

1. SPAC formation
2. Raise capital through an IPO
3. Perform search for a target company to acquire
4. Negotiate with the target company
5. SEC S-1 Filing
6. Shareholder votes

7. 8-K filing takes place

8. Acquisition (business combination) takes place

SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)

SPACs are companies formed to raise capital in an initial public offering (IPO) with the purpose of using the proceeds to acquire one or more unspecified businesses to be identified after the initial IPO.

A special purpose acquisition company (SPAC) is a shell company with no commercial operations organized to acquire one or more operating companies through a business combination. A SPAC raises capital through a public offering of its securities (IPO) to buy another company. Investors are normally private equity funds or the general public.

SPACs typically have two years to complete a business combination[1] or the funds must be returned to investors. A SPAC is sometimes referred to as a **blank check company** (Rule 419).

A blank check company (Rule 419) is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or persons, and is issuing penny stock. A SPAC is exempt from regulation as a blank check company under Rule 419 if its net tangible assets exceed $5 million.

SPACs makes no products or provides no services—its only assets are the money raised in its IPO. The money raised by a SPAC is placed in an interest-bearing trust account until the SPAC identifies a private company looking to go public through an acquisition. Once the business combination occurs, the SPAC's investors can either exchange their shares for that of the merged company or redeem the shares and receive their original investment plus interest that has accrued.

SPACs may have an acquisition target in mind but it is not disclosed to avoid the extensive disclosures required by the SEC as an IPO. Fair market value of the acquired business must exceed 80% of the SPAC's assets. In the SPAC's IPO, the SPAC typically issues to investors a share price per unit of $10 and each unit normally contains both of the following:

- A class "A" common share
- A fraction of a warrant to purchase one class "A" share at a stated exercise price

At the time of the acquisition (business combination) the SPAC changes from essentially a trust account into an operating company.

SPAC Advantages

- Primary advantage to a private company is that being acquired by a SPAC can provide a faster process with an experienced management team with more certainty as to price and terms
- Investors have limited risk because capital is kept in a trust account pending approval of the business combination by a shareholder vote

[1] https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin

- If shareholders do not approve the business combination, the capital plus interest can be returned to the investors

- There is normally no cash compensation needed to the sponsors or management team of the SPAC as a condition of the business combination

- Warrants included in the IPO to initial investors enable the investor to invest more capital at a pre-determined price and increase the investment proportionally

- An acquisition or business combination can be pre-funded

- Higher credibility to seller due to the selling price being available in the SPAC trust

- Greater ability to raise additional capital (debt or possibly private investment in the public company)

SPAC Disadvantages

- SPAC investors often are relying on the SPAC sponsors to manage the acquisition process without any clear perspective on what those acquisitions may be

- Potential shareholder dilution due to SPAC sponsors owning a 20% share of the outstanding stock of the SPAC as well as warrants held by the sponsors to purchase more shares

- Risk that more SPAC investors will redeem their shares before the SPAC acquisition leading to a potential funding shortfall

- Target companies run the risk that the acquisition may be rejected by the SPAC shareholders

- Due diligence for regulatory requirements is often not as rigorous as a traditional IPO leading to potential restatements or even business valuation errors

- SPAC sponsors have two years to find an acquisition, and due to the time constraint, may overpay for the target company

- Target acquisition company often does not have an underwriter that would address regulatory requirements

SEC CONSIDERATIONS

Formation of the SPAC:

- Initial IPO process requires the preparation and filing of Form S-1 with the SEC

- Form S-1 is an initial registration statement under the Securities Act of 1933 necessary to register the securities of a company wishing to go public

- Once approved by the SEC, the SPAC's securities can be traded on an exchange

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

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

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

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

- Amendments to Articles of Incorporation or Bylaws

- Change in Shell Company Status

- Financial Statements and Exhibits including proforma financial information

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

- 10-Qs quarterly

- 10-Ks annually

- Including internal control over financial reporting

On January 11, 2022, the SEC warned that SPACs can't put disclaimers in their financial statements that their financial reporting could run afoul of the U.S, accounting rules. Some SPACs have been issuing broad disclaimers that long-standing SPAC accounting practices could change and lead to future errors. In other words, "accepted practice" may not be the same as U.S. GAAP.

Unit

3

AICPA Update—Audit Engagements

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- **Identify** and describe recently issued SASs (Audit Standards).

INTRODUCTION

Auditing standards have gone through significant changes and updates during the past few years. Starting with SAS 134 through SAS 141 (May 2019 through April 2020), the Auditing Standards Board (ASB) has changed the nature of the auditor's report to reflect both management's and the auditor's responsibilities as well as the overall nature of the audit. This Update includes recently issued audit standards, SAS 142 through SAS 145.

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

PEER REVIEW ISSUES

For peer review, **risk-based auditing** is a continuing issue that needs to be reviewed by firms, especially in light of the significant changes made by the auditing standards issued in 2019/2020, and 2021 (SASs 134, 135, 136, 137, 138, 139, 140, 141, 142, 143, 144, 145). The risk assessment model is not replaced, rather it is enhanced and more robust with more required proceeds, documentation, and changes in definitions of what will constitute a presumed risk that must be addressed.

The Auditing Standards Board (ASB) revised its risk assessment model in 2006. The eight audit risk standards, SAS Nos. 104–111, were prepared in response to the conclusions of the Joint Risk Assessments Task Force of the ASB, the International Auditing and Assurance Standards Board (IASB), and the recommendations of the August 2000 report of the Panel on Audit Effectiveness of the Public Oversight Board. SAS 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, issued in October 2021 is another attempt to emphasize the importance of performing risk-based audits in today's complex audit environment.

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

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

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

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

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

1. Obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether due to error or fraud, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;

2. Report on the financial statements, or otherwise, as required by the SASs, in accordance with the auditor's findings, outlined in AU-C 315, Understanding the Entity and Its Environment and Assessing Risks of Material Misstatements, throughout the conduct of the audit.

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

1. Perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. These procedures include:

   – 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

   – 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

   – 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:

   In reviewing peer review reports over the last 11 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[2]:

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

10. The **five most common risk assessment problems** according to state societies' professional and technical standards personnel include:

    1. Improper use of third-party practice aids—defaulting to a basic set of procedures without assessing risk and assessing risk at the financial statement level rather than at the financial assertion level

    2. Defaulting to high control risk without adequately assessing and documenting the internal control or control risks

    3. Reducing control risks to less than high without testing internal controls

    4. Not identifying a significant risk in areas such as revenue recognition or other material non-routine transactions that require significant professional judgment

    5. Not linking risk assessment and audit response and not tailoring programs to the unique risks identified at the client

11. In the current **coronavirus environment**, heightened audit risks include:

    - Internal control
    - Fraud risks
    - Non-compliance with laws and regulations
    - Accounting estimates

[2] Laura Hay, "Risk Assessment Matters Demystified," *CPA Voice*, October 3, 2018, https://ohiocpa.com/for-the-public/news/2018/10/03/risk-assessment-matters-demystified#:~:text=Forty%20percent%20of%20risk%20assessment,and%20skip%20assessment%20of%20risk.

- Going concern
- Subsequent events

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 **2021-2022 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

SAS 142, *AUDIT EVIDENCE*

Objective

SAS 142 addresses the evolving nature of business and audit services and issues that have arisen since AU-C Section 500, *Audit Evidence*, was originally issued. The issues arising include the use of emerging technologies by both preparers and auditors, the application of professional skepticism, the expanding sources of information to be used as audit evidence, and more broadly, the accuracy, completeness, relevance, and reliability of audit evidence. SAS 142 brings audit evidence into a more current perspective modernizing the guidance for today's and tomorrow's audits.

Prior audit evidence guidance was very focused on paper-based documents and audit evidence that auditors would obtain directly from their clients. Today, there are many different forms of evidence that are available including third-party sources and other external information sources.

The objective of the auditor is to evaluate information to be used as audit evidence including the results of audit procedures to inform the auditor's overall conclusion about whether sufficient appropriate audit evidence has been obtained.

Provisions

Audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. **Audit evidence** is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements. Audit evidence is the result of performing audit procedures as follows:

- Tests of controls
- Risk assessment procedures
- Substantive audit procedures

Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement and the quality of audit evidence obtained.

Appropriateness of audit evidence is the measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based.

SAS 142 is a documentation standard rather than a performance standard. For example, SAS 142 expands the objective of prior guidance to be more broadly focused on considering the attributes of information to be used as audit evidence in assessing whether sufficient appropriate audit evidence has been obtained. Prior audit evidence guidance focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence rather than evaluating the sufficiency and appropriateness of the audit evidence obtained.

This change above is accomplished by establishing attributes of information to be used as audit evidence when evaluating whether sufficient and appropriate audit evidence has been obtained by the auditor. The reliability of information to be used as audit evidence is affected to varying degrees by the following attributes, individually or in combination:

- Accuracy
- Completeness
- Authenticity
- Susceptibility to bias

When evaluating information to be used as audit evidence:

1. The auditor should evaluate information to be used as audit evidence by considering:
   - The relevance and reliability of the information, including its source, and
   - Whether such information corroborates or contradicts assertions in the financial statements
2. The auditor's evaluation of the information to be used as audit evidence in accordance with the above should include:
   - Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes, and
   - Obtaining audit evidence about the accuracy and completeness of the information, as necessary

Finally, SAS 142 states that an auditor may use automated tools and techniques to perform both a risk assessment procedure and a substantive procedure concurrently if the objectives of both types of procedures are achieved. The following exhibit, taken directly from SAS 142, illustrates this approach.

Exhibit

A69.

Exhibit A—Using ADAs to Simultaneously Accomplish Multiple Audit Procedures (Ref: par. A46 and par. A61)

This exhibit illustrates the use of an audit data analytic (ADA) that simultaneously accomplishes the objectives of both risk assessment and substantive audit procedures.

Background

The fact pattern in this example, in which the auditor uses a revenue transaction scoring model, will focus on the audit of an entity that recognizes revenue when control of the product (or satisfaction of the performance obligation) transfers at a specific point in time,3 such as a manufacturer of external data storage devices.

For purposes of this example, assume the following:

- Revenue was determined to be a material account during initial planning and scoping with the occurrence (including cut-off) and accuracy assertions being more susceptible to misstatement.
- The ADA was performed after initial planning and scoping as part of the ongoing and iterative risk assessment process.
- All transactions within the account were subject to the same processes and controls.
- The purpose of the ADA was to design the nature, timing, and extent of the audit procedures and to obtain audit evidence.
- Based on the understanding of controls, the auditor has concluded that the controls over revenue were effectively designed and have been implemented, the auditor has tested certain relevant controls and determined they are operating effectively, and the auditor is otherwise satisfied the entity has appropriately applied the requirements of the applicable financial reporting framework (for example, FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*).
- Data used in the ADA are relevant and reliable and have been tested for accuracy and completeness.
- Customers tend to purchase consistent quantities throughout the year, with the exception of purchases just prior to major retail holidays, such as Memorial Day, Black Friday, and Christmas.
- Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.

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

- The customer base does not fluctuate significantly from period to period.
- Revenue is recognized when control transfers at a free-on-board (FOB) shipping point.
- Invoicing occurs the day the product ships from the entity's warehouse.
- Warehouse personnel typically do not work weekends.
- The company does not sell product to any related parties.

All items that are determined to be individually material were excluded from the ADA and substantively tested separately. The remaining population that was subject to the ADA comprised routine, non-complex transactions with third parties. The processing and recording of transactions are highly automated and less likely to be susceptible to management override.

Description of the ADA

ADA Scoring Model—A complete population of transactions (at the individual item level) for one material account (excluding individually significant items) was subjected to an ADA designed to identify and assess risk and obtain audit evidence specific to a relevant assertion using different routines. The scoring of each routine is based on the evidence expected to be provided by that routine in relation to the auditor's assessment of the risks of material misstatement. The routines were as follows:

Routine	Description	Characteristic	Transaction Scoring Model	Risk Score	Relevant Fact Pattern
1	Identify customers with infrequent revenue activity (less than X transactions)	Volume	Less than 6 transactions	2	Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
			6–12 transactions	1	Some customers only purchase in bulk a few times a year, whereas others purchase smaller quantities one to two times a month.
			More than 12 transactions	0	
2	Identify customers with a significant fluctuation in volume of products purchased (item level) on a period-over-period basis	Volume	Greater than 70% variance	2	Customers tend to purchase consistent quantities throughout the year, with the exception of purchases just prior to major retail holidays, such as Memorial Day, Black Friday, and Christmas.
			30% to 70% variance	1	Some customers only purchase in bulk a few times a year, but most customers consistently purchase quantities one to two times a month.
			Less than 30% variance	0	
3	Identify activity for new customers	Volume	Customer for 6 months or less	1	The customer base does not fluctuate significantly from period to period.
			Customer for greater than 6 months	0	
4	Identify all transactions recorded within X days of quarter-end.	Timing	Within 3 days of quarter end	1	Revenue is recognized when control transfers at FOB shipping point.
			Greater than 3 days of quarter end	0	
5	Identify revenue transactions with an invoice date on	Timing	Transaction on a	2	Invoicing occurs the day the product ships from the company’s warehouse.

Routine	Description	Characteristic	Transaction Scoring Model	Risk Score	Relevant Fact Pattern
	an unusual date (for example, weekend or holiday)		weekend/ holiday		Warehouse personnel typically do not work weekends.
			Transaction on a weekday	0	
6	Identify instances in which the shipping document date and invoice date do not match.	Timing	Invoice and shipping document do not match, and invoice date is before shipping date.	4	Revenue is recognized when control transfers at FOB shipping point.
			Invoice and shipping document do not match, and shipping date is before invoice date.	2	Invoicing occurs the day the product ships from the company's warehouse.
			Invoice and shipping document match.	0	

Running the revenue transaction level detail through the ADA routines produces a total score for each transaction. The auditor then groups each transaction into a sub-population based on the individual transaction score. The number of sub-populations may differ depending upon the type of ADA developed, the scores produced by the ADA, and the auditor's assessment of those scores. For purposes of this example, the auditor grouped the population of the account into sub-populations as follows:

Assessed Risk	Total Risk Score	Group
High risk	8–12	A
Moderate risk	4–7	B
Low risk	0–3	C

- Group A—High risk—Comprises items with characteristics deemed to present a higher risk of material misstatement.

Approach—The auditor would perform additional substantive procedures to provide more persuasive audit evidence for the items identified by the ADA. For example, the nature of the substantive procedure may be confirmation as opposed to inspection; the extent of testing may be greater (larger proportionate sample size); or the timing of the procedure may be at or near the financial statement date as opposed to earlier in the period.

- Group B—Moderate risk—Comprises items that warrant further procedures but do not have characteristics of those in the higher risk group.

Approach—The auditor would perform substantive procedures appropriate for the items identified by the ADA in less depth relative to the higher risk population. For example, the nature of the substantive procedure may be limited to inspection of documents and records; the extent of testing may be less (smaller proportionate sample size); and the timing of the procedure may be earlier in the period.

- Group C—Low risk—Comprises items that demonstrate no unusual characteristics based on the procedure performed using the ADA.

Approach—The results of other audit procedures performed throughout the audit would be evaluated for contradictory information regarding the assessed risk of material misstatement.

In the absence of contradictory information, as the routines of the ADA are sufficiently precise for the auditor to conclude that the risks of material misstatement have been addressed, no additional substantive procedures may be warranted for any reason other than to incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year.

As a result of the previous procedures, the auditor concluded:

- Groups A, B, and C comprise a material account in the aggregate for which each group has differing risks.

- for Group C, the audit evidence provided over the transactions (within the population analyzed by the ADA in combination with the audit evidence provided by testing of certain key controls over revenue as determined by the auditor and the absence of contradictory audit evidence from the testing of related accounts) was sufficiently persuasive for the auditor to conclude that the risk of material misstatement was addressed.

- for Groups A and B, the audit evidence provided by the ADA was not sufficiently persuasive, and further substantive procedures were required to address the risk of material misstatement.

SAS 143, *AUDITING ACCOUNTING ESTIMATES & RELATED DISCLOSURES*

Objective

SAS 143 is intended to enable auditors to appropriately address the increasingly complex scenarios that arise today from new accounting standards that include estimates and related disclosures, and to enhance the auditor's focus on factors driving estimation uncertainty and potential management bias. In the current environment, management's estimates related to asset impairments are particularly important and SAS 143 will aid auditor's in assessing management's estimates during a period of economic uncertainty and volatility.

The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable, in the context of the applicable financial reporting framework.

SAS 143 supersedes AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

Definitions

- Accounting estimate—A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty

- Auditor's point estimate or auditor's range—An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate

- Estimation uncertainty—Susceptibility to an inherent lack of precision in measurement

- Management bias—A lack of neutrality by management in the preparation of information

Provisions

SAS 143 requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated. For the purposes of SAS

143, “reasonable,” in the context of the applicable financial reporting framework, means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address the following:

- The development of the accounting estimate, including the selection of the method, assumptions, and data in view of the nature of the accounting estimate and the facts and circumstances of the reporting entity
- The selection of management’s point estimate
- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty

Examples of Accounting Estimates

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of infrastructure assets, such as buildings and roadways
- Valuation of financial instruments
- Outcome of pending litigation
- Provision for expected credit losses
- Valuation of insurance contract liabilities
- Warranty obligations
- Employee retirement benefits liabilities
- Share-based payments
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Non-monetary exchanges of assets or liabilities between independent parties
- Revenue recognized for long-term contracts

Guidance

- Explains the nature of accounting estimates and the concept of estimation uncertainty
- Provides information about scalability of the SAS for all types of accounting estimates, from those that are relatively simple to those that are complex

- Requires a separate assessment of inherent risk and control risk at the assertion level
- Includes an enhanced risk assessment model intended to address the challenges auditors face when auditing accounting estimates by providing risk assessment requirements that are more specific to estimates and addresses the increasingly complex business environment and complexity in financial reporting frameworks
- Emphasizes that the auditor's further audit procedures need to be responsive to the reasons for the assessed risks of material misstatement at the relevant assertion level
- Refers to relevant requirements in other AU-C sections and provides related guidance to emphasize the importance of the auditor's decisions about internal controls relating to accounting estimates
- Addresses the exercise of professional skepticism when auditing accounting estimates
- Requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework

Documentation

- Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates
- The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the relevant assertion level, considering the reasons given to the assessment of those risks
- The auditor's responses when management has not taken appropriate steps to understand and address estimation uncertainty
- Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph
- Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated

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

Introduction

SAS 144 makes changes to three existing audit standards:

1. AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*

2. AU-C 540, *Auditing Accounting Estimates and Related Disclosures*

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

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

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

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*

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

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

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

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

AU-C 540, *Auditing Accounting Estimates & Related Disclosures*

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

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

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

1. Agreement on the respective roles and responsibilities of the auditor and the auditor's specialist may include the degree of responsibility of the auditor's specialist for the following:

    a. Testing of source data, for example, testing data produced by the reporting entity, or evaluating the relevance and reliability of data from sources external to the entity

    b. Evaluating the significant assumptions used by the reporting entity or management's specialist, or developing the auditor's specialist's own assumptions

c. Evaluating the methods used by the reporting entity or management's specialist, or using the auditor's specialist's own methods

2. Examples of situations in which the auditor may conclude that the work of the auditor's specialist is not adequate for the auditor's purposes include the following:

   a. The specialist's use of data or significant assumptions was not based on consideration of relevant information available to the specialist

   b. The methods used by the specialist were not appropriate

   c. The specialist's work was not performed in accordance with the auditor's instructions

   d. The specialist's findings and conclusions are inconsistent with other information available to the auditor

   e. The specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work

Effective Date

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

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

Introduction

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

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

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

SAS 145 amends the following previously issued audit standards:

- SAS 122, *Statements on Auditing Standards: Clarification and Recodification*
- SAS 126, *Using the Work of Internal Auditors*
- SAS 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated with the Audit of Financial Statements*

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

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

- SAS 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*

- SAS 142, *Audit Evidence*

- SAS 143, *Auditing Accounting Estimates and Related Disclosures*

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

- Understanding the reporting entity's system of internal control, in particular, relating to the auditor's work effort to obtain the necessary understanding

- Modernizing the standard in relation to IT considerations, including addressing risks arising from a reporting entity's use of IT

- Determining risks of material misstatement, including significant risks

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

Objective

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

Assessing the Risks of Material Misstatement

Risk-based auditing is a continuing issue that needs to be reviewed by firms. The risk assessment model is not replaced in SAS 145, rather it is enhanced and more robust with more required proceeds, documentation, and changes in definitions of what will constitute a presumed risk that must be addressed.

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

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

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

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

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

The **risk assessment process** consists of the following activities:

1. Perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. These procedures include:

    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, the applicable financial reporting framework, and internal controls relevant to the audit. "Understanding" internal control relevant to the audit means understanding the design of the systems of controls, and whether the controls have been implemented (D&I). Performing walkthroughs of significant accounting processes by tracing transactions through accounting process steps from the initiation of a transaction through its posting to the appropriate general ledger accounts confirms that controls are implemented as designed.

4. Identify the risk of material misstatement due to fraud or error at both the financial statement and relevant assertion levels (i.e., assertion risks). Revisions to this risk assessment should be made during the course of the audit where additional audit evidence, or new information

obtained, produces inconsistencies with the audit evidence upon which the auditor originally based the assessment.

5. Identify the accounting processes that include assertion risks

6. Identify the key controls within the accounting processes

7. Assess the risk of material misstatement identified as high, moderate, or low. Ensure that significant and fraud risks are identified.

8. Develop tailored audit procedures linked to the risks of material misstatement identified. Note that this is a critical step in the audit planning process, which is necessary to reduce these risks.

9. Document key aspects of the risk assessment process including:

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

   b. Key elements associated with obtaining an understanding of the audit client, its environment, internal control components, sources from which the understanding was obtained, and the risk assessment procedures performed;

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

   d. Risks and controls related to those risks that require special audit consideration (i.e., fraud risk, risks associated with significant related party transactions, economic and accounting matters, etc.).

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

SAS 145 Definitions

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

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

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

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

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

– Procedures are actions to implement policies.

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

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

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

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

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

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

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

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

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

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

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

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

Provisions

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

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

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

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

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

   - The reporting entity

   - The entity's environment

   - The applicable financial reporting framework

   - The entity's system of internal control

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

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

   - Industry, regulatory, and other external factors

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

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

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

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

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

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

   - Controls over journal entries and other adjustments

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

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

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

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

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

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

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

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

Documentation

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

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

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

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

Effective Date

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

Unit

4

AICPA Update—Attestation & Review Engagements

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- **Identify** and **describe** recently issued SSAEs (attestation standards).
- **Apply** SSARs requirements found in recently issued SSARs 25, Materiality in a Review of Financial Statements and Adverse Conclusions to accounting and review service issues such as engagement terms, independence, reporting, and documentation.

INTRODUCTION

Both attestation standards and review standards have had significant changes take place during the past couple of years. SSAEs have become more relevant to the needs of companies and their auditors and review engagements have been updated and reporting outcomes changed more significantly than at any time since review engagements were initially developed in 1978. This section identifies these changes and discusses the use of these newly updated standards.

ATTESTATION ENGAGEMENTS

An attestation engagement is an examination, review, or agreed-upon procedures engagement performed under the attestation standards related to subject matter or an assertion that is the responsibility of another party. The following are the three types of attestation engagements:

1. **Examination Engagement**—An attestation engagement in which the practitioner obtains reasonable assurance by obtaining sufficient appropriate evidence about the measurement or evaluation of subject matter against criteria in order to be able to draw reasonable conclusions on which to base the practitioner's opinion about whether the subject matter is in accordance with (or based on) the criteria or the assertion in order for it to be fairly stated, in all material respects.

2. **Review Engagement**—An attestation engagement in which the practitioner obtains limited assurance by obtaining sufficient appropriate review evidence about the measurement or evaluation of subject matter against criteria in order to express a conclusion about whether any

material modification should be made to the subject matter in order for it to be in accordance with (or based on) the criteria or the assertion in order for it to be fairly stated.

3. **Agreed-Upon Procedures Engagement**—An attestation engagement in which a practitioner performs specific procedures on subject matter or an assertion and reports the findings without providing an opinion or a conclusion.

The **objectives** of the practitioner when performing attestation engagements includes:

- Apply the requirements relevant to the attestation engagement
- In an examination engagement, report on the subject matter or conclusion with an opinion
- In a review engagement, report on the subject matter or assertion with a conclusion
- In an agreed-upon procedures engagement, report on the procedures performed and related findings without providing an opinion or conclusion on the subject matter
- Communicate as required by the applicable AT-C section, in accordance with the results of the practitioner's procedures
- Implement quality control procedures at the engagement level that provide the practitioner with reasonable assurance that the attestation engagement complies with professional standards and applicable legal and regulatory requirements

SSAE 20, *AMENDMENTS TO THE DESCRIPTION OF THE CONCEPT OF MATERIALITY*

Objective

SSAE 20 aligns the materiality definition with the description of materiality used in the U.S. judicial system, the auditing standards of the PCAOB, the SEC, and the FASB. The ASB believes it is in the public interest to eliminate inconsistencies between the AICPA *Professional Standards* and the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators.

Provisions

The Auditing Standards Board issued Statement on Standards for Attestation Engagements No. 20, *Amendments to the Description of the Concept of Materiality* in December 2019. While the concept of materiality is not new, the standard clarifies and provides additional guidance related to the consideration of materiality in attestation engagements.

Specifically, SSAE No. 20 amends Statement on Standards for Attestation Engagements (SSAE) No. 18 in two areas:

1. AT-C Section 205—*Examination Engagements*

2. AT-C Section 210—*Review Engagements*

Materiality is defined in SSAE 20 as:

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

AT-C Section 205 for *Examinations Engagements* is amended to consider misstatements (including omissions) are to be **material** if there is a substantial likelihood that either individually, or in the aggregate, the misstatement would influence the judgement of the user.

For purposes of determining **materiality**, the accountant may assume that intended users:

- Have reasonable knowledge and use reasonable diligence about the subject matter.
- Understand that the concept of appropriate levels of materiality has been applied about the subject matter.
- Understand that there are inherent uncertainties in measuring or evaluating the subject matter.
- Make reasonable judgments based on the subject matter.

AT-C Section 210 for *Review Engagements* has been amended for the same terminology of "substantial likelihood," "judgement," and "for purposes of determining materiality" as AT-C Section 205 for *Examination Engagements*.

SSAE 21, *DIRECT EXAMINATION ENGAGEMENTS*

Objective

SSAE 21 enables practitioners to perform an examination engagement in which the practitioner obtains reasonable assurance by measuring or evaluating underlying subject matter against criteria and expressing an opinion that conveys the results of that measurement or evaluation.

Definitions

- Assertion-Based Examination Engagement—An attestation engagement in which the practitioner obtains reasonable assurance by obtaining sufficient appropriate evidence about the responsible party's measurement or evaluation of the underlying subject matter against criteria in order to be able to draw reasonable conclusions on which to base the practitioner's opinion about whether the subject matter is in accordance with (or based on) the criteria or the responsible party's assertion is fairly stated, in all material respects

- Direct Examination Engagement—An attestation engagement in which the practitioner obtains reasonable assurance by measuring or evaluating the underlying subject matter against the criteria and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of that measurement or evaluation. In a direct examination engagement, the responsible party does not provide an assertion

- Underlying Subject Matter—In an examination engagement, the phenomenon that is measured or evaluated by applying criteria

- Subject Matter Information—The outcome of the measurement or evaluation of the underlying subject matter against criteria. An assertion about whether the underlying subject matter is in accordance with the criteria is a form of subject matter information

- Responsible Party—The party(ies) responsible for the underlying subject matter, which is a party other than the practitioner. In an assertion-based examination if the nature of the underlying subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the underlying subject matter may be deemed to be the responsible party

Provisions

SSAE 21 is organized in two sections:

1. Section 205, Assertion-Based Examination Engagements

2. Section 206, Direct Examination Engagements

Section 205—Assertion-Based Examination Engagement

When performing an assertion-based examination engagement the engagement provides reasonable assurance about whether the subject matter or an assertion about the subject matter is free from material misstatement, whether due to error or fraud. To obtain reasonable assurance, the practitioner should:

- Obtain an assertion from the responsible party

- Plan the work and properly supervise other members of the engagement team

- Identify and assess the risks of material misstatement, whether due to error or fraud, based on an understanding of the subject matter, its measurement or evaluation, the criteria, and other engagement circumstances

- Obtain sufficient appropriate evidence about whether material misstatements exists by designing and implementing appropriate responses to the assessed risks

- Examination procedures may involve inspection, observation, analysis, inquiry, reperformance, recalculation, or confirmation with outside parties

Section 206—Direct Examination Engagement

When performing a direct examination engagement, the practitioner would evaluate whether the underlying subject matter meets the stated criteria and perform other procedures to obtain sufficient appropriate evidence to provide an opinion on the results of that evaluation. In this engagement, the responsible party would make no assertions. To obtain reasonable assurance, the practitioner would:

- Ensure that the responsible party acknowledges its responsibility for the underlying subject matter

- Perform applicable procedures such as planning, risk assessment, materiality considerations, tests of controls, analytical procedures, test of estimates, sampling, evaluation of fraud risk, evaluation of compliance with laws and regulations, using specialist and the work of internal auditors, and considering subsequent events

- Also perform applicable procedures involving the terms of engagement, written representations, and the content of the report

The practitioner must be independent of the underling subject matter.

Effective Date

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

EXAMPLE 1—ASSERTION-BASED EXAMINATION REPORT

Practitioner's Assertion-Based Examination Report on Subject Matter; Unmodified Opinion

The following is an illustrative practitioner's report for an assertion-based examination engagement in which the practitioner has examined the subject matter and is reporting on the subject matter.

Independent Accountant's Report

[Appropriate Addressee]

We have examined [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company's management is responsible for [***identify the subject matter, for example, presenting the schedule of investment returns***] in accordance with (or based on) [***identify the criteria, for example, the ABC criteria set forth in Note 1***].

Our responsibility is to express an opinion on [***identify the subject matter, for example, the schedule of investment returns***] based on our examination. Our examination was conducted in accordance with attestation standards established by the AICPA. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether [identify the subject matter, for example, the schedule of investment returns] is in accordance with (or based on) the criteria, in all material respects. An examination involves performing procedures to obtain evidence about [***identify the subject matter, for example, the schedule of investment returns***]. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of [identify the subject matter, for example, the schedule of investment returns], whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

We are required to be independent and to meet our other ethical responsibilities in accordance with relevant ethical requirements relating to the engagement.

[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]

[Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]

In our opinion, [identify the subject matter, for example, the schedule of investment returns of XYZ Company for the year ended December 31, 20XX, or the schedule of investment returns referred to above], is presented in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.

[Practitioner's signature]

[Practitioner's city and state]

[Date of practitioner's report]

EXAMPLE 2—DIRECT EXAMINATION REPORT

Circumstances include the following:

The practitioner was engaged to measure the rates of return (subject matter information) on XYZ Company's investment transactions during the year ended December 31, 20XX (the underlying subject matter) based on specified criteria and present the rates of return on the investment transactions in a schedule of investment returns (subject matter information).

Independent Accountant's Report

[Appropriate Addressee]

We have examined [identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX]. XYZ Company's management is responsible for [identify the underlying subject matter, for example, its investment transactions during the year ended December 31, 20XX] and maintaining a record of those transactions. Our responsibility is to obtain reasonable assurance by measuring (or evaluating) [identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX] against [identify the criteria, for example, the ABC criteria set forth in Note 1 of the accompanying schedule of investment returns] to determine [identify the subject matter information, for example, the rates of return on those investment transactions] and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of our measurement (or evaluation) based on our examination. We have presented the results of our measurement in the accompanying schedule of investment returns.

Our examination was conducted in accordance with the attestation standards for a direct examination engagement established by the AICPA. Those standards require that we obtain reasonable assurance by measuring (or evaluating) [***identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX***] against [identify the criteria, for example, the ABC criteria set forth in Note 1 of the accompanying schedule of investment returns] and performing other procedures to obtain sufficient appropriate evidence to express an opinion that conveys the results of our measurement or evaluation of [***identify the underlying subject matter, for example, the investment transactions of XYZ Company during the year ended December 31, 20XX***]. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of [***identify the subject matter information, for example, the rates of return on those investment transactions for the year ended December 31, 20XX, as presented in the schedule of investment returns***], whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

We are required to be independent of [***identify the responsible party, for example, XYZ Company***] and to meet our other ethical responsibilities, in accordance with relevant ethical requirements relating to our examination engagement. [***Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the underlying subject matter against the criteria.***] [***Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement, the underlying subject matter, or the subject matter information.***]

In our opinion, [identify the subject matter information, for example, the rates of return on the investment transactions of XYZ Company during the year ended December 31, 20XX included in the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], are fairly presented in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.

[Signature of the practitioner's firm]

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

[Date of the practitioner's report]

SSAE 22, *REVIEW ENGAGEMENTS*

Objective

SSAE 22 describes the types of procedures a practitioner may perform in a review engagement. SSAE 22 also:

- Clarifies for practitioners that the objective of a review engagement is to obtain limited assurance
- Results in more transparent reporting by requiring that the practitioner disclose in a review report the procedures performed to obtain limited assurance
- Allows the practitioner to issue a report containing an adverse review conclusion when the subject matter is materially and pervasively misstated

Provisions

Based on the practitioner's understanding of the subject matter and other engagement circumstances, the practitioner is required to identify areas in which a material misstatement of the subject matter is likely to arise and design and perform procedures to address such areas to obtain limited assurance to support the conclusion in the practitioner's report.

While review evidence obtained through the performance of inquiry and analytical procedures will ordinarily provide the practitioner with a reasonable basis for obtaining limited assurance, analytical procedures may not be possible when the subject matter is qualitative, rather than quantitative. Additionally, analytical procedures may not provide sufficient appropriate review evidence if an expectation cannot be developed. Therefore, the practitioner may determine that other procedures are more effective or efficient to obtain limited assurance. While inquiry procedures are required, in addition to inquiry, SSAE No. 22 provides the following examples of procedures to obtain review evidence:

- Analytical procedures
- Inspection
- Observation
- Confirmation

- Recalculation
- Reperformance

SSAE No. 22 includes a requirement that the practitioner's review report include a description of the work performed as a basis for the practitioner's conclusion. Such description helps the users of the practitioner's report understand the basis for the practitioner's conclusion. The description may be as brief as "the procedures we performed were based on or professional judgment and consisted primarily of analytical procedures and inquiries" or may be more detailed.

SSAE No. 22 requires the practitioner to express an adverse conclusion when the practitioner, having obtained sufficient appropriate review evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the subject matter.

In a review engagement, the practitioner providers a conclusion about whether the practitioner was aware of any material modification that should be made to the subject matter in order for the subject matter to be in accordance with (or based on) the criteria or to an assertion about the subject matter in order for it to be fairly stated. To obtain limited assurance in a review engagement, the practitioner should do the following:

- Obtain an assertion from the responsible party
- Plan the work and properly supervise other members of the engagement team
- Focus procedures in areas where the practitioner believes increased risks of misstatements exist, whether due to error or fraud, based on the practitioner's understanding of the subject matter, its measurement or evaluation, the criteria, and other engagement circumstances
- Obtain review evidence, through the application of inquiry and analytical procedures or other appropriate procedures to obtain limited assurance that no material modifications should be made to the subject matter in order for it to be in accordance with) or based on) the criteria
- A review engagement would normally test fewer transactions or subject matter than that in an assertion-based or direct examination engagement

Effective Date

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

EXAMPLE 3: PRACTITIONER'S REVIEW REPORT ON SUBJECT MATTER; UNMODIFIED CONCLUSION

The following is an illustrative practitioner's review report in which the practitioner has reviewed the subject matter and is reporting on the subject matter.

Independent Accountant's Report

[Appropriate Addressee]

We have reviewed [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company's management is responsible for [identify the subject matter, for example, presenting the schedule of investment returns] in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1]. Our responsibility is to express a conclusion on [identify the subject matter, for example, the schedule of investment returns] based on our review.

Our review was conducted in accordance with attestation standards established by the AICPA. Those standards require that we plan and perform the review to obtain limited assurance about whether any material modifications should be made to [***identify the subject matter, for example, the schedule of investment returns***] in order for it to be in accordance with (or based on) the criteria. The procedures performed in a review vary in nature and timing from and are substantially less in extent than, an examination, the objective of which is to obtain reasonable assurance about whether [***identify the subject matter, for example, the schedule of investment returns***] is in accordance with (or based on) the criteria, in all material respects, in order to express an opinion. Accordingly, we do not express such an opinion. Because of the limited nature of the engagement, the level of assurance obtained in a review is substantially lower than the assurance that would have been obtained had an examination been performed. We believe that the review evidence obtained is sufficient and appropriate to provide a reasonable basis for our conclusion.

We are required to be independent and to meet our other ethical responsibilities in accordance with relevant ethical requirements related to the engagement.

[Include a description of the work performed as a basis for the practitioner's conclusion.]

[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]

[Additional paragraphs may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]

Based on our review, we are not aware of any material modifications that should be made to [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], in order for it be in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1].

[Practitioner's signature]

[Practitioner's city and state]

[Date of practitioner's report]

SSARS REVIEW ENGAGEMENTS

Introduction

The Accounting and Review Services Committee (ARSC) of the AICPA issues Standards for Accounting and Review Services (SSARS). In 2014, ARSC made significant changes to the SSARs literature with the issuance of SSARs 21, *Clarification and Recodification*. SSARS 21 provided guidance in four areas:

- AR-C Section 60, General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services
- AR-C Section 70, Preparation of Financial Statements

- AR-C Section 80, Compilation Engagements
- AR-C Section 90, Review of Financial Statements

The major changes to SSARS engagements made by SSARS 21 include:

- Incorporates the AICPA Clarity Drafting Conventions, similar to those previously applied to auditing standards
- Introduces a new level of service called preparation. This is a non-attest service where the accountant prepares, but does not report or provide any assurance on the financial statements
- Includes revisions to the compilation and review standards, mostly affecting reports and engagement letters
- Management-use-only compilation engagement has been eliminated, so that all compilation engagements will include a report
- Revises guidance on the circumstances that determine the type of service provided. The type of service is dependent on what the accountant was engaged to do
- Requires a signed engagement letter for all engagements covered by SSARS 21, including preparation engagements

Subsequent to the issuance of SSARS 21, the ARSC continued with additional clarifications as amendments to the SSARS literature with the issuance of:

- SSARS 22, *Compilation of Pro Forma Financial Information*, effective for compilation reports on pro forma financial information dated on or after May 1, 2017
- SSARS 23, *Omnibus Statement on Standards for Accounting and Review Services—2016*, generally effective upon issuance
- SSARS 24, *Omnibus Statement on Standards for Accounting and Review Services—2018*, generally effective for compilations and reviews of financial statements for periods ending on or after June 15, 2019

SSARS 21 through SSARS 24 have been covered in previous Kaplan FASB and AICPA Update programs, but due to the amendments to SSARS 21 by SSARS 25 in February 2020, we thought it would be useful to identify all the SSARs statements issued as part of this clarification and recodification initiative.

SSARS 25, *MATERIALITY IN A REVIEW OF FINANCIAL STATEMENTS & 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 statements 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:

- Obtain limited assurance, primarily by performing analytical procedures and inquiries, as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework.

- Report on the financial statements as a whole and communicate, as required by AR-C 90.

The accountant should **inquire** of members of management who have responsibility for financial and accounting matters concerning the financial statements, and **others within the reporting entity**, as appropriate, related to whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied, including how management determined that significant accounting estimates are reasonable in the circumstances.

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:

1. 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.

2. 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.

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

4. Describe the nature of omitted information if the material misstatement relates to the non-disclosure of information required to be disclosed. The accountant should include the omitted disclosures when practicable to do so.

Note: An adverse conclusion relating to a specific matter described in the basis for modification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the accountant's conclusion. In instances in which other identified matters would have otherwise required a modification of the accountant's conclusion, the disclosure of such other matters of which the accountant is aware may be relevant to users of the financial statements.

Consideration of the Applicable Financial Reporting Framework in Relation to the Financial Statements

In forming the conclusion on the financial statements, the accountant should do the following:

- Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

- Consider whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:

  - The terminology used in the financial statements, including the title of each financial statement, is appropriate;

  - The financial statements adequately disclose the significant accounting policies selected and applied;

  - The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

  - Accounting estimates made by management appear reasonable;

  - The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and

  - The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements.

The accountant should consider the impact of the following:

- Uncorrected misstatements identified during the review, and in the previous year's review of the entity's financial statements, on the financial statements as a whole

- Qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments

The accountant's consideration should also include the following:

- The overall presentation, structure, and content of the financial statements

- Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation

Review Documentation

The extent and type of documentation in a review file is a matter of professional judgment. However, verbal explanations in and of themselves are not sufficient to support the work performed or the conclusions reached. The documentation should be sufficient to demonstrate the work performed. Documentation provides evidence that their review was performed in accordance with professional standards and supports the accountant's conclusion. This should include (review) evidence of:

- The nature, timing, extent, and results of the work performed such as inquiry, analytical, or other procedures;

- The review evidence obtained from the review procedures performed and the accountant's conclusion formed on the basis of that review evidence;

- The source of the review evidence; and

- Significant matters arising during the review, the accountant's conclusions reached, and significant professional judgments made in reaching those conclusions.

An accountant can include any additional documentation that the accountant believes is appropriate. AR-C Section 90 states the accountant's documentation should include the following:

- An engagement letter

- A copy of the review report issued and the financial statements

- Analytical procedures performed, including documentation of:

  - The expectation, if not self-evident, and the factors considered in their development;

  - The results of comparing the results of the procedure performed to the general ledger. For example, calculating a gross margin would not be sufficient unless it was compared to prior periods or an industry standard; and

  - Management's explanations if the procedures differ significantly from expectations

- Any additional review procedures performed in response to significant unexpected differences and the results of these procedures
- The results of significant inquiries
- Any significant findings or issues
- Significant unusual matters
- Any verbal or written communication of fraud or illegal acts
- Communications with management regarding the accountant's expectation to include emphasis-of-matter or other-matter paragraph(s) in the accountant's review report
- Communication with management, those charged with governance, and others as relevant to the performance of the review of significant matters arising during the engagement, including the nature of those matters
- If, in the course of the engagement, the accountant identified information that is inconsistent with the accountant's findings regarding significant matters affecting the financial statements, how the inconsistency was addressed
- Communications with other accountants that have audited or reviewed the financial statements of significant components
- A signed representation letter

Note: While SSARS 25 does not explicitly state that **materiality** should be documented in a review, there is now an explicit requirement for the accountant to determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures. When determining and using materiality in a review engagement, the accountant must document materiality in order to reach a review conclusion. The accountant's conclusion states the following:

> *Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with the applicable financial reporting framework.*

In documenting the nature, timing, and extent of procedures performed, the accountant should document the following:

- Who performed the work and the date such work was completed
- Who reviewed the work performed for the purpose of quality control for the engagement and the date and extent of the review

In addition to the above, Kaplan suggests the following additional documentation be included:

- That the accountant has knowledge of the client's business and industry
- A trial balance that bridges the general ledger to the financial statements

- Indication that there are no material modifications required to the financial statements
- A work program, if required by firm policy
- A disclosure checklist, if required by firm policy
- Any consultation performed. Consultation would include discussion with firm personnel, technical research, etc.

EXAMPLE

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Accountant's Conclusion

Based on my (our) reviews, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

EXAMPLE

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

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

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Basis for Adverse Conclusion

As disclosed in Note X to these financial statements, the Company has not consolidated the financial statements of subsidiary ABC Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis by the Company. Under accounting principles generally accepted in the United States of America, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Conclusion

Based on my (our) review, due to the significance of the matter described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

Note: Additional examples are in SSARS 25.

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