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Audit and Accounting Update

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Time Card Administration

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Class:	Audit and Accounting Update
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Learning Objectives

After completing this course, the participants will be able to:

1. Understand the audit updates, effective for audits of financial statements for periods ending on or after December 15, 2021.

2. Understand particular items to focus on when performing and/or preparing audits this year.

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ASU 2021-10 – Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance

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- **Background**
  - Aims to provide increased transparency by requiring business entities to disclose information about certain types of government assistance they receive in the notes to the financial statements.
    - Grants
    - Tax credits
    - Other forms of assistance, i.e. PPP loans
- **Effective Date**
  - Effective for all entities for annual periods beginning after December 15, 2021 Early adoption is permitted

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- **Scope**
  - Applies to all entities except not-for-profit entities and employee benefit plans

  - Applies to transactions with a government that are accounted for by a grant model or contribution model

  - Does not apply to transactions with a government that are accounted for in accordance with other Codification Topics, such as ASC 450, Contingencies; ASC 470, Debt; ASC 606, Revenue from Contracts with Customers; or ASC 740, Income Taxes.

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- **Required Disclosures**
  - Information about the nature of the transactions, including a general description and the form (cash or other assets, for example) in which the assistance has been received
  - The accounting policies used to account for the transactions
  - Line items on the balance sheet and income statement affected by the transactions and the amounts applicable to each financial statement line item in the current reporting period
  - Furthermore, an entity is required to disclose information about the significant terms and conditions of transactions with a government, which may include:
    - The duration or period of the agreement
    - Any commitments made by the parties
    - Provisions for recapture, including the conditions that allow recapture
    - Other contingencies
  - If an entity is legally prohibited from disclosing any of the information required by ASC 832, the entity should instead disclose a description of the general nature of the transaction and indicate that the omitted disclosures are legally prohibited from being disclosed.

ASU 2020-07 – Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets

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- **Background**
  - Clarifies the presentation and disclosure of contributed nonfinancial assets, including land, buildings, and other items
  - The update does not change existing recognition and measurement requirements for contributed nonfinancial assets

- **Effective Dates and Transition**
  - Fiscal years beginning after June 15, 2021 and interim periods within annual periods starting after June 15, 2022
  - Early adoption is permitted
  - Should be applied retrospectively to all periods presented

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Main provisions

- The contributed nonfinancial assets are separately stated as an individual line item in the statement of activities, distinct from contributions of cash or other financial assets
- The contributed nonfinancial assets are disaggregated in a footnote by category that shows the type of contributed nonfinancial assets in the statement of activities
- Expanded disclosures for contributed nonfinancial assets recognized

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- **For each type of contributed nonfinancial assets recognized, an NFP will disclose:**
  - The NFP’s policy (if any) on liquidating rather than using contributed nonfinancial assets
  - Qualitative considerations on whether the contributed nonfinancial assets were liquidated or used during the reporting period. If used, a description of how the asset was employed should be included
  - Any donor-imposed restrictions related to the contributed nonfinancial assets
  - The valuation methods and inputs utilized to determine a fair value measure at initial recognition
  - The principal or most advantageous market utilized to calculate fair value if it is a market in which the NFP is restricted by the donor from selling or utilizing the contributed nonfinancial assets

ASU 2021-03 – Intangibles—Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events

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- **Background**
  - Provides private companies and not-for-profit entities ("NFPs") with an accounting alternative to evaluate triggering events for goodwill impairment only as of the end of each reporting period, whether they report on an interim or annual basis.

- **Effective Date**
  - Effective on a prospective basis for fiscal years beginning after December 15, 2019
  - Early adoption is permitted

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- An 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

- Can be elected by entities whether or not they have elected to amortize goodwill

- If an entity elects this alternative, it should be disclosed as a significant accounting policy in the footnotes to the financial statements

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

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Introduction

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements* ("SAS No. 134")
- Issued in May 2019
- Objective is to enhance the relevance and usefulness of the auditor's report
- Aligns with PCAOB and IAASB standards

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Overview of Changed AU-C Sections

- Supersedes the following sections of SAS No. 122
  - Section 700, *Forming an Opinion and Reporting on Financial Statements*
  - Section 705, *Modifications to the Opinion in the Independent Auditor's Report*
  - Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- Adds a new Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

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Overview of Changed AU-C Sections *(continued)*

- Amends the following sections of SAS No. 122
  - Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
  - Section 210, *Terms of Engagement*
  - Section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
  - Section 230, *Audit Documentation*
  - Section 240, *Consideration of Fraud in a Financial Statement Audit*
  - Section 260, *The Auditor's Communication With Those Charged With Governance*

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Overview of Changed AU-C Sections *(continued)*

- Section 300, *Planning an Audit*
- Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- Section 320, *Materiality in Planning and Performing an Audit*
- Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- Section 450, *Evaluation of Misstatements Identified During the Audit*
- Section 510, *Opening Balances – Initial Audit Engagements, Including Reaudit Engagements*
- Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

Overview of Changed AU-C Sections *(continued)*

- Section 600, *Special Considerations – Audits of Group Financial Statements*
- Section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country*

- Amends SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- Particular attention should be paid to amendments to AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

Communications Impacted

- SAS No. 134 will impact the following communications
  - Engagement letter
  - Management representation letter
  - Auditor’s report on the financial statements
  - Auditor’s communication with those charged with governance

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Changes to the Auditor's Report on Financial Statements

- The "Opinion" section will be presented first, followed by the "Basis for Opinion" section
- The "Basis for Opinion" section will include a statement that the auditor is required to be independent of the entity and to meet other ethical responsibilities
- Provides a framework for auditors of nonissuers to communicate key audit matters ("KAM"). Although communication of KAM is not required for audits of nonissuers, if the terms of the engagement include reporting KAM, the auditor would be required to follow the new AU-C Section 701
  - Communicate in a separate Key Audit Matters section

Changes to the Auditor's Report on Financial Statements *(continued)*

- Expands the description of the responsibilities of management for the financial statements to include management's responsibility to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern
- Expands the description of the responsibilities of the auditor and key features of the audit, including references to the auditor's responsibility to conclude on an entity's ability to continue as a going concern and the auditor's responsibility to communicate with those charged with governance

Illustration of the Auditor's Report: For-Profit Entity (Comparative)

- An auditor's report on comparative financial statements prepared in accordance with U.S. GAAP
- Circumstances include the following:
  - Audit of a complete set of general-purpose financial statements (comparative) and the audit is not a group audit
  - Management is responsible for the preparation of the financial statements in accordance with U.S. GAAP
  - The terms of the engagement reflect the description of management's responsibility for the financial statements
  - The auditor has concluded that an unmodified opinion is appropriate
  - Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern
  - The auditor has not been engaged to communicate key audit matters

Illustration of the Auditor's Report: For-Profit Entity (Comparative) *(continued)*

Independent Auditor's Report

- **Report on the Audit of the Financial Statements [1]**
- ***Opinion***
  - We have audited the financial statements of ABC Company, which comprise the balance sheets as of December 31, 2021 and 2020, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.
  - In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 2021 and 2020, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

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

Illustration of the Auditor's Report: For-Profit Entity (Comparative) *(continued)*

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

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Illustration of the Auditor's Report: For-Profit Entity (Comparative) *(continued)*

- ***Responsibilities of Management for the Financial Statements***
  - Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
  - In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

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Illustration of the Auditor's Report: For-Profit Entity (Comparative) *(continued)*

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

Illustration of the Auditor's Report: For-Profit Entity (Comparative) *(continued)*

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

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

Illustration of the Auditor’s Report: For-Profit Entity (Comparative) *(continued)*

- We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.
- **Report on Other Legal and Regulatory Requirements**
- *[The form and content of this section of the auditor’s report would vary depending on the nature of the auditor’s other reporting responsibilities.* **[3]**
- *[Signature of the auditor’s firm]*
- *[City and state where the auditor’s report is issued]*
- *[Date of the auditor’s report]*

[3] An example would be “Other Reporting Required by Government Auditing Standards”, i.e. the GAS report on internal control over financial reporting and compliance.

Illustration of the Auditor's Report: Not-for-Profit Entity (Single Year)

- An auditor's report on financial statements for a single year prepared in accordance with U.S. GAAP when comparative financial information derived from audited financial statements for the prior year is presented
- Circumstances are the same as in the first illustration, except
  - Audit of a complete set of general purpose financial statements (single year)
  - Prior year summarized comparative information derived from audited financial statements is presented
- All references to "ABC Company", from the first illustration, should, in this illustration, refer to "XYZ Nonprofit Organization"

Illustration of the Auditor's Report: Not-for-Profit Entity (Single Year)*(continued)*

- ***Opinion***
  - We have audited the financial statements of XYZ Nonprofit Organization, which comprise the statement of financial position as of December 31, 2021, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.
  - In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Nonprofit Organization as of December 31, 2021, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.
- ***Basis for Opinion***

We conducted our audit...

Illustration of the Auditor’s Report: Not-for-Profit Entity (Single Year)*(continued)*

- ***Responsibilities of Management for the Financial Statements***
  - Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
  - In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company’s ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

Illustration of the Auditor's Report: Not-for-Profit Entity (Single Year)*(continued)*

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

Illustration of the Auditor's Report: Not-for-Profit Entity (Single Year)*(continued)*

- ***Report on Summarized Comparative Information***
  - We have previously audited XYZ Nonprofit Organization's 2020 financial statements, and we expressed an unmodified opinion on those audited financial statements in our report dated May 15, 2021. In our opinion, the summarized comparative information presented herein as of and for the year ended December 31, 2020, is consistent, in all material respects, with the audited financial statements from which it has been derived.

Communicating Key Audit Matters

- AU-C Section 701 provides guidance on the auditor’s responsibility to communicate key audit matters in the auditor’s report when the auditor is engaged to do so
- It addresses
  - The auditor’s judgment about what to communicate
  - The form and content of the communication
- *Key audit matters* are defined as
  - Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance

Illustration of the Auditor’s Report: Key Audit Matters

- An auditor’s report on comparative financial statements prepared in accordance with U.S. GAAP, including communication of key audit matters
- Circumstances are the same as in the first illustration, except the auditor has been engaged to communicate key audit matters

Illustration of the Auditor's Report: Key Audit Matters *(continued)*

- ***Opinion***
  - We have audited the financial statements of XYZ Nonprofit Organization, which comprise the statement of financial position as of December 31, 2021, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.
  - In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Nonprofit Organization as of December 31, 2021, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Illustration of the Auditor's Report: Key Audit Matters *(continued)*

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

Illustration of the Auditor's Report: Key Audit Matters *(continued)*

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

[Description of each key audit matter in accordance with SAS No. 134, Section 701, Communicating Key Audit Matters in the Independent Auditor's Report]

Communicating Key Audit Matters

- In determining which matters communicated with those charged with governance are key audit matters, the auditor should take into account
  - Areas of higher assessed risk of material misstatement or significant risks identified
  - Areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty
  - The effect on the audit of significant events or transactions that occurred during the period

Communicating Key Audit Matters *(continued)*

- The auditor should describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters", unless:
  - Law or regulation precludes disclosure about the matter
  - The auditor determines that the matter should not be communicated because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits

Communicating Key Audit Matters *(continued)*

- The description of each key audit matter should include a reference to the related disclosures, if any, in the financial statements and should describe
  - Why the matter was considered to be one of most significance in the audit
  - How the matter was addressed in the audit
- The auditor should not communicate a matter in the "Key Audit Matters" section of the auditor's report when the auditor would be required to modify the opinion as a result of the matter

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Communicating Key Audit Matters *(continued)*

- Matters giving rise to a qualified opinion or when substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time are, by their nature, key audit matters
- However, these matters should not be described in the "Key Audit Matters" section of the auditor's report
- In these situations, the auditor should:
  - Report on these matters in accordance with the applicable AU-C sections
  - Include a reference to the "Basis for Qualified Opinion" or "Going Concern" section in the "Key Audit Matters" section

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Communicating Key Audit Matters *(continued)*

- AU-C Section 705 provides that when the auditor expresses an **adverse opinion** or **disclaims an opinion** on the financial statements, the auditor's report should not include a "Key Audit Matters" section
- If the auditor determines that there are no (other) key audit matters to communicate, the auditor should include a statement to this effect in the "Key Audit Matters" section of the auditor's report
  - We have determined that there are no key audit matters to communicate
  - Except for the matter described in the Basis for Qualified Opinion section, we have determined that there are no other key audit matters to communicate

Communicating Key Audit Matters *(continued)*

- Speculation:

  Will OMB require the communication of key audit matters?

  - In the auditor’s report on the financial statements?
  - In the auditor’s report on compliance?

Consideration of Going Concern

- If, after considering conditions and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should include a separate section in the auditor's report, with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" that:
  - Draws attention to the note to the financial statements that discloses
    - The conditions or events identified and management's plans
    - That substantial doubt exists about the entity's ability to continue as a going concern
  - States that the auditor's opinion is not modified with respect to the matter

Illustration of the Auditor's Report: Going Concern

- ***Basis for Opinion***
  - We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.
- ***Substantial Doubt About the Entity's Ability to Continue as a Going Concern [1]***
  - The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations, has a net capital deficiency, and has stated that substantial doubt exists about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

[1] In SAS No. 134, presented immediately after the "Basis for Opinion" section for illustrative purposes.

Consideration of Going Concern

- If adequate disclosure about an entity's ability to continue as a going concern is not made in the financial statements, the auditor should
  - Express a qualified opinion or adverse opinion, as appropriate
  - In the "Basis for Qualified" or "Adverse Opinion" section of the auditor's report, state
    - *Substantial doubt exists about the entity's ability to continue as a going concern and the financial statements do not adequately disclose this matter.*

    or

    - *Substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans but the financial statements do not adequately disclose this matter.*

Consideration of Going Concern
(continued)

- If management concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time has been alleviated, and the auditor agrees with that conclusion and concludes that management's disclosures are adequate, the auditor should include an "Emphasis of Matter" paragraph in the auditor's report, stating
  - *As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note X. Our opinion is not modified with respect to this matter.*

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Modifications to the Auditor's Report

- When the auditor modifies the opinion on the financial statements, the auditor should
  - Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion", "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion", as appropriate
- When the auditor expresses a qualified or adverse opinion, the auditor should amend the statement in the "Basis for Opinion" section about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion, to include the word "qualified" or "adverse", as appropriate

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Modifications to the Auditor's Report *(continued)*

- When the auditor disclaims an opinion on the financial statements, the auditor's report should not include
  - A reference to the section of the auditor's report where the auditor's responsibilities are described and
  - A statement about whether the audit evidence is sufficient and appropriate to provide a basis for the auditor's opinion
- Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should describe the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof in the "Basis for Opinion" section

Modifications to the Auditor’s Report *(continued)*

- When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor should include in the “Auditor’s Responsibilities for the Audit of the Financial Statements” section of the auditor’s report only the following
  - A statement that the auditor’s responsibility is to conduct an audit of the entity’s financial statements in accordance with auditing standards generally accepted in the United States of America and to issue an auditor’s report

Modifications to the Auditor’s Report *(continued)*

- A statement that, however, because of the matters described in the “Basis for Disclaimer of Opinion” section of the auditor’s report, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements
- A statement that the auditor is required to be independent and to meet other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit

Emphasis-of-Matter and Other-Matter Paragraphs

- An emphasis-of-matter paragraph is required by GAAS or is included at the auditor's discretion, that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements
- An other-matter paragraph is required by GAAS or is included at the auditor's discretion, that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report

NEW LEASE ACCOUNTING STANDARD – ASC 842

Operating Leases

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OVERVIEW OF ASC 842

- The purpose of ASC 842 is to increase transparency and comparability among organizations by requiring leases to be recorded on the balance sheet for covered leases.
- Leases less than 12 months are excluded.

OVERVIEW OF ASC 842

Effective Dates

- Public companies: Fiscal years beginning after December 15, 2018.
- Nonpublic companies, nonprofits, and small reporting companies (defined in SEC Rules and Regulations) was delayed to fiscal years beginning after December 15, 2020 and for nonpublic and nonprofit entities was further delayed to fiscal years beginning after December 15, 2021 (i.e., 2022 for calendar year entities). Early adoption is permitted.

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OVERVIEW OF ASC 842

Lease exclusions

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas, and similar nongenerative resources
- Leases of biological assets, including plants, timber and livestock
- Leases of inventory
- Leases of assets under construction, such as a building being built. For a sale-leaseback where a lessee is involved in construction, ASC 842-40 may apply

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SOME KEY CONCEPTS

Definition of lease -What is a lease under ASC 842?

A *lease* is a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

- Lessee: In a contract, the entity that gets the rights to control the use of an underlying asset for a period of time in exchange for consideration is the lessee

- Lessor: The entity that conveys such rights in exchange for a consideration is the lessor

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SOME KEY CONCEPTS

Lease Term

A lease term is the non-cancellable period of the lease including:

- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- periods covered by an option to extend (or not to terminate) the lease in which an exercise of the option is controlled by the lessor

SOME KEY CONCEPTS

Lease Payments

Lease payments may include any of the following:

- Fixed payments, less any incentives paid to the lessee,
- Variable lease payments that depend on an index or a rate,
- Amounts probable of being owed under residual value guarantees,
- Payments for a penalty for failure to renew or extend the lease,
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction, or
- The exercise price of a purchase option.

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SOME KEY CONCEPTS

Lease and Non-lease Components

- What is a component of a contract?
  - These are generally lease and non-lease
  - A contract may also have certain elements that do not transfer goods or services. Example Reimbursement of lessor’s costs.

- Non-lease component is to be accounted with other GAAP

- Accounting policy election may be made to not separate the lease and non-lease components- by both lessee; and by lessor if certain conditions are met

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LEASE CLASSIFICATION

The following classification criteria are applicable to lessees and lessors:

- The lease transfers ownership of the leased asset to the lessee by the end of the lease term.
- The lease contains a purchase option that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the leased asset.
- The present value of the lease payments equals or exceeds substantially all of the fair value of the leased asset.
- The 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.

Let’s call this Group A criteria.

LEASE CLASSIFICATION

The following classification criteria are applicable to lessors only:

- 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 and any other third party unrelated to the lessor, equals or exceeds substantially all of the fair value of the underlying asset.
- The collectability of the lease payments, and any amount necessary to satisfy a residual value guarantee, is probable.

Let's call this Group B criteria.

LEASE CLASSIFICATION

Application of lease classification criteria

Lessee:

- If any of the Group A criteria are met the lessee classifies lease as a finance lease. If not then the lease is an operating lease

Lessor:

- When any of the Group A criteria are met, lessor classifies the lease as a sales-type lease. When none of the criteria are met, a lessor should look to the criteria described in Group B to determine whether the lease should be classified as a direct financing or operating lease.
- If both criteria in Group B are met, the lessor classifies the lease as a direct financing lease. When the criteria are not met, the lessor classifies the lease as an operating lease.
- If the lessor determines that collection of the lease payments is not probable, the lease should be classified as an operating lease.

LEASE CLASSIFICATION

To summarize, steps in determination of lease classification

- Is it a contract? YES
- Is it a lease contract? YES
- Is the party for which the lease being evaluated the lessor or lessee?
- Use the criteria listed in previous slide to classify the lease

LESSEE ACCOUNTING

As of the lease commencement date, lessee recognizes (for both finance leases and operating leases):

- Liability for its lease obligation (initially measured at present value of future lease payments)
- Asset for its right to use the underlying asset (ROU asset)
  - Equal to the lease liability
  - Adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs

LESSEE ACCOUNTING

Operating Lease:

- Allocate total lease payments, including initial direct costs, evenly over the lease term to calculate periodic straight-line expense.
- Interest expense calculated same as finance lease.
- Amortization expenses in plug figure (difference between straight-line and interest).
- Reported as a single item on the income statement – lease expense.

LESSEE ACCOUNTING

Short-term leases (less than 12 months lease):

- Lessee would recognize lease payments as expense over the lease term on a straight-line basis.
- Lessee would also be required to disclose certain information about the short-term lease. Disclosures will be covered in Leases -Part II.
- If lease term increases to more than 12 months, or it is reasonably certain that the lessee will exercise an option to purchase the underlying asset, lessee would no longer apply the short-term lease exception.
- Month-to-month leases would be short-term.

LESSOR ACCOUNTING

Operating Lease:

- No major changes from prior GAAP
- Accounting for operating leases by lessors requires the recognition of lease payments as income over the lease term generally on a straight-line basis
- Variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur
- Initial direct costs (such as commissions and legal fees incurred when negotiating and consummating a lease) are deferred and recorded as an expense over the lease term on the same basis as lease income which is generally straight-line.
- Amortization of lease incentives are contra-revenue

LESSOR ACCOUNTING

Operating Lease:

- Prepaid rent is unearned rental and is usually reflected as current liability
- Rent to be received is reflected as rent receivable and is usually a current asset
- Deferred rent is usually treated as noncurrent asset
- Operating costs such as maintenance, insurance, etc are chargeable against rental revenue (as an expense)
- Lease assets remain on lessor’s balance sheet and are depreciated using lessor’s normal depreciation policy
- Leased assets and related accumulated depreciation are identified separately on the lessor's balance sheet or in the notes thereto

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QUESTIONS

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