Course Material

Annual Accounting and Auditing Update and Review

Course #5410H/QAS5410H

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2010 FASB, SSARS, and SAS Update and Review

(Course #5410H/QAS5410H)

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About the Author

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Mr. Fustolo is a partner with the Boston CPA firm of James J. Fox & Company and Director of the National Tax Institute, Inc. He is a frequent lecturer and author of numerous tax and accounting issues affecting closely held businesses. An AICPA author, Mr. Fustolo’s articles are regularly featured in *The Practical Accountant* and other publications. He is the author of *Practice Issues: Compilation and Review, Accounting and Auditing Reference Guide, Everything You Never Wanted to Know About GAAP, Enron: Fraud, Deception and the Aftermath, FASB Review for Industry, and FASB, SSARS and SAS Update and Review* and numerous other books and manuals that have been published by Practitioners Publishing Company (PPC) and Commerce Clearing House (CCH). He is the recipient of several Outstanding Discussion Leader awards from many professional organizations including the New York and Florida Societies of CPAs. Mr. Fustolo’s course entitled *FASB, SSARS and SAS Update and Review* continues to receive accolades and is regarded as one of the top live CPE programs in the country today with ratings that average 4.91 on a scale of 5.0. He speaks regularly for professional groups including being a guest lecturer at the AICPA Advanced Accounting and Auditing Technical Symposium. Mr. Fustolo is the recipient of the Elijah Watts Sells Award (AICPA) and Silver Medal (Massachusetts) for scores received on the CPA Examination.
2010 FASB, SSARS and SAS Update and Review

Objectives: The purpose of this course is to inform the reader of the various changes affecting accounting, compilation and review, and auditing engagements including newly issued FASB and FASB statements, new statements issued by the Auditing Standards Board, changes in compilation and review, and more.

Upon completing Chapter 1 of this course, you will be able to:

- Distinguish between a merger and an acquisition with a not-for-profit organization
- Identify the rules for a merger
- Identify the rules for an acquisition
- Apply the steps for recording an acquisition
- Describe the disclosures required by FASB No. 164

Upon completing Chapter 2 of this course, you will be able to:

- Define the two types of subsequent events
- Identify events that trigger the subsequent event rules
- Identify non-recognition events

Upon completing Chapter 3 of this course, you will be able to:

- Discuss the types of asset transfers that are subject to the FASB No. 166/140 rules
- Identify the types of transfers that qualify for sale accounting
- Explain how to account for a transfer of a participating interest
- Discuss how to account for a transfer that is not accounted for as a sale

Upon completing Chapter 4 of this course, you will be able to:

- List the three conditions required to consolidate a VIE
- Define a variable interest entity
- Determine which entity is a primary beneficiary
- List the different types of variable interests
- Present the consolidated financial statements that include a variable interest entity

Upon completing Chapter 5 of this course, you will be able to:

- Categorize sources of GAAP into the new GAAP hierarchy
- List the five areas of the Accounting Standards Codification
- Discuss about the simplified language used in the new Codification
- Explain how to reference the new Codification in working papers
Upon completing Chapter 6 of this course, you will be able to:

- Identify the latest FASB Staff Positions (FSPs) and Accounting Standards Updates (ASU) issued in 2009 and 2010
- Discuss the proposed changes to revenue recognition and financial statement display
- Address the international convergence project
- Describe the proposed changes to lease accounting

Upon completing Chapter 7 of this course, you will be able to:

- Describe the extensive changes made by SSARS No. 19
- Explain how the new lack of independence disclosure rules apply to compilation engagements
- Define the new term “review evidence”
- Discuss the new documentation requirements for compilation and review engagements

Upon completing Chapter 8 of this course, you will be able to:

- Read SASs with an understanding of the professional requirements imposed on auditors
- Communicate internal control related matters in accordance with SAS No. 115
- Discuss the audit requirements for a compliance audit
- Apply the compliance requirements for different types of supplementary information found in SAS No. 119-120
- Explain the importance aspects of fraud and fraud prevention
- Implement the changes found in several new auditing standards
- Apply the requirements found in PCAOB AS7
CHAPTER 1

FASB No. 164: Not-for-Profit Entities: Mergers and Acquisitions Including an Amendment of FASB Statement No. 142 (FASB ASC Topic 958)
**FASB No. 164: Not-for-Profit Entities: Mergers and Acquisitions**
**Including an Amendment of FASB Statement No. 142**
**(FASB ASC Topic 958)**

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FASB No. 164: Not-for-Profit Entities: Mergers and Acquisitions Including an Amendment of FASB Statement No. 142 (FASB ASC Topic 958)

I. Introduction

Issued: April 2009

Effective date: The Statement is effective and shall be applied prospectively to a) mergers for which the merger date is on or after the beginning of an initial reporting period beginning on or after December 15, 2009, and b) acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2009.

Earlier application is prohibited. The Statement shall be applied in both annual and interim periods after its effective date.

Objective:

The objective of FASB No. 164 (ASC Topic 958) is to improve the information that a not-for-profit reporting entity provides about a combination with one or more other not-for-profit entities, businesses, or nonprofit activities.

The Statement establishes principles and requirements for how a not-for-profit entity.

- Determines whether a combination is a merger or an acquisition
- Applies the carryover method in accounting for a merger
- Applies the acquisition method in accounting for an acquisition, including determining which of the combining entities is the acquirer
- Determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of a merger or an acquisition

FASB No. 164 also enhances the information a not-for-profit entity provides about goodwill and other intangible assets after an acquisition and changes in the non-controlling interest in subsidiaries after a merger or an acquisition. In doing so, the Statement amends both FASB Statement No. 142, Goodwill and Other Intangible Assets, and ARB No. 51, Consolidated Financial Statements (ASC 810), as amended by FASB Statement No. 160, Non-controlling Interests in Consolidated Financial Statements (ASC 810), to make their provisions fully applicable to not-for-profit entities.

II. Background

Prior to the issuance of FASB No. 141, Business Combinations (subsequently amended with FASB No. 141R, ASC 805), the guidance on accounting for business combinations was provided by APB No. 16, Business Combinations. Yet, because neither Statement 141 nor APB 16 applied to not-for-profit entities, those pronouncements did not address the accounting and reporting for combinations of not-for-profit entities.
With the lack of guidance for not-for-profit organizations, in SOP 94-2, The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations, the AcSEC concluded that not-for-profit entities should apply the guidance in APB 16, which provided for two methods of accounting for business combinations—the pooling method and the purchase method.

There was additional guidance on accounting for combinations of health care entities which was included in the AICPA Audit and Accounting Guide, Health Care Organizations. That guidance describes combinations that involve the receipt or payment of monetary consideration, the change in legal title to assets, or the assumption of liabilities as being similar to a purchase transaction.

The FASB noted that because of limited guidance, currently there is diversity in practice in the accounting for combinations of not-for-profit entities and the use of the pooling method and acquisition method.

On one hand, some combinations of not-for-profit entities are currently accounted for in a manner similar to the pooling method. Some not-for-profit entities apply the acquisition method to all combinations that involve a change in control, while others apply the pooling method to those combinations unless monetary consideration has been exchanged.

The FASB began considering guidance on combinations of not-for-profit entities, the accounting for goodwill and intangible assets acquired in a not-for-profit merger or acquisition, and noncontrolling interests largely to address the lack of consistent application of APB 16 in practice and the resulting disparity in the accounting for economically similar transactions between not-for-profit entities. The Board observed that, through issuance of this Statement, it could improve the comparability of reported financial information, provide more complete financial information, better reflect the underlying economics of not-for-profit combinations, and improve the comparability and the usefulness of not-for-profit combination disclosures.

### III. Scope of FASB No. 164

1. FASB No. 164 applies to a transaction or other event that meets either the definition of a merger of not-for-profit entities or an acquisition by a not-for-profit entity.

2. This Statement does not apply to:

   a. The formation of a joint venture.
   b. The acquisition of an asset or a group of assets that does not constitute either a business or a nonprofit activity. See Exhibit B for an analysis of factors that constitute a business or nonprofit activity.
   c. A combination between not-for-profit entities, businesses, or nonprofit activities under common control.
   d. A transaction or other event in which a not-for-profit entity obtains control of another not-for-profit entity but does not consolidate that entity.
Note: The Statement provides two examples:

- Example 1 is where SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and AICPA Audit and Accounting Guide, Health Care Organizations (health care guide), permit, but do not require an entity to consolidate another not-for-profit entity in which it has a controlling economic interest other than a majority ownership or voting interest, such as control through a contract or an affiliation agreement. Thus, if one not-for-profit entity obtains control of another by means of a contract, for example, but chooses not to consolidate that entity, FASB No. 164 does not apply to the transaction in which control was obtained.

- Example 2 is where the Statement does not apply if a not-for-profit entity that obtained control in a transaction or other event in which consolidation was permitted, but not required, decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

IV. Definitions Used Within FASB No. 164

1. Many of the following definitions used in FASB No. 164 are extracted from other FASB documents which are parenthetically noted.

Acquiree (or acquire): is a business that the acquirer obtains control of in a business combination or a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition.

Acquirer: is the entity that obtains control of the acquire.

Acquisition by a not-for-profit entity: is a transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or business and initially recognizes their assets and liabilities in the acquirer’s financial statements.

Acquisition date: is the date on which the acquirer obtains control of the acquiree.

Business: is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors of other owners, members, or participants.

Collections: are defined as works of art, historical treasures, or similar assets that are all of the following:

- Held for public exhibition, education, or research to further public service rather than financial gain
- Protected, kept unencumbered, cared for, and preserved
- Subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections (paragraph 209 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*).
Conditional promise to give: is a promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

Contribution: is an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Contingent consideration: is an obligation of the acquirer to transfer additional assets or equity interests to the former owners or members of an acquire as part of the exchange for control of the acquire if specified future events occur or conditions are met.

Control of a for-profit business: has the meaning of controlling financial interest in paragraph 2 of ARB 51.

Control of a not-for-profit entity: is “the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.”

Equity interests: ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of not-for-profit entities.

Fair value: is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Goodwill: is an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized.

Identifiable asset: an asset that is either:

- separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible asset: is an asset (not including a financial asset or goodwill) that lacks physical substance.

Merger of not-for-profit entities: is a transaction or other event in which the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity. To cede control requires that the merging entities not retain shared control of the new entity. To qualify as a new entity, the combined entity must have a newly formed governing body; a new entity often is, but need not be, a new legal entity.

Merger date: is the date on which the merger becomes effective.
**Non-controlling interest:** is the equity in (net assets of) a subsidiary not attributable, directly or indirectly, to a parent.

**Nonprofit activity:** is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity’s purpose or mission (for example, goods or services to beneficiaries, customers, or members).

**Not-for-profit entity:** is an entity that possesses the following characteristics that distinguish it from a for-profit business entity.

- Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- Operating purposes other than to provide goods or services at a profit
- Absence of ownership interests with characteristics that are similar to those of a for-profit business entity.

**Owners:** is used broadly to include holders of equity interests of investor-owned entities; owners, members of, or participants in mutual entities; and owner or member interests in the net assets of not-for-profit entities.

**Public entity:** is an entity that has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that is required to file financial statements with the Securities and Exchange Commission, or that provides financial statements for the purpose of issuing any class of securities in a public market.

### V. Rules of FASB No. 164

1. A not-for-profit entity shall determine whether a transaction or other event is a **merger** or an **acquisition** by applying the definitions in the Statement.
   
   a. An **acquisition by a not-for-profit entity** is a transaction or other event in which a not-for-profit **acquirer obtains control** of one or more nonprofit activities or business and initially recognizes their assets and liabilities in the acquirer’s financial statements.

   b. A **merger of not-for-profit entities** is a transaction or other event in which the governing bodies of two or more not-for-profit entities **cede control** of those entities to **create a new not-for-profit entity**.

      1) To **cede control** requires that the merging entities not retain shared control of the new entity. To qualify as a **new entity**, the combined entity must have a newly formed governing body; a new entity often is, but need not be, a new legal entity.

2. **Distinguishing between a merger and an acquisition**

   Factors found in Appendix A of FASB No. 164, that may be considered in determining whether a particular combination is a merger, an acquisition, or another form of combination, such as the formation of a joint venture.
a. **Control**: Ceding control to a new entity is the sole definitive criterion for identifying a merger, and one entity obtaining control over the other is the sole definitive criterion for an acquisition.

1) In a merger, both entities cede control to a newly formed entity with control among the two entities not being a critical factor.

2) In an acquisition, one entity obtains control over the other with no new entity being created. The formation of a new entity is not a significant factor in determining whether one entity obtains control over the other entity.

**Note**: For a merger, determining whether each of the governing bodies of the entities participating in a combination cedes control of those entities to a new entity requires assessing characteristics that include the following:
- The process leading to the combination.
- The participants to the combination.
- The combined entity.

b. **Dominance of the entities in relation to each other**:

1) In a merger, generally no one party dominates or is capable of dominating the negotiations and process leading to the formation of the new combined entity.

2) In an acquisition, one party (the acquirer) typically dominates the negotiation process and may dictate the terms of the transaction, including the date the combination occurs.

c. **Governance and related control powers differ in a merger versus an acquisition**:

1) If one entity appoints significantly more of the governing board of the newly formed entity, retaining significantly more of its key senior officers, or retaining its bylaws, operating policies, and practices substantially unchanged, the transaction is more likely to be a feature of an acquisition than of a merger.

d. **Financial capacity**:

1) The relative financial strength and relative size of the participants in the combination are factors to determine whether one participant is able to dominate the process leading to the combination.

- If one entity is financially strong and the other is experiencing financial difficulty, the stronger entity may be able to dominate the transaction, which would indicate that the transaction is an acquisition rather than a merger.
• A participant that is substantially larger than each of the others in terms of revenues, assets, and net assets may be able to dominate the transaction.

Note: The relative size of an entity, like relative financial strength and the other indicators, is only one characteristic that may help to distinguish between a merger and an acquisition. No one indicator, by itself, is determinative of whether there is a merger or acquisition, except that ceding of control is the sole definitive criterion for a merger.

Unlike an acquisition by a not-for-profit entity, a merger generally is accomplished by combining all of the assets and liabilities of the merging entities into a newly formed entity that assumes all of the assets and liabilities of the participating entities without a transfer of cash or other assets to those entities or any of their owners, members, sponsors, or other designated beneficiaries. Also, unlike the formation of a joint venture in which the venturers continue to exist and usually hold a financial interest, the creators of the merged entity cease to exist as autonomous entities and no one holds financial interests in the merged entity. Moreover, the merged entity generally has a perpetual life rather than a life that is limited by the period of the venture or that allows for one or more of the participating entities to opt out of the venture or other arrangement.

A particular combination of business entities may seem similar in some aspects to a merger of not-for-profit entities. For example, a new entity may be formed to effect a business combination, and no consideration is exchanged in some business combinations. Nevertheless, the guidance in this Statement on mergers does not apply in a business combination, and it should not be applied by analogy.

Examples: Merger versus Acquisition:

The following examples found in FASB No. 164 illustrate how the participants in a combination would apply the control criteria (ceding of control for a merger and obtaining control for an acquisition) and the indicators in identifying the nature of the combination.

Example 1: A Combination That Is a Merger

Facts:

Community Foundation XYZ, a major grantor to social service entities in its metropolitan area, begins a program to encourage its grantees to consider opportunities to improve their services through collaborative arrangements, including mergers, acquisitions, and joint ventures. In January 20X9, Community Foundation XYZ convenes a meeting of the chief officers and chairpersons of several charities that provide complementary and, to some extent, overlapping services within its metropolitan area.

Following that meeting, representatives of Charity A and Charity B see fruitful opportunities for collaborative efforts based on their (a) geographic proximity and service areas, (b) similar missions, programs, and operating practices, and (c) complementary financial strengths with one having a much larger base of current contributors and...
unpaid volunteers and the other having a larger endowment and base of investment income. Charity A is 30 to 40 percent larger than Charity B in terms of most individual financial measures, including revenues and the fair value of assets and net assets.

In February 20X9, the governing boards of Charity A and Charity B authorize the formation of an Exploratory Committee to recommend whether the two charities should combine and, if so, to develop a plan for implementing a combination. The Committee consists of three members from Charity A and the Executive Director and one additional member from Charity B, with administrative support from the legal counsel of each entity. Each of the five Committee members has one vote, and a recommendation of the Committee requires at least four assenting votes. Its recommendation is to be accompanied by the reasons underlying both the recommendation of the Committee and any dissenting votes.

In July 20X9, after completing its discussions, the Committee recommends, with the full support of all five of its members, that Charity A and Charity B combine under an agreement with the following key provisions:

- A new entity named Charity AB is to be formed; to minimize costs, the corporate charter of Charity A is to be retained. The assets and liabilities of Charity B will be transferred to Charity AB, and Charity B will cease to exist. Thus, in effect, both Charity A and Charity B will cease to exist in their precombination forms.

- On the date the combination becomes effective (as approved by the appropriate State official), the corporate charter will be amended to reflect the new entity’s name and its expanded mission, which is to encompass Charity B’s research and advocacy functions as well as the charitable functions of both entities.

- The CEO of Charity B will be offered the position of CEO of Charity AB for a term of at least two years.

- The initial Board of Charity AB will consist of 15 members: (1) Charity A will appoint 9 of the initial members, preferably from the members of its existing 50-member board and its current CEO. (2) Charity B will appoint 6 of the initial members, preferably from its existing 25-member board. (3) The charter of Charity AB will provide for a maximum of 25 board members. The Committee recommended that a search be undertaken to add 6 new members within a year, with each new member requiring approval by a minimum of 10 of the 15 initial members.

- The headquarters of Charity A and its underlying lease (which has eight remaining years) will be retained.

- A transition committee consisting of two members each from the current boards of Charity A and Charity B, under the authority of the CEO of Charity AB, will be appointed to:
  
  (1) Submit a formal plan of merger to each of the governing boards and, if approved, seek approval from the appropriate State authorities.
  
  (2) Seek opportunities to sublease the headquarters space of Charity B for the remaining two-year lease term or to utilize that space for program activities.
(3) Interview existing staff and other candidates for senior management positions.
(4) Make recommendations about:

(a) Eliminating program and operating redundancies, including severance packages for any terminated staff
(b) Improving the current operating policies and practices of Charity A and Charity B
(c) Revising employee benefit plans with the objective of adopting unified plans for Charity AB’s employees without diminishing the overall benefits being offered to existing employees.

• In discussing item 4(c) above, the Exploratory Committee report notes that the Committee interviewed the current CEOs of Charity A and Charity B and found both well-qualified to serve as the CEO of Charity AB. However, although both CEOs are in their early 60s and are eager to assist Charity AB through the initial transition period, the CEO of Charity A had been contemplating retiring within the next year. The Committee saw no need to open the CEO search to other candidates.

• During August 20X9, each of the governing boards of Charity A and Charity B tentatively approves the Committee recommendations and appoints its members to the recommended Transition Committee. The boards also ask their respective Nominating Committees to make recommendations to each of their boards about the initial members to be appointed to the board of Charity AB. During October, each board approves the plan for their combination, and it is submitted to the State for approval.

• In November, the plan receives the required State approval, and the combination becomes effective on January 1, 20X0, as proposed.

Conclusion:

Determining whether each of the governing bodies of the participating entities in a combination cedes control of those entities to a new entity requires assessing the characteristics of the process leading to the combination, the participants in the combination, and the combined entity.

• On the basis of the evidence, both Charity A and Charity B participated in the process leading to the combination.

• The evidence indicates that neither charity was experiencing financial difficulties or other circumstances that might allow the other entity to dominate the negotiations leading to and through the approval of the transaction by both charities.

• Neither charity appointed significantly more of Charity AB’s initial governing board.
• Although the CEO of Charity B is the only key senior officer for which a retention
decision has been made, neither charity dominated the selection process of the
governing board and senior management, collectively.

• Although the corporate charter and bylaws of Charity A were retained, the stated
mission of Charity AB includes the operating objectives of Charity B. In addition,
the bylaws and operating policies and practices of Charity A and Charity B were
similar.

On the basis of the preponderance of the evidence, it is determined that the combination
is a **merger**, and that the governing boards of Charity A and Charity B each ceded
control to the new entity, Charity AB, which has a newly formed governing body.

**Example 2: A Combination That Is Neither a Merger Nor an Acquisition**

**Facts:**

The facts are the same as in Example 1, except that Charity AB is established as a new
legal entity (with its own charter), and Charity A and Charity B each:

• Will continue to exist with its current governing body but cease to operate its
existing programs.

• Has the power to veto nominations for future members of Charity AB’s governing
body for two years.

• Will retain $200,000 in operating cash and all of the investment assets of its
donor-restricted endowment funds. Two years following the combination date,
each charity will dissolve and transfer its remaining assets to Charity AB unless
either exercises its right of withdrawal (next).

• Has the right to dissolve Charity AB, which if exercised will result in a reversion of
assets, liabilities, and staff. Upon reversion, all staff will be retained by their
respective legacy entity. In addition, the assets and liabilities of Charity AB will be
transferred to each legacy entity in a distribution ratio equivalent to the fair value
of the net assets contributed by each (which was determined to be about 65% to
35% at the combination date).

**Conclusion:**

In this revised example, it appears that Charity A and Charity B may intend to combine
after the passage of a two-year period. But neither of their governing boards has ceded
control, as defined, and neither entity has obtained control of the other.

Therefore, the combination is **neither a merger nor an acquisition**; rather, on the basis of
the preponderance of the evidence, it appears that Charity AB is a **joint venture** of
Charity A and Charity B.
Example 3: A Combination That Is an Acquisition

Facts:

- Charity C provides health and human services to residents of the City of XX and two adjoining counties, referred to as Metro Area XX, a substantial portion of which is provided through its support to grantee agencies in its area.

- Charity D provides health and human services to residents of County Y, which adjoins the northern part of Metro Area XX. The charities share a common mission and operate under the same national brand name; that is, the charities operate as [Brand Name] of Metro Area XX and [Brand Name] of County Y. Each charity receives contributions from the residents of its service area.

- In 20X1, the regions served by both charities were experiencing sharp economic declines, and contributions to both charities were declining as a result. To create efficiencies, they entered into two joint operating agreements. Under the first agreement, they conduct joint annual fundraising campaigns. Under the second, Charity C provides all information technology and marketing services to Charity D for a nominal fee.

- By January 20X4, Charity D has successfully implemented three innovative program services, but it has not been able to improve its declining contribution revenues. Despite some staff layoffs, it continues to experience significant operating deficits.

- In March 20X4, the CEOs of the two charities encouraged their respective Executive Committees to explore opportunities to combine and restructure their operations and governance.

- In July 20X4, the Executive Committees of both charities formed a joint Strategy Committee to investigate opportunities to create the best charity for the combined service area and to develop recommendations for accomplishing that objective.

- The Strategy Committee members include the CEOs and 6 directors from each charity and 10 community leaders from the area. It is chaired by the CEO of a major corporation in the area who also is a director of Charity C.

- In January 20X5, although the Strategy Committee’s work was ongoing, the Executive Committees of both charities unanimously approved and advanced to the full governing board of each charity the Committee’s recommendations for (a) the governance model for a new charity to be formed by consolidating and dissolving both of the existing charities and (b) the new charity’s name, mission, vision, and business model. That business model is the same as the model Charity D had adopted in 20X2, under which it successfully implemented three new programs. Charity C wanted to leverage the experiences of Charity D.

- On November 1, 20X5, the governing boards of both charities approve the Strategy Committee’s plan of consolidation. The CEOs of both charities execute a joint Memorandum of Understanding (MOU), which states:
a. The charities will create a new entity named Charity C for Northwestern State (CCNWS) upon completing the due diligence process and obtaining approvals of the State authorities and IRS qualification as a tax-exempt public charity, which will be concluded no later than December 31, 20X5.

b. The bylaws of CCNWS will establish a board of directors of up to 30 members.

c. The board of directors of Charity C will nominate 15 of the initial members of the board of CCNWS. (All 15 nominees selected were current members of the board of directors of which 13 were also members of the Executive Committee.)

d. The board of directors of Charity D will nominate five of the initial members.

e. CCNWS will have four Local Community Committees representing four geographic areas, one of which is County Y. Each Committee will provide advice to the board of directors for local decision making consistent with CCNWS’s mission and vision. At each election after the installation of the initial board, each Committee may nominate up to four candidates for a one-year renewable term on the board of CCNWS. The board will select a minimum of two members from each Local Community Committee, for a total of eight additional members.

f. Amendments to the articles of incorporation or bylaws, significant transactions (a merger, reorganization, termination, or sale of substantially all assets), and reductions in the authority and responsibilities of Local Community Committees will require an affirmative vote of at least 60 percent of the board of directors. Each charity’s board of directors will appoint five members to a joint Transition Committee, with the charge of and authority to implement the plan of consolidation.

g. Until the consolidation is complete, each charity’s board of directors will:

(1) Use reasonable efforts to conduct their activities consistent with their current mission allowing for changes consistent with moving to the business model, mission, and vision of CCNWS.

(2) Preserve their tax-exempt status and relationships with contributors and grantee agencies.

(3) Not materially amend or modify their articles of incorporation or bylaws.

h. During the first three years after the combination, CCNWS will:

(1) Use the business model (direct-services based) to increase its capacity for making sustained change to address key social needs.

(2) Fund and maintain no less than four geographic sites, with one in County Y, to allow for community involvement in campaign, community impact programs, marketing, and public policy.

(3) Fund and maintain the financial and program commitments of both of the consolidating charities to their respective grantee agencies, subject to available funding.

(4) Strive to expand [Brand Name] program of Charity D and its strategies throughout the CCNWS service area. Given the success of that program, its current staff will be given full opportunity and consideration to lead the [Brand Name] program for CCNWS.

(5) Not reduce significantly the current staffs of the charities. It is understood that reassignments or realignments are probable. Any reductions of the staff of Charity D will be made in consultation with its
former CEO, who will become the Vice President for Program Services and Strategic Development of CCNWS.

i. The obligations of Charity D, which are outlined in the MOU, are subject to approval by its board of directors. The obligations of Charity C, which also are outlined in the MOU, are subject to approval by its Executive Committee.

- Following are certain facts for each of the combining charities and the initial staffing of the combined CCNWS:

<table>
<thead>
<tr>
<th>Charity C</th>
<th>Charity D</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(In Millions)</strong></td>
<td><strong>(In Millions)</strong></td>
</tr>
<tr>
<td><strong>Financial information:</strong></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>20X5</td>
</tr>
<tr>
<td>Expenses</td>
<td>$45</td>
</tr>
<tr>
<td>Net excess (deficit)</td>
<td>3</td>
</tr>
<tr>
<td>Net assets-carrying amount</td>
<td>70</td>
</tr>
<tr>
<td>Employee head count</td>
<td>119</td>
</tr>
<tr>
<td><strong>Joint operating agreements:</strong></td>
<td></td>
</tr>
<tr>
<td>Fund raising: net revenue sharing ratio</td>
<td>65%</td>
</tr>
<tr>
<td>Information technology and marketing provided by Charity C</td>
<td>Receives nominal fee, pays all costs</td>
</tr>
<tr>
<td><strong>Governance:</strong></td>
<td></td>
</tr>
<tr>
<td>Members of board of directors</td>
<td>80%</td>
</tr>
<tr>
<td>Members of executive committee</td>
<td>20%</td>
</tr>
</tbody>
</table>

**Staffing of CCNWS:**

- Senior officers of CCNWS:
  - President: Former CEO
  - VP strategic relations: Former CEO
  - CFO: Former CFO
  - VP public policy (vacant, being recruited)

**Conclusion:**

The transaction is an *acquisition* where Charity C is the acquirer.

Some factors in this example might suggest that the combination is a merger while others lead to a conclusion that it is an acquisition. However, the weight of the factors suggests that the transaction is an acquisition, not a merger. Following is the analysis supporting the conclusion.
Factors that indicate a merger include:

- The evidence indicates that each charity participated in the process leading to the combination. The governing boards both approved the formation of the Strategy Committee, both were represented on that Committee, and both had the opportunity to accept or reject the recommendations of the Committee.

- The legal dissolution of both charities to form CCNWS resulted in a new entity with a newly formed governing body, to which the governing boards of both charities ceded control of their operations and net assets, at least in legal form.

Factors that indicate an acquisition include:

- The governing board of the financially stronger and larger Charity C dominated the terms of the combination and did not, in substance, cede control of its operations and net assets to the governing board of CCNWS. Those factors include Charity C’s:
  
a. Dominance in the selection of 15 of the 20 members of the initial board of directors of CCNWS. It also seems that the governing power center of Charity C – its Executive Committee – continues to control because 13 of its members continued as members of the initial 20-member board of CCNWS and, together with the other 2 board members from that charity, would have a strong (if not dominating) voice in selecting at least 6 of the minimum of 8 members yet to be selected from the nominees of the 4 Local Community Committees.
  
b. Dominance in the selection of the key senior officers. The table on the prior page indicates that early on it was decided that the CEO of Charity C would be retained as CEO/President of CCNWS, that the CEO of Charity D of County Y would become one of CCNWS’ Vice Presidents, and that there was no need to open the CEO search process to external parties.
  
c. Dominance in terms of financial capability and viability. Charity D has been experiencing financial difficulties and since 20X1 has been somewhat dependent on Charity C to provide back-office and information technology support for a below-cost fee.

- In addition, it appears that Charity C wanted to preserve and obtain certain aspects of Charity D’s operations and resources, including its:
  
a. Expertise in implementing new programs developed and promoted by the national entity.
  
b. Existing donor relationships.
  
c. Residual net assets.

- Charity C apparently wanted to restructure its governance to have a much smaller governing board of 20 to 30 high-impact community leaders (like the members of its existing Executive Committee). Charity C’s wishes concerning aspects of Charity D’s operations and resources and restructuring its governance do not relate directly to the indicators that help to distinguish a merger from an acquisition. But those additional factors are part of what is considered in making a judgment on the basis of the preponderance of the evidence, as this Statement requires.
On the basis of the preponderance of the evidence, it is determined that Charity C acquired Charity D. The acquisition was achieved by, in effect, a gift of Charity D to Charity C. Although each charity legally dissolved, the substance of the combination is much the same as if Charity C first restructured its board of directors along the lines desired and then absorbed Charity D and added five of its nominees to the restructured board.

Despite the process and legal form used, the economic substance of the transaction is judged to be one in which the central governing power residing in the Executive Committee of Charity C was not surrendered; that is, the governing body of Charity C did not cede control of the entity to the governing body of CCNWS.

The transaction is an acquisition in which the economic substance and existence of Charity C (the acquirer) continue, although with a different name and expanded operations.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following transactions is not included in the scope of FASB No. 164 (ASC 958):
   a) joint venture
   b) a combination between two unrelated not-for-profit entities
   c) a not-for-profit entity that obtains control over another not-for-profit entity and consolidates that entity
   d) an acquisition of a business

2. Which of the following is considered a collection under FASB No. 164 (ASC 958):
   a) a precious coin that is kept in a private collection
   b) a copy of a work of art as long as there are not more than ten copies available
   c) a rare piece of art that is held in a public exhibition
   d) a famous painting that is kept encumbered

3. Which of the following would be an element satisfying the definition of a merger of not-for-profit entities:
   a) both entities must not cede control of their respective entities
   b) at least 50 percent of the original balance sheets must be retained
   c) a new entity must be created
   d) one entity must control the other entity

4. The sole definitive criterion that overrides all others in a merger is:
   a) relative size of the entities involved
   b) financial strength of the entities
   c) governance
   d) control

5. Which of the following factors dealing with governance is not considered in determining whether control powers differ in a merger versus an acquisition:
   a) retaining an entity’s bylaws
   b) retaining an entity’s senior officers
   c) retaining an entity’s name and logo
   d) retaining an entity’s operating policies
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** A joint venture is not included within the scope of FASB No. 164.

   B: Incorrect. Two entities that are unrelated and not under common control are within the scope of FASB No. 164.

   C: Incorrect. A transaction in which a not-for-profit entity obtains control of another not-for-profit entity but does not consolidate that entity is excluded from the scope. In this example, the entities consolidate thereby bringing the transaction within the scope of FASB No. 164.

   D: Incorrect. FASB 164’s scope applies to a business and does not apply to a group of assets that does not constitute a business.

   (See page 4 of the course material.)

2. **A: Incorrect.** A precious coin that is held for public exhibition, education or research for further public service may be a collection, but not a coin that is kept in a private collection.

   B: Incorrect. The original work of art may be a collection, but certainly not a copy of a work of art.

   **C: Correct.** A rare piece of art that is held in a public exhibition, education or research for further public service may be a collection.

   D: Incorrect. A painting must be kept unencumbered to be considered a collection.

   (See page 5 of the course material.)

3. **A: Incorrect.** Both entities must cede control of their entities.

   B: Incorrect. There is no requirement that at least 50 percent of the original balance sheets be retained.

   **C: Correct.** In a merger, a new not-for-profit entity must be created.

   D: Incorrect. In a merger, typically neither entity has direct control of the other entity, which is indicative of an acquisition, not a merger.

   (See page 6 of the course material.)
4. A: Incorrect. Although the relative size of the entities involved is a characteristic, it is not the overriding one.

B: Incorrect. The Statement does recognize that the financial strength of the entities to one another is a characteristic, albeit not the most definitive one.

C: Incorrect. The fact that one entity appoints significantly more of the governing board to the new entity is a criterion to consider, but it is not the most definitive one.

D: Correct. Ceding control to a new entity is the sole definitive criterion for identifying whether there is a merger or not.

(See page 8 of the course material.)

5. A: Incorrect. Retaining an entity’s bylaws in the new entity is a key factor to consider in deciding whether there is a merger or acquisition.

B: Incorrect. Retaining more of an entity’s key senior officers is a factor to consider in deciding whether there is a merger or acquisition.

C: Correct. The Statement does not identify retention of an entity’s name and logo as a factor to consider.

D: Incorrect. Retaining an entity’s operating policies is identified as a key factor.

(See page 8 of the course material.)
3. Rules for a merger:

   a. If there is a merger, the new not-for-profit entity shall account for the merger by applying the carryover method described in this Statement.

   **Carryover method:** Applying the carryover method requires combining the assets and liabilities recognized in the separate financial statements of the merging entities as of the merger date (or that would be recognized if the entities issued financial statements as of that date), adjusted as necessary to reflect a consistent method of accounting and to eliminate intraentity transactions.

   b. The new entity shall recognize in its financial statements the assets and liabilities reported in the separate financial statements of the merging entities as of the merger date in accordance with GAAP.

   c. The carryover method is applied by combining the assets and liabilities recognized in the financial statements of the merging entities as of the merger date.

      1) The new entity does not recognize additional assets or liabilities, such as internally developed intangible assets, that GAAP did not require or permit the merging entities to recognize.

      **Note:** If a merging entity’s separate financial statements are not prepared in accordance with GAAP, those statements shall be adjusted to GAAP before the new entity recognizes the assets and liabilities.

   d. The new entity shall carry forward at the merger date the merging entities’ classifications and designations of their assets and liabilities unless one of the following exceptions applies:

      1) The merger results in a modification of a contract in a manner that would change those previous classifications or designations; or
      2) Reclassifications are necessary to conform accounting policies.

      **Note:** In some situations, GAAP provides for different accounting depending on how an entity classifies or designates a particular asset or liability. The new entity shall carry forward into the opening balances in its financial statements the merging entities’ classifications and designations unless either of the above two exceptions apply.

      In the first situation ((a) above), the new entity shall classify or designate the asset or liability on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the date of that modification. In the second situation ((b) above), the new entity shall classify or designate the asset or liability on the basis of the conformed accounting policies at the merger date.

   e. The new entity shall measure the assets and liabilities in its financial statements as of the merger date at the amounts reported in the financial statements of the merging entities as of that date prepared in accordance with GAAP, adjusted as necessary in accordance with the following:
1) **Adjustment 1:** The merging entities may have measured assets and liabilities using different methods of accounting in their separate financial statements. The new entity shall adjust the amounts of those assets and liabilities as necessary to reflect a consistent method of accounting.

**Note:** Because the carryover method does not reflect a “fresh-start” measurement, a merger is not an event that permits the election of accounting options that are restricted to the entity’s initial acquisition or recognition of an item (or the reversal of a previous election). Thus, for example, one merging entity’s election of the fair value option in FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, for a particular financial asset or liability permits neither the new entity’s election of the fair value option for other financial assets or liabilities at the merger date nor the reversal of the previous selection of the fair value option.

2) The new entity shall eliminate the effects of any intra-entity transactions on its assets, liabilities, and net assets as of the merger date.

f. Presentation for new entity in merger:

1) The entity resulting from a merger is a **new reporting entity**, with no activities before the date of the merger.
   - The new entity’s initial reporting period begins with the merger date, and the merger itself shall not be reported as activity of the new entity’s initial reporting period.
   - The combined assets, liabilities, and net assets of the merging entities are included in the statement of financial position as of the beginning of that initial reporting period, if presented.

2) The new entity’s statement of activities and statement of cash flows for its initial reporting period shall:
   - Include the opening amounts such as a) cash and cash equivalents at the beginning of the period, b) the combined amounts of the merging entities’ assets and liabilities, and c) net assets (in total and by classes of net assets) as of the merger date.
   - Report activity from the merger date through the end of the reporting period.

   **Note:** Opening amounts shall include any accounting changes necessary to adjust a merging entity’s financial statements to GAAP, to conform the individual accounting policies of the merging entities, or to eliminate intra-entity balances.
g. Disclosures for a merger

1) The new entity shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of the merger that resulted in its formation. Those disclosures include:

a) The name and a description of each merging entity
b) The merger date
c) The primary reasons for the merger
d) For each merging entity:
   • The amounts recognized as of the merger date for each major class of assets and liabilities and each class of net assets
   • The nature and amounts, if applicable, of any significant assets (for example, conditional promises receivable or collections) or liabilities (for example, conditional promises payable) that GAAP does not require to be recognized

e) The nature and amount of any significant adjustments made to conform the individual accounting policies of the merging entities or to eliminate intra-entity balances
f) If the new entity is a public entity, as defined in paragraph 3(w) of this Statement, the following supplemental pro forma information:
   • If the merger occurs at other than the beginning of an annual reporting period and the entity’s initial financial statements thus cover less than an annual reporting period, the following information for the current reporting period as though the merger date had been the beginning of the annual reporting period:
     - Revenue
     - For an entity subject to the health care Guide, the performance indicator
     - Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets
   • If the new entity presents comparative financial information in the annual reporting period following the year in which the merger occurs, the entity shall disclose the supplemental pro forma information for the comparable prior reporting period as though the merger date had been the beginning of that prior annual reporting period.

Note: If disclosure of any of the information required by this subparagraph is impracticable, the entity shall disclose that fact and explain why the disclosure is impracticable. This Statement uses the term impracticable with the same meaning as impracticability in paragraph 11 of FASB Statement No. 154, Accounting Changes and Error Corrections (ASC 250).

If the specific disclosures required by this Statement and other GAAP do not meet the objectives of disclosure outlined by the Statement, the entity shall disclose whatever additional information is necessary to meet that objective.
Illustration of Disclosures for a Merger (FASB No. 164)

**Facts:** Three not-for-profit entities – NFP A, NFP B, and NFP C – merge to create a new entity, NFP ABC, a public entity.

The following disclosures present a tabular disclosure that could also be presented in a narrative format. The required supplemental information is presented in a separate schedule outside the notes.

**NOTE X: Merger**

NFP ABC was formed on June 15, 20X1, as the result of a merger of three local not-for-profit entities: NFP A, NFP B, and NFP C. All three entities shared the common mission of supporting youth education. Through their merger, the entities seek to further their common mission to: a) substantially improve their after-school youth programs in the region and their capability to assist youth in need, and b) achieve economies of scale and other synergies through integrating their services.

At June 15, 20X1, NFP A had a conditional promise receivable of $1.4 million from donor XA to be used to construct a new after-school youth facility. The promise is conditioned upon NFP A raising an equivalent amount from others by the end of 20X4 to be used for construction of the facility. At the merger date, NFP A had raised $420,000. NFP ABC expects to successfully raise the remaining amount by the end of 20X4.

Of NFP A’s temporarily restricted net assets at the merger date, $789,000 related to its accounting policy of implying a time restriction on gifts of long-lived assets over the useful life of the donated assets. NFP B and NFP C had elected not to imply a time restriction on those types of gifts, and NFP ABC has conformed its policy to that of NFP B and NFP C. Thus, the time restriction on NFP A’s donated long-lived assets was removed, which increased the opening balance of NFP ABC’s unrestricted net assets by $789,000.
### Major Classes of Assets

_June 15, 20X1_  
(In Thousands)

<table>
<thead>
<tr>
<th>ASSETS:</th>
<th>NFP A</th>
<th>NFP B</th>
<th>NFP C</th>
<th>Adjustments</th>
<th>Total NFP ABC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and equivalents</td>
<td>$4,127</td>
<td>$7,213</td>
<td>$3,179</td>
<td></td>
<td>$14,519</td>
</tr>
<tr>
<td>Contributions receivable</td>
<td>3,053</td>
<td>5,102</td>
<td>2,736</td>
<td></td>
<td>10,851</td>
</tr>
<tr>
<td>Allowance for uncollectibles</td>
<td>(295)</td>
<td>(524)</td>
<td>(157)</td>
<td></td>
<td>(976)</td>
</tr>
<tr>
<td>Net receivables</td>
<td>2,758</td>
<td>4,578</td>
<td>2,539</td>
<td></td>
<td>9,875</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>43,337</td>
<td>59,021</td>
<td>15,875</td>
<td></td>
<td>118,233</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(8,458)</td>
<td>(9,935)</td>
<td>(1,990)</td>
<td></td>
<td>(20,383)</td>
</tr>
<tr>
<td>Property and equipment, net</td>
<td>34,879</td>
<td>49,086</td>
<td>13,885</td>
<td></td>
<td>97,850</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>54,987</td>
<td></td>
<td></td>
<td></td>
<td>205,225</td>
</tr>
<tr>
<td>Total assets</td>
<td>96,751</td>
<td>169,111</td>
<td>61,607</td>
<td></td>
<td>327,469</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES:</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>3,128</td>
<td>6,412</td>
<td>3,333</td>
<td></td>
<td>12,873</td>
</tr>
<tr>
<td>Grants payable</td>
<td>2,893</td>
<td>3,765</td>
<td>2,232</td>
<td></td>
<td>8,890</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>32,980</td>
<td>45,190</td>
<td>18,556</td>
<td></td>
<td>96,726</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>39,001</td>
<td>55,367</td>
<td>24,121</td>
<td></td>
<td>118,489</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>NET ASSETS:</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanently restricted</td>
<td>37,987</td>
<td>58,209</td>
<td>12,929</td>
<td></td>
<td>109,125</td>
</tr>
<tr>
<td>Temporarily restricted</td>
<td>10,847</td>
<td>28,200</td>
<td>15,966</td>
<td>(789)</td>
<td>54,224</td>
</tr>
<tr>
<td>Unrestricted</td>
<td>8,916</td>
<td>27,335</td>
<td>8,591</td>
<td>789</td>
<td>45,631</td>
</tr>
<tr>
<td>Total net assets</td>
<td>$57,750</td>
<td>$113,744</td>
<td>$37,486</td>
<td>$0</td>
<td>$208,980</td>
</tr>
</tbody>
</table>

**Supplementary Information (unaudited)**

NFP ABC’s revenue and changes in unrestricted assets, temporarily restricted net assets, and permanently restricted net assets for the year ended December 31, 20X1, as if the merger had occurred at January 1, 20X1, are as follows:

<table>
<thead>
<tr>
<th>Supplemental pro forma information for January 1 to December 31, 20X1</th>
<th>Change in Unrestricted Net Assets</th>
<th>Change in Temporarily Restricted Net Assets</th>
<th>Change in Permanently Restricted Net Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$17,139</td>
<td>$5,715</td>
<td>$(2,922)</td>
</tr>
</tbody>
</table>

If NFP ABC presents comparative financial information in the annual reporting period following the year in which the merger occurs, the supplemental pro forma information above would be presented in the financial report of that year as well.
4. **Rules for an acquisition:**

1. A not-for-profit entity shall account for each acquisition of a business or nonprofit activity by applying the *acquisition method* as described in this Statement.
   
   a. The *acquisition method* in FASB No. 164 is the same as the acquisition method described in FASB No. 141(R).

   **Note:** In applying the acquisition method, FASB No. 164 provides guidance on items unique or especially significant to a not-for-profit entity (including the provisions on the non-recognition of goodwill for particular acquires) has been added, and guidance that does not apply to a not-for-profit acquirer has been eliminated.

   b. Steps to applying the acquisition method include:

   - **Step 1:** Identify the acquirer.
   - **Step 2:** Determine the acquisition date.
   - **Step 3:** Recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquire.
   - **Step 4:** Recognize and measure goodwill (or the immediate charge to the statement of activities).

   *Exhibit C* (at the end of this chapter) provides further guidance on applying the acquisition method for not-for-profit organizations.

2. A not-for-profit entity that acquires assets that do not constitute a *business* or a *nonprofit activity* as defined by FASB No. 164 shall account for the transaction or other event as an *asset acquisition*.

   **Note:** An asset acquisition involves recording an asset or group of assets at the fair value of the consideration given. Generally, no goodwill is reflected in an asset acquisition.

   **Note:** FASB No. 141(R) (ASC 805) uses the term *business* to differentiate an acquisition of an integrated set of activities and assets that is within the scope of that Statement from an acquisition of a group of assets that is outside its scope. Paragraph 3(d) of FASB No. 141(R) defines *business* as “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.” FASB No. 164 uses the same definition of *business* as found in FASB No. 141(R).

   In addition to the term *business*, FASB No. 164 also uses the term *nonprofit activity* to differentiate an acquisition of an integrated set of activities and assets that is within its scope from an acquisition of a group of assets that is outside its scope. This Statement builds on the definition of a *business* in defining a *nonprofit activity*: each is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits.

   *See Exhibit B* (at the end of this chapter) for more details on the term *business* and *nonprofit activity*.
Step 1: Identify the acquirer

1. For each acquisition, one of the combining entities shall be identified as acquirer.
   a. The existing guidance on control and consolidation of not-for-profit entities shall be used to identify the acquirer, which is the entity that obtains control of the acquiree.
      • For a not-for-profit other than a health care entity, the guidance found in SOP 94-3 is used to identify the acquirer.
      • For a not-for-profit health care, Chapter 11 of the health care guide is used to identify the acquirer.
   b. The acquirer is the entity that obtains control of the acquiree (and recognizes the acquiree in its financial statements).
   c. If an acquisition has occurred but applying the guidance in SOP 94-3, the health care Guide, or ARB 51 does not clearly indicate which of the combining entities is the acquirer, the following factors shall be considered in making that determination of which entity is the acquirer.
      • The entity that transfers the cash or other assets or incurs the liabilities.
      • The entity whose relative size (measured in, for example, assets, revenues, or change in net assets) is significantly larger than that of the other combining entity or entities.
      • The entity that can select or dominate the process of selecting the management team of the resulting entity.
      • The entity whose mission and the legal name is retained in the combined entity.
      • The entity that initiated the transaction, as well as the relative size of the combining entities.
      • The entity whose governing body has the ability to select or dominate the process of selecting the governing body of the combined entity.

Step 2: Determine the acquisition date

1. The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.
   a. The date on which the acquirer obtains control of the acquire generally is the date on which the acquirer legally transfers the consideration (if any), acquires the assets, and assumes the liabilities of the acquiree, which is the closing date.
      • An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.
Note: For an acquisition by a not-for-profit entity, the date on which the acquirer obtains control of another not-for-profit entity with sole corporate membership also is the date on which the acquirer becomes the sole corporate member of that entity. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. One example is where a written agreement provides that the acquirer obtains control of the acquire on a date before the closing date.

Step 3: Recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree

Recognition:

a. As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree.

Note: To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquire or to terminate the employment of or relocate an acquiree’s employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its post-combination financial statements in accordance with other applicable GAAP.

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged (or what was contributed) in the acquisition transaction rather than the result of separate transactions.

b. The acquirer’s application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, the acquirer may recognize the acquired identifiable intangible assets, such as a brand name, a patent, or a customer relationship, that the acquire did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

c. Classify or designate identifiable assets acquired and liabilities assumed in an acquisition

1) At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.
Exceptions: The Statement provides two exceptions under which certain assets are classified under other GAAP:

a) A lease contract classified as either an operating lease or a capital lease in accordance with FASB Statement No. 13, Accounting for Leases (ASC 840), as interpreted by FASB Interpretation No. 21, Accounting for Leases in a Business Combination, and

b) A contract written by an entity that is in the scope of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (ASC 325), as amended, that is classified as an insurance or reinsurance contract or a deposit contract.

In either of these two exceptions, the acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition).

2) In some situations, there is a difference as to how GAAP requires an entity to classify or designate a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:

1) Classification of particular investments in securities as trading or other than trading in accordance with the health care guide.

2) Designation of a derivative instrument as a hedging instrument in accordance with FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (ASC 815).

3) Assessment of whether an embedded derivative should be separated from the host contract in accordance with Statement 133 (which is a matter of classification as paragraph 32 of this Statement uses that term).

Measurement:

a. The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquire at their acquisition-date fair values.

b. Following is the guidance to measuring the fair values of particular identifiable assets, assumed liabilities, and a noncontrolling interest in an acquiree.
### Asset or Liability

<table>
<thead>
<tr>
<th>Description</th>
<th>How to Measure Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets with Uncertain Cash Flows (Valuation Allowances)</strong></td>
<td>The acquirer shall not recognize a separate valuation allowance as of the acquisition date for acquired assets that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure.</td>
</tr>
<tr>
<td><strong>Assets Subject to Operating Leases in Which the Acquiree Is the Lessor</strong></td>
<td>The acquirer shall measure the acquisition-date fair value of an asset, such as a building or a patent or other intangible asset, that is subject to an operating lease in which the acquiree is the lessor separately from the lease contract. The fair value of the asset shall be the same regardless of whether it is subject to an operating lease. The acquirer separately recognizes an asset or a liability if the terms of the lease are favorable or unfavorable relative to market terms.</td>
</tr>
<tr>
<td><strong>Assets That the Acquirer Intends Not to Use or to Use in a Way Other Than Their Highest and Best Use</strong></td>
<td>The acquirer shall measure the asset at fair value determined in accordance with FASB No. 157 (ASC 820), reflecting its highest and best use.</td>
</tr>
<tr>
<td><strong>Measuring the Fair Value of a Noncontrolling Interest in an Acquiree</strong></td>
<td>Acquirer must measure a noncontrolling interest in the acquiree at its fair value at the acquisition date.</td>
</tr>
<tr>
<td><strong>Transfer of Consideration in Which the Acquirer Retains Control</strong></td>
<td>An asset transferred by the acquirer to a designee of the former owner shall be taken into account in measuring consideration transferred unless the acquirer retains control over the transferred assets.</td>
</tr>
</tbody>
</table>

### Exceptions to the Recognition or Measurement Principles

FASB No. 164 provides some exceptions to its recognition and measurement principles under which the acquirer shall apply the specified GAAP or the specified requirements rather than the recognition and measurement principles in FASB No. 164 to determine when to recognize or how to measure the assets or liabilities identified.

**1. Exceptions to the recognition principle:**

**Donor relationships**

Unlike an acquired customer relationship (e.g., customer list), the acquirer shall not recognize an acquired donor relationship (e.g., donor list) as an identifiable intangible asset separately from goodwill.

**Note:** An acquirer also may be able to attribute value to the acquiree’s donor relationships such as the information the acquiree has about its donors, the regular contact the acquiree has with its donors, and the donors’ ability to make direct contact with the acquiree. However, estimating the fair value of acquired donor relationships
would be difficult and so costly that requiring acquirers to do so would not meet a reasonable cost-benefit test. Therefore, unlike acquired customer relationships, acquired donor relationships are not recognized separately; they are instead subsumed into goodwill.

**Collections**

An acquirer that has an organizational policy of not capitalizing collections in accordance with FASB No. 116 (ASC 720) shall not recognize as an asset those items (works of art, historical treasures, or similar assets) that it acquires as part of an acquisition and adds to its collection. Instead, the acquirer shall:

a. Recognize the cost of the purchased (either by the transfer of consideration or the assumption of liabilities in excess of assets acquired) collection items as a decrease in the appropriate class of net assets in the statement of activities and as a cash outflow for investing activities.

b. Not recognize the fair value of contributed collection items – either as an asset or as contribution revenue.

FASB No. 164 provides the following guidance on determining whether an acquired collection item is purchased or contributed and, if purchased, the appropriate amount of cost to attribute to them. An acquired item that is not added to the acquirer’s collection shall be recognized as an asset and measured at fair value in accordance with this Statement.

1. An acquirer that has an organizational policy not to capitalize collections items should apply FASB Statement No. 116, Accounting for Contributions Received and Contributions Made (ASC 720), in accounting for acquired collection items.

   a. FASB No. 116 requires that an entity with such a policy not recognize acquired collection items as an asset. Instead, an entity with such a policy recognizes the cost of purchased collection items as a decrease in the appropriate class of net assets in the statement of activities in the period acquired and as a cash outflow for investing activities if purchased by cash. Therefore, the acquirer will need to determine whether acquired collection items were purchased or contributed and, if purchased, the cost to attribute to them.

Examples from FASB No. 164:

**Example 1: Collection items received in an acquisition by gift**

**Facts:** Museum B, which has a policy of not capitalizing collection items, acquires Museum A without transferring consideration. As part of the transaction, Museum B acquires 500 paintings owned by Museum A. Museum B adds 450 of Museum A’s paintings to its collection. The remaining 50 paintings acquired from Museum A are not suitable for Museum B’s collection. They are not subject to donor restrictions, and Museum B expects to sell them. The fair values of Museum A’s assets and liabilities other than collection items (the 450 paintings) at the acquisition date are as follows:
Cash $200
Accounts receivable 400
Contributions receivable 200
Property, plant and equipment 800
Paintings (50 paintings) 100
Liabilities (200)
Identifiable net assets other than collections $1,500

Conclusion: Because Museum B transferred no consideration, it would recognize a separate credit to its statement of activities (contribution received) of $1,500 in accordance with FASB No. 164. No measurement of the collection items (the 450 paintings) would be required because it is evident that those items were contributed as part of the acquisition. It is evident that the items were contributed because the fair value of the identifiable assets (excluding the collection items) exceeds the fair value of the liabilities assumed and no consideration was transferred for the acquiree. Any value that might be ascribed to the newly acquired collection items would increase the amount of the contribution received by Museum B in the acquisition. Consistent with FASB No. 116, contributed collection items that meet the criteria of that Statement are not recognized as an asset and a contribution received.

Example 2: Collection items received in an acquisition

Facts: Museum D, which has a policy of not capitalizing collection items, acquires Museum C. To effect the acquisition, Museum D agrees to transfer cash consideration of $1,600 to a foundation designated by Museum C. As part of the acquisition, Museum D acquires 800 paintings owned by Museum C. Museum D adds all of Museum C’s paintings to its collection. The fair values of Museum C’s assets and liabilities other than collection items at the acquisition date are as follows:

Cash $100
Accounts receivable 50
Contributions receivable 75
Property, plant and equipment 675
Liabilities (200)
Identifiable net assets other than collections $700

Conclusion: It is unclear whether the collection items were contributed or purchased because the fair value of the consideration transferred ($1,600) exceeds the aggregate of the identifiable net assets acquired (excluding the collection items) ($700). The excess $900 paid could be attributable entirely to either the collection items or goodwill, or part could be attributed to the cost of the collection items and part to goodwill. In this situation, if Museum D determines that the acquisition-date fair values of the collection items are far greater than $900, it would presume that $900 of the excess relates to the cost of the purchased collection items and that the remainder of the excess relates to contributed collection items. Consistent with how purchased collections are recognized in FASB No. 116, that $900 cost would be recognized as a decrease in the appropriate class of net assets in the statement of activities in the period of the acquisition. No goodwill or contribution revenue would be recognized. If Museum D instead determines that the acquisition-date fair values of the collection items are less than $900, for example, $300, it could not presume that the entire $900 excess relates to the collection. Rather, Museum D would attribute that lesser amount to the cost of the purchased collection items and attribute the remaining portion of the excess ($600) to goodwill.
(The acquiree, Museum C, as part of the acquired entity is expected to obtain so much of its support from sources other than contributions and returns on investments that it does not qualify to immediately charge to the statement of activities the amount that otherwise is recognized as goodwill.)

**Conditional promises to give**

A conditional promise to give is a promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor, under FASB No. 116.

An acquirer shall apply the guidance in paragraphs 22 and 23 of FASB No. 116 to account for conditional promises to give, which requires the acquirer to:

- Recognize a conditional promise only if the conditions on which it depends are substantially met as of the acquisition date.
- Recognize a transfer of assets with a conditional promise to contribute them as a refundable advance unless the conditions have been substantially met as of the acquisition.

2. Exceptions to both the Recognition and Measurement Principles

**Assets and liabilities arising from contingencies**

With respect to any assets or liabilities arising from contingencies, the acquirer shall recognize as of the acquisition date, assets acquired and liabilities assumed that would be within the scope of FASB Statement No. 5, Accounting for Contingencies, if not acquired or assumed in a business combination, except for assets or liabilities arising from contingencies that are subject to specific guidance in this Statement, as follows:

- If the acquisition-date fair value of the asset or liability arising from a contingency can be determined during the measurement period, that asset or liability shall be recognized at the acquisition date measured at fair value. For example, the acquisition-date fair value of a warranty obligation often can be determined.
- If the acquisition-date fair value of the asset or liability arising from a contingency cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if both of the following criteria are met:
  1. Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur, and
  2. The amount of the asset or liability can be reasonably estimated.

Note: Criteria (1) and (2) shall be applied using the guidance in FASB No. 5 and FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, for application of similar criteria in paragraph 8 of FASB No. 5.

If neither criterion (1) nor criterion (2) is met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date. In periods after the acquisition date, the acquirer shall account for an
asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including FASB No. 5, as appropriate.

Contingent consideration arrangements of an acquire assumed by the acquirer in an acquisition shall be recognized initially at fair value.

**Income taxes**

The acquirer shall recognize and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in an acquisition in accordance with FASB Statement No. 109, Accounting for Income Taxes, as amended.

The acquirer shall account for the potential tax effects of temporary differences, carry-forwards, and any income tax uncertainties of an acquire that exist at the acquisition date or that arise as a result of the acquisition in accordance with Statement 109, as amended, and related interpretative guidance, including FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes.

**Employee benefits**

The acquirer shall recognize and measure a liability (or asset, if any) related to the acquiree’s employee benefit arrangements in accordance with other GAAP, as amended. For example, employee benefits in the scope of the following standards would be recognized and measured in accordance with those standards.

- a. APB Opinion No. 12, Omnibus Opinion – 1967 (deferred compensation contracts) (ASC 710)
- b. FASB Statement No. 43, Accounting for Compensated Absences (ASC 360)
- c. FASB Statement No. 87, Employers’ Accounting for Pensions (ASC 715)
- d. FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (ASC 715)
- e. FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions (ASC 715)
- f. FASB Statement No. 112, Employers’ Accounting for Postemployment Benefits (ASC 712)
- g. FASB Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities (one-time termination benefits) (ASC 420)
- h. FASB Statement No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans (ASC 715)

**Indemnification assets**

The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. For an indemnification asset measured at fair value, the effects of uncertainty about future cash flows because of collectability considerations are included in the fair value measure, and a separate valuation allowance is not necessary.
Note: In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingency that is not recognized at the acquisition date because it does not satisfy the criteria for recognition at that date. Alternatively, an indemnification may relate to an asset or a liability, for example, one that results from an uncertain tax position, that is measured on a basis other than acquisition-date fair value. In those circumstances, the indemnification asset shall be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management’s assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount.

3. Exceptions to the Measurement Principle

Reacquired rights

The acquirer shall measure the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

Assets held for sale

At the acquisition date, the acquirer shall measure an acquired long-lived asset (or disposal group) that is classified as held for sale in accordance with FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, at fair value less cost to sell in accordance with paragraphs 34 and 35 of that Statement.

Step 4: Recognizing and measuring goodwill acquired or a contribution received

Goodwill acquired:

a. Unless the operations of the acquire as part of the combined entity are expected to be predominantly supported by contributions and returns on investments, the acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (1) over (2) below:

1) Fair value of consideration given: The aggregate of:
   • The consideration transferred measured at its acquisition-date fair value.
   • The fair value of any non-controlling interest in the acquiree.
   • In an acquisition achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquire.

2) Fair value of assets and liabilities: The net of the acquisition-date fair value of amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Statement.

Goodwill formula looks like this:
The acquirer shall recognize goodwill as of the acquisition date, measured based on the following formula:
A  Fair value of consideration given:
   • Consideration transferred measured at acquisition-date fair value
   • Fair value of any noncontrolling interest in the acquiree
   • If a business combination achieved in stages, the acquisition-date fair value of the acquirer’s previously held equity interest in the acquiree

B  Fair value of identifiable assets acquired and the liabilities assumed

\[ A-B = \text{GOODWILL} \]

Example:

NP X purchases the net assets of NP Y for $5,000,000. The fair value of the net assets is as follows:

<table>
<thead>
<tr>
<th>Fair value of consideration given</th>
<th>$5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of identified assets and liabilities:</td>
<td></td>
</tr>
<tr>
<td>Property and equipment</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Accounts payable and other current liabilities assumed</td>
<td>(3,500,000)</td>
</tr>
<tr>
<td>- Fair value assets purchased</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Entry at acquisition date:

|Property and equipment           | 7,000,000 |
|Other assets                     | 1,000,000 |
|**Goodwill**                     | **500,000** |
|Accounts payable and other current liabilities assumed | 3,500,000 |
|Cash, notes payable, equity, etc.| 5,000,000 |

b. If the operations of the acquire as part of the combined entity are expected to be predominantly supported by contributions and returns on investments, the acquirer shall recognize an excess of the amount in paragraph a(1) above over the amount in paragraph a(2) above, as a separate charge in its statement of activities as of the acquisition date rather than as goodwill, predominantly supported by means that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenues.

Example: Management of Organization ABC expects the soup kitchen resulting from the conversion of Restaurant XYZ to be predominantly supported by contributions and returns on investments. Specifically, the operating costs of the soup kitchen are expected to be funded by Organization ABC’s existing contribution base.
Conclusion: The following table from FASB No. 164 illustrates how Organization ABC might present the separate charge to the statement of activities at the acquisition date.

<table>
<thead>
<tr>
<th>Organization ABC</th>
<th>Statement of Activities</th>
<th>For the Year Ended December 31, 20X0</th>
<th>(presented in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue, gains, and other support</td>
<td>$ 8,640</td>
<td>$ 6,510</td>
<td>$ 280</td>
</tr>
<tr>
<td>Net assets released from restrictions</td>
<td>5,820</td>
<td>(5,820)</td>
<td></td>
</tr>
<tr>
<td>Total revenues, gains, and other support</td>
<td>14,460</td>
<td>690</td>
<td>280</td>
</tr>
<tr>
<td>Expenses</td>
<td>(13,115)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in net assets before changes related to acquisition of Restaurant XYZ</td>
<td>1,345</td>
<td>690</td>
<td>280</td>
</tr>
<tr>
<td>Excess of consideration transferred over net assets acquired in acquisition of Restaurant XYZ (Note X)</td>
<td>(115)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in net assets</td>
<td>$ 1,230</td>
<td>$ 690</td>
<td>$ 280</td>
</tr>
</tbody>
</table>

Note: The Statements notes that an acquirer shall consider all relevant qualitative and quantitative factors in determining the expected nature of the predominant source of support for an acquiree’s operations as part of the combined entity. For example, an acquirer shall consider qualitative and quantitative information about all forms of contributed support, including contributions that are precluded from being recognized or are not required to be recognized in the financial statements (such as certain contributed services and collection items and conditional promises to give).

In some acquisitions by not-for-profit entities, no consideration is transferred. In that situation, the result of the equation noted above will be to measure goodwill or the separate charge to the statement of activities as the excess of liabilities assumed over assets acquired.

Contribution received (bargain purchase)

a. The acquirer shall recognize an excess of the fair value of identified assets acquired and liabilities assumed over the fair value of consideration given as a separate credit in its statement of activities as of the acquisition date.

b. In an acquisition effected without the transfer of consideration (and in which items also are not present), the excess amount will be the excess of assets acquired over liabilities assumed.

c. Formula for contribution received:
A gain shall be recognized as a contribution received on the statement of activities at the acquisition date for the value of a bargain purchase. A bargain purchase occurs when the fair value of the net assets acquired is greater than the fair value of the consideration given.

Bargain purchase (recorded as contribution received) is:

- Fair value of identifiable assets acquired and liabilities assumed $XXX
- Fair value of consideration given (XX)

BARGAIN PURCHASE $XXX
**Example:** NP X purchases the net assets of NP Y for $100,000. The fair value of the net assets acquired is $125,000.

**Conclusion:** There is a bargain purchase of $25,000 representing the difference between the fair value of the net assets acquired ($125,000) and the fair value of the consideration given ($100,000).

**Entry at acquisition date:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets of acquiree (at fair value)</td>
<td>125,000</td>
</tr>
<tr>
<td>Cash, notes payable, equity, etc.</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Contribution received</strong></td>
<td><strong>25,000</strong></td>
</tr>
</tbody>
</table>

**Observation:** The accounting for the bargain purchase element as a contribution received on the statement of activity is consistent with its application in FASB No. 141(R) with respect to a for-profit entity. In FASB No. 141(R), the credit is recognized as a gain on the income statement.

Although FASB No. 164 states that the credit should be presented as a contribution received in the statement of activity, an entity has flexibility to recast the amount under a different title on the statement of activity. Paragraph 72 of FASB No. 164 states that the excess amount shall be reported in a “separate line item on the face of the statement of activities, appropriately described.” Paragraph 72 provides several examples of captions for that credit as follows:

- “Excess of assets acquired over liabilities assumed in donation of Entity XY”
- “Contribution received in donation of Entity XY”
- “Excess of fair value of net assets acquired over consideration paid in acquisition of Entity XY”

**Consideration transferred**

a. The consideration transferred in an acquisition by a not-for-profit entity shall be measured at *fair value*, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer and the liabilities incurred by the acquirer.

Examples of potential forms of consideration include cash, other assets, a business or a nonprofit activity of the acquirer, and contingent consideration.

b. An asset transferred by the acquirer to an unrelated third party as a required condition of an acquisition shall be accounted for as consideration transferred for the acquire unless the acquirer retains control over the transferred assets.

1) An acquirer that *retains control* over the transferred assets shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognize a gain or loss in the statement of activities on assets or liabilities it controls both before and after the acquisition.

Examples of asset transfers in which control over the future economic benefits of the transferred assets is retained by the acquirer include the following:
• The assets are transferred to the acquiree rather than to its former owners or are otherwise transferred to a recipient that is controlled by the acquirer. Due to having control over the recipient, the acquiring entity has the ability to revoke the transfer or to direct the use of the assets to itself or an affiliate.
• The asset transfer is otherwise revocable, repayable, or refundable.
• The assets are transferred with the stipulation that they be used on behalf of, or for the benefit of, the acquiree, the acquirer, the consolidated entity, or their affiliates.

Example 1: Asset transfer in which the acquirer retains control over the future economic benefits after the acquisition

(As published in FASB No. 164)

Facts: An independent not-for-profit community hospital (Hospital) agreed to be acquired by a nearby not-for-profit health care system (System). Hospital was in the midst of a major capital project at the acquisition date. To ensure completion of that capital project, Hospital’s board of directors required that System transfer $20 million to a newly formed, unrelated foundation (Foundation) governed by a self-perpetuating board of directors. Foundation’s initial board of directors is composed of the former board of directors of Hospital. The acquisition agreement requires that the $20 million be used to complete the project, if necessary, and that any assets remaining in Foundation on completion of the capital project be used solely for future capital projects at Hospital.

Conclusion: In this example, the acquirer has transferred assets to an unrelated third party as a required condition of the acquisition. However, because those assets may be used only for future capital additions at Hospital, System has retained control over the future economic benefits of those assets. A transferor that retains control over the economic benefits in the transferred assets has not transferred assets in exchange for the acquiree. Rather, that transferor has exchanged one asset for another. An asset transfer of that type should be accounted for as an asset-for-asset exchange rather than as consideration transferred.

Contingent consideration

a. The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

3. Additional guidance for applying the acquisition method (from FASB No. 164):

Exhibit C (at the end of this chapter) provides more information on applying the acquisition method.

a. An acquisition achieved in stages:

An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, Entity A holds a 35 percent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 percent interest in Entity B, which gives it control of Entity B.
This Statement refers to such a transaction as an acquisition achieved in stages, sometimes also referred to as a step acquisition.

In an acquisition achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree (in the example in paragraph 59, the 35 percent non-controlling equity interest in Entity B) at its acquisition-date fair value and recognize the resulting gain or loss, if any, in the statement of activities. An entity subject to the health care Guide shall include the gain or loss in the performance indicator. In prior reporting periods, an acquirer that is subject to the health care Guide may have recognized changes in the value of its equity Interest in the acquiree outside the performance indicator (for example, because the investment was classified as other than trading). If so, the amount that was recognized outside the performance indicator shall be reclassified and included in the calculation of gain or loss on the previously held equity interest as of the acquisition date.

b. Measurement period

If the initial accounting for an acquisition is incomplete by the end of the reporting period in which the acquisition occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. During the measurement period, the acquirer also shall recognize additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition.

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for the acquisition. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of this Statement:

- The identifiable assets acquired, liabilities assumed, and any non-controlling interest in the acquiree
- The consideration transferred for the acquiree
- In an acquisition achieved in stages, the equity interest in the acquiree previously held by the acquirer
- The resulting goodwill recognized (or the charge to the statement of activities) or the contribution received recognized

The acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the time at which additional information is obtained and whether the acquirer can identify a reason for a change to provisional...
amounts. Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill or by a direct credit (charge) to the statement of activities if goodwill is not recognized as an asset. However, new information obtained during the measurement period sometimes may result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree’s facilities, part or all of which are covered by the acquiree’s liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability would be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

During the measurement period, the acquirer shall recognize adjustments to the provisional amounts as if the accounting for the acquisition had been completed at the acquisition date. Thus, the acquirer shall revise comparative information for prior periods presented in financial statements as needed, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting.

After the measurement period ends, the acquirer shall revise the accounting for an acquisition only to correct an error in accordance with FASB No. 154, Accounting Changes and Error Corrections.

c. Determining what is part of the acquisition transaction

The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the acquisition began, or they may enter into an arrangement during the negotiations that is separate from the acquisition. In either situation, the acquirer shall:

- identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the acquisition, that is, amounts that are not part of the exchange for the acquiree.

- recognize as part of applying the acquisition method only the consideration transferred for the acquiree. Separate transactions shall be accounted for in accordance with the relevant GAAP.

Note: A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction.
The following are examples of *separate transactions* that are not to be included in applying the acquisition method:

- A transaction that in effect settles preexisting relationships between the acquirer and acquiree.
- A transaction that compensates employees or former owners of the acquiree for future services.
- A transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs.
- A payment by a former owner of an acquired business that is unrelated to the acquiree, such as a contribution to fund activities of the acquirer or its affiliates that are unrelated to those of the acquiree. Those contributions made should be accounted for in accordance with FASB No. 116.

**What factors should be considered in determining what is part of the acquisition?**

FASB No. 164 identifies several factors that should be considered to determine whether a transaction is part of the consideration transferred for the acquiree or whether the transaction is separate from the acquisition:

a. *The reasons for the transaction:* The reasons why the parties to the combination (the acquirer, the acquiree, and their owners, directors, managers, and their agents) entered into a particular transaction or arrangement may provide insight into whether it is part of the consideration transferred and the assets acquired or liabilities assumed.

   **Example:** If a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than primarily for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the exchange for the acquiree. Accordingly, the acquirer would account for that portion separately from the acquisition.

b. *Who initiated the transaction:* Who initiated the transaction may also provide insight into whether it is part of the exchange for the acquiree.

   **Example:** A transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. On the other hand, a transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the acquisition transaction.

c. *The timing of the transaction:* The timing of the transaction may also provide insight into whether it is part of the exchange for the acquiree.

   **Example:** A transaction between the acquirer and the acquiree that takes place during the negotiations of the terms of an acquisition may have been entered into in contemplation of the acquisition to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the acquisition are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.
Example: Asset Acquired from a Third-Party Donor That Is Included in the Acquisition Accounting

Facts: To induce the acquisition of WO (Weak Organization) by SO (Strong Organization), as a condition of SO’s acquisition of WO, a third-party donor agrees to provide a cash contribution to support WO’s mission. That assistance is transferred to SO (the consolidated entity) upon the closing of the acquisition agreement. The donor, as part of its mission and purpose, has an interest in supporting certain not-for-profit entities. From the perspective of the donor, the assistance provided to induce SO to acquire WO is in the furtherance of its mission.

Conclusion: The transaction was arranged primarily to achieve economic benefits favorable to the acquiree. Thus, that assistance would be an asset acquired at the acquisition date that is recognized as part of accounting for the acquisition. The cash assistance is also included in the acquisition accounting even though it is transferred to the resulting combined entity. The situation is accounted for the same as if the third-party donor had contributed the cash to WO before SO’s acquisition of WO.

d. Acquisition-related costs

Acquisition-related costs are costs the acquirer incurs to effect an acquisition. Those costs include finder’s fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt securities shall be recognized in accordance with other applicable GAAP.

5. Presentation of an acquisition:

Statement of activities:

a. The acquirer shall classify an inherent contribution received presented on the basis of the type of restrictions imposed on the related net assets. In classifying those net assets, an acquirer shall:

- Include restrictions imposed on the net assets of the acquiree by a donor before the acquisition and those imposed by the donor of the business or nonprofit activity acquired, if any, in accordance with paragraph 14 of Statement 116.
- Report donor-restricted contributions as restricted support even if the restrictions are met in the same reporting period in which the acquisition occurs. That is, the acquirer shall not apply the reporting exception in paragraph 14 of Statement 116 to restricted net assets acquired in an acquisition.

Thus, the contribution received may increase permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, or some combination of those items.
Example 1: Donor Restrictions on a Contribution Received

Facts: Charity A acquires Charity B. Charity A transfers no consideration in exchange for Charity B. The acquisition was achieved by, in effect, a gift of Charity B to Charity A. The fair values of Charity B’s assets and liabilities, including donor-imposed restrictions, at the acquisition date are as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 75</th>
<th>Unrestricted net assets</th>
<th>$ 550</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions receivable</td>
<td>225</td>
<td>Temporarily restricted net assets</td>
<td>250</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>500</td>
<td>Permanently restricted net assets</td>
<td>200</td>
</tr>
<tr>
<td>Plant, property, and equipment</td>
<td>430</td>
<td>Total net assets</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,230</td>
<td>Total liabilities</td>
<td>(230)</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(65)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage</td>
<td>(165)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities</td>
<td>(230)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total net assets</td>
<td>$ 1,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Conclusion: Charity A recognizes a $1,000 contribution received in the acquisition (the excess of the acquisition-date values of the identifiable assets acquired over the acquisition-date values of the liabilities assumed). Charity A classifies the inherent contribution received according to the type of donor-imposed restrictions, including any imposed by the donor of the business or nonprofit activity acquired. Based on donor restrictions on Charity B’s net assets at the acquisition date, net assets with a fair value of $250 and $200 were classified as temporarily restricted and permanently restricted net assets, respectively. In this example, Charity B is, in effect, the donor of the acquired nonprofit activity, and it imposes no additional donor restrictions. To recognize the fiduciary responsibilities to the donors of Charity B that are assumed when Charity B’s assets and liabilities are acquired, Charity A would classify changes to its net assets as follows:

- Increase in unrestricted net assets: Contribution received in the acquisition of Charity B $550
- Increase in temporarily restricted net assets: Contribution received in the acquisition of Charity B 250
- Increase in permanently restricted net assets: Contribution received in the acquisition of Charity B 200

Example 2: Donor Restrictions on a Contribution Received

Facts: The facts are the same as in Example 1, except that Charity B is a subsidiary of Parent before the acquisition by Charity A.

As a condition of the merger, Parent’s governing board requires that Charity A use $175 of unrestricted net assets for future capital improvements to the facility acquired. The requirement is irrevocable and is not self-imposed.

Conclusion: To recognize the fiduciary responsibilities to the donors of Charity B that are assumed when Charity B’s assets and liabilities are acquired, Charity A would classify changes to its net assets as follows:
Increase in unrestricted net assets:
  Contribution received in the acquisition of Charity B $375

Increase in temporarily restricted net assets:
  Contribution received in the acquisition of Charity B 425

Increase in permanently restricted net assets:
  Contribution received in the acquisition of Charity B 200

An acquirer that transfers assets as consideration for an acquired nonprofit activity or business shall assess whether that transaction satisfies a donor-imposed restriction or otherwise results in a change in its net asset classifications. For example:

a. Transferring consideration in an acquisition might satisfy a donor-imposed restriction on the acquirer’s net assets that were restricted for acquisition of land, buildings, works of art, or other long-lived assets if the acquiree had the qualifying assets. If so, the acquirer may either report the expiration of those restrictions separately or aggregate and report them together with other similar expirations of donor-imposed restrictions during the period in which the acquisition occurs.

b. The acquirer shall report other changes to its net asset classifications separately from both any other reclassifications and any expiration of those restrictions during the period in which the acquisition occurs. For example, an acquirer that transfers as consideration its unrestricted assets and acquires assets from the acquiree that have permanent or temporary donor restrictions shall recognize a reclassification in its statement of activities.

**Statement of Cash Flows**

The acquirer shall present the following cash inflows and outflows and noncash items related to an acquisition in the statement of cash flows:

a. The entire amount of any net cash flow (cash paid as consideration, if any, less acquired cash of the acquiree) shall be reported as an investing activity.

b. Noncash contributions received and any other noncash amounts received or transferred shall be reported in related disclosures as noncash activities in accordance with paragraph 32 of FASB Statement No. 95, *Statement of Cash Flows*.

**Example (from FASB No. 164):** Entity X, a not-for-profit entity acquires Entity S from Entity S’s parent. As part of the acquisition, Entity S’s parent requires that Entity X transfer consideration of $300 to a third-party community foundation. The fair values of Entity S’s assets and liabilities at the acquisition date are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$25</td>
</tr>
<tr>
<td>Contributions receivable</td>
<td>155</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>900</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,080</td>
</tr>
<tr>
<td>Long-term note payable</td>
<td>(375)</td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>$705</td>
</tr>
</tbody>
</table>

Chapter 1: FASB No. 164: Not-for-Profit
Entities: Mergers and Acquisitions
Conclusion: Entity X reports the acquisition as a single line in the investing activities section of the statement of cash flows, as follows:

Investing activities:
Payment for acquisition of Entity S, net of cash acquired $(275) (1)

(1) $300 cash paid less $25 cash acquired.

Entity X discloses the following additional information in a supplemental schedule of noncash investing and financing activities:

Note X: The Company acquired Entity S by transferring cash of $300. In conjunction with the acquisition, liabilities were assumed in the amount of $375 and a contribution was received from Entity S’s parent as follows:

Fair value of assets acquired $1,080
Cash transferred to community foundation (300)
Liabilities assumed (375)
Contribution received in acquisition of Entity S $405

6. Subsequent measurement after an acquisition

a. In general, an acquirer shall subsequently measure and account for assets acquired and liabilities assumed or incurred in an acquisition in accordance with other applicable GAAP for those items, depending on their nature. However, FASB No. 164 provides guidance on subsequently measuring and accounting for the following assets acquired and liabilities assumed or incurred in an acquisition:

• Reacquired rights
• Assets and liabilities arising from contingencies recognized as of the acquisition date
• Indemnification assets
• Contingent consideration
• Contingent consideration arrangements assumed by the acquirer

1) Reacquired rights: A reacquired right recognized as an intangible asset shall be amortized over the remaining contractual period of the contract in which the right was granted. An acquirer that subsequently sells a reacquired right to a third party shall include the carrying amount of the intangible asset in determining the gain or loss on the sale.

2) Assets and liabilities arising from contingencies: An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies, depending on their nature.

3) Indemnification assets: At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management’s assessment of the
collectability of the indemnification asset. The acquirer shall derecognize the indemnification asset only when it collects the asset, sells it, or otherwise loses the right to it.

4) **Contingent consideration:** Some changes in the fair value of contingent consideration and contingent consideration arrangements assumed from an acquiree that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. However, changes resulting from events after the acquisition date, such as meeting an earnings or other performance target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for such changes by remeasuring the related asset or liability to fair value at each reporting date until the contingency is resolved and recognizing the changes in fair value in the statement of activities. An entity subject to the health care Guide shall recognize the changes within the performance indicator unless the arrangement is a hedging instrument for which FASB No. 133, in effect, requires such entities to recognize the changes outside the performance indicator.

*Contingent consideration arrangements assumed by an acquirer:* Contingent consideration arrangements of an acquiree assumed by the acquirer shall be measured subsequently in accordance with the guidance for contingent consideration arrangements. See Exhibit C (at the end of this chapter).

5) **Goodwill and other intangible assets acquired in an acquisition:** A not-for-profit entity shall apply FASB No. 142 (ASC 350), as amended, in subsequently accounting for goodwill and other intangible assets recognized in an acquisition of a business or a nonprofit activity.

**Note:** FASB No. 142 categorizes intangible assets into three categories:

<table>
<thead>
<tr>
<th>Intangible asset type</th>
<th>Accounting treatment – FASB No. 142</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible assets (other than goodwill), with <em>finite lives</em></td>
<td>Capitalized and amortized over the estimated useful life</td>
</tr>
<tr>
<td></td>
<td>Tested for impairment only if there is a reason to do so under FASB No. 144</td>
</tr>
<tr>
<td>Intangible assets, (other than goodwill), with <em>indefinite lives</em></td>
<td>Not amortized</td>
</tr>
<tr>
<td></td>
<td>Tested annual for impairment</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Capitalized and not amortized</td>
</tr>
<tr>
<td></td>
<td>Tested annually for impairment</td>
</tr>
</tbody>
</table>

6) **Ownership interests in subsidiaries:** A not-for-profit entity shall apply ARB 51 (ASC 810), as amended by FASB No. 160 (ASC 810) and this Statement, in accounting for changes in a parent’s ownership interest in a subsidiary after control is obtained.
Disclosures for an acquisition

1. The acquirer makes disclosures, the objective of which is to enable users of its financial statements to evaluate the nature and financial effect of an acquisition that occurs either:
   a. During the current reporting period; or
   b. After the reporting date but before the financial statements are issued or are available to be issued.

2. The acquirer shall disclose the following information for each acquisition that occurs during the reporting period. If the specific disclosures noted below do not meet the objective, the acquirer shall disclose whatever additional information is necessary to meet the objective.
   a. The name and a description of the acquiree.
   b. The acquisition date.
   c. If applicable, the percentage of ownership interest, such as voting equity instruments, acquired.
   d. The primary reasons for the acquisition and a description of how the acquirer obtained control of the acquiree.
   e. A qualitative description of the factors, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors, such as the non-recognition of collections, that make up either:
      (1) The goodwill recognized; or
      (2) The separate charge recognized in the statement of activities in accordance with paragraph 51.
   f. The acquisition-date fair value of the total consideration transferred (or if no consideration was transferred, that fact) and the acquisition-date fair value of each major class of consideration, such as:
      (1) Cash.
      (2) Other tangible or intangible assets, including a business or subsidiary of the acquirer.
      (3) Liabilities incurred, for example, a liability for contingent consideration.
   g. For contingent consideration arrangements and indemnification assets:
      (1) The amount recognized as of the acquisition date
      (2) A description of the arrangement and the basis for determining the amount of the payment.
      (3) An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.
   h. For acquired receivables not subject to the requirements of AICPA Statement of Position 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer:
      (1) The fair value of the receivables.
      (2) The gross contractual amounts receivable.
      (3) The best estimate at the acquisition date of the contractual cash flows not expected to be collected.
The disclosures shall be provided by major class of receivable, such as loans, contributions, direct finance leases in accordance with Statement 13, and any other class of receivables.

i. The amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed.

j. For assets and liabilities arising from contingencies recognized at the acquisition date:
   (1) The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Statement 5 and Interpretation 14).
   (2) The nature of the contingencies.

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

k. For assets and liabilities arising from contingencies that have not been recognized at the acquisition date, the disclosures required by Statement 5 if the criteria for disclosures in that Statement are met. The disclosures, if any, shall be included in the note that describes the acquisition.

l. The total amount of goodwill that is expected to be deductible for tax purposes.

m. The amount of collection items acquired that are recognized in the statement of activities as a decrease in the acquirer’s net assets.

n. The undiscounted amount of conditional promises to give acquired or assumed and a description and the amount of each group of promises with similar characteristics, such as amounts of promises conditioned on establishing new programs, completing a new building, or raising matching gifts by a specified date.

o. For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the acquisition:
   (1) A description of each transaction.
   (2) How the acquirer accounted for each transaction.
   (3) The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized.
   (4) If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.

p. The disclosure of separately recognized transactions shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the statement of activities in which that expense is recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

q. If the acquisition results in an inherent contribution received, a description of the reasons that the transaction resulted in a contribution received.

r. For each acquisition in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date:
   (1) The fair value of the non-controlling interest in the acquiree at the acquisition date.
   (2) The valuation technique(s) and significant inputs used to measure the fair value of the non-controlling interest.

s. In an acquisition achieved in stages:
   (1) The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date.
   (2) The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the
acquisition (paragraph 60) and the line item in the statement of activities in which that gain or loss is recognized.

t. If the acquirer is a public entity:
   (1) Each of the following amounts attributable to the acquiree since the acquisition date that are included in the statement of activities for reporting period:
      (a) Revenues.
      (b) For an entity subject to the health care Guide, the performance indicator.
      (c) Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets.
   (2) The following supplemental pro forma information for the current reporting period as though the acquisition date for all acquisitions that occurred during the current year had been the beginning of the annual reporting period:
      (a) The revenue of the combined entity.
      (b) For an entity subject to the health care Guide, the performance indicator.
      (c) Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets.
   (3) If the acquirer presents comparative financial statements, the supplemental pro forma information in paragraph 66(t)(2)(a)-(c) for the comparable prior reporting period as though the acquisition date for all acquisitions that occurred during the current year had been the beginning of the comparable prior annual reporting period.

3. If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable.

4. For individually immaterial acquisitions occurring during the reporting period that are material collectively, the acquirer shall disclose the above disclosures in the aggregate.

5. If the date of an acquisition is after the reporting date but before the financial statements are issued or available for issue, the acquirer shall disclose the information noted above unless the initial accounting for the acquisition is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason that they could not be made.

6. The acquirer shall disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognized in the current reporting period that relate to acquisitions that occurred in the current or previous reporting periods. To meet this objective, the acquirer shall disclose the following information for each material acquisition or in the aggregate for individually immaterial acquisitions that are material collectively.
   a. If the initial accounting for an acquisition is incomplete (paragraph 61) for particular assets, liabilities, non-controlling interests, or items of consideration and the amounts recognized in the financial statements for the acquisition thus have been determined only provisionally:
Chapter 1: FASB No. 164: Not-for-Profit Entities: Mergers and Acquisitions

VI. Effective Date and Transition

1. This Statement shall be applied prospectively to:

   a. Mergers for which the merger date is on or after the beginning of an initial reporting period beginning on or after December 15, 2009.
   b. Acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2009.

   Earlier application is prohibited. This Statement shall be applied in both annual and interim periods after its effective date.

2. A not-for-profit entity shall apply the following standards prospectively in the first set of initial or annual financial statements for a reporting period beginning on or after December 15, 2009:

   a. FASB No. 142’s requirements on subsequent accounting for goodwill and other intangible assets acquired in an acquisition (FASB No. 142 refers to assets acquired in a business combination).
   b. The amendments FASB No. 160 made to ARB 51 and to other existing pronouncements.
   c. The amendments Appendix D of this Statement makes to ARB 51 on disclosure and presentation of non-controlling interests.
   d. The amendments FASB No. 141(R) (ASC 805) made to existing pronouncements.

3. Except for goodwill and other intangible assets, assets and liabilities that arose from mergers or acquisitions whose dates preceded the application of this Statement shall not be adjusted upon application of this Statement.
Transition for Previously Recognized Goodwill

1. An entity that is predominantly supported by contributions and returns on investments shall write off previously recognized goodwill by a separate charge in the statement of activities for the effect of the accounting change.

2. An entity that is not predominantly supported by contributions and returns on investments shall establish its reporting units on the basis of the guidance in paragraph 54 of FASB No. 142 as follows:
   
a. At the date this Statement is initially applied, an entity shall establish its reporting units based on its reporting structure at that date.

   b. Recognized net assets, excluding goodwill, shall be assigned to those reporting units using the guidance in paragraphs 32 and 33 of FASB No. 142.

   • Recognized assets and liabilities that do not relate to a reporting unit, such as an environmental liability for an operation previously disposed of, need not be assigned to a reporting unit.

   **Note:** All goodwill recognized in an entity’s statement of financial position at the date this Statement is initially applied shall be assigned in a reasonable and supportable manner. The sources of previously recognized goodwill shall be considered in making that initial assignment as well as the reporting units to which the related acquired net assets were assigned.

3. After establishing its reporting units, an entity that is not predominantly supported by contributions and returns on investments shall subject previously recognized goodwill in each reporting unit to the transitional impairment evaluation required by paragraphs 55-58 of Statement 142, as follows:

   a. Goodwill in each reporting unit shall be tested for impairment as of the beginning of the fiscal year in which this Statement is initially applied in its entirety (in accordance with paragraphs 19-21 of FASB No. 142). An entity has six months from the date it initially applies this Statement to complete the first step of that transitional goodwill impairment test. However, the amounts used in the transitional goodwill impairment test shall be measured as of the beginning of the year of initial application. If the carrying amount of the net assets of a reporting unit (including goodwill) exceeds the fair value of that reporting unit, the second step of the transitional goodwill impairment test must be completed as soon as possible, but no later than the end of the year of initial application.

   b. An impairment loss recognized as a result of a transitional goodwill impairment test shall be recognized as the effect of a change in accounting principle. The effect of the accounting change and related income tax effects shall be presented in the [statement of activities] between the captions extra\mordinary items and [change in net assets]….

   c. If events or changes in circumstances indicate that goodwill of a reporting unit might be impaired before completion of the transitional goodwill impairment test, goodwill shall be tested for impairment when the impairment indicator
arises (refer to paragraph 28 of FASB No. 142). A goodwill impairment loss that does not result from a transitional goodwill impairment test shall not be recognized as the effect of a change in accounting principle; rather it shall be recognized in accordance with paragraph 43 of FASB No. 142. In addition to the transitional goodwill impairment test, an entity shall perform the required annual goodwill impairment test in the year that this Statement is initially applied in its entirety. That is, the transitional goodwill impairment test may not be considered the initial year’s annual test unless an entity designates the beginning of its fiscal year as the date for its annual goodwill impairment test.

4. An entity shall present a write-off of goodwill or an impairment loss recognized as a result of a transitional goodwill impairment evaluation, and the related income tax effects, if any, in a separate line item in the statement of activities. A not-for-profit entity shall present that transitional impairment loss outside a performance indicator or any intermediate measure of operations, if one is presented.

5. An entity that reports on an interim basis shall recognize a write-off of goodwill or a transitional impairment loss for goodwill in the first interim period regardless of the period in which an impairment loss is measured. Interim periods of the fiscal year that preceded the period in which the write-off of goodwill or transitional goodwill impairment loss is measured shall be restated to reflect the accounting change in those periods. The aggregate amount of the accounting change shall be included in restated changes in net assets of the first interim period of the year of initial application (and in any year-to-date or last-12-months-to-date financial reports that include the first interim period). Whenever financial information is presented that includes the periods that precede the period in which the transitional goodwill impairment loss is measured, it shall be restated.

Transition for Previously Recognized Intangible Assets Other Than Goodwill Acquired in a Purchase Accounted for Under Opinion 16

1. An entity that previously recognized intangible assets other than goodwill in a transaction accounted for using the purchase method in APB Opinion No. 16, Business Combinations, shall reassess the useful lives of those intangible assets using the guidance in paragraph 11 of FASB No. 142 and adjust the remaining amortization periods as necessary. For example, the amortization period for a previously recognized intangible asset might be increased if its original useful life was estimated to be longer than the 40-year maximum amortization period allowed by APB Opinion No. 17, Intangible Assets.

2. The reassessment shall be completed before the end of the first interim period of the fiscal year in which this Statement is initially applied. The entity shall test previously recognized intangible assets deemed to have indefinite useful lives for impairment as of the beginning of the fiscal year in which this Statement is initially applied in accordance with paragraph 17 of FASB No. 142. That transitional intangible asset impairment test shall be completed in the first interim period in which this Statement is initially applied, and any resulting impairment loss shall be recognized as the effect of a change in accounting principle. A not-for-profit entity shall present that transitional impairment loss, net of any related income tax effects, in a separate line item outside a performance indicator or any intermediate measure of operations, if one is presented.
Income Taxes

1. For acquisitions of businesses or nonprofit activities in which the acquirer is subject to taxes on portions of its income and the acquisition date was before the effective date of this Statement, the acquirer shall apply the requirements of Statement 109, as amended, prospectively. That is, the acquirer shall not adjust the accounting for prior acquisitions for previously recognized changes in acquired tax uncertainties or previously recognized changes in the valuation allowance for acquired deferred tax assets. However, after the effective date of this Statement:

   a. The acquirer shall recognize, as an adjustment to income tax expense (or a direct adjustment to contributed capital in accordance with paragraph 26 of Statement 109), changes in the valuation allowance for acquired deferred tax assets.

   b. The acquirer shall recognize changes in the acquired income tax positions in accordance with Interpretation 48, as amended.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. If there is a merger, the combining assets and liabilities are accounted for under which of the following approaches:
   a) the assets and liabilities of the separate entities are combined
   b) the assets and liabilities are grossed up to fair value
   c) the assets and liabilities are recorded at a fresh start measurement
   d) the assets and liabilities are recorded using acquisition method accounting

2. In connection with a merger, the initial reporting period of the new entity begins with which date:
   a) the beginning of the earliest year presented
   b) the merger date
   c) the end of the first reporting period
   d) a retroactive date that begins with the prior period of each of the merged entities

3. How should a not-for-profit entity that acquires assets that do not constitute a business or a nonprofit entity account for the transaction:
   a) as a merger
   b) as an asset acquisition
   c) as an acquisition
   d) as a reorganization

4. Which of the following factors would not be considered in selecting the acquirer in an acquisition:
   a) an entity transfers cash to effect the acquisition
   b) an entity’s legal name is retained in the combined entity
   c) an entity is the smallest size of the entities involved in the acquisition
   d) an entity initiated the acquisition transaction

5. According to FASB No. 164, which of the following is the way in which an entity should account for an acquired donor relationship:
   a) like an acquired customer relationship, a donor relationship should be recognized as an identifiable intangible asset
   b) a donor relationship may be recorded as an identifiable intangible asset separate from goodwill
   c) a donor relationship is not recognized separately and instead is part of goodwill
   d) the cost of a donor relationship is expensed as a period cost
6. In an acquisition, if there is an excess of the fair value of identified assets acquired and liabilities assumed over the fair value of the consideration, there is a resulting credit which should be presented as:

   a) negative goodwill on the balance sheet
   b) separate credit on the statement of activities
   c) a credit to be allocated to all identified assets and liabilities
   d) a credit in the liability section of the balance sheet

7. How should an acquirer present the entire amount of the net cash flow (cash paid as consideration less acquired cash of the acquiree) related to an acquisition on the statement of cash flows:

   a) as an operating activity
   b) as an investing activity
   c) as a financing activity
   d) as a split between investing and financing activities

8. Subsequent to the acquisition, how should an indemnification asset be accounted for:

   a) on the same basis as the indemnified asset or liability
   b) at fair value at each reporting date
   c) at carrying value unless there is evidence of a material impairment
   d) amortized over its useful life

9. How does FASB No. 164 require that goodwill be accounted for subsequent to the acquisition:

   a) amortized over a fifteen-year period, straight-line
   b) amortized over the goodwill’s estimated useful life
   c) apply FASB No. 142 guidance
   d) expense goodwill immediately after the acquisition

10. Under FASB No. 164’s transition rules, for acquisitions of businesses or nonprofit activities in which the acquirer is subject to taxes on portions of its income and the acquisition date was before the effective date of FASB No. 164, the acquirer shall apply the requirements of FASB No. 109:

   a) retroactively
   b) prospectively
   c) by adjusting the accounting for income taxes related to prior acquisitions
   d) by adjusting previously recognized changes in acquired tax uncertainties or the valuation allowance for acquired deferred tax assets
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** The assets and liabilities of the separate entities are combined and recognized at amounts that would be recognized if the entities issued financial statements.

   B: Incorrect. There is no gross up of asset and liability values in a merger.

   C: Incorrect. Fresh start measurement is not applicable to a merger.

   D: Incorrect. By definition, a merger is not an acquisition and thus acquisition method accounting is not used.

   (See page 21 of the course material.)

2. A: Incorrect. With a merger, there is no activity before the date of the merger so that previous reporting periods do not exist.

   **B: Correct.** The new entity’s initial reporting period begins with the merger date.

   C: Incorrect. FASB No. 164 does not state that the merger begins at the end of the first reporting period.

   D: Incorrect. With a merger, there is no retroactive date because there is no activity prior to the merger date.

   (See page 22 of the course material.)

3. A: Incorrect. By definition, an acquisition is not a merger and should not be accounted for that way.

   **B: Correct.** If the assets are not a business or nonprofit activity, the transaction is accounted for as an asset acquisition and not as an acquisition.

   C: Incorrect. The assets must constitute a business or nonprofit activity to be accounted for as an acquisition.

   D: Incorrect. FASB No. 164 does not address accounting for a transaction as a reorganization.

   (See page 26 of the course material.)
4. A: Incorrect. One factor that assists in choosing the acquirer is if the entity transfers cash to effect the acquisition.

B: Incorrect. The fact that an entity’s legal name is retained in the combined entity is a factor to consider in selecting an acquirer.

C: Correct. Although the relative size of an entity (e.g., revenue and assets) is a factor in selecting an acquirer, the fact that an entity is the smallest within the group is likely to lead to that entity not being considered as the acquirer.

D: Incorrect. The entity that initiates the acquisition transaction may be the acquirer subject to the consideration of the other factors.

(See page 27 of the course material.)

5. A: Incorrect. A donor relationship should not be recognized as an identifiable intangible asset. This approach is unlike that of a customer relationship which is recognized as an identifiable intangible asset.

B: Incorrect. A donor relationship should not be recorded as an identifiable intangible asset separate from goodwill. Even though there may be value attributed to the donor relationship, estimating the value would be difficult and costly.

C: Correct. A donor relationship is not recognized separately and instead is part of goodwill. FASB No. 164 states that the effort to obtain the value of a donor relationship would be costly and would not meet the cost-benefit test. Thus, its value is included as part of goodwill.

D: Incorrect. There is no authority to expense the cost of a donor relationship.

(See page 31 of the course material.)

6. A: Incorrect. FASB No. 164 does not address the concept of negative goodwill.

B: Correct. The excess is presented as a separate credit on the statement of activities using a caption similar to contribution received.

C: Incorrect. There is no authority permitting the excess to be allocated to all identified assets and liabilities

D: Incorrect. FASB No. 164 does not provide for the excess to be presented in the liability section of the balance sheet.

(See page 37 of the course material.)
7. **A:** Incorrect. None of the acquisition relates to an operating activity.

**B:** Correct. The entire amount of any net cash flow (cash paid as consideration, if any, less acquired cash of the acquiree) shall be reported as an investing activity.

**C:** Incorrect. No portion of the acquisition relates to a financing activity.

**D:** Incorrect. There is no allocation of the transaction to financing activities. Thus, the entire amount is presented in investing activities only.

(See page 45 of the course material.)

8. **A:** Correct. At each subsequent reporting date, the acquirer shall measure an indemnification asset on the same basis as the indemnified asset or liability.

**B:** Incorrect. The asset is not recorded at net present value unless that is the basis by which the underlying indemnified asset or liability is measured.

**C:** Incorrect. FASB No. 164 does not provide for the asset to be recorded at carrying value.

**D:** Incorrect. There is no provision for amortizing the indemnification asset over its useful life.

(See page 46 of the course material.)

9. **A:** Incorrect. There is no provision for amortizing goodwill over a fifteen-year period, straight-line, even though that method is the one used for tax purposes.

**B:** Incorrect. There is no provision for amortizing goodwill over its estimated useful life.

**C:** Correct. FASB No. 164 requires that the guidance of FASB No. 142 should be followed subsequent to acquisition. That guidance requires that goodwill be capitalized and not amortized, with an annual test performed for impairment.

**D:** Incorrect. Goodwill should not be expensed immediately after the acquisition unless it is written off as part of an impairment writedown under FASB No. 142.

(See page 47 of the course material.)
10. A: Incorrect. FASB No. 164 does not provide for retroactive application for income taxes.

**B: Correct.** The Statement provides for prospective application of income taxes.

C: Incorrect. The Statement specifically states that there should be no adjustments of the accounting for income taxes related to prior acquisitions.

D: Incorrect. Previously recognized changes in acquired tax uncertainties or the valuation allowance for acquired deferred tax assets shall not be adjusted under the transition rules.

(See page 54 of the course material.)
Exhibit A  
Recognizing Particular Assets Acquired and Liabilities Assumed  
(From FASB No. 164)

Operating Leases
The acquirer shall recognize no assets or liabilities related to an operating lease in which the acquiree is the lessee except as required by the following:

a) Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree’s operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.

b) An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants’ willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, for example, as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) as an intangible asset separately from goodwill.

Recognition of Intangible Assets Separately from Goodwill
The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired.

An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion.

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

For example:

a. An acquiree leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill even though the acquirer cannot sell or otherwise transfer the lease contract.

b. An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the fair value of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.
c. An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, donor, customer, and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its donor or customer lists have characteristics different from other donor or customer lists, the fact that such lists are frequently licensed generally means that the acquired list meets the separability criterion. However, an acquired donor or customer list would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its donors or customers.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability. For example, an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.

Reacquired rights
As part of an acquisition, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer’s recognized or unrecognized assets. Examples of such rights include a right to use the acquirer’s trade name under a franchise agreement or a right to use the acquirer’s technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognizes separately from goodwill.

If the terms of the contract giving rise to a reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer shall recognize a settlement gain or loss.

Assembled workforce and other items that are not identifiable
The acquirer subsumes into goodwill (or the separate change recognized) the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to
operate an acquired business or nonprofit activity from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce – the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

The acquirer also subsumes into goodwill (or the separate change recognized) any value attributed to items that do not qualify as assets at the acquisition date. For example, the acquirer might attribute value to potential gifts or contracts the acquiree is negotiating with prospective new donors or customers at the acquisition date. Because those potential gifts or contracts are not themselves assets at the acquisition date, the acquirer does not recognize them separately from goodwill. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date. However, the acquirer should assess the facts and circumstances surrounding events occurring shortly after the acquisition to determine whether a separately recognizable intangible asset existed at the acquisition date.

After initial recognition, an acquirer accounts for identifiable intangible assets acquired in accordance with the provisions of FASB Statements No. 142, Goodwill and Other Intangible Assets, and FASB No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. However, as described in paragraph 8 of FASB No. 142, the accounting for some acquired intangible assets after initial recognition is prescribed by other Statements.

The identifiability criteria determine whether an intangible asset is recognized separately from goodwill. However, the criteria neither provide guidance for measuring the fair value of an intangible asset nor restrict the assumptions used in estimating the fair value of an intangible asset. For example, the acquirer would take into account assumptions that market participants would consider, such as expectations of future contract renewals, in measuring fair value. It is not necessary for the renewals themselves to meet the identifiability criteria. EITF Issue No. 02-7, “Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets,” provides guidance for determining whether indefinite-lived intangible assets should be combined into a single unit of account to test for impairment if they are operated as a single asset and essentially are inseparable from one another.

**Examples of Intangible Assets That Are Identifiable**

The following are examples of identifiable intangible assets acquired in an acquisition. Some of the examples may have characteristics of assets other than intangible assets. The acquirer should account for those assets in accordance with their substance. The examples are not intended to be all-inclusive.

Intangible assets designated with the symbol # are those that arise from contractual or other legal rights. Those designated with the symbol * do not arise from contractual or other legal rights but are separable. Intangible assets designated with the symbol # might also be separable, but separability is not a necessary condition for an asset to meet the contractual-legal criterion.
Marketing-related intangible assets
Marketing-related intangible assets are primarily used in the marketing or promotion of products or services. Examples of marketing-related intangible assets are:

a. Trademarks, trade names, service marks, collective marks, certification marks
b. Trade dress (unique color, shape, package design)
c. Newspaper mastheads
d. Internet domain names
e. Noncompetition agreements

**Trademarks, trade names, service marks, collective marks, certification marks**
Trademarks are words, names, symbols, or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. A service mark identifies and distinguishes the source of a service rather than a product. Collective marks identify the goods or services of members of a group. Certification marks certify the geographical origin or other characteristics of a good or service.

Trademarks, trade names, service marks, collective marks, and certification marks may be protected legally through registration with governmental agencies, continuous use in commerce, or by other means. If it is protected legally through registration or other means, a trademark or other mark acquired is an intangible asset that meets the contractual-legal criterion. Otherwise, a trademark or other mark acquired can be recognized separately from goodwill if the separability criterion is met, which normally it would be.

The terms *brand* and *brand name*, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Statement does not preclude an entity from recognizing, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives.

**Internet domain names**
An Internet domain name is a unique alphanumeric name that is used to identify a particular numeric Internet address. Registration of a domain name creates an association between that name and a designated computer on the Internet for the period of the registration. Those registrations are renewable. A registered domain name acquired meets the contractual-legal criterion.

Customer- and donor-related intangible assets
Examples of customer- and donor-related intangible assets are:

a. Customer and donor lists
b. Order or production backlog
c. Customer contracts and related customer relationships
d. Noncontractual customer relationships

**Customer and donor lists**
A customer list consists of information about customers, such as their names and contact information. A customer list also may be in the form of a database that includes other information about the customers, such as their order histories and demographic information. A customer list generally does not arise from contractual or other legal
rights. However, customer lists are frequently leased or exchanged. Therefore, a customer list acquired in an acquisition by a not-for-profit entity, like one acquired in a business combination, normally meets the separability criterion. However, a customer list would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

A donor list is different from a customer list, although a donor list consists of similar information about donors, such as their names and contact information. A donor list also may be in the form of a database that includes other information about the donors, such as their donation histories and demographic information. A donor list may, but does not always, arise from contractual or other legal rights. However, donor lists are frequently leased or exchanged. Therefore, a donor list acquired in an acquisition by a not-for-profit entity normally meets the separability criterion. However, a donor list would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its donors.

**Order or production backlog #**
An order or production backlog arises from contracts such as purchase or sales orders. An acquired order or production backlog meets the contractual-legal criterion even if the purchase or sales orders are cancelable.

**Customer contracts and the related customer relationships #**
If an entity establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships meet the contractual-legal criterion, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree.

A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the two assets are consumed may differ.

A customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer, and (b) the customer has the ability to make direct contact with the entity. Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date. Customer relationships also may arise through means other than contracts, such as through regular contact by sales or service representatives. An order or a production backlog arises from contracts such as purchase or sales orders and therefore is considered a contractual right. Consequently, if an entity has relationships with its customers through these types of contracts, the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion.

**Donor relationships:** An acquirer also may attribute value to the acquiree’s donor relationships – the information the acquiree has about its donors, the regular contact the acquiree has with its donors, and the donors’ ability to make direct contact with the acquiree. However, estimating the fair value of acquired donor relationships would be difficult and so costly that requiring acquirers to do so would not meet a reasonable cost-benefit test. Therefore, unlike acquired customer relationships, acquired donor
relationships are not recognized separately; they are instead subsumed into goodwill (also see footnote 7 on terminology).

**Noncontractual customer relationships** *

An acquired customer relationship that does not arise from a contract may nevertheless be identifiable because the relationship is separable. Exchange transactions for the same asset or a similar asset that indicate that other entities have sold or otherwise transferred a particular type of noncontractual customer relationship would provide evidence that the noncontractual customer relationship is separable.

**Examples illustrating acquired customer contract and customer relationship intangible assets**

The following examples illustrate the recognition of customer contract and customer relationship intangible assets acquired in an acquisition by a not-for-profit entity.

a. Acquirer Company (AC) acquires Target Company (TC) on December 31, 20X5. TC has a five-year agreement to supply goods to Customer. Both TC and AC believe that Customer will renew the agreement at the end of the current contract. The agreement is not separable. The agreement, whether cancelable or not, meets the contractual-legal criterion. Additionally, because TC establishes its relationship with Customer through a contract, not only the agreement itself but also TC’s customer relationship with Customer meet the contractual-legal criterion.

b. AC acquires TC on December 31, 20X5. TC does business with its customers solely through purchase and sales orders. At December 31, 20X5, TC has a backlog of customer purchase orders from 60 percent of its customers, all of whom are recurring customers. The other 40 percent of TC’s customers also are recurring customers. However, as of December 31, 20X5, TC has no open purchase orders or other contracts with those customers. Regardless of whether they are cancelable or not, the purchase orders from 60 percent of TC’s customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 percent of its customers through contracts, not only the purchase orders but also TC’s customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40 percent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at December 31, 20X5.

**Artistic-related intangible assets**

Examples of artistic-related intangible assets are:

a. Plays, operas, ballets #
b. Books, magazines, newspapers, other literary works #
c. Musical works such as compositions, song lyrics, advertising jingles #
d. Pictures, photographs #
e. Video and audiovisual material, including motion pictures or films, music videos, television programs #

Artistic-related assets are identifiable if they arise from contractual or legal rights such as those provided by copyright. The holder can transfer a copyright, either in whole through an assignment or in part through a licensing agreement. An acquirer is not precluded from recognizing a copyright intangible asset and any related assignments or license
agreements as a single asset, provided they have similar useful lives.

**Contract-based intangible assets**

Contract-based intangible assets represent the value of rights that arise from contractual arrangements. Customer contracts are one type of contract-based intangible asset. If the terms of a contract give rise to a liability (for example, if the terms of an operating lease or customer contract are unfavorable relative to market terms), the acquirer recognizes it as a liability assumed in the acquisition. Examples of contract based intangible assets are:

a. Licensing, royalty, standstill agreements#
b. Advertising, construction, management, service or supply contracts#
c. Lease agreements (whether the acquiree is the lessee or the lessor)#
d. Construction permits#
e. Franchise agreements#
f. Operating and broadcast rights#
g. Employment contracts#
h. Use rights such as drilling, water, air, timber cutting, and route authorities#

**Employment contracts**#

Employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is favorable relative to market terms are one type of contract-based intangible asset.

**Use rights**#

Use rights such as drilling, water, air, timber cutting, and route authorities are contract-based intangible assets to be accounted for separately from goodwill. Particular use rights may have characteristics of tangible, rather than intangible, assets. For example, mineral rights, defined as the legal right to explore, extract, and retain at least a portion of the benefits from mineral deposits, are tangible assets. An acquirer should account for use rights based on their nature.

**Technology-based intangible assets**

Examples of technology-based intangible assets are:

a. Patented technology#
b. Computer software and mask works#
c. Unpatented technology*
d. Databases, including title plants*
e. Trade secrets, such as secret formulas, processes, recipes#

**Computer software and mask works**#

Computer software and program formats acquired that are protected legally, such as by patent or copyright, meet the contractual-legal criterion for identification as intangible assets.

Mask works are software permanently stored on a read-only memory chip as a series of stencils or integrated circuitry. Mask works may have legal protection. Mask works with legal protection that are acquired in an acquisition by a not-for-profit entity meet the contractual-legal criterion for identification as intangible assets.
Databases, including title plants *
Databases are collections of information, often stored in electronic form (such as on computer disks or files). A database that includes original works of authorship may be entitled to copyright protection. A database acquired that is protected by copyright meets the contractual-legal criterion. However, a database typically includes information created as a consequence of an entity’s normal operations, such as customer lists, or specialized information, such as scientific data or credit information. Databases that are not protected by copyright can be, and often are, exchanged, licensed, or leased to others in their entirety or in part. Therefore, even if the future economic benefits from a database do not arise from legal rights, a database acquired meets the separability criterion.

Title plants constitute an historical record of all matters affecting title to parcels of land in a particular geographical area. Title plant assets are bought and sold, either in whole or in part, in exchange transactions or are licensed. Therefore, title plant assets acquired meet the separability criterion.

Trade secrets such as secret formulas, processes, recipes #
A trade secret is “information, including a formula, pattern, recipe, compilation, program, device, method, technique, or process that (1) derives independent economic value, actual or potential, from not being generally known and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.” If the future economic benefits from a trade secret acquired are legally protected, that asset meets the contractual-legal criterion. Otherwise, trade secrets acquired are identifiable only if the separability criterion is met, which is likely to be the case.
Exhibit B
Definition of a Business and a Nonprofit Activity
(From FASB No. 164)

Appendix A to FASB No. 164 provides detailed guidance on the definition of a business and a nonprofit activity, as follows.

1. The nature of the benefits provided distinguishes a business from a nonprofit activity. For a business, those benefits are economic benefits that are provided as a return to investors (either reflected in the market price of the equity or through dividends) or other economic benefits, such as lower costs, that are provided directly to owners, members, or participants. For a nonprofit activity, the benefits are provided to fulfill the purpose or mission for which an entity exists (for example, goods or services provided to beneficiaries, customers, or members) rather than goods or services provided at a profit or profit equivalent.

2. Both a business and a nonprofit activity consist of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses or nonprofit activities usually have outputs, outputs are not required for an integrated set to qualify as a business or nonprofit activity.

3. The three elements of a business or nonprofit activity are defined as follows:
   a. Input – Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, ability to obtain access to necessary materials or rights, and employees.
   b. Process – Any system, standard, protocol, convention, or rule that when applied to an input or inputs creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. Those processes typically are documented, but an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.)
   c. Output – The result of inputs and processes applied to those inputs that provide or have the ability to provide either:
      (1) A return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants; or
      (2) Goods or services to beneficiaries, customers, or members that fulfill the purpose or mission for which a not-for-profit entity exists.

4. To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs – that together are or will be used to create outputs. However, a business or nonprofit activity need not include all of the inputs or processes that the seller used in operating that business or nonprofit activity if market participants are capable of acquiring the business or nonprofit activity and continuing to produce outputs, for example, by integrating the business or nonprofit activity with their own inputs and processes. FASB Statement No. 157, Fair Value
Measurements, describes market participants as buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

a. Independent of the reporting entity; that is, they are not related parties

b. Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. Able to transact for the asset or liability

d. Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so

5. The nature of the elements of a business or nonprofit activity varies by industry and by the structure of an entity’s operations (activities), including the entity’s stage of development. Established businesses or nonprofit activities often have many, and different, kinds of inputs, processes, and outputs, whereas new businesses or nonprofit activities often have few inputs and processes, and sometimes only a single output (product). Nearly all businesses or nonprofit activities also have liabilities, but a business or nonprofit activity need not have liabilities.

An integrated set of activities and assets in the development stage might not have outputs. If it does not, the acquirer should consider other factors to determine whether the set is a business or nonprofit activity. Those factors include, but are not limited to, whether the set:

a. Has begun planned principal activities

b. Has employees, intellectual property, and other inputs and processes that could be applied to those inputs

c. Is pursuing a plan to produce outputs

d. Will be able to obtain access to customers, beneficiaries, or members that will purchase or otherwise receive the outputs that fulfill the purpose or mission for which a not-for-profit entity exists

6. Determining whether a particular set of assets and activities is a business or nonprofit activity should be based on whether the integrated set is capable of being conducted and managed as a business or nonprofit activity by a market participant. Thus, in evaluating whether a particular set is a business or nonprofit activity, it is not relevant whether a seller operated the set as a business or nonprofit activity or whether the acquirer intends to operate the set as a business or nonprofit activity. In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill (or an amount that could qualify as a separate charge under paragraph 51) is present shall be presumed to be a business or nonprofit activity. However, a business or nonprofit activity need not have goodwill.
Exhibit C
Further Guidance on Applying the Acquisition Method
(From FASB No. 164)

Measurement Period

If the initial accounting for an acquisition is incomplete at the end of the financial reporting period in which the combination occurs, paragraph 61 of FASB No. 164 requires that the acquirer recognize in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer recognizes adjustments to the provisional amounts needed to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. Paragraph 65 requires the acquirer to recognize such adjustments as if the accounting for the acquisition had been completed at the acquisition date. Measurement period adjustments are not included in changes in net assets.

Example: Appraisal That Is Incomplete at the Reporting Date
AC acquires TC on September 30, 20X7. AC does not expect TC’s operations to be primarily supported by contributions and returns on investments. AC seeks an independent appraisal for an item of property, plant, and equipment acquired in the combination, and the appraisal was not complete by the time AC issued its financial statements for the year ending December 31, 20X7. In its 20X7 annual financial statements, AC recognized a provisional fair value for the asset of $30,000. At the acquisition date, the item of property, plant, and equipment had a remaining useful life of five years. Five months after the acquisition date, AC received the independent appraisal, which estimated the asset’s acquisition-date fair value as $40,000.

In its financial statements for the year ending December 31, 20X8, AC retrospectively adjusts the 20X7 prior-year information as follows:

a. The carrying amount of property, plant, and equipment as of December 31, 20X7, is increased by $9,500. That adjustment is measured as the fair value adjustment at the acquisition date of $10,000 less the additional depreciation that would have been recognized had the asset’s fair value at the acquisition date been recognized from that date ($500 for 3 months’ depreciation).

b. The carrying amount of goodwill as of December 31, 20X7, is decreased by $10,000.

c. Depreciation expense for 20X7 is increased by $500.

In accordance with paragraph 90(a), AC discloses:

a. In its 20X7 financial statements, that the initial accounting for the acquisition has not been completed because the appraisal of property, plant, and equipment has not yet been received.

b. In its 20X8 financial statements, the amounts and explanations of the adjustments to the provisional values recognized during the current reporting period. Therefore, AC discloses that the 20X7 comparative information is retrospectively adjusted to increase the fair value of the item of property, plant, and equipment at the acquisition date by $9,500, offset by a decrease to goodwill of $10,000 and an increase in depreciation expense of $500.
Effective Settlement of a Preexisting Relationship between the Acquirer and the Acquiree

The acquirer and acquiree may have a relationship that existed before they contemplated the acquisition, referred to here as a preexisting relationship. A preexisting relationship between the acquirer and the acquiree may be contractual (for example, vendor and customer or licensor and licensee) or noncontractual (for example, plaintiff and defendant).

If the acquisition in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

a. For a preexisting noncontractual relationship (such as a lawsuit), fair value

b. For a preexisting contractual relationship, the lesser of:
   (1) The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. (An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)
   (2) The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If (2) is less than (1), the difference is included as part of the acquisition accounting.

The amount of gain or loss recognized may depend in part on whether the acquirer had previously recognized a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated.

A preexisting relationship may be a contract that the acquirer recognizes as a reacquired right. If the contract includes terms that are favorable or unfavorable when compared with pricing for current market transactions for the same or similar items, the acquirer recognizes, separately from the acquisition, a gain or loss for the effective settlement of the contract.

Example: Effective settlement of a supply contract as a result of an acquisition

AC purchases electronic components from TC under a five-year supply contract at fixed rates. Currently, the fixed rates are higher than rates at which AC could purchase similar electronic components from another supplier. The supply contract allows AC to terminate the contract before the end of the initial 5-year term only by paying a $6 million penalty. With 3 years remaining under the supply contract, AC pays $50 million to acquire TC, which is the fair value of TC based on what other market participants would be willing to pay.

Included in TC’s identifiable net assets is $8 million related to the fair value of the supply contract with AC. The $8 million represents a $3 million component that is “at market” because the pricing is comparable to pricing for current market transactions for the same or similar items (selling effort, customer relationships, and so forth) and a $5 million component for pricing that is unfavorable to AC because it exceeds the price of current market transactions for similar items. TC has no other identifiable assets or liabilities related to the supply contract, and AC has not recognized any assets or liabilities related to the supply contract before the acquisition.

In this example, AC recognizes a loss of $5 million (the lesser of the $6 million stated settlement amount and the amount by which the contract is unfavorable to the acquirer).
separately from the acquisition. The $3 million at-market component of the contract is part of goodwill.

**Example: Effective settlement of a contract between the acquirer and the acquiree in which the acquirer had recognized a liability before the acquisition**

Whether AC had previously recognized an amount in its financial statements related to a preexisting relationship will affect the amount recognized as a gain or loss for the effective settlement of the relationship. In the previous example dealing with the effective settlement of a supply contract as a result of an acquisition, generally accepted accounting principles (GAAP) might have required AC to recognize a $6 million liability for the supply contract at the most recent reporting date. (The $6 million amount required by GAAP might not have been fair value; if it was, the fair value has decreased by the acquisition date.) In that situation, AC recognizes a $1 million settlement gain on the contract in the statement of activities at the acquisition date (the $5 million measured loss on the contract less the $6 million loss previously recognized). In other words, AC has in effect settled a recognized liability of $6 million for $5 million, resulting in a gain of $1 million.

**Arrangements for Contingent Payments to Employees or Selling Shareholders**

Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the acquisition or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the acquisition, the acquirer should consider the following indicators:

a. **Continuing employment** – The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.

b. **Duration of continuing employment** – If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.

c. **Level of compensation** – Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.

d. **Incremental payments to employees** – If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling
shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.

e. **Number of shares owned** – The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

f. **Linkage to the valuation** – If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. **Formula for determining consideration** – The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the acquisition and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. **Other agreements and issues** – The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the acquisition.

**Example: Arrangement for contingent payment to an employee**

TC hired a candidate as its new CEO under a 10-year contract. The contract required TC to pay the candidate $1.5 million if TC is acquired before the contract expires. AC
acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

**Conclusion:** In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay $1.5 million is included in the application of the acquisition method. In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the acquisition. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method.

**Illustrations of Presentation in the Statement of Activities**

If the operations of the acquiree are expected to be predominantly supported by contributions and returns on investments, paragraph 51 requires the acquirer to recognize an excess of consideration transferred over the net assets acquired as a separate charge in its statement of activities as of the acquisition date.

*Example: Acquiree Expected in the Combined Entity to Be Predominantly Supported by Contributions and Returns on Investments, and Related Disclosure Requirements*

On February 10, 20X0, Organization ABC, a religious not-for-profit entity, purchases 100 percent of the ownership interests in Restaurant XYZ for consideration of $525,000. On the acquisition date, the amount of the net identifiable assets of Restaurant XYZ recognized and measured in accordance with this Statement was $410,000. Organization ABC acquired Restaurant XYZ for the purpose of converting it into a soup kitchen.

Management of Organization ABC expects the soup kitchen resulting from the conversion of Restaurant XYZ to be predominantly supported by contributions and returns on investments. Specifically, the operating costs of the soup kitchen are expected to be funded by Organization ABC’s existing contribution base. The following table illustrates how Organization ABC might satisfy the requirements of paragraph 71 for presenting the separate charge to the statement of activities at the acquisition date.
Paragraph 86 of this Statement specifies information to be disclosed to satisfy the objective of enabling users of its financial statements to evaluate the nature and financial effect of an acquisition that occurs during the reporting period. In the example, Organization ABC might satisfy the requirements of paragraph 86(a)–(e) as shown in the illustrative note below.

**Note X: Acquisition of Restaurant XYZ**

On February 10, 20X0, Organization ABC acquired Restaurant XYZ, a local restaurant, which it converted into a soup kitchen. Organization ABC acquired Restaurant XYZ as part of furthering its mission to care for the needy. The acquisition was effected by purchasing 100 percent of the ownership interests in Restaurant XYZ.

Because the operations of the soup kitchen are expected to be predominantly supported by contributions and returns on investments, Organization ABC has recognized the excess of the consideration transferred over the net assets acquired as a separate charge in its statement of activities rather than as goodwill. Organization ABC paid consideration of $525,000 for Restaurant XYZ. On the acquisition date, the net identifiable assets of Restaurant XYZ were $410,000. The excess of the amount paid over the net identifiable assets acquired represents (a) the value of Restaurant XYZ’s assembled workforce, which is not recognized as a separate intangible asset, and (b) the value of Restaurant XYZ’s earnings potential as a restaurant to other potential buyers.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. How should operating leases be accounted for under FASB No. 164:
   a) the acquirer shall recognize an asset or liability for an operating lease
   b) the acquirer shall recognize an intangible liability if the terms of the lease are favorable relative to market terms
   c) the value of the lease shall be included as part of goodwill
   d) the acquirer shall recognize an intangible asset if the terms of the lease are favorable relative to market terms

2. An intangible asset that is not identifiable is accounted for as:
   a) an asset separate from goodwill
   b) an expense as a period cost
   c) part of goodwill
   d) a prorata allocation between goodwill and a separate intangible asset

3. A donor list acquired in an acquisition is similar to a customer list in which of the following ways:
   a) both meet the separability criterion
   b) both meet the contractual-legal criterion
   c) neither type of list are typically leased or exchanged
   d) a donor list is not typically part of an acquisition involving a not-for-profit organization

4. Which of the following is an example of an input:
   a) long-lived assets
   b) goods or services to customers
   c) management processes
   d) a return in the form of lower costs

5. In connection with an acquisition that settles a preexisting noncontractual relationship, how should the transaction be handled:
   a) as part of the acquisition accounting
   b) as a gain or loss measured at carrying value
   c) as a gain or loss measured at fair value
   d) as part of period costs expensed at the date of settlement
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The general rule is that the acquirer shall not recognize an asset or liability for an operating lease unless certain conditions are met.

   B: Incorrect. The acquirer shall recognize an intangible liability if the terms of the lease are unfavorable, not favorable relative to market terms.

   C: Incorrect. The value of the lease, if favorable or unfavorable, shall be included as a separate intangible asset, and not as part of goodwill.

   D: Correct. If an operating lease has terms that are favorable relative to market terms, an intangible asset shall be recognized.

   (See page 61 of the course material.)

2. A: Incorrect. An intangible must meet the criteria to be identifiable to be recorded separately from goodwill.

   B: Incorrect. By definition, the asset is not expensed because it is capitalized.

   C: Correct. If an intangible is not identifiable, it is considered part of goodwill.

   D: Incorrect. There is no authority for recording a prorata allocation between goodwill and a separate intangible asset.

   (See page 62 of the course material.)

3. A: Correct. Both typically meet the separability criterion unless there is some prohibition for an entity to sell, lease or exchange donor information.

   B: Incorrect. In most cases, the customer or donor list do not meet the contractual-legal criterion.

   C: Incorrect. Typically, both a donor list and a customer list are leased and exchanged.

   D: Incorrect. A donor list is typically part of an acquisition involving a not-for-profit organization.

   (See pages 64 to 65 of the course material.)
4. **A: Correct.** A long-lived asset, including a right to use a long-lived asset is an example of an input. An input is defined as any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it.

   B: Incorrect. Goods or services to customers is an example of an output, not an input.

   C: Incorrect. Management processes is an example of a process, not an input.

   D: Incorrect. A return in the form of lower costs is an example of an output, not an input.

   (See page 69 of the course material.)

5. **A: Incorrect.** The transaction is treated as part of the acquisition accounting only if it settles a preexisting contractual relationship and other conditions are met.

   B: Incorrect. The gain or loss is measured at fair value, not carrying value.

   **C: Correct.** If the transaction involves a preexisting noncontractual relationship, a gain or loss is measured at fair value.

   D: Incorrect. The Statement does not provide for any part of the transaction being accounted for as period costs expensed at the date of settlement.

   (See page 72 of the course material.)
CHAPTER 2

FASB No. 165: Subsequent Events
(FASB ASC Topic 855)
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I. Introduction

Issued: May 2009

Effective Date: Interim or annual financial periods ending after June 15, 2009, and shall be applied prospectively.

Objective:

The objective of this Statement is to establish GAAP and requirements for subsequent events. FASB No. 165 (ASC Topic 865) deals with:

- The period after the balance sheet date during which management of a reporting entity shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements.
- The circumstances under which an entity shall recognize events or transactions occurring after the balance sheet date in its financial statements.
- The disclosures that an entity shall make about events or transactions that occurred after the balance sheet date.

II. Background

In general, current guidance for subsequent events is found in auditing literature in AU Section 560, Subsequent Events, which requires the auditor to evaluate subsequent events. No such guidance and requirement exists for company management even though there is some limited guidance scattered throughout other accounting literature. Examples include:

- FASB No. 5, Accounting for Contingencies
- FASB No. 48, Accounting for Uncertainty in Income Taxes
- FASB No. 128, Earnings per Share

The FASB has undertaken several projects to incorporate accounting guidance that originated as auditing standards into the body of GAAP. In addition to FASB No. 165, other projects include FASB No. 162, The Hierarchy of Generally Accepted Accounting Principles, and guidance about a going concern. Including guidance in GAAP, as well as in auditing standards, helps to emphasize that accounting and reporting are the primary responsibility of an entity’s management, and not its auditor.

Accordingly, the FASB decided to issue FASB No. 165 so that management now is responsible for evaluating subsequent events in connection with a company’s financial statements.

In October 2008, the FASB issued an Exposure Draft, Subsequent Events, for a 60-day comment period. In May 2009, a final statement was issued.

Because FASB No. 165 has adopted most of the same provisions found in auditing standards, as well as existing guidance spread throughout other GAAP, there should not be significant changes in the subsequent events that an entity reports either through
recognition or disclosure. There are no changes made to auditing standards found in AU Section 560 so that the rules related to subsequent events now exist in both auditing and accounting standards establishing a requirement for both the auditor and management to evaluate subsequent events.

In addition, as part of the international convergence project, FASB No. 165 brings United States GAAP more in line with international standards and in particular, IAS 10, Events after the Reporting Period. There still remain some small differences between FASB No. 165 and IAS 10 in the areas of refinancing of short-term obligations and curing breaches of borrowing covenants.

III. Requirements of FASB No. 165

1. Scope:
   a. The Statement shall be applied to the accounting for and disclosure of subsequent events not addressed in other applicable GAAP.

      **Note:** Other applicable GAAP may address the accounting treatment of events or transactions that occur after the balance sheet date but before the financial statements are issued or are available to be issued. If an event or transaction is within the scope of other applicable GAAP, then an entity shall follow the guidance in that applicable GAAP, rather than the guidance in this standard. Examples of other applicable GAAP that already addresses the accounting and disclosures for specific subsequent events include:

      • FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes
      • FASB Statement No. 128, Earnings per Share
      • FASB Statement No. 5, Accounting for Contingencies

2. Definitions used within FASB No. 165
   a. **Subsequent events:** events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued.

      1) Financial statements are considered **issued** when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.

      2) Financial statements are considered **available to be issued** when they are:

         • complete in a form and format that complies with GAAP, and
         • all approvals necessary for issuance have been obtained, such as those from management, the board of directors, and/or significant shareholders.

   b. There are two types of subsequent events:

      • **Type 1 subsequent events (recognized subsequent events):** events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.
• **Type 2 subsequent events (nonrecognized subsequent events):** consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

3. **Rules:**
   
a. **Subsequent event period:**
   
   1) An entity that has a current expectation of widely distributing its financial statements to its shareholders and other financial statement users (including a public entity) shall evaluate subsequent events through the date that the financial statements are issued.
   
   2) All entities other than those in (1) above shall evaluate subsequent events through the date that the financial statements are available to be issued.

   **Note:** A public entity is required to evaluate subsequent events through the date that the financial statements are issued. The Statement defines a public entity as any entity that meets any of the following conditions:

   - Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
   - It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
   - It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
   - It is required to file or furnish financial statements with the SEC.
   - It is controlled by an entity covered by any of the above criteria.

   **Observation:** The FASB Board reached the conclusion that the management of a reporting entity should evaluate events or transactions occurring after the balance sheet date through the date that the financial statements are issued or are available to be issued, depending on an entity’s current expectation with respect to the distribution of the financial statements. Under auditing standards (AU Section 560), subsequent events are evaluated through the issuance of financial statements. In EITF Topic No. D-86, “Issuance of Financial Statements,” the SEC staff stated that “financial statements are “issued” as of the date they are distributed for general use and reliance in a form and format that complies with GAAP. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users or filed with the Commission. Furthermore, the issuance of an earnings release does not constitute issuance of financial statements because the earnings release would not be in a form and format that complies with GAAP and GAAS.

   The FASB generally agreed with the SEC staff’s view as to when financial statements should be considered issued for SEC registrants. However, not all entities that are subject to FASB No. 165 have their financial statements audited, and others may not widely distribute those financial statements upon completion.
As it relates to non-public entities, the concept of an “issuance date” is not meaningful because non-public companies do not have a typical issue date. By way of example, the audit, review or compilation work may be completed on one date, and the financial statements may be sent to users on different dates thereafter.

The Board also considered the guidance in IAS 10, under which entities must evaluate subsequent events through the date when the financial statements are authorized for issuance.

In the end, the FASB concluded that management of a reporting entity is required to evaluate subsequent events through the date that the financial statements are issued or are available to be issued. Public entities and other entities that have a current expectation of widely distributing their financial statements should evaluate subsequent events through the date that the financial statements are issued. All other entities (for example, nonpublic entities that do not widely distribute their financial statements to shareholders or other financial statement users) should evaluate subsequent events through the date that the financial statements are available to be issued. As a result, an entity that does not widely distribute its financial statements will not be required to continue to evaluate subsequent events for an extended period of time following the completion of the financial statements.

b. Recognized subsequent events:

1) An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

Examples of recognized subsequent events:

**Example 1:** The events that gave rise to litigation took place before the balance sheet date. The Company records an estimated liability for the litigation in the amount of $100,000. The litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued. The final settlement amount (after the balance sheet date) is $120,000, which is different from the $100,000 liability recorded in the balance sheet.

**Conclusion:** The liability at the balance sheet date should be recognized using the $120,000 settlement amount even though that amount is settled after the balance sheet date. FASB No. 165 requires that the effects of all subsequent events that provide additional guidance about conditions that existed at the balance sheet date be recognized.

**Example 2:** An entity has recorded a trade receivable in the amount of $200,000 on its balance sheet. Subsequent to the balance sheet date and before the financial statements are issued or available to issue, information is obtained that the trade receivable customer’s financial condition has deteriorated and the customer is headed toward bankruptcy.
Conclusion: The customer’s subsequent bankruptcy filing is likely to be indicative of a condition that existed at the balance sheet date. The effects of the customer’s bankruptcy filing should be considered in determining the amount of uncollectible trade receivable recognized at the balance sheet date and the portion for which an allowance should be established.

c. Nonrecognized subsequent events:

1) An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet, but arose after the balance sheet date but before financial statements are issued or are available to be issued.

The Statement provides the following examples of non-recognized subsequent events:

- Sale of a bond or capital stock issued after the balance sheet date but before financial statements are issued or are available to be issued.
- A business combination that occurs after the balance sheet date but before financial statements are issued or are available to be issued.
- Settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued.
- Loss of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued.
- Losses on receivables resulting from conditions (such as a customer’s major casualty) arising after the balance sheet date but before financial statements are issued or are available to be issued.
- Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates after the balance sheet date but before financial statements are issued or are available to be issued.
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the balance sheet date but before financial statements are issued or are available to be issued.

4. Disclosures:

An entity shall disclose the following:

a. The date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued.

b. For those non-recognized subsequent events that are of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, an entity shall disclose the following:

- The nature of the event.
- An estimate of its financial effect, or a statement that such an estimate cannot be made.
Note: An entity also shall consider supplementing the historical financial statements with pro forma financial data. Occasionally, a non-recognized subsequent event may be so significant that disclosure can best be made by means of pro forma financial data. Such data shall give effect to the event as if it had occurred on the balance sheet date. In some situations, an entity also shall consider presenting pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

5. Reissuance of financial statements

a. An entity may need to reissue financial statements, for example, in reports filed with the SEC or other regulatory agencies. After the original issuance of the financial statements, events or transactions may have occurred that require disclosure in the reissued financial statements to keep them from being misleading.

1) If an entity reissues its financial statements, the entity shall not recognize events occurring between the time the financial statements were issued or available to be issued and the time the financial statements were reissued unless the adjustment is required by GAAP or regulatory requirements.

2) An entity shall not recognize events or transactions occurring after the financial statements were issued or were available to be issued in financial statements that are later reissued in comparative form along with financial statements of subsequent periods unless the adjustment meets the criteria stated in this paragraph.

3) An entity shall disclose the date through which subsequent events have been evaluated in both the originally issued financial statements and the reissued financial statements.

6. Effective date and transition

a. FASB No. 165 is effective for interim or annual financial periods ending after June 15, 2009, and shall be applied prospectively.

b. The provisions of the Statement do not apply to immaterial items.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following would be an example of financial statements being issued:
   a) financial statements were issued in draft form to management in a GAAP format
   b) financial statements were widely distributed in an abbreviated non-GAAP format
   c) financial statements were distributed to third parties other than shareholders in a GAAP format
   d) financial statements were widely distributed to shareholders and other users in a GAAP format

2. Which of the following would be an example of financial statements available to be issued:
   a) financial statements are complete in a GAAP format but have not been approved for issuance
   b) financial statements are in an abbreviated non-GAAP format and have been approved for issuance
   c) financial statements are complete in a GAAP format and have been approved for issuance
   d) financial statements are in an abbreviated non-GAAP format and have not been approved for issuance

3. An entity that does not have a current expectation of widely distributing its financial statements to its shareholders and other financial statement users are required to evaluate subsequent events through the date on which the financial statements are:
   a) issued
   b) available to be issued
   c) ready to be issued
   d) later of the date issued or available to be issued

4. Which of the following events would require that an entity recognize the effects of a subsequent event at the balance sheet date:
   a) inventory loss due to a fire that occurred after the balance sheet date and after the financial statements were issued or available to be issued
   b) loss on a receivable due to a condition arising after the balance sheet date but before financial statements are issued or available to be issued
   c) a litigation loss based on events that took place before the balance sheet date
   d) settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Financial statements issued in draft form to management in a GAAP format are not considered issued until they are issued to shareholders and other users.

   B: Incorrect. To be considered issued, financial statements must be issued in a GAAP format.

   C: Incorrect. Financial statements must be distributed to shareholders and other users to be considered issued.

   **D: Correct.** Financial statements are considered issued if they are widely distributed to shareholders and other users in a GAAP format.

   (See page 4 of the course material.)

2. A: Incorrect. All approvals necessary for issuance of GAAP financial statements must have been obtained for financial statements to be available to be issued.

   B: Incorrect. Financial statements must be in a GAAP format, which they are not in this example.

   **C: Correct.** Financial statements must been in a GAAP format and all approvals necessary for issuance must have been obtained, which is the case in this example.

   D: Incorrect. The financial statements must be in a GAAP format and approvals must have been obtained for issuance. Neither of these factors exist in this example.

   (See page 4 of the course material.)

3. A: Incorrect. Only an entity that has a current expectation of widely distributing its financial statements should use the “issued” date.

   **B: Correct.** If there is no wide distribution of the financial statements, the “available to be issued” date should be used.

   C: Incorrect. The “ready to be issued” date is not referenced in FASB No. 165.

   D: Incorrect. FASB No. 165 does not give the option of using the later of the date issued or available to be issued.

   (See page 5 of the course material.)
4. A: Incorrect. Because the loss occurred after the balance sheet date, the effect would not be recognized at the balance sheet date. Moreover, its effect was not discovered until the financial statements were issued.

B: Incorrect. The condition that resulted in the loss occurred after the balance sheet date so that its effect would not be recognized at the balance sheet date.

C: Correct. Because the loss was based on events that took place before the balance sheet date, its effect would be recorded at the balance sheet date.

D: Incorrect. The settlement was based on an event that took place after the balance sheet date. The result is that its effect should not be recorded at the balance sheet date.

(See page 6 of the course material.)
CHAPTER 3

FASB No. 166: Accounting for Transfers of Financial Assets: An Amendment of FASB Statement No. 140
# FASB No. 166: Accounting for Transfers of Financial Assets: An Amendment of FASB Statement No. 140

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FASB No. 166: Accounting for Transfers of Financial Assets:  
An Amendment of FASB Statement No. 140

Issued: June 2009

Effective date: The Statement is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods, thereafter. Earlier application is prohibited.

Objective:

The objective of FASB No. 166 is to make changes to the accounting by a reporting entity for the transfer of financial assets and liabilities, including the effects of a transfer on its financial position, financial performance, and cash flows, and a transferor’s continuing involvement in transferred financial assets.

FASB No. 166 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

Background:

FASB No. 140 was issued in September 2000 and replaced FASB No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. FASB No. 140 provided accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities.

The purpose of FASB No. 140 was to prevent the transfers of financial assets from being accounted for as sales if the transferor (sponsor) had certain continuing involvement in those assets or a portion of the assets.

In particular, FASB No. 140 established conditions that an entity must meet to be a qualifying special-purpose entity (QSPE) and be exempt from consolidation under FIN 46R’s QSPE exemption.

FASB No. 140 was an extension of the FASB’s financial instruments project that includes off-balance financing issues. The Statement replaced FASB No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities, and revised the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures. Most of the provisions of FASB No. 125 were carried over to FASB No. 140 without change.

FASB No. 140’s standards were based on application of a financial-components approach focusing on control.

The financial-components approach states that after a transfer of financial assets, an entity must recognize the financial and servicing assets it controls and the liabilities it has incurred, and derecognize financial assets when control has been surrendered, and derecognize liabilities when extinguished. FASB No. 140 provided standards for distinguishing transfers of financial assets that were sales from transfers which were secured borrowings.
Since the issuance of FASB No. 140, the FASB has been concerned that FASB No. 140 did not satisfy the FASB’s original objective. In particular, using FASB No. 140’s and FIN 46’s consolidation exemption for qualified special purpose entities (QSPEs), there were repeated examples of transferors (sponsors) who accounted for the transfer of securitized assets as sales even though the transferor had continued involvement in those transferred assets.

The FASB issued FASB No. 166 to deal with issues related to FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Since 2003, the FASB issued two FASB statements and four FASB Staff Positions that amend particular aspects of FASB No. 140 as follows:

- FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*
- FASB No. 156, *Accounting for Servicing of Financial Assets*
- FSP FAS 140-1, *Accounting for Accrued Interest Receivable Related to Securitized and Sold Receivables under FASB Statement No. 140*
- FSP FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*
- FSP FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*
- FSP FAS 140-4

In December 2008, the FASB simultaneously issued an exposure draft on FASB No. 166, and FASB No. 167, *Amendments to FASB Interpretation No. 46(R)*. Within FASB No. 167, the FASB addressed, among many changes, elimination of the exemption from the FIN 46R consolidation rules, for QSPEs.

In June 2009, the FASB issued FASB No. 166 at the same time it issued FASB No. 167.

Prior to the issuance of FASB No. 166, most mortgage securitizations had been structured as sales under GAAP where the sponsor transferred the assets to a subsidiary structured as a qualified special purpose entity (QSPE). Usually the sponsor retained limited defined rights. The assets and related debt were removed from the sponsor’s balance sheet. On the income statement, the sponsor typically recorded a gain on the sale of the securities equal to the present value of the cash flows to be received from the retained interest.

Under FASB No. 166, and the issuance of FASB No. 167, the concept of QSPEs is eliminated along with the exemption from FIN 46R. Now, a transferor (sponsor) may be required to consolidate the transferee that holds the securitized assets and liabilities.

With the elimination of the concept of a QSPE and related exemption from FIN 46R, a sponsor is required to consolidate on its balance sheet, the securitized assets and liabilities if the sponsor is the primary beneficiary who has:

- a. Power to direct the most significant activities of the QSPE entity, and
- b. The right to receive benefits or absorb losses of the QSPE entity.
Transfers of financial assets by a transferor to a transferee may take several forms:

1. The transferor has no continued involvement, or

2. The transferor has some continued involvement with the assets transferred, or with the transferee.

Examples include servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments, pledges of collateral, and the transferor’s beneficial interests in the transferred financial assets.

Where there is continued involvement by the transferor, there are issues as to whether a sale should be recorded or whether the transaction should be accounted for as a secured borrowing.

Moreover, an entity may settle a liability by transferring assets to the creditor, obtaining an unconditional release, or entering into another arrangement designed to set aside assets dedicated to ultimately settling the liability. Such an arrangement raises the issue as to when the liability should be considered extinguished.

In accounting for transfers of financial assets, each party to the transaction (transferor and transferee) should:

1) recognize only assets it controls and liabilities it has incurred.

2) derecognize assets and liabilities, only when control over assets has been surrendered, and when liabilities have been extinguished.

The sales and other transfers of financial assets and liabilities often result in a disaggregation of the assets and liabilities into components, which become separate assets and liabilities. For example, an entity may sell a portion of a financial asset it owns, while retaining a portion of the asset separate from the portion sold and from the assets received in the exchange.

FASB No. 166 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as follows:

a. Removes the concept of a qualifying special-purpose entity (QSPE) from FASB No. 140 and removes the exception from applying FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, to variable interest entities that are qualifying special-purpose entities.

b. Modifies the financial-components approach used in FASB No. 140 and limits the circumstances in which a transferor derecognizes a portion or component of a financial asset when the transferor has not transferred the original financial asset to an entity that is not consolidated with the transferor and/or when the transferor has continuing involvement with the financial asset.

c. Introduces the concept of a participating interest.
d. Establishes three conditions for reporting a transfer of a portion (or portions) of a financial asset as a sale.

e. Clarifies the principle that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents, effectively control the transferred financial asset directly or indirectly.

f. Requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor’s beneficial interest) and liabilities incurred as a result of a transfer of an entire financial asset or a group of financial assets accounted for as a sale.

g. Removes the fair value practicability exception from measuring the proceeds received by a transferor in a transfer that meets the conditions for sale accounting at fair value.

h. Requires enhanced disclosures to provide financial statement users with greater transparency about transfers of financial assets and a transferor’s continuing involvement with transfers of financial assets accounted for as sales.

Rules:

1. Scope:

This Statement has the same scope as FASB No. 140 which is that it applies to all entities.

2. The Statement does not address or apply to the following transactions:

   a. Transfers of custody of financial assets for safekeeping
   b. Contributions
   c. Transfers of ownership interests that are in substance sales of real estate
   d. Exchanges of equity method investments for similar productive assets
   e. Investments by owners or distributions to owners of a business enterprise
   f. Subsequent measurement of assets and liabilities

Note: FASB No. 140 does apply to the subsequent measurement of assets and liabilities related to a) servicing assets and liabilities, and b) interest-only strips, other beneficial interests, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment and that are not within the scope of FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

g. Accounting for employee benefits subject to FASB Nos. 87, 88 and 106.

h. Leveraged leases or money-over-money and wrap lease transactions per FASB No. 13, *Accounting for Leases* and FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*. 
3. The Statement does not address transfers of nonfinancial assets, such as servicing assets, or transfers of unrecognized financial assets, such as minimum lease payments to be received under operating leases.

4. Transfers of financial assets and liabilities:

   a. Transfers of financial assets can come in the form of:
      • A transfer of an entire financial asset,
      • A transfer of a group of entire financial assets, or
      • A transfer of a portion of a financial asset (called a participating interest).

   b. A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those assets shall be accounted for as a sale if and only if all of the following three conditions are met:

      1) The transferred assets have been isolated from the transferor.

         Examples include where assets have been put beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

         Note: Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets could be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates that are included in the financial statements being presented.

      2) Each transferee (or third-party holder of its beneficiary interest) has the right to pledge or exchange the assets or beneficiary interests it received, and no condition does both of the following:

         • Constrains the transferee or third party holder of its beneficiary interest, from taking advantage of its right to pledge or exchange, and

         • Provides more than a trivial benefit to the transferor.

      3) The transferor, its consolidated affiliates, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests therein.

         Examples where a transferor has effective control over financial assets include:

         • An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity,

         • An agreement that provides the transferor with both unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call, or
• An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets, at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them.

Observation: FASB No. 140 used a so-called financial-components approach for sale accounting, based on the concept that each party to a transfer recognizes the assets and liabilities that it controls after the transfer. Under the financial-components approach, both the transferor and transferee recognize the assets that it controls and liabilities that it assumes as a result of the transfer, and no longer recognizes the assets and liabilities that were surrendered or extinguished in the transfer. The key concept to the financial-components approach is that the transferor no longer recognizes the transferred financial asset if it surrendered control.

In FASB No. 140, the FASB provided guidance on the conditions that had to be met for a transferor to surrender control over transferred assets when all of the financial asset was transferred. However, guidance was not explicit as to how control was surrendered when a portion, but not all, of an asset was transferred. In particular, concerns were raised as to sales of undivided interests in pools of financial assets. In some such cases, such transfers were being accounted for as sales even though the transferor had some form of control, continued involvement and/or custody of the transferred asset.

To deal with the transfer of a portion of an asset, the FASB introduced the concept of a “participating interest” as a benchmark for permitting a partial transfer to use sale accounting.

In FASB No. 166, the FASB uses the concept of a participating interest and stipulates that in a partial asset transfer, it is appropriate to apply the sale accounting conditions to a portion of a financial asset if the transferor and transferee proportionately share in all of the rights, risks, and benefits of the entire financial asset. Below, the author discusses the definition of a “participating interest” and how the rules work for partial transfers of financial assets.

c. Transfer of a participating interest: Upon completion of a transfer of a participating interest that satisfies the three conditions for a sale (paragraph 1 above), the transferor (seller) shall do the following:

1) Allocate the previous carrying amount of the entire financial asset between the participating interests sold and those interests that continue to be held by the transferor

a) The allocation should be done on a relative fair value basis at the date of the transfer.

1 FASB No. 166 does not modify certain other GAAP, such as FASB No. 35, Accounting and Reporting by Defined Benefit Pension Plans, which might require accounting at the trade date for certain contracts to purchase or sell securities. In general, a transfer of securities may not be considered to be completed until the settlement date.
2) Derecognize the participating interests sold.

3) Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale (such as cash).

4) Recognize in earnings any gain or loss on the sale.

5) Report any participating interest or interests that continue to be held by the transferor as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

Upon completion of a transfer, the transferee (buyer) shall recognize the participating interests obtained, other assets obtained, and any liabilities incurred, and initially measure them at fair value.

What is the definition of a participating interest?

The requirements of FASB No. 166 apply to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a participating interest in an entire financial asset (all of which are referred to collectively in this Statement as transferred financial assets).

A participating interest is a transfer of a portion of an asset or assets and has all of the following characteristics:

1. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset.

2. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership.

3. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder’s interest is subordinated to the interest of another participating interest holder.

4. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance for determining whether the transfer is a sale (e.g., if three conditions are met, the transaction is a sale).

If, instead, a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer as a secured borrowing. However, if the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, the rules for accounting for the transfer as a sale (e.g., meet the three conditions) shall be applied to the entire financial asset once all portions have been transferred.
c. **Transfer of an entire financial asset or a group of entire financial assets:** Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the three conditions to be accounted for as a sale, the transferor (seller) shall do the following:

1) Derecognize the transferred financial assets.

2) Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including a transferor’s beneficial interest in the transferred financial assets) and liabilities incurred in the sale.

3) Recognize in earnings any gain or loss on the sale.

Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the three conditions to be accounted for as a sale, the transferee (buyer) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

2. **Transfer not accounted for as a sale:**

a. If there is a transfer that does not satisfy the three conditions to qualify as a sale, the following guidance must be followed:

1) The transaction is accounted for as a secured borrowing with pledge of collateral.

2) Under the secured borrowing with pledge of collateral rules, a debtor grants a security interest in certain assets to a lender to serve as collateral under the obligation, with or without recourse to other assets of the debtor.

   a) If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately from other assets not so encumbered.

   b) If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of a sale noted above.

   c) If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

   d) Except for c) above, the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

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2 FASB No. 166 identifies other assets obtained and liabilities incurred to include cash, put or call options, forward commitments, and swaps, among others.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following is an example where a transferor has effective control over financial assets:

   a) an agreement that permits the transferor to require the transferee to repurchase the transferred financial assets
   b) an agreement that provides the transferor with a trivial benefit attributable to transferred asset
   c) an agreement that obligates the transferor to repurchase a financial asset at maturity
   d) an agreement that entitles and obligates the transferor to redeem the financial asset before its maturity

2. In dealing with the carrying amount of a financial asset in a transfer of a participating interest, which of the following is the appropriate basis that should be used:

   a) allocate carrying amount based on relative revenue
   b) allocate carrying amount based on a relative fair value basis
   c) allocate carrying amount based on residual value
   d) transfer the entire carrying amount to the transferee

3. Facts: A transferor transfers a portion of a financial asset. The transfer does not meet the definition of a participating interest. How should the transaction be accounted for:

   a) record the transfer as a sale for the entire asset
   b) record the transfer as a partial sale of the asset
   c) record the transfer as a secured borrowing
   d) record the transfer as a nonmonetary transaction
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. An agreement that permits the transferee to require the transferor, and not the transferor to require the transferee, to repurchase the transferred financial assets, is an example.

B: Incorrect. An agreement that provides the transferor with more-than-trivial benefit and not a just trivial benefit, is an example where a transferor has effective control.

C: Incorrect. An agreement that obligates the transferor to repurchase a financial asset before maturity, and not at maturity, is an example.

D: Correct. One example is an agreement that entitles and obligates the transferor to redeem the financial asset before its maturity.

(See page 7 of the course material.)

2. A: Incorrect. Use of relative revenue is not authorized by FASB No. 166.

B: Correct. FASB No. 166 requires that the carrying amount be allocated between participating interests sold and those interests that continue to be held by the transferor, based on a relative fair value basis.

C: Incorrect. There is no authorization to make an allocation based on residual value.

D: Incorrect. A participating interest is a partial transfer and requires an allocation of the carrying amount, and not a transfer of the entire carrying amount.

(See page 8 of the course material.)

3. A: Incorrect. The transfer must be a participating interest to be treated as a sale. Further, if it were recorded as a sale, it would not be recorded for the entire asset.

B: Incorrect. The transfer must be a participating interest to be treated as a sale. However, if it were recorded as a sale, it would be recorded as a partial sale.

C: Correct. Because it does not meet the definition of a participating interest, it is recorded as a secured borrowing instead of as a sale.

D: Incorrect. FASB No. 166 does not provide for the transfer to be record as a nonmonetary transaction.

(See page 9 of the course material.)
5. Servicing financial assets and liabilities:

   a. An entity shall recognize and initially measure at fair value, a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in either of the following two situations:

      1) A servicer’s transfer of an entire financial asset, group of entire financial assets, or a participating interest in an entire financial asset that meets the three requirements for a sale.

      2) An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented.

   Note: If an entity transfers its financial assets to an unconsolidated entity in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities held-to-maturity under FASB No. 115, it may either separately recognize its servicing assets or liabilities, or report those servicing assets or liabilities together with the asset being serviced.

   b. An entity shall subsequently measure each class of servicing assets and liabilities using one of the following methods:

      1) **Amortization method:** Servicing assets and liabilities are amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed costs) or net servicing loss (if servicing costs exceed servicing revenues). At each reporting date, the servicing assets or liabilities are assessed for impairment or increased obligation based on fair value at each reporting date.

      2) **Fair value method:** Servicing assets and liabilities are measured at fair value at each reporting date and the changes in fair value are reported in earnings in the period in which the change occurs.

   Note: The election to use either the amortization method or the fair value method is made separately for each class of servicing assets and servicing liabilities. An entity shall apply the same subsequent measurement method to each servicing asset and servicing liability in a class. Classes of servicing assets and servicing liabilities shall be identified based on: (a) the availability of market inputs used in determining the fair value of servicing assets or servicing liabilities, (b) an entity’s method for managing the risks of its servicing assets or servicing liabilities, or (c) both. Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election shall not be reversed.

6. Special rules for financial assets subject to prepayment:

   a. Those financial assets, other than instruments that are within the scope of FASB No. 133, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB No. 115.
Examples of such financial assets include interest-only strips, and other beneficial interests.

7. Disclosures:

a. The objectives of the disclosures required by FASB No. 166 are to provide users with an understanding of all of the following:

1) A transferor’s continuing involvement with transferred financial assets.

2) The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets.

3) How servicing assets and liabilities are reported.

4) For transfers accounted for as sales when a transferor has continuing involvement with the transferred assets, and for transfers accounted for as secured borrowings, how the transfer affects a transferor’s financial position, financial performance, and cash flows.

Note: The above-noted objectives apply regardless of whether FASB No. 166 requires specific disclosures. The specific disclosures required are minimum requirements and an entity may need to supplement the required disclosures depending on the facts and circumstances of a transfer, the nature of an entity’s continuing involvement with the transferred financial assets, and the effect of an entity’s continuing involvement on the transferor’s financial position, financial performance, and cash flows. Disclosures required by other U.S. generally accepted accounting principles (GAAP) for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this Statement have been met.

The disclosures shall be presented in a manner that clearly and fully explains the transferor’s risk exposure related to the transferred financial assets and any restrictions on the assets of the entity.

Finally, to apply the disclosures, an entity shall consider all involvements by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents to be involvements by the transferor.

b. General rules associated with the format of disclosures follow:

1) Disclosures may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information.

2) A transferor shall disclose how similar transfers are aggregated.

3) A transferor shall distinguish transfers that are accounted for as sales from transfers that are accounted for as secured borrowings.
4) In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets. For example, consideration should be given, but not limited, to the following:

- The nature of the transferor’s continuing involvement, if any
- The types of financial assets transferred
- Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor’s risk profile as a result of the transfer
- The requirements of FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*

c. **Specific disclosures:**

An entity must disclose the following:

1) For collateral:

   a) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security.

   b) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position, the carrying amounts and classifications of both those assets and associated liabilities as of the date of the latest statement of financial position presented, including qualitative information about the relationship(s) between those assets and associated liabilities.

      Example: If assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets, shall be disclosed.

   c) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.

2) For in-substance defeasance of debt:

   a) If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt*, prior to the effective date of previously issued and superseded FASB No. 125, a general description of the transaction and the amount of debt that is considered extinguished at the end of each period as long as that debt remains outstanding.
3) For all servicing assets and servicing liabilities:

   a) Management’s basis for determining its classes of servicing assets and servicing liabilities.

   b) A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.)

   c) The amount of contractually specified servicing fees (as defined in the glossary), late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

   d) Quantitative and qualitative information about the assumptions used to estimate the fair value (for example, discount rates, anticipated credit losses, and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, is encouraged, but not required, to disclose quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.)

4) For servicing assets and servicing liabilities subsequently measured at fair value:

   a) For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

   - The beginning and ending balances
   - Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)
   - Disposals
   - Changes in fair value during the period resulting from:
     - Changes in valuation inputs or assumptions used in the valuation model
     - Other changes in fair value and a description of those changes
   - Other changes that affect the balance and a description of those changes

5) For servicing assets and servicing liabilities subsequently amortized in proportion to and over the period of estimated net servicing income or loss and assessed for impairment or increased obligation:
a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in the carrying amount are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
  - The beginning and ending balances
  - Additions (through purchases of servicing assets, assumptions of servicing obligations, and recognition of servicing obligations that result from transfers of financial assets)
  - Disposals
  - Amortization
  - Application of valuation allowance to adjust carrying value of servicing assets
  - Other-than-temporary impairments
  - Other changes that affect the balance and a description of those changes

b) For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period if it is practicable to estimate the value.

c) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment.

d) The activity by class in any valuation allowance for impairment of recognized servicing assets, including beginning and ending balances, aggregate additions charged and recoveries credited to operations, and aggregate write-downs charged against the allowance, for each period for which results of operations are presented.

6) For securitizations, asset-backed financing arrangements, and similar transfers accounted for as sales when the transferor has continuing involvement (as defined in the glossary) with the transferred financial assets:

a) For each income statement presented:
  - The characteristics of the transfer including a description of the transferor’s continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer, and the gain or loss from sale of transferred financial assets. For initial fair value measurements of assets obtained and liabilities incurred in the transfer, the following information:
    - The level within the fair value hierarchy (as described in FASB Statement No. 157, Fair Value Measurements) in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (level 1), significant other observable inputs (level 2), and significant unobservable inputs (level 3).
- The key inputs and assumptions used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor’s continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, and, if applicable, including expected static pool losses).

- The valuation technique(s) used to measure fair value.

- Cash flows between a transferor and transferee, (including proceeds from new transfers, proceeds from collections reinvested in revolving-period transfers, purchases of previously transferred financial assets, servicing fees, and cash flows received from a transferor’s beneficial interests).

b. For each statement of financial position presented, regardless of when the transfer occurred:

- Qualitative and quantitative information about the transferor’s continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor’s risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), such as:

- The total principal amount outstanding, the amount that has been derecognized, and the amount that continues to be recognized in the statement of financial position

- The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders, including a description of any events or circumstances that could expose the transferor to loss and the amount of the maximum exposure to loss

- Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including when the transferor assisted the transferee or its beneficial interest holders in obtaining support, including:
  o The type and amount of support
  o The primary reasons for providing the support
- Information is encouraged about any liquidity arrangements, guarantees, and/or other commitments provided by third parties related to the transferred financial assets that may affect the transferor’s exposure to loss or risk of the related transferor's interest

- The entity’s accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets.

- The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor's continuing involvement (including, at a minimum, but not limited to, and if applicable, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses).

- For the transferor’s interests in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

- Information about the asset quality of transferred financial assets and any other assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to:
  - Delinquencies at the end of the period
  - Credit losses, net of recoveries, during the period

**Note:** The disclosures in paragraph 5 above apply to transfers accounted for as sales when the transferor has continuing involvement with transferred financial assets as a result of a securitization, asset-backed financing arrangement, or a similar transfer. If specific disclosures are required for a particular form of the transferor’s continuing involvement by other U.S. GAAP, the transferor shall provide the information required in 5(a) and 5(b) as noted above with a cross-reference to the separate notes to financial statements so a financial statement user can understand the risks retained in the transfer. The entity need not provide each specific disclosure required if the disclosure is not required by other U.S. GAAP.
7) Disclosure requirements for transfers of financial assets accounted for as secured borrowings:

a) The carrying amounts and classifications of both assets and associated liabilities recognized in the transferor’s statement of financial position at the end of each period presented, including qualitative information about the relationship(s) between those assets and associated liabilities. For example, if assets are restricted solely to satisfy a specific obligation, the carrying amounts of those assets and associated liabilities, including a description of the nature of restrictions placed on the assets.

8. Unit of account in applying FASB No. 166:

a. The conditions that determine whether a transfer is a sale state that sale accounting conditions are applied to transfers of an entire financial asset, transfers of a group of entire financial assets, and transfers of a participating interest in an entire financial asset.

b. In order to be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest.

c. In determining what constitutes an entire financial asset, the legal form of the asset and what the asset conveys to its holders is considered. Examples that illustrate the application of what constitutes an entire financial asset include the following:

<table>
<thead>
<tr>
<th>Situation</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization.</td>
<td>The contract is considered an entire financial asset.</td>
</tr>
<tr>
<td>A beneficial interest in securitized financial assets after the securitization process has been completed.</td>
<td>The beneficiary interest is considered an entire financial asset.</td>
</tr>
<tr>
<td>A transferred interest in an individual loan.</td>
<td>The transferred interest is not to be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.</td>
</tr>
<tr>
<td>Situation</td>
<td>Conclusion</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>The transferor creates an interest-only strip from a loan and transfers the interest-only strip.</td>
<td>The interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded).</td>
</tr>
<tr>
<td></td>
<td>In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.</td>
</tr>
<tr>
<td>If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan).</td>
<td>An advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety.</td>
</tr>
<tr>
<td></td>
<td>However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest.</td>
</tr>
<tr>
<td></td>
<td>Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.</td>
</tr>
</tbody>
</table>
9. Removal of Qualifying Special-Purpose Entity (QSPE) Concept

Perhaps one of the most significant changes made by FASB No. 166 is the elimination of the concept of a qualifying special-purpose entity (QSPE). Previously, FASB No. 140 held the concept of a QSPE and FIN 46R exempted QSPEs from the consolidation rules of FIN 46R. Thus, entities that were structured to meet the definition of a QSPE were able to avoid consolidation of that entity with its transferor (seller).

FASB No. 140 defined a QSPE as a trust or other legal vehicle that: a) was demonstrably distinct from the transferor, b) had certain permitted activities, significantly limited and specified in the legal documents, and c) held certain passive financial assets.

In issuing FASB No. 166, the FASB removed the concept of a QSPE altogether. Further, in amending FIN 46R, FASB No. 167 eliminated the exemption from the consolidation rules for QSPEs.

The result may be significant for certain entities that previously met the definition of a QSPE and did not consolidate the QSPE with the transferor (seller). Now, the consolidation exemption is eliminated. Consequently, such entities are now required to be consolidated with the transferor if the FIN 46R rules for consolidation are met.

In removing the QSPE concept, the FASB noted that the application of the conditions for a qualifying special-purpose entity had been extended in some cases beyond the intent of FASB No. 140, thus effectively rendering the conditions no longer operational in practice.

10. Examples of Applications of FASB No. 166

The following two examples have been extracted from FASB No. 166.

Example 1:

Facts: Company X transfers entire loans with a carrying amount of $1,000 to an unconsolidated securitization entity and receives proceeds with a fair value of $1,030.

The transfer meets the three conditions and is accounted for as a sale.

The Company retains no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans.

Company X agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (e.g., that provision is effectively an interest rate swap).
Details follow:

**Fair values:**
- Cash proceeds $1,050
- Interest rate swap 40
- Recourse obligation 60

**Net proceeds:**
- Cash received $1,050
  - Plus:
    - Interest rate swap 40
  - Less: Recourse obligation (60)
  - Net proceeds $1,030

**Gain on sale:**
- Net proceeds $1,030
- Carrying amount of loans sold 1,000
- Gain on sale $30

**Conclusion:** The transfer in Example 1 represents a transfer of an entire financial asset. A given fact is that the transfer satisfies the three conditions that allow the transaction to be accounted for as a sale. Under this example, the transferor does the following:

1) Deregognize the transferred financial assets (loans) with a carrying value of $1,000.
2) Recognize and initially measure at fair value any assets obtained (interest rate swap of $40) and liabilities incurred (recourse obligation of $60).
3) Recognize in earnings a gain of $30.

Although not presented in Example 1, upon completion of a transfer of the loans to the transferee, the transferee (buyer), shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

**Entry:**

Cash 1,050  
Interest rate swap 40  
Loans 1,000  
Recourse obligation 60  
Gain on sale 30  

To record transfer of loans
Example 2: Sale of Receivables with Servicing Retained

**Facts:** Company X originates $1,000 of loans that yield 10% interest income for their estimated lives of nine years. The Company transfers the entire loans to an unconsolidated entity and the transfer is accounted for as a sale.

The company receives, as proceeds $1,000 cash, a beneficiary interest to receive one percent of the contractual interest on the loans (an interest-only strip receivable), and an additional one percent of the contractual interest as compensation for servicing the loans.

The fair value of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

**Conclusions:** Similar to Example 1, Example 2 represents a transfer of an entire financial asset, which is the $1,000 of loans. A given fact is that the transfer satisfies the three conditions that allow the transaction to be accounted for as a sale. Under this example, the transferor does the following:

1) Derecognize the transferred financial assets (loans) with a carrying value of $1,000.

2) Recognize and initially measure at fair value any assets obtained (interest-only strip receivable $60, and $40 servicing asset) and liabilities incurred (none in this example).

3) Recognize in earnings a gain of $100.

Although not presented in Example 1, upon completion of a transfer of the loans to the transferee, the transferee (buyer) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.
Details of the computations and related entries follow:

**Fair values:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
</tbody>
</table>

**Net proceeds:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
<tr>
<td><strong>Net proceeds</strong></td>
<td><strong>$1,100</strong></td>
</tr>
</tbody>
</table>

**Gain on sale:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$1,100</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Gain on sale</strong></td>
<td><strong>$ 100</strong></td>
</tr>
</tbody>
</table>

**Entries:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>100</td>
</tr>
</tbody>
</table>

To record transfer and recognize interest-only strip receivable and servicing asset

**Example 3: Recording Transfers of Participating Partial Interests**

**Facts:** Company B transfers nine-tenths participating interest in a loan with a fair value of $1,100 and a carrying amount of $1,000.

It is assumed that the transfer satisfies the three conditions and is accounted for as a sale.

The servicing contract has a fair value of zero, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

**Conclusion:** In Example 3, there is a transfer of a participating (partial) interest in the loans. Because the transfer satisfies the three conditions for sale accounting, the transfer is recorded as a sale. In recording the sale, the following is done:

1. Allocate the $1,000 carrying amount of the entire loans between the participating interests sold (90%) and those interests that continues to be held by the transferor (10%). The allocation should be done on a relative fair value basis at the date of the transfer.

2. Derecognize (remove) the participating interests sold by recording the portion of the carrying value sold, which is $900.
3. Recognize and initially measure at fair value any servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale. In this example, the servicing assets have a zero value.

4. Recognize in earnings any gain or loss on the sale which is a $90 gain.

5. Report the participating interest that continues to be held by the transferor as the difference between the previous carrying amount of the entire financial asset ($1,000) and the amount derecognized ($900). The portion held is $100.

<table>
<thead>
<tr>
<th>Fair values</th>
<th>Allocated fair value</th>
<th>% fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portion sold: 9/10 of participating interest sold</td>
<td>$1,100 x 9/10</td>
<td>$990</td>
</tr>
<tr>
<td>Portion held by transferor: 1/10 of interest</td>
<td>1,100 x 1/10</td>
<td>110</td>
</tr>
<tr>
<td>$1,100</td>
<td>$1,100</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Allocation of carrying value</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Portion sold: 9/10 of participating interest sold</td>
<td>% fair value</td>
<td>Allocated carrying value</td>
</tr>
<tr>
<td>Portion held by transferor: 1/10 of interest</td>
<td>90%</td>
<td>$900</td>
</tr>
<tr>
<td></td>
<td>10%</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Computation of gain on portion transferred</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$990</td>
</tr>
<tr>
<td>Carrying value of portion sold</td>
<td>900</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$90</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Entry to record transfer of loans</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>990</td>
</tr>
<tr>
<td>Loans (portion sold)</td>
<td>900</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>90</td>
</tr>
</tbody>
</table>

11. Effective date:

The Statement is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter.

Earlier application is prohibited.

The recognition and measurement provisions of the Statement shall be applied to transfers that occur on or after the effective date.

Additionally, on and after the effective date, existing qualifying special-purpose entities (as defined under previous accounting standards) must be evaluated for consolidation by reporting entities in accordance with the applicable consolidation guidance. If the
evaluation on the effective date results in consolidation, the reporting entity shall apply the transition guidance provided in the pronouncement that requires consolidation.

The disclosure provisions of this Statement shall be applied to transfers that occurred both before and after the effective date of this Statement. An entity is encouraged, but not required, to disclose comparative information for periods earlier than the effective date for disclosures that were not previously required by Statement No. 140 for nonpublic entities or by FASB Staff Position FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*, for public entities. Comparative disclosures for those disclosures that were not previously required by Statement No. 140 for nonpublic entities or by FSP FAS 140-4 and FIN 46(R)-8 for public entities are required only for periods after the effective date.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

i. Using the amortization method, a servicing asset is amortized in proportion to and over:
   a) the period of estimated net servicing income or loss
   b) the estimated useful life of the transferred asset
   c) the remainder of the transfer contract
   d) an estimated straight-line period consistent with industry practices

2. A transferor has a servicing asset in connection with a transferred asset. The servicing asset is not subsequently measured at fair value. Which of the following is not a disclosure required for the transferor:
   a) basis for determining the classes of servicing assets
   b) a description of the risks inherent in servicing assets
   c) the amount of contractually specified servicing fees
   d) the activity in the balance of servicing assets

3. Which of the following is a byproduct of FASB No. 166’s removal of the QSPE concept:
   a) financial assets will be transferred at higher values than previously used
   b) more transferors of financial assets may have to consolidate transferees
   c) more entities will meet the QSPE definition even if it is not codified
   d) there will be no impact as the QSPE concept was not applicable in most cases

4. Facts: A company (transferor) transfers 100 percent of the loans it holds with a carrying value of $4,000, to a transferee. The transfer qualifies as a sale transaction. The company receives $5,000 cash for the transferred assets. The transferor receives 2 percent of the contracted interest as compensation for servicing the loans. The fair value of the servicing asset is $500. What is the gain or loss recognized on the transfer:
   a) $1,500
   b) $500
   c) $1,000
   d) zero
5. Facts: Company X transfers 75 percent participating interest in a loan. The fair value of the loan is $2,000 and the carrying value is $1,200. The transfer satisfies the three conditions for a sale transaction. How much is the gain to be recognized by the transferor:

a) none  
b) $800  
c) $600  
d) $2,000
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** Servicing assets and liabilities are amortized over the period of estimated net servicing income or loss. If servicing income exceed costs, it is based on net servicing income. If servicing costs exceed income, it is based on net servicing loss.

   B: Incorrect. The asset transferred is a financial asset and does not have a useful life.

   C: Incorrect. FASB No. 166 does not provide for using the remainder of the contract.

   D: Incorrect. There is no requirement to use a straight-line period based on industry practices.

   (See page 13 of the course material.)

2. **A: Incorrect.** Management’s basis for determining the classes of servicing assets (and liabilities) is a requirement for all servicing assets and liabilities.

   B: Incorrect. A description of the risks inherent in servicing assets, as well as the instruments used to mitigate the income statement effect of the changes in fair value, is a required disclosure for all servicing assets.

   C: Incorrect. The amount of contractually specified servicing fees, as well as late and ancillary fees earned for which results of operations are presented, is required for all servicing assets.

   **D: Correct.** A disclosure of the activity in the balance of servicing assets is required only if the servicing assets (and liabilities) are subsequently measured at fair value. If not, the disclosure is not required. That activity includes the beginning and ending balances, additions, disposals, changes in fair value during the period, and other changes.

   (See page 16 of the course material.)

3. **A: Incorrect.** There will be no effect on the values at which financial assets will be transferred.

   **B: Correct.** Because the QSPE exemption is eliminated, more transferors of financial assets may have to consolidate transferees if certain conditions are met under FIN 46R.

   C: Incorrect. There is no change to the definition of a QSPE. Instead, the entire concept is eliminated under FASB No. 166.

   D: Incorrect. Companies had structured their asset transfers to get under the QSPE exemption. Now that exemption is gone and the impact could be significant.

   (See page 22 of the course material.)
4. **A: Correct.** The gain is equal to $5,000 cash proceeds plus the $500 fair value of the servicing asset, minus the $4,000 carrying value.

   B: Incorrect. The $500 assumes that the $500 fair value of the servicing asset is deducted in determining the gain, when in fact it is added as part of net proceeds.

   C: Incorrect. The $1,000 gain would be the correct answer if the $500 servicing asset fair value were not considered.

   D: Incorrect. Zero is not an option. When a transfer of an entire asset is made, a gain or loss is recognized.

   (See pages 24 to 25 of the course material.)

5. A: Incorrect. Because the transaction qualifies as a sale transaction, a gain or loss is recognized. Thus, zero is an incorrect answer.

   B: Incorrect. $800 is the gain on the total transaction. X transferred only 75 percent of the asset so that recognition of the total gain is not appropriate under the participating interest rules.

   **C: Correct.** Because the transaction is a participating interest, the participating interest transferred (75 percent) is derecognized. In doing so, 75 percent of the fair value ($2,000 x 75% = 1,500), and 75 percent of the carrying value ($1,200 x 75% = $900) are derecognized resulting in a gain of $600.

   D: Incorrect. $2,000 represents the total fair value and ignores the derecognized portion of the carrying value of the interest transferred.

   (See pages 25 to 26 of the course material.)
CHAPTER 4

FASB No. 167: Amendments to FASB Interpretation No. 46R: Consolidation of Variable Interest Entities – *An Interpretation of ARB No. 51*: (FASB ASC Topic 810)
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SECTION 1:

I. Introduction

FASB Interpretation No. 46R (FIN 46R) (ASC Topic 810) was issued in December 2003 and replaces the original Interpretation No. 46 that was issued in January 2003. FIN 46R, as revised, addresses the consolidation rules found in ARB No. 51, Consolidated Financial Statements, and FASB No. 94, Consolidation of All Majority-Owned Subsidiaries, as they relate to off-balance sheet entities, referred to as variable interest entities (VIEs).

In June 2009, the FASB issued FASB No. 167, Amendments to FASB Interpretation No. 46R, which has as its primary goal, to improve the application of certain provisions found in FIN 46R including changes made to the Qualified Special Purpose Entity (QSPE) rules.

The general rule for consolidation of entities found in ARB No. 51, Consolidated Financial Statements (ASC Topic 810) is that consolidation occurs when one entity directly or indirectly has a controlling financial interest in another entity. A controlling financial interest is deemed to occur when one entity (the parent) owns more than 50% of the voting shares of another entity (the subsidiary.) Prior to FIN 46R, with respect to an enterprise that controlled, but did not own another entity, the rules had been scattered among a series of FASB Emerging Issues Task Force opinions. In most cases, an enterprise that controlled another (through contract, support, or otherwise), but did not own the majority of its voting equity, was not required to consolidate with that entity provided certain criteria were met. Thus, the concept of “off-balance sheet” entities (that is, unconsolidated entities), has evolved over the years.

FIN 46R, as amended, addresses those so called “off-balance sheet” entities (referred to as variable interest entities or VIEs) and establishes rules as to when one entity must consolidate another entity that it effectively controls, even though there may be no controlling ownership between the two entities.

FIN 46R replaces the previously used term “special purpose entity” or “SPE” with the term “variable interest entity” or “VIE,” to identify those entities that now may have to be consolidated.

A. CONSOLIDATED STATEMENTS

General:

The rules for consolidations are found in Accounting Research Bulletin (ARB) 51, Consolidated Financial Statements, as amended by Financial Accounting Standards Board (FASB) Statement No. 94, Consolidation of All Majority-Owned Subsidiaries (ASC Topic 810, Consolidation, in the Accounting Standards Codification).
ARB No. 51 states:

“There is a presumption that consolidated statements are more meaningful than separate statements…”

In general, ARB No. 51 and FASB No. 94 require the consolidation of all majority-owned subsidiaries; that is, a situation in which one entity has a controlling financial interest (through ownership of more than 50% voting shares) in another entity.

**Note:** Previously, there were several exceptions to the consolidation requirement whereby an entity was not required to consolidate another even though ownership exceeded the 50% threshold. Those exceptions included situations involving non-homogeneous operations, foreign ownership, or where control was temporary or did not rest with the majority owner. FASB Nos. 94 and 145 eliminated these exceptions. Now, there are no exceptions to the consolidation rules if one enterprise owns more than 50 percent of the voting shares of another entity. An entity that owns more than 50% of the voting shares of another entity is required to consolidate that entity’s financial statements with its own.

**The Variable Interest Entity (VIE) Rules – FIN 46R**

**FASB Interpretation No. 46R – Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51:**

An exception to the more-than-50%-ownership rule for consolidation, is where there is an off-balance entity that is categorized as a variable interest entity (VIE) as discussed in FASB Interpretation No. 46R, Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51, as amended by FASB No. 167.

FIN 46R, was issued in December 2003, and amended by FASB No. 167, Amendments to FASB Interpretation No. 46R, in June 2009.

A discussion of FIN 46R takes up the remainder of this course. The terms “FIN 46R,” “Interpretation FIN 46R,” and “the Interpretation” are used interchangeably throughout this section.

Part of the challenge in dealing with FIN 46R is that, in writing the final document, the FASB chose to limit the guidance and examples that illustrate its application. Although not formally identified as such, FIN 46R represents the FASB’s first attempt at applying principles-based accounting under which broad concepts and principles are given with few rules to illustrate the application of those principles. The result is that the profession is left with a document that is difficult to understand and implement. A validation of this fact is that, subsequent to the issuance of the original Interpretation No. 46 in January 2003, the FASB Staff had issued six FASB Staff Positions (FSPs) essentially “interpreting FIN 46R,” and had proposed five additional FSPs. Ultimately, it had to issue a revised Interpretation in December 2003.

Subsequently, the FASB issued FASB No. 167 to make further changes to FIN 46R but added little additional guidance on how to implement it except that it expanded the number of examples within its appendix.
Even with the issuance of a revised Interpretation, as amended by FASB No. 167, there is little doubt that the FASB Staff will be required to issue more FSPs in the future. Consequently, in this document the author has incorporated his own views on how to apply FIN 46R based on unofficial discussions with the FASB Staff and others.

In addition to amending FIN 46R, FASB No. 167 either rescinded or amended several FASB Staff Positions related to FIN 46R, as follows:

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**Key Changes Made to FIN 46R by FASB No. 167**

FASB 167 was issued to amend FIN 46R to address concerns made by parties that key provisions had to be modified.

In general, FASB No. 167 makes the following changes to FIN 46R:

a. Adds qualifying special-purpose entities (QSPEs) to the scope of entities subject to FIN 46R.

b. Changes to the concept of a primary beneficiary which may be required to consolidate a variable interest entity.

- The definition of primary beneficiary is changed.

- Use of a quantitative method to determine whether an entity is the primary beneficiary has been eliminated and is replaced by sole use of a qualitative approach.
Chapter 4: FASB No. 167: Amendments 7 to FASB Interpretation No. 46R

c. Requires a variable interest holder to perform ongoing reassessments of a VIE to determine whether the variable interest holder is the primary beneficiary required to consolidate the VIE. Previously FIN 46R required that a reassessment be performed only if certain triggering events occurred.

d. Amends the definition of a variable interest entity.

e. Adds an additional reconsideration event for determining whether an entity is a variable interest entity when certain facts and circumstances occur.

f. Enhances the disclosures required.

Although most of the changes appear to be made for the better, FIN 46R, as amended, is still a highly complex and difficult standard to apply in practice.

The changes made by FASB No. 167 are effective as of the beginning of each reporting enterprise’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early application is prohibited.

In 2010, the FASB issued an Accounting Standards Update (ASU) to ASC 810, Consolidation, entitled, Amendments to Statement 167 for Certain Investment Funds. The ASU defers the effective date of FASB No. 167 indefinitely for a reporting enterprise’s (investment manager’s) interest in an entity that 1) has the attributes of an investment company, or 2) for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies.

What is a variable interest entity (VIE)?

A variable interest entity (VIE) is nothing more than an off-balance sheet entity that now may be required to be consolidated by another entity from which it receives financial support.

A VIE is not self-supportive in that it cannot finance its activities without financial support from another entity or individual.

Example: A company is not able to obtain bank financing without an affiliate guaranteeing its bank loan. FIN 46R states that because the company must receive additional financial support from others (e.g., in this example, in the form of another entity guaranteeing its loan), it is not self-supportive. Thus, it is a VIE. If certain other criteria are met, the VIE must be consolidated with the reporting enterprise that has a controlling financial interest through other than ownership in equity.

Not all off-balance sheet entities are VIEs, and those that are not, should not be consolidated under FIN 46R. In fact, many off-balance-sheet entities are not VIEs because they are self-supportive and can easily finance their activities without additional financial support from another entity or individual. A non-VIE is never consolidated under FIN 46R and is only consolidated if another entity owns more than 50% of its voting stock, as required by ARB No. 51.
The following chart summarizes the way in which the reader should look at the term VIE as used throughout the remainder of this course:

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<th>Off-Balance Sheet Entities</th>
<th>General description</th>
<th>Rules – Interpretation No. 46R</th>
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<tr>
<td>Variable interest entity (VIE)</td>
<td>Is not self-supportive – cannot finance its activities without additional subordinated financial support from others (e.g., guarantees, subordinated loans, etc.)</td>
<td>May have to be consolidated under FIN 46R if certain other criteria are met.</td>
</tr>
<tr>
<td>Non-variable interest entity (Non-VIE)</td>
<td>Self-supportive – can finance its activities without additional subordinated financial support from others.</td>
<td>Not required to be consolidated under FIN 46R. Consolidated only based on the traditional consolidation rules (more than 50% ownership in voting equity).</td>
</tr>
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B. GENERAL RULES OF FIN 46R

Application of FIN 46R:

FIN 46R rules as follows:

1. The term special-purpose entity (SPE) is superseded by the term “variable interest entity (VIE).” Typically, VIEs are involved in:
   - Leasing arrangements, including sales with leasebacks (referred to as synthetic leases)
   - Financing arrangements with third party financial institutions to fund acquisitions of certain assets or businesses
   - Management of certain receivables or investments
   - Research and development and other project development activities
   - Hedge activities to manage risk
   - Management services
   - Distribution services

2. The rules apply to all entities (except as otherwise noted in (3) below) and include any type of entity that is a legal structure used to conduct activities or to hold assets such as corporations, partnerships, limited liability companies, grantor and other types of trusts.

   **Note:** The rules apply to all entities including one-member LLCs. Although a one-member LLC is a “non-entity” for income tax purposes, it is a legal entity to which FIN 46R applies. If a one-member LLC is a VIE, it is conceivable that it will be consolidated by another entity.
3. **FIN 46R does not apply** to:


   1) The definition of a not-for-profit organization, found in Paragraph 168 of FASB No. 117 includes an entity that possesses the following characteristics:

   - Contributions of significant amounts of resources from resource providers who do not expect commensurate proportionate pecuniary return,

   - Operating purposes other than to provide goods or services for profit, and

   - Absence of ownership interests like those of business reporting enterprises.

   2) Entities that fall outside the definition of a not-for-profit organization include all investor-owned companies, and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants. Examples of entities that do not meet the definition of not-for-profit organizations include mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans.

   **Exceptions to the not-for-profit organizations:**

   - If a not-for-profit entity is used by a business reporting enterprise in a manner similar to a VIE in an effort to circumvent the provisions of FIN 46R, the not-for-profit entity is subject to FIN 46R.

   - A not-for-profit organization may be considered a related party for purposes of applying the related party rules found in FIN 46R (discussed further on in this chapter).

   **Note:** Upon the issuance of the original interpretation, it was not clear as to whether health care organizations were subject to FIN 46R. In a subsequently issued FASB Staff Position (FSP), the FSP concluded that all not-for-profit organizations were excluded from the requirements of FIN 46R, including health care organizations subject to the Audit Guide. The revised Interpretation reaffirms that all not-for-profit organizations are excluded from the application of FIN 46R unless they are used by a for-profit organization to circumvent the rules of FIN 46R.

Example: A company is not required to consolidate with its pension plan even though the company may control that plan.

c. Investments accounted for at fair value in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide, Investment Companies.

d. Separate accounts of life insurance entities as described in AICPA Audit and Accounting Guide, Life and Health Insurance Entities.

e. **Special Exemptions** from FIN 46R:
   1) Special exemption for non-substantive terms, transactions, and arrangements
   2) Special exemption for variable interest holders who have difficulty obtaining information
   3) Special exemption for certain entities that are businesses

   (These three special exemptions are discussed further on in this section of the course.)

f. **Certain governmental organizations**: An entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity (1) is not a governmental organization and (2) is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of FIN 46R.

g. **Property held individually**: Real estate or other assets held individually is not subject to consolidation under FIN 46R. Thus, determination as to whether real estate or other assets is consolidated differs based on how title is held to the real estate or other assets.

*Do the rules apply to an individual who is the primary beneficiary of a VIE?*

An individual may be required to issue personal financial statements to a bank or other third party. That individual may have a controlling financial interest in a VIE (through ownership or non-ownership such as guarantees, or other forms of financial support). In such a case, the consolidation rules of FIN 46R do not apply. FIN 46R only applies to a legal entity and not to an individual.

---

1 Amended per FSP FIN 46(R)-7. Previously, the exemption applied to a reporting enterprise that was subject to SEC Regulation S-X, Rule 6-03(c)(1).
What about qualifying SPEs?

Prior to the issuance of FASB No. 167, FIN 46R excluded two entities from the application of FIN 46R:

- A transferor of financial assets or its affiliates to a special-purpose entity (SPE) or a formerly qualifying SPE as described in FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

- A reporting enterprise that holds variable interests in a qualifying SPE or a formerly qualifying SPE as described in FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

With the issuance of FASB No. 166, *Accounting for Transfers of Financial Assets (ASC 860)*, the FASB eliminated the concept of a qualifying special-purpose entity (QSPE) that was previously covered in FASB No. 140. Consequently, in FASB No. 167, the FASB eliminated the exemption in FIN 46R related to QSPEs. Thus, QSPEs are included within the scope of FIN 46R.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. The general rule for consolidation of entities found in ARB No. 51, Consolidated Financial statements (ASC 810), is that consolidation occurs when:
   a) one entity controls, but does not own, another entity
   b) one entity directly or indirectly has a controlling financial interest in another entity
   c) one entity owns less than 50% of the voting shares of another entity
   d) there is an off-balance sheet entity

2. Under FASB No. 94 (ASC 810) and FASB No. 145 (ASC 205), what is an exception to the consolidation rules:
   a) situations involving foreign ownership
   b) situations involving non-homogeneous operations
   c) situations where control was temporary
   d) there are no exceptions

3. Under FIN 46R, a non-variable interest entity (non-VIE) is:
   a) consolidated only based on the traditional consolidation rules
   b) unable to finance its activities without additional subordinated financial support
   c) not self-supportive
   d) required to be consolidated

4. Which of the following is correct with respect to how qualifying SPEs (QSPEs) should be accounted for under FIN 46R:
   a) QSPEs are excluded from FIN 46R’s scope
   b) QSPEs are included within FIN 46R’s scope
   c) QSPEs are not addressed by FIN 46R
   d) QSPEs may be subject to FIN 46R only if certain special provisions are satisfied
1. A: Incorrect. With respect to an entity that controlled, but did not own, another entity, the rules have been scattered among a series of FASB Emerging Issues Task Force opinions.

   B: Correct. The general rule for consolidation of entities found in ARB No. 51, *Consolidated Financial statements*, is that consolidation occurs when one entity directly or indirectly has a controlling financial interest in another entity.

   C: Incorrect. Consolidation does not occur at less than 50% ownership. Instead, either the equity or cost method is used.

   D: Incorrect. Typically, an entity that has controlled another, but not owned the majority of its voting equity, has not consolidated that entity provided certain criteria were met.

   (See page 4 of the course material.)

2. A: Incorrect. Previously, an entity was not required to consolidate another even though ownership exceeded the 50% threshold if there was foreign ownership. That exception has been eliminated.

   B: Incorrect. Previously, an entity was not required to consolidate another even though ownership exceeded the 50% threshold if there were non-homogeneous operations. That exception has been eliminated.

   C: Incorrect. Previously, an entity was not required to consolidate another even though ownership exceeded the 50% threshold where control was temporary or did not rest with the majority owner. That exception has been eliminated.

   D: Correct. Presently, there are no exceptions to the consolidation rules. Therefore, an entity that owns more than 50% of the voting shares of another entity must consolidate that entity’s financial statements with its own.

   (See page 5 of the course material.)
3. **A: Correct.** A non-variable interest entity is consolidated only based on the traditional consolidation rules (more than 50% ownership in voting equity). The reason is because a non-VIE is self-supportive and does not have to be consolidated under the FIN 46R rules.

B: Incorrect. A non-variable interest entity can finance its activities without additional subordinated financial support from others.

C: Incorrect. A non-variable interest entity is self-supportive, while a VIE is not self-supportive.

D: Incorrect. A non-VIE is *not* required to be consolidated under FIN 46R. Outside of the traditional consolidation rules, a VIE, and not a non-VIE, must be consolidated under FIN 46R.

(See page 8 of the course material.)

4. A: Incorrect. Prior to the issuance of FASB No. 167, QSPEs were excluded from FIN 46R’s scope. With FASB No. 167, QSPEs are now included under FIN 46R.

**B: Correct.** Under FASB No. 167, QSPEs are included within FIN 46R’s scope.

C: Incorrect. FIN 46R, as amended, does address QSPEs.

D: Incorrect. Since there is no exclusion for QSPEs, such entities are subject to the provisions of FIN 46R and there are no special provisions related to it.

(See page 11 of the course material.)
SECTION 2:

I. Rules of FIN 46R

As we reviewed in Section 1, the general rule for consolidation found in ARB No. 51 is that one reporting enterprise (parent) consolidates another other entity (subsidiary) if the parent owns more than 50% of the voting shares of the subsidiary. ARB No. 51 assumes that a parent that owns more than 50% of the voting shares of subsidiary has a controlling financial interest in that entity.

Interpretation 46R deals with instances in which one reporting enterprise does not own the majority of the voting shares of another. Yet, if certain conditions are satisfied, that reporting enterprise still may have a controlling financing interest through other than ownership.

Specifically, FIN 46R requires that one reporting enterprise (the primary beneficiary) consolidate an entity (the variable interest entity (VIE)) if the primary beneficiary has a controlling financial interest in the VIE, that is not based on ownership.

A controlling financial interest is achieved by other than ownership if two criteria are satisfied.

First, the primary beneficiary must have the power to direct the VIE’s most significant activities.

Secondly, the primary beneficiary is obligated to absorb the losses of the VIE and has the right to receive the benefits of the VIE’s.

Ownership of the VIE is not necessary for a reporting enterprise to be the primary beneficiary that consolidates a VIE.

Thus, FIN 46R expands the consolidation rules model found in ARB No. 51 (based on more-than-50% ownership) with one that requires consolidation based on a reporting enterprise (primary beneficiary) having the attributes of power and the economic risks and benefits of that VIE without having any ownership in that VIE.

FIN 46R is built on the premise that a reporting enterprise (the primary beneficiary) that has power and access to the economic risks and rewards of a VIE has a controlling financial interest in the VIE, thereby acting as a “de facto owner,” even if that primary beneficiary has no ownership in the VIE. Therefore, in substance, the reporting enterprise should consolidate the VIE as if it were the majority owner of the VIE’s equity.

FIN 46R uses the following terms that are used throughout this chapter:

Variable interest entity (VIE): An entity that is not self-supportive in that it cannot finance its activities without receiving additional subordinated financial support from another entity or individual.
**Variable interest (VI):** A form of financial support given by one entity or individual to a VIE in the form of a guarantee, loan, certain lease payments, certain management fees, etc.

**Primary beneficiary (PB):** The entity or individual that has a controlling financial interest in a VIE by having a) the power to direct the VIE’s significant activities, and b) the obligation to absorb the VIE’s losses and right to receive the VIE’s benefits that are significant to the VIE. If the primary beneficiary is an entity, it consolidates the VIE, while if it is an individual, it does not consolidate the VIE.

**Basic Rules for Consolidation – 3 Requirements:**

In order for one reporting enterprise to consolidate an off-balance sheet entity under FIN 46R, there are **three requirements** that must exist:

**Requirement 1:** There must be a **variable interest entity (VIE)** (off-balance sheet entity that is not self-supportive).

**Requirement 2:** Reporting entities and/or individuals must have **variable interests** in the VIE (e.g., provide subordinated financial support to the VIE through equity, loans, guarantees, etc.).

**Requirement 3:** A reporting enterprise must be the **primary beneficiary** of the VIE by having a controlling financial interest in that VIE through other than majority ownership.

If all **three requirements are met** and if a reporting enterprise is the primary beneficiary, it **must consolidate the VIE**.

- If an individual (rather than a reporting enterprise) is the primary beneficiary, there is no consolidation required of the VIE.
• If all three requirements are not satisfied, no consolidation of the VIE is required.

• If a reporting enterprise has a variable interest in a VIE, but the reporting enterprise is not the primary beneficiary, consolidation is not required but certain disclosures must be made. A discussion of disclosures is made later on in this chapter.

The *three requirements* must be met in order for one entity to consolidate another. The following chart illustrates the interrelation of the three requirements.

<table>
<thead>
<tr>
<th>Three Requirements for Consolidation of a VIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the entity a VIE? (not self-supportive)</td>
</tr>
<tr>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
</tbody>
</table>

** If the primary beneficiary is an individual, no consolidation of the VIE is required.

The following flowchart illustrates the logic used to apply the FIN 46R requirements.
Flowchart to Consolidation – FIN 46R

Is the entity a variable interest entity (VIE)? (e.g., not self-supportive)

YES

Do other entities or individuals have variable interests in the VIE (e.g., give the VIE financial support)?
- Guarantor of the VIE debt
- Management fees-not at market value
- Subordinated debt/intercompany loans
- Lease payments-above or below market
- Distributor relationship

NO

YES

Is an entity or individual the primary beneficiary (PB) of the VIE?

Controlling financial interest:
(power criterion and losses/benefits criterion met)

NO

YES

Entity is the PB: Must consolidate the VIE in its own financial statements. Individual is the PB: No consolidation of the VIE is required.

No consolidation of the VIE required under FIN 46R.

Consolidate based on existing GAAP only:
- Only if more-than-50% ownership in the entity per ARB No. 51.

Each of the three requirements is analyzed in the following section.
II. Requirement 1 for Consolidation of a VIE: There Must Be a Variable Interest Entity (VIE)

In order for an off-balance sheet entity to be consolidated, it must be a variable interest entity (VIE). A variable interest entity (VIE) is an entity that is not self-supportive by having one or both of the following conditions:

1. It has an insufficient amount of equity for it to finance its activities, without receiving additional subordinated financial support from other parties or individuals, or

2. Its equity owners lack the typical power, risks and rights of equity owners.

An entity that either has an insufficient amount of equity to finance its activities (Condition 1), or has equity owners that do not have the typical power, risks and rights of ownership (Condition 2), is not self-supportive and is a VIE in that it needs additional sources of financial support to survive. Because a VIE lacks financial support to survive, it must obtain such financial support from other individuals and reporting enterprises. That financial support is referred to as variable interests and is discussed in Requirement 2 further on in this chapter. If certain criteria are met, one of the reporting enterprises or individuals who gives the VIE financial support (a variable interest) may be considered the VIE’s de facto parent, otherwise called the primary beneficiary who may consolidate the VIE.

1. Definition of a VIE:

FIN 46R provides a formal definition of a VIE.

An entity is considered a VIE if, by design, it has one or both of the following two conditions:

**Condition 1 to be a VIE**: The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.

Examples:

- The entity does not have enough equity to fund its expected losses without additional financial support.

- The entity is unable to obtain outside financing from an independent third party (such as a bank or other lender), without additional financial support from other parties.

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2 FIN 46R states that the phrase “by design” refers to entities that meet the conditions of being a VIE because of the way they are structured. For example, an entity under the control of its equity holders that originally was not a VIE does not become one because of operating losses.
Such additional subordinated financial support (referred to as variable interests) may come in the form of any of the following:

- Guarantees of the entity’s loans from lenders
- Management fees that are not at market value
- Above-market lease payments
- Subordinated (intercompany) loans
- Distribution of the entity’s products by contract or other agreement
- Management or other services that are not at market value.

**Condition 2 to be a VIE: As a group, the holders of equity investments at risk lack any one of the following three characteristics:**

1) Lack the *power* through voting rights or similar rights to *direct* the entity’s activities that most significantly impact the entity’s economic performance.

   - Investors do not have the power if no owners hold voting rights or similar rights that are similar to those of a common shareholder in a corporation or a general partner in a partnership.

2) Lack the *obligation to absorb the expected losses* of the entity.

   - Investors do not have the obligation to absorb losses if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.

3) Lack the *right to receive expected residual returns* of the entity.

   - Investors do not have the right if their return is *capped* by the entity’s governing documents or arrangements with other variable interest holders or the entity. The return is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options are exercised, the holders will become additional equity investors.

The total equity investment at risk *excludes:*

- Equity interests that the entity issued in exchange for subordinated interests in other variable interest entities.

   **Note:** The FASB included this anti-abuse provision to preclude two entities from issuing excess equity capitalized with the same investment.

- Amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (e.g., by fees, contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

- Amounts financed for the equity investor (such as by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
**Impact of kick-out and participating rights on the power to direct activities**

FASB No. 167 amends FIN 46R to address the impact of equity holders having kick-out rights or participating rights on whether other parties have power to direct activities.

1. **Exceptions:**
   
   a. A single equity holder (including related parties and de facto agents) that has the unilateral ability to exercise such kick-out or participating rights does in fact, negate another party’s power to direct activities.

   b. If interests other than those of equity holders hold such kick-out or participating rights, those rights do not prevent the equity holders from having such power unless one single party has the unilateral ability to exercise those rights.

**What about protective rights?**

Protective rights are rights designed to protect the interests of the party holding those rights, without giving that party a controlling financial interest in the entity to which they relate. Protective rights held by other parties do not prevent a reporting enterprise from having the power to direct the activities of a VIE.

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**Variable Interest Entity (Not self-supportive)**

**Condition 1:**
- Total equity investment is *not sufficient to finance its activities* without additional subordinated financial support from other parties including equity holders:
  - Management fees- above market
  - Loans
  - Leases- above or below market
  - Guarantees

**Condition 2:**
- Holders of equity investments *lack characteristics* typical of a controlling financial interest:
  - Lack power to direct the entity’s significant activities
  - Lack obligation to absorb losses
  - Lack right to receive residual returns

---

**What if an entity is not a variable interest entity (VIE)? Is consolidation ever required?**

No. If an entity is not a VIE, there is no consolidation required of the entity under FIN 46R. By not being a VIE, the entity has demonstrated that it is self-supportive. Therefore, if an entity is not a VIE, it is not consolidated under FIN 46R. The only way it would be consolidated is under the existing consolidation rules; that is, if another entity owns more than 50% of the entity’s voting stock.
Analysis of the two conditions to being a VIE:

**Condition 1 to being a VIE is that:**

*The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.*

One way in which an entity is a VIE is if the *total equity investment at risk is not sufficient* for it to finance its activities without obtaining additional subordinated financial support from other parties, whether an individual or entity.

**Example:** Company A owns real estate and leases it to Company B. Company A seeks bank financing but is unable to obtain it because it does not have enough equity in the value of its real estate to satisfy the bank’s underwriting requirements. Therefore, the bank requires that A obtain a guarantor of its note. B agrees to guarantee the note for A.

**Conclusion:** Company A’s equity is not sufficient to obtain financing without obtaining additional financial support from other parties, such as B’s guarantee. Therefore, A may be a VIE.

a. Determining whether an entity has sufficient equity investment to finance its activities without additional subordinated financial support:

If an entity’s equity is not sufficient to finance its activities on its own, the entity is considered a VIE because it is assumed it must rely on another party (entity or individual) for additional financial support.

Examples of such additional support may come in the form of:

- Guarantees or cross-collateral of loans
- Management fees- not at market value
- Lease payments that are above or below market
- Distribution services
- Loans

**Example:** In order to receive a bank loan, an entity must obtain a guarantee of its loan from its shareholder or an affiliate.

**Conclusion:** The entity’s equity is not sufficient because it must obtain additional financial support (e.g., guarantees) in order to obtain the outside bank financing. Thus, the entity is a VIE.

**Example:** An entity’s equity is not sufficient to absorb its expected losses.

**Conclusion:** Because the entity’s equity cannot absorb any expected losses, it is not sufficient to finance its activities. Therefore, the entity is a VIE.

**Note:** The term “finance activities” is not defined in FIN 46R. The FASB has indicated that one way an entity is able to “finance its activities” is if it can obtain nonrecourse financing from an unrelated party, (such as in the case of obtaining bank or other
independent financing), without receiving additional subordinated financial support in the form of a guarantee or a subordinated loan. Additionally, an entity is able to “finance its activities” if it has enough equity to fund any expected losses (e.g., it has enough equity to fund a worst-case scenario of expected losses).

Determining whether an entity has sufficient equity investment to finance its activities without additional subordinated financial support is a matter of facts and circumstances.

FIN 46R provides several methods by which any entity can demonstrate it has sufficient equity to finance its own activities without additional financial support. There is also a 10-percent presumption rule that is discussed below.

b. Methods to demonstrate sufficiency of equity – Condition 1:

The revised Interpretation provides a series of methods to demonstrate that an entity has sufficient equity to finance its activities without additional subordinated financial support from other parties, including equity holders. The methods include both qualitative and quantitative analyses, as well as an overall 10-percent equity rule, summarized as follows:

- **Overall rule – 10 percent presumption rule:**

- **Methods to demonstrate sufficiency of equity:**

  **Qualitative Methods:**

  1. **Non-recourse financing method:** The entity has demonstrated that it can obtain non-recourse, investment-grade financing from an unrelated party, without additional subordinated financial support.

  2. **Similar entity method:** The entity has at least as much equity as a similar entity that finances its operations with no additional subordinated financial support.

  3. **Other facts and circumstances method:** Based on other facts and circumstances, the entity demonstrates that it can finance its activities without additional subordinated financial support.

  **Quantitative Method:**

  1. **Expected losses method:** The entity’s equity is greater than its expected losses.

The demonstration that equity is sufficient may be based on either qualitative or quantitative analysis, or both, based on the following guidance:

1. **Qualitative Methods:** Use of qualitative methods will, in some cases, be conclusive to determine that the entity’s equity at risk is sufficient.
2. **Quantitative Method:** The use of a quantitative method should be used if, after diligent effort, a reasonable conclusion about the sufficiency of the entity’s equity at risk cannot be reached based solely on use of qualitative methods.

3. **Both Qualitative and Quantitative Methods:** If neither a qualitative nor a quantitative method, taken alone, is conclusive, the combination of both qualitative and quantitative methods should be used to determine whether the equity at risk is sufficient.

If an entity can satisfy any one of the above methods (either qualitative, quantitative, or both), its equity is considered sufficient to finance its activities without additional subordinated financial support, resulting in the entity being self-supportive. Therefore, the entity is not a VIE based on Condition 1 (sufficiency of equity). Yet, it still could be categorized as a VIE based on Condition 2 (its shareholders lack certain characteristics: lack: a) power to direct significant activities, b) obligation to absorb expected losses, or c) right to receive residual returns).

The following chart summarizes the methods used to satisfy Condition 1, sufficiency of equity.

c. 10 percent presumption rule:

FIN 46R provides a 10 percent equity rule that can be used as a benchmark as to whether an entity might have enough equity to finance its operations without additional subordinated financial support.

The 10-percent equity presumption rule works like this:

**Less than 10 percent equity investment at risk:** There is a presumption that an equity investment of less than 10 percent of the entity’s total assets is not sufficient for the entity to finance its activities without additional subordinated financial support.

- An entity with less than 10 percent equity is presumed to be unable to finance its activities without additional subordinated financial support.
- For purposes of the 10-percent test, both equity and total assets are measured at fair value, rather than book value:

\[
\frac{\text{Fair value of equity}}{\text{Total assets at fair value}} = \% \text{ equity}
\]

**10 percent or more equity:** It is not presumed that equity is sufficient at 10 percent or more equity. Therefore, an entity is not relieved of the responsibility to demonstrate that its equity is sufficient even if its equity is 10 percent or more.

- 10 percent or more equity is not a safe harbor threshold.
- Additional tests must be performed even when the equity is 10 percent or more of total assets.
Qualitative Methods for Determining the Sufficiency of Equity

As previously outlined in this section, an entity should first consider qualitative methods to determine whether the entity has enough equity to finance its activities without additional subordinated financial support. If the entity can satisfy one of the qualitative methods (or the quantitative method—expected losses method), it is deemed to have sufficient equity and is not considered a VIE. If it is not a VIE, it will not be consolidated under the rules of FIN 46R.

The *three qualitative methods* include:

1. **Non-recourse financing method**: The entity has demonstrated that it can obtain non-recourse, investment-grade financing from an unrelated party, without additional subordinated financial support.

2. **Similar entity method**: The entity has at least as much equity as a similar entity that finances its operations with no additional subordinated financial support.

3. **Other facts and circumstances method**: Based on other facts and circumstances, the entity demonstrates that it can finance its activities without additional subordinated financial support.

**QUALITATIVE METHOD 1: Non-Recourse Financing Method**

In Qualitative Method 1, an entity’s equity is sufficient if the entity:

*Has demonstrated that it can obtain non-recourse, investment grade financing from an unrelated party without additional subordinated financial support (loan guarantees, etc.) from other entities or individuals, including equity holders.*

If an entity has demonstrated that it can obtain non-recourse, investment-grade financing, it satisfies Method 1 and its equity is considered sufficient to finance its activities without additional subordinated financial support. Because the entity is self-supportive, it is not a VIE.

If, instead, the entity has not demonstrated that it can obtain non-recourse, investment-grade financing, it fails Method 1. Thus, the only way to avoid categorizing the entity as a VIE is to use Qualitative Method 2 or 3 (similar entity method or other facts and circumstances method) or the Quantitative Method 1 (expected losses method).

**Observation**: The non-recourse financing method is found in Paragraph 9(a) of FIN 46R. Specifically, the Paragraph states that an entity is not a VIE if it “has demonstrated that it can finance its activities without additional subordinated financial support.” There is no specific mention of the requirement to demonstrate the ability to obtain non-recourse, investment-grade financing. The FASB Staff has stated that Paragraph 9(a) is satisfied if an entity has demonstrated that it can obtain “non-recourse, investment-grade financing” without additional subordinated financial support. That is, non-recourse investment-grade financing without receiving guarantees from others, loans, or other additional financial support that allows the entity to obtain that non-recourse financing.
Example: Company X has demonstrated that it can obtain a non-recourse, investment grade loan from a local bank. The loan does not require any guarantees from X’s shareholders or affiliates. Further, X does not need an additional subordinated loan from another party (e.g., second mortgage or unsecured loan) in order to obtain the non-recourse bank financing.

Conclusion: X has demonstrated that it can obtain non-recourse, investment grade financing from an unrelated party (e.g., a bank) without additional subordinated financial support (loan guarantees, additional loans, etc.) from other entities or individuals. Therefore, X has satisfied the non-recourse financing method (Qualitative Method 1) and is considered to have equity sufficient to finance its activities without additional subordinated financial support. X is not a VIE.

Change the facts: The Bank requires X’s shareholder and affiliate to guarantee X’s loan.

Conclusion: X has not demonstrated that it can obtain non-recourse, investment-grade financing without additional subordinated financial support, in that guarantees are required by other parties. The guarantee is a form of additional support. Thus, X fails Method 2 and must use one of the other two methods to demonstrate that it is not a VIE.

What is additional subordinated financial support?

Additional subordinated financial support is referred to as an additional variable interest that will absorb some or all of an entity’s expected losses, if they occur. Examples of variable interests include one entity supporting the other by means of paying management fees, lease payments, guarantees, or making subordinated or senior loans. In fact, a bank loan is also a variable interest in that the bank provides a form of financial support to the entity. Although, as a first lien holder, rarely will a bank be considered the primary beneficiary as it usually does not have enough risk or return to provide the majority of support to the VIE.

Further, additional subordinated financial support can come from all parties including the equity holders. Thus, for example, an equity shareholder that makes a loan to an entity in which it holds an equity investment, is a form of additional subordinated financial support.

As it relates to the non-recourse financing method (Qualitative Method 1) and the ability to obtain non-recourse financing, additional subordinated financial support is usually in the form of any of the following variable interests:

- Guarantees of the entity’s loan by its owners or other affiliated entities
- Additional loans (subordinated to the bank financing such as a second mortgage or intercompany loan) made to the entity to enable it to obtain bank financing
- Additional collateral for a loan
- Above-market lease payments, management or service contract fees paid to the VIE at the time the entity demonstrates it can obtain non-recourse, investment-grade financing
- Additional loans from the equity holders
- Additional equity infused by equity holders where the additional equity is not at risk.
Does the entity actually have to obtain non-recourse investment-grade financing to demonstrate that it “could” obtain non-recourse financing?

This issue is not clear and is not addressed in FIN 46R.

Paragraph 9 (a) of FIN 46R uses the term “has demonstrated” as it relates to an entity’s ability to satisfy non-recourse financing method (Qualitative Method 1).

At present, there are differing opinions as to the meaning of “has demonstrated.”

Let’s look at a fact pattern to use as a basis of discussion of the issue:

Facts: Company X presently has a recourse loan outstanding with No Loan Bank secured by a commercial building. The loan was obtained 10 years ago when X had little equity in the real estate. At the time the loan was obtained (10 years ago), the loan-to-value was 75 percent, requiring a guarantee from both X's shareholder and Company Y, an affiliate that leases the building from X.

Now, ten years later, the value of the real estate has increased significantly and the loan principal has been paid down, resulting in the existing loan-to-value of 45 percent. X does not wish to refinance the loan because of the transaction costs associated with such a refinancing.

However, X has contacted a mortgage broker who has confirmed that, based on X’s existing equity, X could easily obtain a non-recourse bank loan at 45-percent loan-to-value, with no required guarantees or other subordinated financial support from others. X has received a letter from the mortgage broker, confirming X’s ability to obtain such non-recourse financing.

Has X demonstrated that it can obtain non-recourse, investment-grade financing, thereby satisfying Method 2?

FIN 46R does not address the meaning of “has demonstrated” thereby leaving the issue wide open.

The author believes that X has demonstrated it can obtain non-recourse, investment-grade financing. The term “has demonstrated” does not necessarily mean that the entity must actually obtain non-recourse financing. The intent of the non-recourse financing method (Qualitative Method 1) is to test the ability of an entity to be self-supportive at a particular point in time, thereby not being reliant on additional financial support from others. Provided an entity can demonstrate that it has the ability to obtain non-recourse financing, the author believes the entity has demonstrated that it “can” obtain such non-recourse financing, even though it chooses not to act on the financing at the present time.

Demonstrating the ability to obtain non-recourse, investment-grade financing

In satisfying the “has demonstrated” criterion, the author takes a position that is less conservative than certain other firms. His view is that in certain situations, an entity should be able to satisfy the “has demonstrated” criterion merely by being able to prove that it “can” obtain non-recourse financing, even though it chooses not to do so.
To demonstrate that an entity can obtain non-recourse financing, a comparison should be made of the entity’s existing financial attributes to those benchmarks required by a lender to underwrite a non-recourse loan. The author believes that a specific lender should be identified and contacted and that its underwriting requirements be obtained in writing.

Examples of specific attributes of an entity that should be compared with those required to underwrite a non-recourse loan include:

- Amount of financing the entity would need
- Loan-to-value ratio
- Cash flow coverage ratio
- Whether the entity’s industry is attractive to a non-recourse lender

Assuming an entity’s attributes satisfy those required by a specific lender, it would appear that the entity has demonstrated that it can obtain non-recourse, investment-grade financing.

Of course, facts and circumstances of each situation must be considered. For example, an entity that barely meets the minimum underwriting criteria for obtaining non-recourse financing may not provide a sufficient margin for error to assert that it has demonstrated it can obtain non-recourse, investment grade financing. Conversely, an entity that easily satisfies such underwriting criteria is more likely to justify that it “has demonstrated” that it can obtain non-recourse, investment-grade financing.

**Example:** Company X is a real estate LLC that leases real estate to an affiliate. X has an existing recourse loan that has a balance at 68% loan-to-value. Based on information obtained from several local banks in the area, certain lenders are willing to give a non-recourse loan at 70% loan-to-value. Based on a comparison of the entity’s attributes to the underwriting standards for non-recourse financing, the entity might be able to satisfy the criteria, but approval may be difficult to obtain.

**Conclusion:** Although the entity might be able to satisfy the underwriting criteria to obtain non-recourse financing, the entity has not demonstrated that it can obtain such financing. The entity’s financial criteria are too close to the minimum requirements needed to obtain non-recourse financing.

Thus, the entity probably has not satisfied the non-recourse financing method (Qualitative Method 1) in that it has not demonstrated that it can obtain non-recourse, investment-grade financing.

**Change the facts:** The entity’s loan-to-value is 30% and all evidence suggests that the entity could easily replace the 30% loan with a non-recourse loan at an investment-grade interest rate (prime rate).

**Conclusion:** The entity probably has satisfied Method 2 in that it has demonstrated that it can obtain non-recourse, investment-grade financing.


What is the definition of “investment-grade” financing?

FIN 46R does not actually address the issue of investment-grade financing. The FASB Staff has indicated that it is assumed that any non-recourse financing must be investment-grade; that is, financing typically obtained from a bank or other lender at rates customarily offered to the lender’s best customers.

If an investment-grade threshold were not required, an entity could satisfy non-recourse financing method (Qualitative Method 1) by obtaining non-investment-grade, non-recourse financing from a lender that would accept a lower-equity threshold, by charging a higher interest rate commensurate of the greater lending risk.

Note: It would appear that an entity has demonstrated its ability to obtain non-recourse financing if it can obtain non-recourse financing at the same loan-to-value as its existing debt outstanding.

For example, an entity that presently has a 70-percent loan-to-value recourse loan outstanding can demonstrate that it can replace a 70-percent recourse loan with a 70-percent non-recourse loan.

Example 1: Company S owns commercial real estate that it leases to Company P, an affiliate. John Smith is the 100% shareholder of Company S.

Company S’s financial information follows:

| Total assets, primarily real estate (at fair value) | $5,000,000 |
| Existing loan- bank | 2,500,000 |
| Equity (fair value) | 2,500,000 |

Loan-to-value ratio 50%

P, as a variable interest holder, is testing S to determine if it is a VIE.

P has confirmed with a local bank that S can refinance its real estate with a non-recourse loan for the 50% loan-to-value, with no guarantees from S’s shareholder, John Smith, or from P. Further, P has reviewed the bank’s underwriting criteria and believes that S can easily satisfy its lending requirements for non-recourse financing.

Based solely on the information provided, has Company S demonstrated that it can obtain non-recourse financing, thereby satisfying non-recourse financing method (Qualitative Method 1)?

Conclusion: Yes.

S has demonstrated that it can obtain financing by the bank agreeing to offer non-recourse financing at the present 70-percent loan-to-value. Therefore, S satisfies the non-recourse financing method (Qualitative Method 1) and is deemed to have sufficient equity to finance its activities without additional subordinated financial support from others. Thus, S is not a VIE.
Example 2: Same facts as Example 1 except that the bank, as matter of policy, requires personal guarantees from both John Smith, its shareholder, and Company P, its affiliate. S has checked with several other banks that also require, at a minimum, personal guarantees from the shareholder(s) if the loan-to-value is 70 percent or greater.

Based solely on the information provided, has Company S demonstrated that it can obtain non-recourse financing, thereby satisfying non-recourse financing method (Qualitative Method 1)?

Conclusion: No.

In this Example, S determines that the bank requires more than 30 percent equity in order to obtain non-recourse financing. Consequently, S can only obtain recourse financing, thereby requiring additional subordinated financial support in the form of guarantees from others (P and John Smith).

The conclusion is that at its present loan-to-value, S cannot obtain non-recourse financing. Therefore, S fails non-recourse financing method (Qualitative Method 1), but can still use the other two qualitative methods (similar entity method or other facts and circumstance method), or use a quantitative method (expected losses method), to avoid being categorized as a VIE.

Example 3: Same facts as Example 2 except that the bank is willing to give S a 60-percent loan on a nonrecourse basis without guarantees. S obtains the additional 10 percent from Joey “the Knuckles,” a second-mortgage broker at prime plus 8%.

Conclusion: Although S is able to obtain 60-percent nonrecourse financing, it requires additional subordinated financial support in the form of a 10-percent second mortgage note. The second mortgage is additional subordinated financial support regardless of the fact that it is not investment grade (e.g., prime plus 8%). Thus, because S is required to obtain additional subordinated financial support to obtain 60-percent non-recourse bank financing, S fails the non-recourse financing method (Qualitative Method 1).

QUALITATIVE METHOD 2: Similar Entity Method:

The second qualitative method that can be used to determine whether an entity has sufficient equity to avoid being considered a VIE is to demonstrate that the entity has at least as much equity as a similar entity that finances its operations with no additional subordinated financial support.

Although FIN 46R does not give any guidance as to how this method should be applied, it appears that its use is limited to specialized industries. For example, certain industries, such as telecommunications, are able to obtain special financing terms due to government regulation.

Example: Company X is a telephone company and has only 5-percent equity.

Telephone companies are able to obtain 100-percent non-recourse financing under a special government program.
Other telephone companies of similar size, assets and profitability have recently received such financing with similar equity levels (e.g., equity level of 5% or less).

**Conclusion:** Because X can demonstrate that it has at least as much equity as a similar entity that finances its operations with no additional subordinated financial support, X is considered self-supportive and not a VIE.

**Observation:** The similar entity method has very limited use in that it applies primarily to specialized industries that might offer favorable financing terms. If one entity in the industry is able to obtain non-recourse financing at particularly low equity levels, it would be reasonable for another entity, with a similar equity structure, to be able to obtain the same or similar financing.

**QUALITATIVE METHOD 3: Other Facts and Circumstances Method:**

The third qualitative method is to consider other facts and circumstances that may lead to the conclusion that an entity has sufficient equity to finance its activities without additional subordinated financial support. Here, no one single factor will be conclusive and the determination as to whether the entity has sufficient equity is based on the evidence as a whole. Further, some of the qualitative facts and circumstances may overlap with those found in Qualitative Methods 1 and 2.

**Quantitative Method for Determining the Sufficiency of Equity**

To recap, FIN 46R states that *both qualitative and quantitative analyses* should be considered in determining whether an entity has sufficient equity to finance its activities without obtaining additional subordinated financial support. Although the Board suggests that qualitative methods should be applied before using a quantitative method, the two categories, qualitative and quantitative, appear to be mutually exclusive.

In the previous section, we discussed the three qualitative methods that can be used including the non-recourse financing method, similar entity method, and the other facts and circumstances method. In many cases, the use of the qualitative methods will not provide the evidence to support that the entity’s equity is sufficient. Consequently, use of a quantitative method is the last chance to otherwise avoid categorizing an entity as a VIE. The one quantitative method provided by FIN 46R is the expected losses method.

**QUANTITATIVE METHOD 1 – Expected losses method:**

One prime benchmark used by FIN 46R to determine whether an entity has sufficient equity investment to finance its activities without additional financial support from others, is to use the expected losses method. The expected loss concept is confusing, subject to a high degree of judgment, and very difficult to apply. Because qualitative methods may be futile to supporting a case that an entity’s equity is sufficient, in most cases, the expected losses method may be the only method available to prove an off-balance sheet entity is not a VIE.
a. The basis of the expected losses method – FASB Concept Statement No. 7:

The basis for the expected loss method is the *expected cash flows approach* found in FASB Concept Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

Using Statement No. 7’s *expected cash flows approach*, multiple estimated cash flows are developed based on several scenarios. For each scenario, estimated cash flows are first discounted to present value using a risk-free interest rate. Then, the discounted cash flows are probability weighted to arrive at a series of expected cash flows that, in the aggregate, equal the fair value of the underlying asset. Concept Statement No. 7 applies the following rules on using the expected cash flows approach:

Cash flows should reflect *two components*:

1. Present value, and
2. The range of possible estimated cash flows and their possible outcomes:
   - The sum of probability-weighted discounted cash flows is reflective of a series of possible outcomes.
   - Probability weighting of cash flows helps incorporate uncertainties in estimated cash flows.
3. In applying present value to cash flows, a *risk-free interest rate* should be used.
   - Risk is already reflected in the probability weighting.
   - Risk-free interest rate is the rate of a U. S. Treasury instrument for the period of time for which the cash flows relate.
4. The expected cash flows approach is more reflective of the range of possible outcomes than the traditional approach (e.g., a single estimated cash flow is discounted using a single credit-adjusted interest rate).

Concept Statement No. 7’s expected cash flow formula works as follows:

**Facts:** Assume that an entity is purchasing an asset that will generate estimated cash flows (including ultimate disposition of the asset) of between $100,000 and $300,000 one year from the date of purchase. The risk-free rate of return is 5%.

**What is the fair value of the asset based on the expected cash flow approach?**

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Possible estimated cash flows</th>
<th>Probability of occurrence</th>
<th>Expected Cash flow</th>
<th>Present value of expected cash flows (5%, 1 year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
<td>20%</td>
<td>$20,000</td>
<td>$19,048</td>
</tr>
<tr>
<td>2</td>
<td>200,000</td>
<td>30%</td>
<td>60,000</td>
<td>57,143</td>
</tr>
<tr>
<td>3</td>
<td>300,000</td>
<td>50%</td>
<td>150,000</td>
<td>142,857</td>
</tr>
<tr>
<td></td>
<td></td>
<td>100%</td>
<td></td>
<td>$219,048</td>
</tr>
</tbody>
</table>
Using the expected cash flow approach, the asset’s fair value is $219,048. If the entity purchases the asset for $219,048, based on its probability-weighted cash flows, it will generate a return of 5% one year from the date of purchase.

**Note:** Concept Statement No. 7’s expected cash flows approach is certainly not without critics. Many believe that the approach is simply too arbitrary and dependent on too many variables. For example, a successful result is based on the entity being able to properly compute two variables: cash flows and probability weighted cash flows.

In comparison, the traditional cash-flow method (e.g., discount one cash flow at an interest rate commensurate with the risk), is less susceptible to the risk that assumptions have been misapplied.

**b. The expected losses method computation:**

The expected losses method is based on the assumption that if an entity’s equity is greater than its expected losses, it has demonstrated that it has enough equity to finance its activities without additional financial support. That is, if the worst case scenario occurs (e.g., expected losses exist), the entity still has enough equity to fund those losses without seeking additional outside financial support from others.

Moreover, the FASB selected expected losses as a benchmark because it indicates the amount of equity that an entity must have to induce lenders or investors to provide funds needed by the entity to conduct its activities. Generally, for example, a lender looks at a borrower to satisfy certain profitability or cash-flow coverage ratios to demonstrate that it can support its debt service with its earnings and cash flow.

The expected losses formula looks like this:

\[
\text{Equity} \quad \text{GREATER THAN} \quad \text{Expected losses} = \text{Entity not a VIE (self-supportive)}
\]

\[
\text{Equity} \quad \text{LESS THAN} \quad \text{Expected losses} = \text{Entity is a VIE (not self-supportive)}
\]

**c. Definition of expected losses:**

For purposes of determining if an entity has an equity investment sufficient to finance its activities without obtaining financial support from other entities, an entity’s equity investment is compared with its expected losses.

1. Expected losses include the expected negative variability in the fair value of the entity’s net assets, exclusive of variable interests.

2. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the entity, which is usually the expected cash flows of the entity.
3. Expected cash flows exclude:

- Fees paid to a decision maker and service providers, such as management and other fees, that are considered variable interests (discussed below).

  **Note:** If such fees are not considered a variable interest, the fees are not excluded from the expected cash flows.

- Cash inflow and outflow related to variable interests such as:
  - Difference between actual rental income and market value rental income related to an above- or below-market lease\(^3\)
  - Principal and interest payments on debt
  - Fees and other expenses paid to variable interest holders
  - Fees paid to guarantors
  - Dividends and distributions to holders of equity investments that are at risk

  **Note:** The concept of expected losses found in FIN 46R is not based on expected cash flows but rather on the variability of the cash flows that create expected losses and residual returns (gains).

The methodology is based on Concept Statement No. 7’s expected cash flows method under which expected cash flows are discounted and then converted to present value to arrive at the probability-weighted present value of cash flows, which should be the fair value of the asset.

Further, the computation of expected losses is made individually by each variable interest holder in determining whether an entity is a variable interest entity (VIE). In theory, each variable interest holder, based on use of imperfect information, could reach a different conclusion as to whether an entity is a VIE.

**Simple example of the application of expected cash flows**

Now that we have set the framework for using the expected cash flows method, let’s start out with a simple example illustrating how the expected loss computation is made.

**Example 1:** Assume an entity makes an investment of $1,000 that is expected to generate total cash flows ranging from $0 to $1,100, one year from the investment date. Assume the risk free discount rate is 5% (e.g., the interest rate on a one-year Treasury instrument).

All cash flows are expected to occur in one year or not at all.

\(^3\) Rental income related to a market-value lease is included in the net cash flow computation.
Expected cash flows would be determined as follows:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Estimated cash flows</th>
<th>Present value of estimated cash flows (5%, 1 year)</th>
<th>Probability of occurrence</th>
<th>Present value of expected cash flows (5%, 1 year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 0</td>
<td>$ 0</td>
<td>10%</td>
<td>$ 0</td>
</tr>
<tr>
<td>2</td>
<td>500</td>
<td>476</td>
<td>20%</td>
<td>95</td>
</tr>
<tr>
<td>3</td>
<td>900</td>
<td>857</td>
<td>30%</td>
<td>257</td>
</tr>
<tr>
<td>4</td>
<td>1,100</td>
<td>1,048</td>
<td>40%</td>
<td>419</td>
</tr>
</tbody>
</table>

**Fair value of investment $771**

The fair value of the investment is $771. That is, if the entity purchases the investment for $771, based on probability weighting, it is expected to generate a 5% return within one year. There is a 10-percent probability that it will receive $0 from the investment (Scenario 1); that is, the investment becomes defunct. There is a 20-percent probability that Scenario 2 will occur and the entity will receive a total of $500 in one year. There is a 30-percent probability that it will receive $900, and a 40-percent probability that it will receive $1,100.

When the four weighted probabilities are factored into the formula along with a 5% discount, the fair value of the investment is $771.

Continuing with the example, if any one of the four scenarios above were to occur, the cash flow would not be exactly $771. Instead, it would be higher or lower than $771 resulting in a variance (gain or loss). For example, if Scenario 4 were to occur, there would be a variance between the present value of the estimated cash flows ($1,048) and the expected cash flow (fair value of $771), resulting in a positive expected variance of $277 (expected gain). Conversely, if Scenario 1 were to occur, there would be a negative variance between the present value of estimated cash flow received ($0) and the expected (fair value of $771), resulting in a expected loss of $771.

The following table illustrates the mechanics that follow to compute expected losses and gains.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Present value of estimated cash flows (fair value)</th>
<th>Expected cash flows</th>
<th>Variance Difference (loss or gain)</th>
<th>Probability of occurrence</th>
<th>Expected losses</th>
<th>Expected residual return (gain)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 0</td>
<td>$771</td>
<td>$(771)</td>
<td>10%</td>
<td>$(77)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>476</td>
<td>771</td>
<td>(295)</td>
<td>20%</td>
<td>(59)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>857</td>
<td>771</td>
<td>86</td>
<td>30%</td>
<td>$ 25</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>1,048</td>
<td>771</td>
<td>277</td>
<td>40%</td>
<td>111</td>
<td></td>
</tr>
</tbody>
</table>

Based on each scenario, the expected cash flows (fair value of $771) is compared with the present value of estimated cash flows to compute a gain or loss. Expected losses are accumulated in one column, while expected gains are accumulated in another column.
The result is that in the worst case, on a present-value basis, total expected losses from the investment would be $(136) and expected returns (gains) would be $136. If the entity has expected losses of $136, it must have at least $136 of equity to fund those expected losses. If the entity cannot fund those losses with its equity, some other entity or individual must fund those losses by providing additional financial support.

Assuming the entity above only has $100 of equity (at fair value), it would not be able to pay for the expected losses of $(136) if they were to occur. Consequently, the entity would have to call on another entity or individual for additional financial support to pay for the expected losses. In such a case, the entity would not be self-supportive, and would fail Quantitative Method 1. In order not to be categorized as a VIE, one of the qualitative methods would have to be satisfied.

Thus, the expected losses formula looks like this:

\[
\text{Equity} \quad \text{LESS THAN} \quad \text{Expected losses} = \begin{cases} \text{Entity is a VIE} \\ \text{(not self-supportive)} \end{cases}
\]

\[
\begin{array}{ccc}
$100 & \text{LESS THAN} & $(136) \\
\end{array}
\]

Note: Notice in the above example that on the other side, expected residual gains would be $136 and would be received by either the entity or another entity or individual. With few exceptions, expected losses of $(136) must equal expected residual gains $(136) because both are computed from the mean value which is fair value of $771.

2. Timing of determining whether an entity is a VIE:

Date of initial test: The initial determination of whether an entity is a VIE is made on the date at which the variable interest holder first becomes involved with the VIE.

a. The date at which the variable interest holder first becomes involved with the VIE is the date on which the entity consummates ownership, contractual or other pecuniary interests with the VIE.

Example: Company P makes a new loan to S on June 1, 20X3. P has no other variable interests in S.

Conclusion: On June 1, 20X3 (the date on which P first becomes involved with S), P should test S to determine if S is a VIE, using one of the three methods. The initial test is based on the fair value of S’s equity on June 1, 20X3.

b. The determination should be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

Who performs the VIE test?

Each variable interest holder should perform the test of the VIE on the date the holder first becomes involved with the VIE. Therefore, if there are several variable interest holders, each would perform a separate test of the VIE and, presumably, each could arrive at a different conclusion as to whether the entity is a VIE and whether the holder is the primary beneficiary that should consolidate that VIE.
Example: Company X is an entity that receives financial support (variable interests) from several entities as follows:

<table>
<thead>
<tr>
<th>Variable interest holder</th>
<th>Type of variable interest</th>
<th>First date involved with X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Y</td>
<td>Guarantees X’s bank loan</td>
<td>February 5, 20X4</td>
</tr>
<tr>
<td>Company Z</td>
<td>Made loan to X</td>
<td>July 7, 20X4</td>
</tr>
<tr>
<td>Company C</td>
<td>Lease with X- above market</td>
<td>August 6, 20X4</td>
</tr>
</tbody>
</table>

Conclusion: Each variable interest holder tests Company X on the date that it first becomes involved with X.

In this example, Y should test X on February 5, 20X4. Z should test X on July 7, 20X4, and C should test X on August 6, 20X4.

On each of the above dates, each variable interest holder separately tests X to determine whether X is a VIE using one of the three qualitative methods (non-recourse financing, similar entity, or other facts and circumstances methods) or the one quantitative method (expected losses method). If a variable interest holder determines that the entity is a VIE, the holder also tests to determine whether it is the primary beneficiary that should consolidate the VIE. If a variable interest holder determines that an entity is a VIE and that it is the primary beneficiary, it consolidates the VIE as of the date of the test (e.g., the date on which the variable interest holder first becomes involved with the VIE).

Because each variable interest holder performs its own independent test, there is the possibility that more than one variable interest holder reaches the conclusion that it is the primary beneficiary and consolidates the same VIE.

3. Reconsideration of VIE status:

An entity that previously was not subject to Interpretation No. 46 shall not become subject to it simply because of losses in excess of expected losses that reduce the equity investment.

Once an initial test is done to determine if an entity is a VIE, an update test is not done on a regular basis (e.g., no annual or periodic update date is performed). Specifically, a variable interest holder does not reconsider (retest) the VIE unless a triggering event occurs.

a. The initial determination of whether an entity is a VIE is reconsidered (retested) only if one or more of the following triggering events occurs:

Triggering events requiring reconsideration:

1) The VIE’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity’s equity investment at risk.

2) The VIE’s equity investment, or some part thereof, is returned to the equity investors, and other parties become exposed to expected losses.
3) The VIE undertakes additional activities or acquires additional assets, (beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event), that increase the entity’s expected losses.

4) The VIE receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases expected losses.

5) Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance.

**Note:** FASB No. 167 added the fifth provision triggering event noted above.

b. The reconsideration should be done at *fair value of equity* and total assets at the date on which the reconsideration is performed.

c. An entity that previously was not a VIE shall not become a VIE simply because subsequent losses reduce the equity investment to an insufficient level to obtain financing.

**Note:** Previously, FIN 46R stated that a troubled debt restructuring (as defined by FASB No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), was not a triggering event that requires reconsideration of whether the entity involved is a VIE. With the issuance of FASB No. 167, the troubled-debt exception was eliminated so that a troubled-debt restructuring may be considered a triggering event under item (a)(1) above. On its face, a troubled debt restructuring typically results in the VIE’s governing documents and/or contractual arrangements changing in a manner that may change the characteristics or adequacy of the entity’s equity investment at risk.

**Discussion of Condition 2 to be a VIE:**

Before we go on, let’s quickly review the rules that determine whether an entity is a VIE.

An entity can be categorized as a VIE based on having *one of two conditions:*

**Condition 1:** The total equity investment at risk is not sufficient to permit the entity to finance its activities without obtaining additional subordinated financial support provided by any party, including equity holders, or

**Condition 2:** As a group, the holders of equity investments at risk lack any one of the following three characteristics:

1. Lack the power through voting rights or similar rights to *direct* the entity’s activities that most significantly impact the entity’s economic performance.

2. Lack the *obligation to absorb the expected losses* of the entity.

3. Lack the *right to receive the expected residual returns* of the entity.
Previously, we discussed the approach performed to test whether an entity was a VIE because of Condition 1. Under Condition 1, FIN 46R provides three qualitative methods and one quantitative method under which an entity can demonstrate that its equity is sufficient for it to finance its activities without additional subordinated financial support. Those qualitative methods are (Method 1: nonrecourse financing method; Method 2: similar entity method; Method 3: other facts and circumstances method). The sole quantitative method is the expected losses method. If an entity satisfies any one of the three qualitative methods or the sole quantitative method, it is considered to be self-supportive and is not a VIE.

If an entity is not a VIE under Condition 1 (e.g., it can demonstrate that its equity is sufficient to finance its activities without additional subordinated financial support), it still may be considered a VIE based on meeting Condition 2.

In Condition 2, an entity is a VIE if its equity owners do not have the typical risks and rights of ownership.

That is, as a group, the holders of equity investment at risk, lack any of the three typical characteristics (risks and rights) such that they:

1. Lack the power through voting rights or similar rights to direct the entity’s activities that most significantly impact the entity’s economic performance.
2. Lack the obligation to absorb the expected losses of the entity.
3. Lack the right to receive the expected residual returns of the entity.

Observation: An entity is a VIE if the holders of its equity investments lack any of the three characteristics that are typical of controlling equity interests: the power to direct the activities, absorb an entity losses, and receive an entity residual returns. If any one of these three characteristics is lacking, this means the equity owners do not engage in the entity’s decisions nor give it financial support. Therefore, if the equity owners lack any of these three characteristics, some other entity or individual must have the power to direct the entity’s activities, absorb the entity’s losses and receive its residual gains.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. What is a primary beneficiary:
   a) a form of financial support given by one entity or individual to a VIE
   b) an entity or individual that has a controlling financial interest in a VIE
   c) an entity that is not self-supportive in that it cannot finance its activities without receiving additional subordinated financial support
   d) a component of stockholders’ equity

2. What condition characterizes a VIE:
   a) it has a sufficient amount of equity for it to finance its activities
   b) it is either an individual or entity
   c) its owners have the power to direct activities, absorb losses, and receive returns
   d) its owners do not hold the typical power, risks and rights of equity owners

3. An entity is considered a VIE by design if, as a group, the holders of equity investments at risk have:
   a) an obligation to absorb the expected losses of the entity
   b) no right to receive the expected residual returns of the entity
   c) the direct ability to make decisions about the entity’s activities that have a significant effect on the success of the entity
   d) the indirect ability to make decisions about the entity’s activities that have a significant effect on the success of the entity

4. The FASB has indicated that one way an entity is able to “finance its activities” without additional subordinated financial support is if it can obtain:
   a) a guarantee from another party
   b) a subordinated loan from another party
   c) above-market lease payments from a lessee
   d) nonrecourse financing from an unrelated party

5. What method does FIN 46 suggest should be used first to determine if an entity is a VIE:
   a) combination of qualitative and quantitative
   b) expected losses
   c) qualitative
   d) quantitative
6. Which of the following methods to determine if an entity is a VIE is considered a quantitative method:
   a) similar entity method
   b) expected losses method
   c) 10-percent equity threshold rule
   d) non-recourse financing exception

7. Who should perform the VIE test on the date the holder first becomes involved with the VIE:
   a) any company whose interest would not be a significant variable interest
   b) each variable interest holder
   c) only the primary beneficiary
   d) related parties who are not involved in forming the entity

8. If an entity is reconsidering its VIE status, such reconsideration should be done at:
   a) carrying value of equity and total assets at the date on which the reconsideration is performed
   b) fair value of equity and total assets at the beginning of the year of reconsideration
   c) carrying value of equity and total assets at the beginning of the year of reconsideration
   d) fair value of equity and total assets at the date on which the reconsideration is performed
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A variable interest (VI) is a form of financial support given by one entity or individual to a VIE in the form of a guarantee, loan, lease payments, management fees, etc.

   B: Correct. A primary beneficiary is an entity or individual that has a controlling financial interest in a VIE. That controlling financial interest is based on the primary beneficiary having power to direct the VIE’s significant activities, the obligation to absorb the VIE’s losses, and the right to receive the VIE’s residual benefits that are significant to the VIE.

   C: Incorrect. A variable interest entity (VIE) is an entity that is not self-supportive in that it cannot finance its activities without receiving additional subordinated financial support.

   D: Incorrect. A primary beneficiary is either an individual or entity, and not a balance sheet component.

   (See page 16 of the course material.)

2. A: Incorrect. A VIE is an entity that is not self-supportive in that it has an insufficient amount of equity for it to finance its activities with additional support from others.

   B: Incorrect. A variable interest entity must be an entity, not an individual.

   C: Incorrect. A VIE is an entity that is not self-supportive if its owners do not have the power to direct activities, absorb losses, and receive returns.

   D: Correct. A VIE is an entity that is not self-supportive if its owners do not hold the typical power, risks and rights of equity owners.

   (See page 19 of the course material.)

3. A: Incorrect. An entity is considered a VIE by design if, as a group, the holders of equity investments at risk have no obligation to absorb the expected losses of the entity.

   B: Correct. An entity is considered a VIE by design if, as a group, the holders of equity investments at risk have no right to receive the expected residual returns of the entity.

   C: Incorrect. A VIE’s equity holders may lack the direct ability to make decisions about the entity’s activities that have a significant effect on the success of the entity. However, this criterion is not a factor in determining whether an entity is a VIE.

   D: Incorrect. A reporting enterprise is considered a VIE by design if, as a group, the holders of equity investments at risk lack the power to direct the significant activities of the VIE. The reporting enterprise’s indirect ability to make decisions is not a factor.

   (See page 20 of the course material.)
4. **A:** Incorrect. A guarantee is considered additional subordinated financial support.

   **B:** Incorrect. A subordinated loan is considered additional subordinated financial support.

   **C:** Incorrect. Above-market lease payments are considered a form of additional subordinated financial support.

   **D:** Correct. The FASB has indicated that one way an entity is able to “finance its activities” is if it can obtain nonrecourse financing from an unrelated party, such as in the case of obtaining bank or other independent financing.

   (See pages 22 to 23 of the course material.)

5. **A:** Incorrect. In instances in which a conclusion cannot be reached using either qualitative or quantitative methods, a combination of both types should be used.

   **B:** Incorrect. The expected losses method is the quantitative method used to demonstrate sufficiency of equity.

   **C:** Correct. FIN 46R suggests that the qualitative methods be used first.

   **D:** Incorrect. FIN 46R suggests that the quantitative method be used after the qualitative methods.

   (See page 25 of the course material.)

6. **A:** Incorrect. The similar entity method is a qualitative method under which one determines whether the entity has at least as much equity as a similar entity that finances its operations with no additional subordinated financial support.

   **B:** Correct. The expected losses method is the only quantitative method discussed in Interpretation 46R.

   **C:** Incorrect. The 10-percent equity threshold rule is a threshold and not a method to determine whether an entity is a VIE.

   **D:** Incorrect. The non-recourse financing exception is a qualitative method under which an entity demonstrates that it can obtain non-recourse, investment-grade financing from an unrelated party, without additional subordinated financial support.

   (See page 31 of the course material.)
7. A: Incorrect. A company (variable interest holder) is not required to determine whether another entity is a VIE if it is obvious that the company’s interest would not be a significant variable interest.

B: Correct. Each variable interest holder should perform the test of the VIE on the date the holder first becomes involved with the VIE.

C: Incorrect. The primary beneficiary is one of several variable interest holders to perform the test. However, a variable interest holder does not know if it is the primary beneficiary of a VIE until it performs the test.

D: Incorrect. A company (variable interest holder) is not required to determine whether another entity is a VIE if the entity (including its related parties and de facto agents) were not involved in forming the entity.

(See page 36 of the course material.)

8. A: Incorrect. Carrying value of equity is not used. Rather, fair value at the date on which the reconsideration is performed is used.

B: Incorrect. Although fair value of equity and total assets is used, it is not measured at the beginning of the year of reconsideration. Instead, it is measured at the fair value at the date on which the reconsideration is performed.

C: Incorrect. Carrying value of equity and total assets is not used. Further, measurement is not determined at the beginning of the year of reconsideration.

D: Correct. In a reconsideration, the fair value of equity and total assets at the date on which the reconsideration is performed is the value used.

(See page 38 of the course material.)
SECTION 3:

I. Requirement 2 for Consolidation: Entities and/or Individuals Must Have Variable Interests in the VIE

If, in Requirement 1, it is determined that an entity is not a VIE, there is no need to continue because the entity shall not be consolidated under FIN 46R. Instead, the only way it will be consolidated is based on majority ownership (more than 50% ownership) under ARB No. 51.

Assume, instead, that in Requirement 1, the entity is deemed to be a VIE in that either it does not have sufficient equity or its owners do not have the typical power, risks or rewards of ownership. If so, Requirement 2 is to identify those parties that hold variable interests in the VIE (variable interest holders); that is, the enterprises or individuals that provide financial support to the VIE. Only a variable interest holder can consolidate with a VIE. The variable interest holder that ultimately consolidates the VIE is called the primary beneficiary. The concept of a primary beneficiary is discussed further on in this course.

1. Definition of a variable interest:

A variable interest is defined as a contractual, ownership, or other pecuniary interest in a VIE that changes with changes in the fair value of the VIE’s net assets, exclusive of variable interests.

a. A variable interest is a means through which one enterprise (or individual) provides financial support to a VIE that could result in the providing enterprise (or individual):

   1. Absorbing a portion of the VIE’s expected losses, or
   2. Receiving a portion of the VIE’s expected residual returns.

b. The labeling of an item as an asset, liability, equity or as a contractual arrangement does not determine whether it is a variable interest. Instead, it is the role of the item, which is to absorb or receive the entity’s variability due to the change in its net assets, that determines if it is a variable interest.

Note: The best way to look at the variable interest is that it is a form of financial support provided by an entity or individual to a VIE that has a variable component to it that acts like an equity investment. The result is that the entity (or individual) that provides the financial support (variable interest) may receive upside (portion of expected residual returns) or downside (absorb a portion of expected losses) through its variable interest.

A variable interest can be in the form of ownership (ownership of voting or non-voting equity) or no ownership (guarantees, certain lease arrangements, debt, management and other service fees contracts in limited cases). The key point is that the variable interest holder (provider) acts like an equity owner even if it may not have formal ownership. Through its variable interest (support), the variable interest holder is exposed to the risk of absorbing a portion of the VIE’s expected losses (absorbs a portion of the downside), or receives a portion of the VIE’s expected residual gains (receives a portion of the upside).
The labeling of an item as an asset, liability, equity or as a contractual arrangement does not determine whether it is a variable interest. Instead, it is the role of the item, which is to absorb or receive the entity’s variability due to the change in its net assets, that determines if it is a variable interest.

c. Examples of variable interests include:

1) **Equity investments:**
   - Equity investments in a VIE are variable interests to the extent that they are at risk
   
   **Note:** An equity interest that is not at risk still may be a variable interest provided it absorbs or receives some of the entity’s variability.

2) **Liabilities – recorded or not recorded:**
   - Guarantees
   - Written put options on the assets of the VIE
   - Obligations that protect holders of senior interests from suffering
   - Subordinated beneficial interest
   - Subordinated debt due from the VIE such as unsecured loans
   - Senior debt including bank loans
   - Forward contracts to sell assets that are owned by the VIE
   - Derivatives

3) **Certain contracts with the VIE:**
   - Leases:
     a) Leases that have terms that are above or below market for similar property in the same geographic location.
     b) Leases that have any of the following embedded features:
        - Residual value guarantee
        - Option to acquire leased assets at a fixed or predetermined price
        - Lease renewal option at a fixed or predetermined lease rate
     
     **Note:** A lease that has a market rate and terms and has none of the above embedded features is not a variable interest.
   - Contracts for fees paid to a decision maker or service providers (e.g., management contracts) that are not at arm’s length and do not satisfy six conditions. (See discussion below.)

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4 Beneficial interests are rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.
• Distribution contracts that have variable payments linked to an entity’s performance.

• Royalty, license and other contracts that have variable payments linked to an entity’s performance.

d. A variable interest excludes:

1) Most assets of a VIE:

   • Most assets that create variability (e.g., create the change in fair value of assets)\(^5\)

2) Equity investments in a VIE that are not at risk or do not absorb or receive some of the entity’s variability.

3) Certain contracts:

   • Contracts for fees paid to a decision maker or service providers (e.g., management contracts) that satisfy six conditions (see discussion below)

   • Leases at a market rate and terms and that have no residual value guarantee, no option to purchase the leased property at a fixed or predetermined price, or no renewal option at a fixed or predetermined lease rate

   • Trade receivables and payables in the normal course of business

   • Casual purchases and sales at market value

Note: Most liabilities and equity of a VIE are variable interests while most assets are not. Most assets of a VIE create variability; that is, they create the increase or decrease in the net fair value of the VIE. On the other side, most liabilities and equity absorb that variability in that they absorb the losses (decreases in fair value) and receive the residual gains (increases in fair value).

Both the equity and debt represent variable interests in that both either absorb a portion of expected losses or receive a portion of residual returns due to changes in the fair value of net assets.

A quick way to remember how variable interests work is that most assets create the change in fair value (e.g., create variability), while most liabilities and equity absorb the change in fair value (e.g., absorb the variability).

\(^5\) In general, assets are not variable interests because they create the variability (the gains or losses). However, assets of an entity that take the form of derivatives, guarantees, or other similar contracts may be variable interests.
2. Fees paid to decision makers or service providers:

Contracts related to fees paid to a decision maker or service provider, such as management or service fees, are generally not variable interests if the contracts satisfy all of the following six conditions:

1. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services (e.g., the fees are at an arm’s-length rate).

2. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity’s activities, such as trade payables.

3. The decision maker or service provider and its related parties, if any, do not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the entity’s expected losses or receive more than an insignificant amount of the entity’s expected residual returns.

4. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length (e.g., the fees are at market value).

5. The total amount of anticipated fees are insignificant relative to the total amount of the VIE’s anticipated economic performance.

6. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity’s anticipated economic performance.

Fees paid to decision makers or service providers that meet all of the above conditions (1-6) are not considered variable interests.

Conversely, if fees paid to decision makers or service providers that do not meet all of the above conditions (1-6), the fees contract is considered a variable interest.

3. Leases:

Leases represent one of the most significant transactions that must be addressed under FIN 46R. Confusion exists as to whether a lease is a variable interest, and whether embedded features such as residual value guarantees, options to purchase the leased property, or lease renewal options are variable interests.

In general, from the lessee’s perspective, a lease that has lease terms that are at market terms of similar property in the same geographic location, is not a variable interest in the lessor (VIE).

If, instead, the lease terms are either above- or below-market value, the lease is a variable interest because the lessee may absorb some of the variability of the lessor. If
the lease is above market value, the lessee absorbs some of the losses of the lessor by paying higher lease payments. Conversely, if the lease is below market value, the lessee receives some of the residual returns of the lessor through making lease payments that are below what the market bears.

**Embedded features in a lease:**

If a lease has an embedded feature that absorbs the variability of the underlying leased asset, the lease is a variable interest, regardless of whether or not the lease is at market value.

Embedded features that absorb variability include:

- Residual value guarantee
- Option to acquire leased assets at a fixed or predetermined price
- Lease renewal option at a fixed or predetermined lease rate for a period beyond the base lease term.

**Residual value guarantee:** It is common for a lease agreement to require the lessee to guarantee that the leased property is worth a certain value at the end of the lease, referred to as a residual value guarantee. A residual value guarantee is a variable interest in the VIE because the lessee absorbs some of the losses of the leased asset that would otherwise be absorbed by the equity holders.

**Option to purchase the leased asset at a fixed or predetermined price:** If a lease allows the lessee the option to purchase the leased property at a fixed or predetermined purchase price, the lease option is a variable interest. The reason is because the lessee has the option to purchase the leased asset at a price that is less than the fair value of the asset, pulling residual returns away from the equity owners. Through the option the lessee is receiving some of the residual returns of the VIE that would otherwise belong to the equity holders.

**Lease renewal option at a fixed or predetermined lease rate:** Most leases not involving related parties have renewal options at lease rates that are fixed or predetermined and may not be at market rates. A lease that has a renewal option at a fixed or predetermined lease rate for a period that is beyond the original term of the underlying lease, is a variable interest. The reason is because the renewal option allows the lessee to benefit from a lease price that is less than the market value for a period that is beyond the lease period, thereby giving the lessee a portion of the residual value of the leased asset that would otherwise belong to the equity holders.

**What if a lease (or embedded feature in a lease) is for an asset of the VIE that represents less than 50 percent of the fair value of the VIE’s total assets?**

If the embedded feature (residual guarantee, option, or renewal option) is based on leased assets that consist of less than 50 percent of the fair value of the VIE’s total assets, the lease is not a variable interest in the VIE. Instead, the lease represents a variable interest in specified assets.
Variable Interests (Financial Support of the VIE)

Absorb a portion of the VIE’s losses, or receive a portion of the VIE’s expected residual returns

- Guarantee
- Contracts for fees to the decision maker and service providers*
- Leases: above or below-market, and/or have a residual guarantee, option, or renewal option
- Loans
- Equity investments

Variable Interest Entity (VIE)

*Contracts for fees to decision makers (management contracts) and service providers are considered a VIE only in limited cases where the contract is not at market value and certain other conditions are met. See previous discussion of this issue.

A variable interest, by definition, absorbs some of the “variability” due to changes in the VIE’s net asset values. That means that if the VIE’s net asset values change, the variable interest holder may be required to absorb a portion of the VIE’s expected losses, or it will receive a portion of expected residual returns.

4. Receivables:

A VIE makes a loan to another entity. Is that loan a variable interest in the VIE?

Remember that a variable interest results in an entity (a variable interest holder) absorbing some of the expected losses or receiving some of the residual returns of a VIE. A loan receivable to a VIE does not absorb expected losses or residual returns of that VIE. Instead, as an asset, it creates variability in that it is part of the change in the fair value of the VIE’s net assets. In general, liabilities and equity of a VIE absorb the
change in the fair value of the VIE, thus usually being considered variable interests. Assets of the VIE do not absorb any variability because they create it.

5. **Typical degree of variability – variable interests:**

Some variable interests are stronger than others in that they give greater financial support to the VIE. Those stronger variable interests absorb a greater portion of expected losses or receive a greater portion of residual returns.

Some variable interest holders will never be categorized as the primary beneficiary of a VIE because they do not provide the majority of the VIE’s financial support. Conversely, certain variable interest holders may provide greater support and may be considered the primary beneficiary of the VIE.

Although most variable interests will absorb some of the VIE’s expected losses or receive a portion of its residual returns, some share in the VIE’s expected losses and residual returns more than others, as noted in the following chart.
<table>
<thead>
<tr>
<th>Variable Interest</th>
<th>Typical Degree of Variability</th>
<th>Likelihood of being the primary beneficiary of the VIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity ownership, unrestricted</td>
<td>Usually highest degree of variability and most likely to be the primary beneficiary. Usually the equity owners will absorb the majority of expected losses and receive the majority of residual returns of the VIE.</td>
<td>Highest</td>
</tr>
<tr>
<td>Unsecured and subordinated loans</td>
<td>Usually next highest degree of variability and typically absorbs expected losses right after equity owners.</td>
<td>Higher</td>
</tr>
<tr>
<td>Guarantees</td>
<td>Typically absorbs expected losses right after unsecured loans.</td>
<td>Moderate</td>
</tr>
<tr>
<td>Residual value guarantee embedded as part of a lease</td>
<td>Typically absorbs expected losses right after unsecured loans.</td>
<td>Moderate</td>
</tr>
<tr>
<td>Option to purchase at a fixed or predetermined price that is embedded as part of a lease</td>
<td>Lease option to purchase at a fixed or predetermined price could have a high degree of variability if the value of the underlying leased property fluctuates relative to the fixed option purchase price.</td>
<td>Moderate</td>
</tr>
<tr>
<td>Lease renewal option at a fixed or predetermined lease rate</td>
<td>Could have a high degree of variability if the value of the underlying lease rate fluctuates relative to the fixed or predetermined lease rate in the renewal option.</td>
<td>Moderate</td>
</tr>
<tr>
<td>Management fees and service provider contract that are considered a variable interest</td>
<td>Might share in losses or residual gains if payments fluctuate based on a percentage of the VIE’s assets or some other floating factor.</td>
<td>Low</td>
</tr>
<tr>
<td>Above- or below-market lease</td>
<td>Lessee might share in losses if payments are above market or share in the residual returns if the lease is below market.</td>
<td>Low</td>
</tr>
<tr>
<td>Secured debt (including bank debt)</td>
<td>Least likely to absorb any VIE expected losses or receive its residual gains unless loan agreement has a variable feature (residual fee based on sale of property, etc.). Because the loan is secured, the bank is the least likely to absorb the majority of a VIE’s expected losses or receive the majority of VIE residual returns.</td>
<td>Lowest</td>
</tr>
</tbody>
</table>
6. Implicit variable interests:

Variable interests that directly absorb the losses or receive the returns of a VIE through contracts, are considered explicit variable interests, such as loans, guarantees, and equity interests. Most variable interests are explicit variable interests.

Explicit variable interests are those that have been discussed throughout this course.

There are instances in which an enterprise may have an implicit variable interest in a VIE which is an indirect variable interest that is not identified by contract. For example, an enterprise may have an implicit guarantee of another entity’s loan even though there is no contractual obligation to do so.

In identifying variable interests, an enterprise must consider all variable interests, including both explicit and implicit variable interests. That is, even though a particular enterprise holds no (explicit) variable interest, it may hold an implicit variable interest if it has either or both an obligation or incentive to protect other variable interest holders from losses even though it has no contractual obligation to do so.

An implicit variable interest is given the same weight as an explicit variable interest even though it is far more difficult to identify an implicit variable interest in comparison to an explicit variable interest.

The reader should focus on those instances in which an implicit variable interest may exist, which is when there are the following elements:

- Related parties exist
- One party is guaranteeing the loan of another party
- Another party within the group is likely to have to step in to satisfy the guarantee of the other party.

FASB Staff Position- FSP- FIN 46(R)-5- Implicit Variable Interests, as amended, provides the limited guidance that exists in connection with implicit variable interests.

The FSP is focused on interpreting Paragraph B-10 of FIN 46(R) which states:

“Guarantees of the value of the assets and liabilities of a variable interest entity, written put options on the assets of the entity, or similar obligations such as some liquidity commitments or agreements (explicit or implicit) to replace impaired assets held by the entity are variable interests if they protect holders of other interests from suffering losses.”

The FSP deals with an implicit variable interest, such as an implicit guarantee of debt.

The general concepts of an implicit variable interest follow:

1. If a reporting enterprise has an implicit variable interest in a VIE, the reporting enterprise may be required to absorb the variability of the VIE or potential VIE.

   Example: Through its relationship with a common owner guarantor, an operating company may be called upon to satisfy the owner’s guarantee of a VIE’s debt even though the operating company has not executed a contract to guarantee that debt.
2. An implicit variable interest (e.g., indirect guarantee) acts the same as an explicit variable interest (direct guarantee) except that an implicit variable interest involves absorbing and/or receiving the variability indirectly from the VIE, rather than directly from the VIE.

3. If an enterprise has an implicit variable interest in a VIE, the enterprise is brought into the related party rules and could be considered the primary beneficiary of the VIE.

**Observation:** The most common example of where there is an implicit variable interest is where a common owner guarantees the debt of a lessor VIE. The related party lessee may be deemed to have an implicit guarantee of that VIE’s debt even though no contractual guarantee exists between the lessee and lessor. The argument in favor of the lessee being an implicit guarantee is based on the assumption that because of the related-party relationship, the lessee operating entity would do whatever is needed to ensure that the lessee’s underlying asset(s) (e.g., real estate) was protected on behalf of the common shareholder. For example, if the lessor VIE were unable to support its debt service and the owner’s guarantee were called by the bank, the lessee operating company would provide the additional financial support needed to satisfy the guarantee.

FIN 46R, as amended, states:

“The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a VIE directly absorb or receive the variability of the VIE. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the VIE, rather than directly from the VIE. Therefore, the identification of an implicit variable interest involves determining whether an enterprise may be indirectly absorbing or receiving the variability of the VIE. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting enterprise can be required to protect a variable interest holder (such as a common owner) in a VIE from absorbing losses incurred by the VIE.”

FIN 46R gives limited guidance as to how to determine whether an entity actually has an implicit variable interest in a VIE. Instead, it states that such a determination is based on the facts and circumstances.

**Where is the likely place one will find an implicit variable interest?**

Although there may be more esoteric examples of implicit variable interests, the most common situation in which an implicit variable interest may exist is where there is an implicit guarantee of a loan among related parties with one common owner, and the owner has guaranteed the VIE’s debt. In certain situations there is presumed to be an “implicit guarantee” of the debt by the related party entities.
What factors should be considered in determining whether an enterprise holds an implicit variable interest in a VIE?

FIN 46(R)-5 states that the determination of whether an implicit variable interest exists should be based on "all facts and circumstances in determining whether the reporting enterprise may absorb variability of the VIE or potential VIE."

Although it may be difficult to ascertain whether an enterprise holds an implicit variable interest, FSP FIN 46(R)-5 states that the analysis should take into consideration all relevant facts and circumstances, that should include asking the following questions:

Even though there is no contractual obligation,

1. Does the enterprise have the obligation to protect another entity against loss?
2. Does the enterprise have an economic incentive to protect another entity against loss?
3. Has the enterprise acted as a protector in similar situations in the past?
4. Would the enterprise acting as a protector be a conflict of interest or be illegal?

Example:
John owns Company Y and Company X.
John guarantees a bank loan for Company X.
John’s primary asset to fulfill the guarantee would be the 100% ownership in Y.

Conclusion:
Y may have an implicit guarantee of X’s bank loan, which is an implicit variable interest.

If John’s guarantee were to be called, Y, as the primary asset of John, would be called upon to satisfy the guarantee.

In determining whether Y has an implicit guarantee, Y should ask the following questions:

Even though there is no contractual obligation for Y,

1. Does Y have the obligation to protect X against loss?
2. Does Y have an economic incentive to protect X against loss?
3. Has Y acted as a protector in similar situations in the past?
4. Would Y acting as a protector of X be a conflict of interest or be illegal?

If some of the above factors are affirmative, Y has an implicit guarantee of X’s bank loan.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A variable interest is:
   a) a contractual, ownership, or other pecuniary interest in a VIE that does not change with changes in the fair value of the VIE’s net assets
   b) a means through which one entity provides financial support to a VIE
   c) a means through which one entity absorbs a portion of the VIE’s expected losses but does not receive a portion of the VIE’s expected residual returns
   d) financial support that has a variable component to it that acts like a liability

2. Variable interests include:
   a) casual purchases and sales at market value
   b) equity investments that are at risk
   c) most assets that create variability
   d) all fees paid to decision makers and service providers

3. In many cases, _____ may hold the largest variable interest other than equity ownership.
   a) derivative instruments
   b) forward contracts related to assets owned
   c) guarantees
   d) unsecured and subordinated debt

4. What type of variable interest holder has the lowest likelihood of being the primary beneficiary of a VIE:
   a) a guarantor
   b) an equity holder
   c) a holder of secured debt
   d) a holder of unsecured loans
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A variable interest is a contractual, ownership, or other pecuniary interest in a VIE that changes with changes in the fair value of the VIE’s net assets, exclusive of variable interests.

   **B: Correct.** A variable interest is a means through which one entity (or individual) provides financial support to a VIE that could result in the providing entity (or individual) absorbing a portion of the VIE’s expected losses or receiving a portion of the VIE’s expected residual returns.

   C: Incorrect. A variable interest holder generally absorbs a portion of the VIE’s expected losses and also the VIE’s expected residual returns.

   D: Incorrect. A variable interest has a variable component to it that acts like an equity investment than debt in that there is risk associated with the variable interest.

   (See page 45 of the course material.)

2. A: Incorrect. A variable interest excludes certain contracts such as casual purchases and sales at market value.

   **B: Correct.** Equity investments that are at risk are variable interests while those that are not at risk are not.

   C: Incorrect. A variable interest excludes most assets that create variability (e.g., create the change in fair value of assets).

   D: Incorrect. Most contracts related to fees paid to decision makers and service providers are not variable interests provided they satisfy six criteria that include that the contract must be arm’s length and at market value, among other requirements.

   (See page 46 of the course material.)

3. A: Incorrect. Derivative instruments held or written by a VIE should be analyzed in terms of their option-like, forward-like, or other variable characteristics. Generally such instruments do not hold the largest variable interest.

   B: Incorrect. Forward contracts to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. However, rarely are forward contracts the largest variable interests as they do not have the greatest degree of variability.

   C: Incorrect. A guarantee is a variable interest but typically does not result in it being the largest variable interest other than equity ownership.

   **D: Correct.** Unsecured and subordinated debt are variable interests that in many cases may hold the largest variable interest other than equity ownership. The reason is because unsecured and subordinated debt is at the “bottom of the food chain” in being paid in the event of a decline in the net asset values of the VIE.

   (See page 52 of the course material.)
4. A: Incorrect. A guarantor has a moderate likelihood of being the primary beneficiary of a VIE. It typically absorbs expected losses right after unsecured loans.

B: Incorrect. An equity holder who is at risk has a high likelihood of being the primary beneficiary as that holder has the greatest risk of absorbing losses and receiving residual returns of the VIE.

C: Correct. A secured debt holder has the lowest likelihood of being the primary beneficiary of a VIE. The reason is because the holder is the last one to absorb any VIE expected losses, and generally does not receive its residual gains unless loan agreement has a variable feature.

D: Incorrect. A holder of unsecured loans has a higher likelihood of being the primary beneficiary of a VIE. Right after equity holders, it usually has the next highest degree of variability and typically absorbs expected losses.

(See page 52 of the course material.)
SECTION 4:

I. Requirement 3 for Consolidation: Determine the Primary Beneficiary Who Consolidates the VIE

The third and final requirement to consolidating a VIE is to identify the enterprise that will consolidate the VIE.

a. The general rule is that a reporting enterprise shall consolidate a VIE when that reporting enterprise has a variable interest (or a combination of variable interests) that provides the reporting enterprise with a controlling financial interest in the VIE.

b. The reporting enterprise that holds the controlling financial interest in a VIE is called a primary beneficiary.

Essentially, the primary beneficiary is the entity or individual that has a controlling financial interest in the VIE and, therefore, consolidates that VIE. If the primary beneficiary is an entity, it consolidates the VIE into its financial statements. If the primary beneficiary is an individual, no consolidation of the VIE is required.

Observation: In many instances, an individual is the primary beneficiary. In such a case, the VIE will not be consolidated because an individual does not consolidate even if it issues personal financial statements. In reality, an individual is not going to perform a test to determine whether it is the primary beneficiary because, the result has no impact on the individual; that is, the individual does not consolidate the VIE in any case. Instead, only a variable interest holder that is an enterprise will test the VIE to determine if the enterprise is the primary beneficiary that should consolidate the VIE.

1. Definition of a primary beneficiary:

FIN 46R defines a primary beneficiary as the following:

An enterprise or individual is considered the primary beneficiary of the VIE if it has a variable interest (or a combination of variable interests) in a VIE and has a controlling financial interest in that VIE.

An entity has a controlling financial interest in a VIE if it has both of the following criteria:

a. The power to direct the activities of a VIE that most significantly impact the entity’s economic performance (the power criterion), and

b. The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (the loss/benefits criterion).

Although many variable interest holders may have to test to determine whether they are primary beneficiaries, only one enterprise or individual can ultimately be deemed the primary beneficiary.

Note: There may be many variable interest holders that may have an obligation to absorb some of the losses of the VIE or have the right to receive some of the benefits
from the VIE (loss/benefits criterion in (2) above), there is only enterprise or individual, if any, that has the power to direct the activities of a VIE that most significantly impact the entity’s economic performance (power criterion in (1) above).

**Shared power rules:** If a reporting enterprise determines that power is shared among multiple unrelated parties such that no one party has the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance, then *no party is the primary beneficiary* and the VIE is not consolidated.

a. Power is shared if:

   - two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and
   - decisions about those activities require the consent of each of the parties sharing power.

b. If a reporting enterprise concludes that power is not shared but the activities that most significantly impact the entity’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the power to direct the activities.

c. Power is not shared if the entities are related parties.

**2. Rules for determining the primary beneficiary:**

Each variable interest holder must perform its own assessment of whether that reporting enterprise has a controlling financial interest in the VIE and thus is the primary beneficiary.

a. A *controlling financial interest* is achieved if the holder has:

   1) The power to direct the activities of a VIE that most significantly impact the entity’s economic performance (power criterion), and
   2) The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (losses/benefits criterion).

b. The assessment should be performed first at the time when a reporting enterprise obtains a variable interest (or combination of variable interests) in a VIE, and should continue on an ongoing basis while the entity is a variable interest holder.

c. The assessment of whether the holder has a controlling financial interest includes a review of several factors:

   - The characteristics of the reporting enterprise’s variable interest(s) in the VIE.
   - Involvement of the reporting enterprise’s related parties and de facto agents, and other variable interest holders in the VIE.
• The VIE’s purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders.

• **The extent to which the reporting enterprise was involved in the initial design of the VIE including preparing the governing documents.**

• Which activities most significantly impact the entity’s economic performance and determine whether it has the power to direct those activities.

**Observation:** In assessing whether it is the primary beneficiary that has a controlling financial interest in a VIE, a variable interest holder is required to review several factors noted above. One key factor is the extent to which the reporting enterprise (variable interest holder) was involved in the initial design of the VIE including whether that reporting enterprise prepared the governing documents.

d. A reporting enterprise is also required to perform a test to determine whether an entity in which it has a variable interest is actually a VIE.

**Note:** Recall that in performing an assessment, each variable interest holder, in addition to performing a test to determine whether it is the primary beneficiary of the VIE, must also perform a test to determine whether the entity is a VIE. If it is not a VIE, the test as to whether the variable interest holder is a primary beneficiary is moot. Therefore, if there are several variable interest holders, each would perform a separate test of the VIE and, presumably, each could arrive at a different conclusion as to whether the entity is a VIE and whether the holder is the primary beneficiary that should consolidate that VIE.

e. There can be only one primary beneficiary of a VIE.

**Observation:** Inherent in the application of FIN 46R is the risk that two variable interests holders, with the same facts, could each reach the same conclusion that it is the primary beneficiary of the same VIE. The result is that the same VIE could be consolidated with two different variable interest holders.

Note further that in some instances, there will be no primary beneficiary that consolidates a VIE. Examples include:

• An individual is considered the primary beneficiary and does not consolidate the VIE.

• One variable interest holder meets the “power” criterion, while another satisfies the second criterion, obligation to absorb losses or right to receive benefits, but no party satisfies both criteria.

• A party meets the power criterion but holds no variable interest in the VIE and does not satisfy the second criterion.

• **Power is shared among various parties.**
Reconsideration of primary beneficiary status:

1) A variable interest holder is required to continually reconsider whether it is the primary beneficiary of a VIE.

**Note:** FASB No. 167 requires that a variable interest holder reconsider whether it is a primary beneficiary on a continued basis. This is a departure from the originally issued FIN 46R which requires that reconsideration be done when certain triggering events occur such as a change in the governing documents or if the primary beneficiary sells all or a part of its variable interest.

FASB No. 167 does not address how often a variable interest holder must reconsider whether it is the primary beneficiary. Presumably, a new assessment should be done at least once per year and at a time that gives the reporting enterprise time make any necessary adjustment (consolidation or deconsolidation) in time to issue its annual financial statements.

**Must a variable interest holder in a VIE test to determine if it is the VIE’s primary beneficiary if it knows that it will not absorb the majority of the VIE’s expected losses, or receive the majority of its residual returns?**

The answer is no.

FASB No. 167 amends FIN 46R to provide that in applying FIN 46R, only substantive terms, transactions, and arrangements (whether contractual or noncontractual), shall be considered.

Any term, transaction, or arrangement that does not have a substantive effect on a) an entity’s status as a VIE, b) an entity’s power over a VIE, or c) an entity’s obligation to absorb losses or its right to receive benefits of the VIE, are disregarded in applying FIN 46R.

What this means is that if a reporting enterprise holds a variable interest in a VIE (an arrangement) and knows that such an interest will not have a substantive effect on that reporting entity’s power over the VIE, obligation to absorb losses or right to receive benefits of the VIE, then that reporting enterprise is not required to test to determine whether it is a primary beneficiary of the VIE.

**Criterion 1 (Power Criterion): Power to direct the activities of the VIE that most significantly impact the VIE’s economic performance:**

In order to satisfy the “power criterion,” a variable interest holder must:

- Identify those activities that most significantly impact the VIE’s economic performance, and
- Identify who has the power to direct those activities.

FIN 46R does not give guidance on the types of activities that “most significantly impact the VIE’s economic performance.” However, the examples found in Appendix C to FASB No. 167, suggest that activities that most significantly impact a VIE’s economic performance are those that impact the performance of the underlying assets including retention of the value of those assets.
Thus, activities that \textit{protect, maintain, and maximize the value} of the entity’s assets would be considered significant, while those activities involving ongoing administration may not be considered significant.

One way to look at whether an activity is significant is to ask the following question: \textit{Does the activity protect, safeguard, maintain or enhance the value of the underlying assets?} If it does, then that activity is likely to significantly impact the VIE’s economic performance. If not, it does not.

Following are some guidelines that might assist in determining which variable interest holder satisfies the power criterion:

1. Look for activities that \textit{protect, maintain, and maximize the value} of the entity’s assets.

2. A party’s power to direct those activities of the VIE that most significantly impact the VIE’s economic performance is based on the facts and circumstances.

3. The power can be dormant in that it is available to be used regardless of whether that party actually uses it. In some instances, the power may not be day-to-day decision making and it may be contingent on certain events occurring such as a power that is triggered in the event of a default or other event occurring.

4. There can only be one variable interest holder that satisfies the power criterion.

\textit{Criterion 2 (Losses/Benefits Criterion): The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.}

In order for a variable interest holder to be a primary beneficiary that consolidates a VIE, it must satisfy the two criteria (power criterion and losses/benefits criterion).

If a variable interest holder satisfies the power criterion (Criterion 1), it must also satisfy the second criterion (losses/benefits criterion) in order for that enterprise to be the primary beneficiary that consolidates a VIE. In some instances, an individual will meet both criteria in which case the VIE is not consolidated.

Conversely, if a variable interest holder does not satisfy the “power criterion,” there is no need for that holder to test the losses/benefits criterion because that holder cannot be the primary beneficiary.

In order for a variable interest holder to satisfy the losses/benefits criterion (criterion 2), that variable interest holder must have:

\textit{The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (losses/benefits criterion).}

FASB No. 167 eliminates use of the quantitative method to determine which variable interest holder has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.
Prior to the issuance of FASB No. 167, FIN 46R allowed a variable interest holder to perform its assessment of who absorbed losses and received residual benefits by using either a quantitative method (expected losses method) or a qualitative method based on the facts and circumstances, without performing a detailed quantitative analysis.

In FASB No. 167, the FASB eliminated use of a quantitative method. Now, a variable interest holder makes an assessment of which variable interest holder absorbs losses and receives residual benefits of the VIE by using a qualitative method based on facts and circumstances.

Following are some guidelines in assessing whether a variable interest holder satisfies the losses/benefits criterion:

1. The holder has to satisfy either the obligation to absorb losses of the VIE, or the right to receive benefits of the VIE that could potentially be significant to the VIE.
   
   a. It is possible that one variable interest holder has the obligation to absorb losses, while another has the right to receive benefits that could potentially be significant to the VIE.

2. FIN 46R, as amended, does not define the term “significant.”

   Note: The FASB intentionally did not define the term “significant” to avoid creating a “bright line” that would be used in practice as the sole factor to determine a significant threshold. In its Basis for Conclusions (Appendix A to FASB No. 167), the FASB did make the following observations:

   Whether the obligation to absorb losses, or right to receive benefits of the VIE, could potentially be significant to the VIE requires judgment and consideration of all facts and circumstances about the terms and characteristics of the variable interests. Further, the design and characteristics of the VIE, and the other involvements of the enterprise with the VIE might be considered.

The following examples illustrate the application of the primary beneficiary rules.

Example 1: Basic Application:

Company S is established under the following structure:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt, 5-year fixed note, personally guaranteed by Company P</td>
<td>$250,000</td>
</tr>
<tr>
<td>Equity – 100% owned by Company P</td>
<td>750,000</td>
</tr>
<tr>
<td>Total debt and equity</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Company S purchased $1,000,000 of real estate with the debt and equity.

Company P pays $750,000 for 100% of the voting shares of Company S.

It is a given fact that S is not a VIE.
Conclusion:
FIN 46R does not apply because there is no VIE. However, P would consolidate S under ARB No. 51 consolidation rules because it owns more than 50% of the voting shares of S.

Example 2:
Same facts as Example 1 except that Company X is a VIE in that its total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support in the form of a guarantee of its loan by Company P.

Company P has full control over its voting rights in S’s equity.

Conclusion: Because S is a VIE, FIN 46R applies. Thus, each variable interest holder must make an assessment to determine whether it has a controlling financial interest in S and thus consolidates S.

A variable interest holder has a controlling financing interest in a VIE if the holder has both of the following characteristics:

1) The power to direct the activities of a VIE that most significantly impact the entity’s economic performance, and
2) The obligation to absorb losses of the VIE, or the right to receive benefits from the VIE that could potentially be significant to the VIE.

In this example, the variable interest holders consist of:

- Debt holder
- Equity holder – Company P

The first step is to determine which variable interest holder has the power to direct the activities of Company S that most significantly impact S’s economic performance. Clearly, Company P has the power to direct the activities of S that most significantly impact S’s economic performance. In fact, P has the power to control all of S’s activities.

Second, in order for P to be the primary beneficiary, it must have the obligation to absorb S’s losses or the right to receive S’s benefits that could potentially be significant to S. Because P owns 100% of the voting shares, it has the obligation to absorb the first losses of S before the debt holder absorbs losses. Further, P has the right to receive all the residual returns (the upside) from its investment in S.

P is the primary beneficiary that consolidates S, because it has a controlling financing interest in S due to having:

1) The power to direct the activities of S that most significantly impact the entity’s economic performance, and
2) The obligation to absorb losses and the right to receive benefits from S that could potentially be significant to the VIE.
**Observation:** In an instance in which one reporting enterprise or individual owns 100% of the voting equity of a VIE and there are no restrictions on that equity, it is easy to ascertain that the primary beneficiary is the 100-percent shareholder. Typically, no test or analysis is needed in such a situation.

**Example 3:**
(from Appendix of FASB No. 167, as modified by the author)

**Facts:**

An entity (Company X) is created and financed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing, 5 year fixed rate loan</td>
<td>$950</td>
</tr>
<tr>
<td>Equity</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

- The $1,000 is used to purchase a property that is leased to a lessee that has a AA credit rating.
- The equity is subordinate to the debt as the debt is paid off first before any cash flow is paid to the equity holders. The equity holder is an enterprise.
- Company X is tested and it is considered a VIE because it cannot finance its activities without additional subordinated financial support from other parties.
- The lease has a five-year lease term.
- The lessee provides a residual value guarantee of the leased property at the end of the five-year lease term and has an option to purchase the property at the residual value (the option price).
- If the lessee does not exercise its option and the lessor sells it at less than the option price, the lessee must pay the lessor the shortfall in selling price and remarket the property for the lessor (X).
- If the property is sold for an amount greater than the option price, the lessee receives the excess of the selling price over the option price.
- The lease agreement and governing documents of X (lessor):
  1) Do not permit X to purchase additional assets or sell existing assets during the five-year holding period.
  2) Do not provide the equity holders with the power to direct any activities of X.
- X was formed so that the lessee would have rights to use the property under an operating lease and would retain substantially all of the risks and rewards from appreciation or depreciation in value of the leased property. The lessee was involved in the design of X (lessor).
• The transaction was marketed to the debt and equity holders as follows:

**Debt holders:** As an investment in a portfolio of AA-rated assets collateralized by leased property that would provide a fixed-rate return to debt holders equivalent to AA-rated assets.

**Equity holders:** As an investment with a return slightly higher than that of the debt holders because the equity is subordinate to the debt.

**Conclusion:**

In this example, following is the analysis that should be performed by the variable interest holders who consist of:

• Debt investors
• Equity investors
• Lessee

The lease is a variable interest because it has a residual value guarantee and an option to purchase at a fixed price.

Each variable interest holder is required to make an assessment to determine whether it is the primary beneficiary of X that should consolidate X.

**General assessment of the facts:**

In making that assessment, each variable interest holder performs a review of several factors:

• the characteristics of the reporting enterprise’s variable interest(s) in X
• involvement of the reporting enterprise’s related parties and de facto agents, and other variable interest holders in X
• X’s purpose and design, including the risks that X was designed to create and pass through to its variable interest holders
• the extent to which the reporting enterprise was involved in the initial design of X including preparing the governing documents
• which activities most significantly impact X’s economic performance and determine whether it has the power to direct those activities

Each variable interest holder should determine the purpose and design of X, including the risks that X was designed to create a pass-through to its variable interest holders. In this case,

• The primary purpose for which X was created was to provide the lessee with use of the property for five years with substantially all of the rights and obligations of ownership, including tax benefits.

• X was marketed to potential investors as an investment in a portfolio of AA-rated assets collateralized by leased property that provides a fixed-rate return to debt holders. The return to equity investors is expected to be slightly higher than the return to debt investors.
• The residual guarantee by the lessee essentially transfers most of the risk associated with the underlying property (decreases and increases in value) to the lessee.

• X was designed to be exposed to the risks associated with a cumulative change in fair value of the leased property at the end of the five-year lease as well as credit risk related to the potential default by the lessee of its contractually required lease payments.

Determining who is the primary beneficiary:

Each variable interest holder (debt holder, equity holder, and lessee) is required to assess whether it is a primary beneficiary of X by having a controlling financial interest in X. That controlling financial interest is achieved based on having the:

1) power to direct the activities of X that most significantly impact X’s economic performance, and

2) obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

Step 1. Who has the power to direct the activities of X (the VIE) that most significantly impact X’s economic performance?

The most significant activities of X include:

• Managing the property, including maintenance
• Marketing the property for sale

The lessee has the power to direct both of the above activities under the lease.

Moreover, the lessee was involved in the initial design of X and its governing documents might suggest that the lessee had the ability to establish power for itself within that design and documents.

Step 2: Who absorbs the losses or has the right to receive benefits from X that could potentially be significant to X?

Since the lessee has the power to direct the activities of X (lessee) that are most significant, the only variable interest holder that could be the primary beneficiary is the lessee, but only if the lessee has the obligation to absorb losses and the right to receive benefits that could potentially be significant to X.

In this case, the lessee has both the obligation to absorb losses and the right to receive benefits that could potentially be significant to X through the residual value guarantee and the purchase option.

On the basis of the facts and circumstances, the lessee is considered the primary beneficiary of X because of the following:
a. It is a variable interest holder with the power to direct the activities of X that most significantly impact X’s economic performance, through its power to maintain and manage the property, and market it for sale.

b. Through its residual value guarantee and purchase option, the lessee has the obligation to absorb losses of X and the right to receive benefits from X that could potentially be significant to the variable interest entity.

**Why isn’t the equity holder the primary beneficiary in Example 3?**

Typically, one would look to the equity holder(s) as being the variable interest holder that has both the power to direct the VIE’s significant activities, and the obligation to absorb losses or right to receive residual returns of the VIE.

In Example 3, the lessee, through its contractual rights and obligations, overrides the equity holder’s rights and obligations. Through the lease, the lessee has the power, obligations and rights that catapult it to being the primary beneficiary even though it has no ownership.

**What if in Example 3, the lessee had a simple market-rate lease with no residual value guarantee or option to purchase?**

If the lessee has a market-rate lease, it has no variable interest in X in that it will not absorb any losses of X nor receive any right to residual returns of X. Once the lessee is out of the picture as a variable interest holder, the equity holder is most likely the primary beneficiary.

**What if in Example 3, the lessee has a triple net market-rate lease and is responsible for managing the property?**

Let’s assume the lessee has a triple net market-rate lease under which the lessee pays all the operating expenses and maintains the leased property. However, there is no residual guarantee nor option to purchase the leased property.

Even though the lessee has the responsibility to pay all the bills and to manage the property, it would appear that the lessee does not have the power to direct the activities that are most significant to X. The most significant activities would be those that retain or enhance the value of X. Although the lessee does have the power to manage the property during the lease term, such management is not an activity that is significant to X as there is no responsibility to maintain or enhance the value of the property unless there is a residual value guarantee, which there is not.

Thus, the power to direct the activities that are significant to X (power criterion) lies with the equity holder. If the equity holder holds the power, then does it also have the obligation to absorb losses or right to receive residual value that is significant to X? Yes. The equity holder has the obligation to absorb losses and right to receive the residual benefits of X because no other entity has that right through contract or otherwise.

The equity holder (an enterprise) is the primary beneficiary that consolidates X.
Abbreviated examples of FIN 46R’s application

Many of the previous examples walk the reader through an elaborate analysis to determine the variable interest holders and the primary beneficiary. In many instances, such an analysis is not needed and an abbreviated, short-cut approach can be used to drill down in identifying the primary beneficiary of a VIE.

Following is a series of examples that trim the analysis down to the core issues that are needed to identify the primary beneficiary of a VIE. In most, but not all, situations, an abbreviated approach can be used and will achieve the same results as if a more extensive, thoughtful analysis was employed.

Example 1:

Company X is a VIE. X is owned 100% by John, who has all the typical risks and rewards of ownership.

The following individuals and entities have variable interests in X:

- John is the 100% shareholder of X’s voting common stock.
- John is a guarantor of X’s bank loan.
- Company Y is a guarantor of X’s bank loan with Bank A.
- Bank A has a loan outstanding with X.
- Company Q has a loan it has made to Company X that is subordinated to X’s bank loan.

Companies Y, Q, and Bank A are not related parties of X or John.

The variable interest holders of X are summarized in the following chart.

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**Variable Interests in Company X**

*Financial support*

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- John – Equity investment in X and guarantor of X’s Bank loan
- Company Y – Guarantee of X’s loan
- Bank A – Loan to X
- Company Q – Subordinated loan to X

---

Company X

Variable Interest Entity (VIE)
**Which entity or individual is the primary beneficiary that should consolidate Company X?**

**Conclusion:** The primary beneficiary is the entity or individual that has a controlling financial interest in a VIE. That controlling financial interest is achieved based on having the:

1) power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and

2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Notice that the primary beneficiary could be an individual instead of an entity. If an individual, there is no consolidation.

In this example, there are many variable interest holders in Company X. It may be possible that none has a controlling financial interest, thus none is the primary beneficiary.

**First: Who has the power to direct the activities of X that most significantly impact X’s economic performance?**

**Second: Who has the obligation to absorb losses of the VIE or the right to receive benefits from X that could potentially be significant to X?**

Let’s look at the following table:

<table>
<thead>
<tr>
<th>Determining the Primary Beneficiary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Power to direct the activities of X?</strong></td>
</tr>
<tr>
<td>------------------------------------</td>
</tr>
<tr>
<td>Bank A (loan)</td>
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</tr>
<tr>
<td>Company Y</td>
</tr>
<tr>
<td>Q’s (subordinated debt)</td>
</tr>
<tr>
<td>John-equity interest and guarantor of loan</td>
</tr>
</tbody>
</table>

**Conclusion:** John is the primary beneficiary. Because John is an individual, and not a separate entity, X is not consolidated by John.

**Change the facts:** Assume that instead of John being an individual, John is a corporation named John, Inc.

**Conclusion:** Because John, Inc. is the primary beneficiary of X, John, Inc. should consolidate X.
**Observation:** Example 1 above illustrates an important point. If the majority owner of a VIE has an equity investment that is at risk (that is, the owner has no restrictions on decision making), and shares in the losses and residual returns of the VIE, then the majority owner will almost always be the primary beneficiary of the VIE through its equity investment variable interest. The reason is because the equity owner will usually absorb the majority of the losses and receive the majority of the residual returns of the VIE. If the majority owner of the equity investment in a VIE is an individual (rather than a corporation or other type of entity), the VIE will not be consolidated.

**Example 2:**

Company X is a VIE.

X’s majority shareholder's equity investment is held by John. Under John’s investment agreement, John does not share significantly in the profits and losses of X. Instead, John receives a fixed return on his investment and such return and equity is guaranteed from loss by Y and Z. Moreover, John does not have the ability to make significant decisions about the company such as those involving the purchase of assets or the ultimate sale of the company.

Companies Y and Z are both major suppliers of X and are both joint and several guarantors for X’s significant bank loan. Y and Z agreed to guarantee the loan in exchange for both entities receiving distribution contracts to distribute X’s products.

As a condition of signing its guarantee, Y has the ability to make most significant decisions about the operations of X including the purchase and disposal of assets or the sale of Company X. Such decisions are not available to Z unless Y commits gross negligence in performing its activities.

There are no other variable interest holders.

**Conclusion:**

Each variable interest holder is required to assess whether it is a primary beneficiary of a VIE by having a controlling financial interest in a VIE. That controlling financial interest is achieved based on having the:

1) Power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and

2) The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

**First: Who has the power to direct the activities of X that most significantly impact X’s economic performance?**

X’s majority shareholder, John, does not have a variable interest in X because his equity investment does not share significantly in the profits and losses of X. That is, his investment really is *not at risk*. FIN 46R states that an equity investment that is not at risk is not considered a variable interest. Consequently, John cannot be the primary beneficiary because he holds no variable interest in X.
As to who holds the power, through its agreement, Y has the power to direct significant activities of X.

**Second: Who has the obligation to absorb losses of the VIE or the right to receive benefits from X that could potentially be significant to X?**

Because Y has the power to direct the significant activities of X, Y will be the primary beneficiary if it satisfies the second criterion: that is, it must have the obligation to absorb the losses of X or the right to receive the benefits from X that could potentially be significant.

In this example, because Y is guarantor of the bank loan, Y has the obligation to absorb losses that could be significant to X.

Thus, because Y has the power to direct significant activities of X and Y has the obligation to absorb losses that could be significant, Y is the primary beneficiary that consolidates X.

**Observation:** This example illustrates how an entity can be considered the primary beneficiary even though it holds no equity interest in a VIE. In this example, Y’s guarantee of the bank loan coupled with the power to make significant decisions for X is sufficient enough for Y to be considered the primary beneficiary that consolidates X.

Note further that in the above example, the bank was not assessed for being the primary beneficiary. The reason is because it is highly unlikely that the bank would have the power to direct the significant decisions of X. Further, because the bank is in first position, it generally does not have the obligation to absorb significant losses. The first losses of X will be absorbed by Y and Z well before there are any losses that have to be absorbed by the bank. The bank has no right to receive residual returns of X.

**Example 3:**

Company X is a VIE. Companies Y and Z have variable interests in X.

Y is a guarantor of X’s debt and would absorb the majority of the VIE’s losses if the VIE’s net asset value declined.

Z is the holder of a note with variable returns from X under which Z receives residual returns if X’s net asset value increases.

There are no other variable interest holders of X.

X’s majority shareholder’s equity investment is not at risk in that it is guaranteed from loss by Z and Y and is not subject to receipt of significant residual returns. Under an agreement among the shareholder and Y and Z, the shareholder has no power to direct any significant activities of X. The power to direct X’s significant activities is shared by Y and Z in that their agreement stipulates that all significant decisions involving X must be made jointly.
Which one should consolidate X?

Conclusion:

It appears that Y and Z are both primary beneficiaries of X.

The primary beneficiary is the one that has:

1) power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, and

2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

In this example, neither Y nor Z has power in that it is shared among them. Further, the shareholder has no power. Thus, the first criterion is not satisfied and no party can be considered the primary beneficiary. X is not consolidated.

Note further, that typically the majority shareholder in X would be considered the primary beneficiary in that the decision-making rests with the shareholder. However, in this example, the shareholder’s investment is not at risk, resulting in the equity investment not being considered a variable interest in X. As a result, Y and Z are the only entities that hold variable interests in X.

3. Related-party rules – primary beneficiaries:

There is trap in FIN 46R under which related parties, in particular, brother-sister entities, may be required to consolidate with each other solely due to their related-party affiliation.

FIN 46R states the following:

a. In determining whether a reporting enterprise (or individual) is the primary beneficiary of a VIE, an enterprise (or individual) with a variable interest shall treat variable interests in that same VIE held by its related parties as its own interests.

b. A related party includes:

   - Related parties defined in FASB No. 57, Related Party Disclosures (ASC 850), and

   - De facto agents or principals of the variable interest holder.

FASB No. 57 (ASC 850) defines related parties as:

“affiliates of the reporting enterprise, equity investments, trusts for the benefit of employees, the principal owners of the reporting enterprise, its management, members of the immediate families of the principal owners of the reporting enterprise and its management, and other parties with which the reporting enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate
interests, or another party that can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.”

The list of related parties includes:

- Parent company and its subsidiaries
- Subsidiaries of a common parent
- A reporting enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the entity’s management
- An entity and its principal owners, management, or members of their immediate families
  - **Principal owners** are owners of record or known beneficial owners of **more than 10 percent** of the voting interests in the entity.
  - **Immediate family members** are those who a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- Affiliates of the reporting enterprise, including a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

3. **De facto agents and principals** of a variable interest holder consist of any of the following:

- A party that cannot finance its operations without subordinated financial support from the variable interest holder, for example, another VIE of which the entity is the primary beneficiary
- A party that received its variable interests in the VIE through a contribution or loan from the variable interest holder
- An officer, employee, or member of the governing board of the variable interest holder
- A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE **without the prior approval** of the variable interest holder

  - **Note:** The right of prior approval creates a de facto agency relationship only if that right could constrain the other party’s ability to manage the economic risks or realize the economic rewards from its rewards in a VIE through the sale, transfer, or encumbrance of those interests.
However, a de facto agency relationship does not exist if both the reporting enterprise and the party have right of prior approval and the rights are based on mutually agreed upon terms by willing, independent parties.

- A party that has a close business relationship with the variable interest holder such as a professional service provider (accountant or lawyer) relationship with one of its significant clients.

Examples:

The following series of examples illustrate the allocation of the related party rules in conjunction with the other rules found in FIN 46R.

Example 1: Company Y is the primary beneficiary of Company X through being the majority holder of various variable interests including guarantees, subordinated loans, and management fees.

Y does not want to consolidate X and comes up with a plan to avoid consolidation.

Y decides to transfer several of its variable interests in X to Y’s attorney who provides significant legal services to Y. After the transfer, Y is no longer the primary beneficiary and believes it is not required to consolidate with X.

Conclusion: Wrong conclusion. Under FIN 46R, the variable interests of a variable interest holder are combined with those of all related parties and de facto agents. The definition of a de facto agent includes any party that has a “close business relationship” with the variable interest holder such as a professional service provider. In this case, Y’s attorney is considered a de facto agent of Y and thus, the attorney’s variable interest in X is combined with Y’s to determine whether Y is the primary beneficiary of X.

Example 2: Company Y has a variable interest in Company X but is not the primary beneficiary. Y wishes to purchase an equity investment in Company X but is concerned that, by doing so, it will be considered the primary beneficiary of X, requiring consolidation.

Y asks Company C to purchase the equity investment in Company X on its behalf and makes a loan to C for it to fund the purchase. Y believes that it has circumvented the consolidation rules by having C purchase the equity investment in X, and, thus not being considered the primary beneficiary of X.

Conclusion: Wrong, again. C is considered a de facto agent of Y because it received a loan from Y in order to purchase the equity investment in X. Therefore, C’s equity investment in X is combined with Y’s other variable interests in X in determining whether Y is the primary beneficiary of X.

Because Y now has several variable interests in X, including the equity investment held by C, Y may be the primary beneficiary of X, thus requiring consolidation of X.
Tie-breaker rule for related parties

FIN 46R provides a tie-breaker rule as a method to determine the primary beneficiary among several related parties.

The tie-breaker rule applies only if there are several related parties, and no party within the group satisfies both criteria to being a primary beneficiary (the power criterion and losses/benefits criterion), but as a group, both criteria are met. Thus, collectively the related parties satisfy the two criteria for being a primary beneficiary but individually, no one party within the group meets both criteria.

The tie-breaker rule works like this:

1. If a reporting enterprise concludes that neither it nor any other of its related parties individually satisfies the two criteria to be a primary beneficiary, but, as a group, the enterprise and its related parties (including de facto agents) do satisfy the two criteria, the tie-breaker rule shall be used to determine which party within the related party group is the primary beneficiary that consolidates the VIE.

2. Under the tie-breaker rule, the related party that is designated to be the primary beneficiary is the party within the related party group, that is **most closely associated with the VIE**.

3. The determination of which party within the related party group is most closely associated with the VIE requires judgment and should be based on an analysis of all relevant facts and circumstances including:
   a. The existence of a principal-agency relationship between parties within the related party group.
   b. The relationship and significance of the activities of the VIE to the various parties within the related party group.
   c. A related party’s exposure to the variability associated with the anticipated economic performance of the VIE.
   d. The design of the VIE, such as the purpose for which the entity was created.

Observation: The FASB’s inclusion of the “most closely associated” provision within the tie-breaker rule is ambiguous and gives a group of related parties tremendous latitude in designating a primary beneficiary to consolidate a VIE. In the first Interpretation, the determination was based on “activities most closely associated with the VIE.” In the revised Interpretation, the concept of activities was eliminated and replaced with “the related party most closely associated with the VIE.” What does this mean? FIN 46R gives little guidance on how to select the finalist as the primary beneficiary among a group of related parties. Factors it does include are:
   a. The existence of a principal-agency relationship between parties within the related party group.
   b. The relationship and significance of the activities of the VIE to the various parties within the related party group.
c. A related party’s exposure to the variability associated with the anticipated economic performance of the VIE.

d. The design of the VIE, such as the purpose for which the entity was created.

After the initial Interpretation was issued, the FASB Staff reviewed a series of case studies submitted to them in which conclusions were reached as to which entity had activities most closely associated with those of the VIE. In many instances, the FASB Staff determined that the conclusions reached were not consistent with the intent of the FASB. That is, in many instances, the wrong entity or individual was selected as having activities most closely associated with the VIE, and thus, the wrong entity or individual was deemed the primary beneficiary.

In the revised Interpretation, the FASB decided to make the “most closely associated” criteria vague. By doing so, entities have greater flexibility to determine which entity or individual is most closely associated with the VIE and would be able to evaluate all facts and circumstances in making that decision.

Examples illustrating the application of the related party and tie-breaker rules:

Example 1:

Company X is a VIE. Company Y and Z are related parties that have variable interests in X. Y has the power to direct the activities of X that are significant to X’s economic performance. Z has the obligation to absorb the losses of X and/or the right to receive the residual returns of X. Neither Y nor Z individually satisfies both criteria.

Conclusion: Y and Z must use the tie-breaker rule to determine which of them is the primary beneficiary. In doing so, Y and Z determine which of them is most closely associated with X using the four factors. That entity is the primary beneficiary that consolidates X.

Change the facts:

Y satisfies both criteria to being a primary beneficiary (power criterion and losses/benefits criterion). Z satisfies the second criterion only (losses/benefits criterion).

Conclusion: The tie-breaker rule is not applicable because individually, one of the related parties (Y) satisfies both criteria. Y is the primary beneficiary and consolidates X.

Example 2: Company X, a manufacturer of packaging materials, is a VIE as it does not have sufficient equity to finance its activities without additional subordinated financial support from other parties.

X’s 100% shareholder is John.

Company A and B are related parties of X.

Company A is a manufacturer of golf clubs. Periodically, X sells packaging and boxes to Company A.
Company B is a consulting company. B does no day-to-day business with X.

Company A and B each has variable interests in X.

- Company A is the guarantor of X’s bank loan and has also made a significant unsecured loan to X. In return, A receives 90% of the residual returns of X if X is ultimately sold. John receives the other 10%.

- Company B has made a subordinated (second mortgage) loan to X.

- John’s variable interest is through his equity ownership in X. In general, John has the power to direct X’s significant activities.

- There are variable interests held by other unrelated entities that, individually, are not significant.

**Conclusion:** Because X is a VIE, it does not have a sufficient equity investment to finance its activities without additional subordinated financial support from other parties.

Presently, X receives its support from outside entities including A (through its guarantee and loan), B (through its subordinated debt), and other variable interest holders.

**Who is the primary beneficiary of X? Is it A, B, John, or none?**

FIN 46R states that each variable interest holder is required to assess whether it is a primary beneficiary of a VIE by having a controlling financial interest in a VIE. That controlling financial interest is achieved based on having the:

1) Power to direct the activities of a VIE that most significantly impact the entity’s economic performance, and

2) The obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

In this example, John appears to have the power to direct the activities of X that most significantly impact X’s economic performance. Further, Company A appears to be the entity that has the obligation to absorb the losses and right to receive most of the residual returns of X if it is ultimately sold. Thus, the two criteria for determining who is the primary beneficiary are split between John and Company A.

Under the tie-breaker rule, the related party, within the related party group, that is *most closely associated with the VIE* is the primary beneficiary.

The determination of which party within the related party group is most closely associated with the VIE requires judgment and should be based on an analysis of all relevant facts and circumstances including:

1. The existence of a principal-agency relationship between parties within the related party group.
2. The relationship and significance of the activities of the VIE to the various parties within the related party group.

3. A related party’s exposure to the variability associated with the anticipated economic performance of the VIE (the extent to which the party will absorb the VIE’s losses or receive the VIE’s residual returns).

4. The design of the VIE, such as the purpose for which the entity was created.

In this case, the initial conclusion is that Company A is most closely associated with Company X for several reasons.

First, there is no principal-agency relationship between Company A and X, so that the first factor is irrelevant.

Second, X and A are both manufacturers and, therefore, have activities that are more closely associated with each other than X has with either B or John.

Third, Company A has more variable interests in X (through both the guarantee and the unsecured loan) than John, and presumably, is exposed to a significant amount of losses of X.

Fourth, there is no information as to the purpose of X’s design and whether such design was created for X’s relationship with Company A. Thus, assume that this fourth factor provides no bias toward any of the variable interest holders.

Assuming there are no other important factors, Company A should be designated as the primary beneficiary and should consolidate Company X. This conclusion is based on the above factors that suggest that Company A is more closely associated with X than John.

Is it possible that two entities each consider themselves the primary beneficiary?

It is conceivable that two variable interest holders reach the same conclusion independently of each other, and that each concludes that it is the primary beneficiary of X. In such circumstances, in error, two variable interest holders would each consolidate a VIE’s financial statements with its own. FIN 46R does not deal with the issue of having two primary beneficiaries. In fact, it states that there can be only one primary beneficiary.

4. The Lease Issue-Implicit Variable Interests

Perhaps one of the most confusing elements of the 46R rules is determining whether a lessee is required to consolidate a lessor who is a VIE. FIN 46R provides limited guidance on dealing with lease-related transactions, and certainly does not specifically address the numerous permutations that exist in such lease structures.

For example,

How should a lessee deal with a lease that includes a residual value guarantee, option to purchase, or renewal options?
Should the accounting for a lease be different if the lease is above- or below-market value?

In this section, the author reviews various lease situations, separating them into those leases involving unrelated parties versus related parties. Because there is limited authority, many of the conclusions reached by the author in this section are non-authoritative and based on discussions the author has had with FASB staff members and others. Further, some of the conclusions reached may differ from those opinions given by other authors and commentators. Remember that FIN 46R was written under the umbrella of principle-based accounting under which no hard and fast rules are supposed to apply and the user is required to look at the economic substance of the transaction instead of its form.

Operating lease – unrelated parties:

If the lessor and lessee are not related parties, the general rules follow, from the lessee’s perspective. Assume that the lessor is a VIE.

1. If the lease is at a market rate and terms for a similar property in the same general geographic location, and there is no residual guarantee, no option to purchase at a fixed or predetermined price, or no lease renewal option at a fixed or predetermined lease amount, then the lease is not a variable interest, and the lessee is not the primary beneficiary that consolidates the lessor VIE.

2. If the lease terms are above- or below-market value, the lease is a variable interest.

3. If the lease (regardless of whether the lease is at market value or not) has any of the following, the lease is a variable interest and the lessee could be the primary beneficiary that consolidates the lessor VIE:
   - Residual value guarantee
   - Option to purchase the property at a fixed or predetermined price, or
   - Lease renewal option at a fixed or predetermined lease amount for a term that is beyond the lease term.

Thus, a straight market-value lease with no variability through a residual value guarantee, no option to purchase at a fixed or predetermined price, or lease renewal option at a fixed or predetermined rate, is not a variable interest.

If, instead the lease deviates from market value (e.g., above- or below-market value terms), and/or has a residual value guarantee, an option to purchase at a fixed or predetermined price, or a lease renewal option at a fixed or predetermined lease amount for a term beyond the lease term, that lease is a variable interest. If the lease is a variable interest, the lessee could be the primary beneficiary.
**Does it matter whether the lease is treated as an operating or capital lease by the lessee?**

No. How the lessee accounts for the lease (operating or capital lease) has no impact on whether the lease is a variable interest in the lessor VIE.

**What if the option to purchase or lease renewal option is at a variable rate based on some sort of market formula or at market value at the time the option is exercised?**

If the option to purchase or lease renewal option is not at a fixed or predetermined price or rate, and instead is at a market value rate, such an option does not make the lease a variable interest. The reason is because the option holder (the lessee) does not have any variability in the option. That is, the option will never deviate from market value and there will not be any loss or residual return that will shift to the lessee because of that option.

For example, if the option to purchase is at a fixed price, there is the risk that the option holder (lessee) will absorb losses or receive gains from the option price being lower than the market value price at the time the option is exercised. Presumably, if the option price were higher than market value, the lessee would not exercise the option unless the lessee must do so to protect the location for its business. If the fixed option price is lower than the market value, the lessee option holder would be receiving a portion of the residual returns that belong to the equity holders. Therefore, the lease would be a variable interest.

If, instead, the option price is at market value and not fixed, there is no risk that the lessee option holder would absorb a loss or receive a return from the option price being different than its market value.

Thus, a lease that has an option to purchase or lease renewal option at a fixed or predetermined price or rate is a variable interest while one that is based on a floating market value is not.

**What if a lease has a market lease payment with periodic increases (such as CPI increases)?**

FIN 46R does not address such details. However, if overall lease terms, including periodic increases, are consistent with market terms for similar property in the same general geographic location, the lease should be considered to be at market value and the lease is not a variable interest.
DECISION AS TO WHETHER AN UNRELATED LESSEE CONSOLIDATES A LESSOR

Is the lease at market value?

NO

YES

Does the lease have a residual value guarantee?

NO

YES

Does the lease have an option to purchase at a fixed or predetermined price?

NO

YES

Does the lease have a lease renewal option at a fixed or predetermined price?

Lease is not a variable interest

NO

Lease is a variable interest

NO

YES

Does lessee have the power to direct the lessor’s significant?

NO

YES

Does lessee have the obligation to absorb losses or right to receive residual returns that are significant to lessee?

NO

Lessee is not the primary beneficiary

Lessee does not consolidate the Lessor

YES

Lessee is the primary beneficiary

Lessee consolidates the Lessor
Let’s look at several examples that illustrate the application of the rules to leases among unrelated parties.

**Example 1: Operating Lease – Unrelated Parties**

**Facts:** Lessee (Y) and lessor (X) are unrelated parties and have signed a market-value operating lease with no residual value guarantee, no option to purchase, or renewal option. There are no variable interests between the parties such as loans, guarantees, etc.

Under the lease, the lessee does pay a portion of the operating expenses of the leased property, but does not manage the day-to-day operations of the property nor make significant decisions about the property.

X, the lessor, is a VIE because it has a bank loan that is at 75% loan-to-value and its owner has guaranteed the loan.

**Conclusion:**

Because the lease is at market value and has no residual value guarantees, no purchase option and no lease renewal option, the lease is not a variable interest. The reason is because there is no variability in the lease; that is, the lessee will not absorb any losses of the VIE or receive any of the residual value of the VIE. If the leased asset increases or decreases in value, the lessee does not share in that upside or downside.

Therefore, Y (lessee) will not be the primary beneficiary that consolidates X (lessor) because Y has no variable interests in X.

**What if the lease is above or below market value?**

If the lease is above- or below-market value, it is a variable interest even if there is no residual guarantee, option to purchase, or renewal option. However, in this case, the lessee would most likely not be the primary beneficiary because through the lease, the lessee does not have the power to direct the activities of the lessor that are potentially significant to the lessor. That power lies with the equity owner of the lessor.

**Example 2: Operating Lease with Renewal Option – Unrelated Parties**

Same facts as Example 1 except the lessee has two, five-year renewal options (10 years total) at a fixed rate plus small percentage increases per year.
Conclusion:

Although there is an operating lease, the fact that there is a renewal option means that Y (the lessee) has a variable interest in X.

Now that Y (the lessee) has a variable interest, the next step is to determine who holds the variable interests.

Variable interest holders are:

- Company Y (lessee) has a variable interest through its residual value guarantee.
- The owner of X has a variable interest through its loan guarantee and equity ownership.

The primary beneficiary is the party that has the:

1. power to direct the activities of X that most significantly impact X's economic performance, and
2. obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

In this example, the fact that Y (the lessee) does not manage the day-to-day operations nor make significant decisions about the property, Y probably does not have the power to direct the significant activities of X. Instead, that power lies with the owner of X through his or her equity ownership.

Second, because the owner of X has the power to direct X's significant activities, the next issue is whether the owner also has the obligation to absorb the losses of X or the right to receive residual returns of X that might potentially be significant to X. Through its loan guarantee and equity ownership, clearly the owner of X has both the obligation to absorb losses and right to receive benefits from X that could potentially be significant to X.

Thus, the owner of X is the primary beneficiary. If the owner is an individual, he or she would not consolidate X.

Note that Y, as lessee, may also have the obligation to absorb losses of X or receive residual returns of X through Y’s fixed lease renewal option. However, that fact is moot because Y does not have the power to direct X’s significant activities and cannot be the primary beneficiary.

Example 3: Triple-net lease – unrelated parties

Facts: Lessee and lessor have signed a lease at market rates commensurate with the leased property and general geographic area. The lessee is a single-tenant lessee for the entire 100,000 square foot facility.
Lessor is a VIE in that it has a bank loan that is 75% loan to value and its owner has guaranteed the loan.

Under the lease, the lessee:

- Pays all operating expenses (triple-net lease)
- Manages the property and makes all decisions about the property
- Performs all maintenance on the property.

There is no residual value guarantee other than the lessee must maintain the property and return it to the approximate condition that the property existed in at the inception of the lease. Further, there is no option to purchase the property and there is no lease renewal option.

**Conclusion:**
The lease is at market value with no residual value guarantee. Therefore, there is no variability in the lease in that the lessee does not absorb any of the upside or downside in value of X’s property. The fact that the lessee must maintain the condition of the property does not mean the lessee has a requirement to guarantee the value of the property. Thus, the lease is not a variable interest and the lessee will not be the primary beneficiary that consolidates X.

Interestingly, the fact that the lease is triple net and the lessee manages the property and takes responsibility for the operations of the property would probably mean the lessee has the power to direct the activities of the lessor (the power criterion). That is one of the requirements for a variable interest holder to be a primary beneficiary. However, because the lessee holds no variable interest, it will never absorb the losses of X nor receive any of the residual returns of X (the losses/benefits criterion) to be a primary beneficiary.

**Example 4: Triple-net lease with residual value guarantee- unrelated parties**

Same facts as Example 3 except that the lease has a residual-value guarantee. The lessee guarantees that the property will have a value of not less than $10 million at the end of the lease based on two appraisals or the ultimate sale of the property at the end of the lease.
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Conclusion:
Because Y has a residual guarantee, Y has the obligation to absorb some of the losses of X if the property value declines. Thus, Y has a variable interest in X (the VIE).

Now that Y (the lessee) has a variable interest, the next step is to determine who holds the variable interests.

Variable interest holders are:
- Company Y (lessee) has a variable interest through its residual value guarantee.
- The owner of X has a variable interest through its loan guarantee and equity ownership.

The primary beneficiary is the party that has the:
1. power to direct the activities of X that most significantly impact X’s economic performance, and
2. obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

First, through its lease, the lessee has the power to direct the activities of X in that Y:
- Pays all operating expenses (triple net lease)
- Manages the property and makes all decisions about the property
- Performs all maintenance on the property.

Secondly, because Y has the power (power criterion), does Y also have the obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X? Yes, through the residual value guarantee, Y does have the obligation to absorb losses of X that could be significant to X.

Thus, Y is the primary beneficiary that should consolidate X.

Note that Y may not necessarily be the variable interest holder that has the obligation to absorb the largest amount of losses or right to receive the majority of residual returns. What the rules state is that the variable interest holder must have the obligation to absorb losses that might potentially be significant to the VIE. Although FIN 46R does not define what “significant” is, it would seem that the risk of guaranteeing the value of X would satisfy the "significant" threshold.
The owner of X (through its equity ownership and guarantee of X’s debt) also has the obligation to absorb losses and has the right to receive residual returns that might potentially be significant to X. However, that owner cannot be the primary beneficiary because he/she does not have the power to direct the significant activities of X. That power rests with Y as the lessee, through its lease.

Example 5: Triple-net lease with lease renewal option at fixed rate- unrelated parties

Same facts as Example 3 except that the lease has a lease renewal option for two, five-year options (10 years total beyond the base lease term) at a fixed rate plus annual increments.

Conclusion:
Because the lease has a fixed lease renewal option, the lessee has the obligation to absorb some of the losses of X if the property value declines. Thus, the lessee has a variable interest in X (the VIE).

Now that Y (the lessee) has a variable interest in X, the next step is to determine who holds the variable interests.

Variable interest holders are:

- Company Y (lessee) has a variable interest through its lease renewal option.
- The owner of X has a variable interest through its loan guarantee and equity ownership.

The primary beneficiary is the party that has the:

1. Power to direct the activities of X that most significantly impact X’s economic performance, and
2. Obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

First, through its lease, Y (lessee) has the power to direct the activities of X in that Y:

- Pays all operating expenses (triple-net lease).
- Manages the property and makes all decisions about the property.
- Performs all maintenance on the property.
Secondly, because Y has the power (power criterion), does Y also have the obligation to absorb losses of X or the right to receive benefits of X that could potentially be significant to X? Yes, through the lease renewal option, Y does have the obligation to absorb losses of X that could be significant to X. The fact that the property has a single-tenant, it would appear that losses or residual returns generated from the spread between market value and a fixed lease option would most likely be significant to X.

Thus, Y is the primary beneficiary that should consolidate X.

Observation: In the above example, there is a single-tenant building and a tenant that has a lease renewal option. The author reached the conclusion that the tenant (lessee) is the primary beneficiary that consolidates the VIE (X). In reaching the conclusion that Y is the primary beneficiary, the author believes that Y has the power to direct X’s significant activities because Y has a triple-net lease in which Y manages the property as if it were the owner of the property. In concluding that Y also has the obligation to absorb X’s losses or right to receive X’s residual returns that may be potentially significant to X, the author believes that the fact that Y is a single tenant in the building elevates the impact of its variable interest (lease renewal option) to being significant to X.

Thus, the author reaches the conclusion that Y is the primary beneficiary that consolidates X.

What if Y were not a single tenant?

If there are several tenants in the building, there may be a question as to whether Y’s lease renewal option would elevate Y’s obligation to absorb X’s losses or right to receive residual returns of X to being significant. In some instances, depending on the amount of Y’s lease income relative to the total lease income for the property, such losses and/or residual returns may not be significant. If not significant, Y (lessee) is not the primary beneficiary and does not consolidate X. In order for the lease renewal option to be a variable interest in the VIE as a whole, the leased property to which the option applies must be more than 50 percent of the fair value of the total property fair value.

What if the lessor in the above example has real estate that has a fair value of $1,000,000 and a mortgage balance outstanding of $500,000, with the remainder $500,000 being equity. Moreover, there are no guarantees of the $500,000 loan, that is, it is a nonrecourse loan.

Conclusion:
The fact that the lease has a lease renewal option is irrelevant. X is not a VIE and will not be consolidated.

The reason why X is not a VIE is due to the fact that it has demonstrated that it can obtain non-recourse financing, without any additional subordinated support such as a guarantee.

Remember, once an entity is not a VIE, it will not be consolidated and no analysis of the variable interest holders to find a primary beneficiary is necessary.
Operating lease – related parties:

Not all related party leases result in the lessee consolidating the lessor VIE. Nevertheless, the rules are slightly different than those for unrelated party leases and more related-party lessees will consolidate the related party lessor VIE if certain conditions are met. In many instances, leases among related parties may have a result that is different than leases among unrelated parties.

Before looking at the rules for operating leases involving related parties, let’s review the implicit variable interest rules that the author addressed earlier in the course and that may impact the determination as to whether a related-party lessee consolidates its lessor VIE.

The general concepts of an implicit variable interest follow:

1. If an enterprise has an implicit variable interest in a VIE, the enterprise (e.g., operating entity) may be required to absorb the variability of the VIE or potential VIE.

   Example: Through its relationship with a common owner guarantor, an operating company may be called upon to satisfy the owner’s guarantee of a VIE’s debt.

2. An implicit variable interest (e.g., indirect guarantee) acts the same as an explicit variable interest (direct guarantee) except that an implicit variable interest involves absorbing and/or receiving the variability indirectly from the VIE, rather than directly from the VIE.

3. If an enterprise has an implicit variable interest in a VIE, the enterprise could be considered the primary beneficiary of the VIE.

The following fact pattern is used to deal with the related-party leasing rules:

Assume:

- Company X (an LLC) is a lessor and a VIE.
- Company Y (an LLC) is a related party lessee of the real estate held by X.
- John, is the 100% individual owner of both X and Y.

Rules for related party leases from the perspective of the lessee (Company Y).

1. If the lease has a market value rate and terms, with no residual value guarantee, no option to purchase at a fixed or predetermined price, and no lease renewal option at a fixed or predetermined lease amount, the following rules apply:

   a. If there are no guarantees of X’s debt by John or Y (lessee), then Y is not the primary beneficiary of X and does not consolidate X.

   b. If there is a guarantee of X’s debt by Y, then Y is the primary beneficiary and consolidates X.
c. If there is a guarantee of X’s debt by John only:

- Y has an implicit guarantee of X’s debt and is the primary beneficiary that consolidates X if it is likely that John will have to call upon Y to satisfy John’s guarantee if that guarantee is called by the lender.

- Y does not have an implicit guarantee of X’s debt and is not the primary beneficiary that consolidates X if it is not likely that John will have to call upon Y to satisfy John’s guarantee if that guarantee is called by the lender.

2. If the lease has any of the following elements (regardless of the other terms of the lease), Y (lessee) is the primary beneficiary and consolidates X regardless of whether X’s loan is guaranteed by John and/or Y.

   a. The lease is above or below market value.
   b. The lease has a residual value guarantee.
   c. The lease has an option to purchase at a fixed or predetermined price, or
   d. The lease has a renewal option(s) at a fixed or predetermined lease amount for a lease period beyond the base lease term.

Observation: In general, if there is a related-party lease (market rate lease with no option, no residual value guarantee or renewal option), the lease is not a variable interest and the lessee does not consolidate X, as long as John (the owner) and/or the lessor are not guaranteeing X’s debt.

If, instead, John is guaranteeing the debt and it is likely that John may have to call upon Y to satisfy its guarantee obligation if the lender calls that guarantee, that guarantee is assigned to Y (the lessee) as an implicit guarantee of X’s debt. Once Y has an implicit guarantee of X’s debt, Y is the primary beneficiary and consolidates X.

Let’s look at a few examples.

**Example 1: Lease with no residual value guarantee, no option to purchase, and no lease renewal – related parties**

**Facts:**

- John is a 100% shareholder of Company X (lessor VIE) and Company Y (lessee operating company).
- X is a VIE and owns real estate that it leases to Company Y.
- The lease is at a market rate with no residual value guarantee, no option to purchase at a fixed price, and no renewal options. There are no variable interests between the parties such as loans, guarantees, etc.
Conclusion: Because the lease is at a market rate, with no residual value guarantee, no purchase option at a fixed price, and no lease renewal option at a fixed lease rate, the lease is not a variable interest. Further, there are no guarantees of X’s debt by either Y or the common owner. Thus, there is no risk of there being an implicit guarantee of X’s debt being assigned to Y.

Therefore, Y (lessee) is not the primary beneficiary that consolidates X (lessee). Instead, John, the 100% equity holder is the primary beneficiary and, as an individual, would not consolidate X.

Example 2: Lease with above-market lease rate

Same facts as Example 1 except that the monthly lease payments are above market value.

Conclusion:

Because the lease does not have a market lease rate, the lease is a variable interest. The reason is because by paying higher than market lease payments, the lessee is absorbing losses that would otherwise be absorbed by other variable interest holders such as equity holders.

Next question is whether Y is the primary beneficiary, which is the party that has:

1. Power to direct the activities of X that most significantly impact X’s economic performance, and
2. Obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

First, through its variable-rate lease, and its relationship with John, Y (lessee) has the power to direct the activities of X.
Secondly, because Y has the power (criterion 1), does Y also have the obligation to absorb losses of X or the right to receive benefits of X that could potentially be significant to X? Yes, through the fluctuating lease payments, Y does have the obligation to absorb losses of X that could be significant to X.

Thus, Y is the primary beneficiary that should consolidate X.

**Example 3: Lease with residual value guarantee – related parties**

**Facts:**

- John is a 100% shareholder of Company X (lessor VIE) and Company Y (lessee operating company).
- X is a VIE and owns real estate that it leases to Company Y.
- The lease is at a market lease rate with a residual value guarantee under which the lessee is required to guarantee the value of the real estate at $2 million at the end of the lease.

**Conclusion:**

Because the lease has a residual guarantee, the lessee has the obligation to absorb some of the losses of X (the VIE) if the property value declines. Thus, the lessee has a variable interest in X (the VIE).

Next question is whether Y is the primary beneficiary, which is the party that has:

1. power to direct the activities of a VIE that most significantly impact the entity’s economic performance, and
2. obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

First, through its lease, its relationship with John, and the residual value guarantee, Y (lessee) has the power to direct the activities of X.

Secondly, because Y has the power (power criterion 1), does Y also have the obligation to absorb losses of X or the right to receive benefits of X that could potentially be significant to X? Yes, through the residual value guarantee, Y does have the obligation to absorb losses of X that could be significant to X.

Thus, Y is the primary beneficiary that should consolidate X.

**Example 4: Lease with loan guarantee by owner**

**Facts:**

- John is a 100% shareholder of Company X (lessor VIE) and Company Y (lessee operating company).
- X is a VIE and owns real estate that it leases to Company Y.
- The lease is at a market lease rate with no residual value guarantee, no option to purchase at a fixed price, and no renewal options. There are no variable interests between the parties such as loans, guarantees, etc.
- X has a $1,000,000 bank loan and John has personally guaranteed that loan.
- Y has not guaranteed X’s loan although there are no restrictions to Y if it had chosen to guarantee X’s loan. Y has not guaranteed the loans of any entities in the past.
- John’s primary assets are his 100% equity holding in Y and X.

Because the lease is at a market rate, with no residual value guarantee, no purchase option, and no lease renewal option, the lease is not a variable interest.

Without any additional information, Y would have no variable interests and would not consolidate X. However, there is one additional piece of information that changes the conclusion. John is the guarantor of X’s bank loan, a primary asset of John that would be used to satisfy that guarantee if it were to be called would be Y’s net assets. Thus, Y may have an implicit guarantee of X’s loan.
In making a determination as to whether Y has an implicit guarantee, Y should ask the following questions.

Even though there is no contractual obligation for Y to do so:

1. Does Y have the obligation to protect X against loss?
2. Does Y have an economic incentive to protect X against loss?
3. Has Y acted as a protector in similar situations in the past?
4. Would Y acting as a protector of X be a conflict of interest or be illegal?

**Does Y have the obligation to protect X against loss?** Yes. Y is a primary asset of John that would be used to fulfill John's obligation under the guarantee.

**Does Y have the economic incentive to protect X against loss?** Yes. Y's incentive is through its relationship with John.

**Has Y acted as a protector in similar situations in the past?** No. Y has not guaranteed the loans of other entities in the past.

**Would Y, acting as a protector of X, be a conflict of interest or be illegal?** No. The facts state that Y would not be precluded from guaranteeing X's loan if it chose to do so.

Y indirectly has both the obligation and incentive to protect X against a loss (questions 1 and 2 above) if the bank loan were to be called. That is, if John's guarantee were to be called, Y would have both the obligation and incentive to pay for the loss.

Y has not acted as a guarantor in the past (question 3) and Y would have no conflict of interest if Y acted as a guarantor of X's loan (question 4).

The answers to the questions above, particularly questions 1 and 2, support that Y has an implicit guarantee of X's loan which is a variable interest in X. The implicit guarantee exists even though there is no explicit (contractual) variable interest through its lease with X.

**Who holds the variable interests in X?**

John holds variable interests in X through John's (explicit) guarantee and his equity ownership.

Y holds a variable interest in X through its implicit guarantee of X's bank loan.

Bank has a variable interest in X through its bank loan.

**Who is the primary beneficiary?**

The primary beneficiary is the party that has the:

1. power to direct the activities of X that most significantly impact X's economic performance, and
2. obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.
In this example, through the related party relationship with John and its implicit guarantee of X’s bank loan, Y (lessee) has the power to direct the activities of X.

Second, because Y has the power (criterion 1), does Y also have the obligation to absorb losses of X or the right to receive benefits of X that could potentially be significant to X? Yes, through its implicit guarantee, Y does have the obligation to absorb losses of X that could be significant to X.

Thus, Y is the primary beneficiary that should consolidate X.

Note further that John too has the obligation to absorb losses of X and the right to receive benefits. However, John does not have the power to direct X’s significant activities.

**Example 5: Lease with Lessee guarantee**

Same facts as Example 4 except that Company Y directly guarantees X’s loan.

**Conclusion:**

Y has an (explicit) guarantee of X’s loan.

Y has both the power to direct X’s significant activities through the guarantee and lease, and through the guarantee has the obligation to absorb X’s losses that could potentially be significant to X.

Y is the primary beneficiary of X and consolidates X.

**Example 6: Lease with implicit guarantee – related party with no involvement**

**Facts:**

John is the 100% owner of Company Z (a marketing company) and Company X (real estate lessor VIE).

Z has no direct financial involvement with X through leases, loans, guarantees, etc.

Z has not acted as a guarantor in the past and if Z were to guarantee a loan, it would not be in violation of any covenants or laws.

John has guaranteed X’s bank debt. Z has not guaranteed X’s bank debt.

John’s equity ownership in Z and X are John’s primary assets to the extent that John would have to use Z to fund any guarantee of X’s loan.

**Conclusion:**

Even though Z has no direct involvement with X, it is likely that Z has an implicit guarantee of X’s debt.

In making a determination as to whether Z has an implicit guarantee in X, Z should ask the following questions.
Even though there is no contractual obligation for Z to do so:

1. **Does Z have the obligation to protect X against loss?**
2. **Does Z have an economic incentive to protect X against loss?**
3. **Has Z acted as a protector in similar situations in the past?**
4. **Would Z acting as a protector of X be a conflict of interest or be illegal?**

**Does Z have the obligation to protect X against loss?** Yes. Z is the primary asset of John that would be used to fulfill John's obligation under the guarantee.

**Does Z have the economic incentive to protect X against loss?** Yes. Z’s incentive is through its relationship with John.

**Has Z acted as a protector in similar situations in the past?** No. Z has not acted as a guarantor in the past.

**Would Z acting as a protector of X be a conflict of interest or be illegal?** No. The facts state that Z would not be precluded from guaranteeing X’s loan if it chose to do so.

Z indirectly has both the obligation and incentive to protect X against a loss (questions 1 and 2 above) if the bank loan were to be called. That is, if John’s guarantee were to be called, Z would have both the obligation and incentive to pay for the loss.

Z has not acted as a guarantor in the past (question 3) and Z would have no conflict of interest if Z acted as a guarantor of X’s loan (question 4).

Thus, Z does have an implicit guarantee of X’s loan.

**Who holds the variable interests in X?**

John holds variable interests in X through John's (explicit) guarantee and his equity ownership.

Z holds a variable interest in X through its implicit guarantee of X’s bank loan.

Bank has a variable interest in X through its bank loan.

**Who is the primary beneficiary?**

The primary beneficiary is the party that has the:

1. power to direct the activities of X that most significantly impact X’s economic performance, and
2. obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.

First, through the related-party relationship with John and its implicit guarantee of X's bank loan, Z could have the power to direct the activities of X. However, that power is likely to reside with John, not Z, due to the fact that Z has no involvement with X through a lease, loan, etc.
Secondly, because John has the power (criterion 1), does John also have the obligation to absorb losses of X or the right to receive benefits of X that could potentially be significant to X? Yes, through John’s (explicit) guarantee and his equity investment in X, John has the obligation to absorb losses and the right to receive residual returns of X that could be significant to X.

Thus, John is the primary beneficiary and as an individual, would not consolidate X.

**Observation:** The above example illustrates the rather distorted nature of certain aspects of FIN 46R as it relates to who can hold an implicit guarantee of another party. There is no requirement that a related party have any pecuniary involvement with a VIE in order for there to be an implicit guarantee. In fact, FSP FIN 46(R)-5, as amended, states “the significance of an enterprise’s involvement or interest should not be considered in determining whether the enterprise holds an implicit variable interest in the entity (VIE).”

Thus, a related-party entity, with no direct involvement with a VIE through loans, guarantees, etc. could have an implicit guarantee simply by being a primary asset of a common owner who would be called upon to fulfill that guarantee.

Once an implicit guarantee is assigned to a related party with no involvement in the VIE (company Z in this example), the next question is whether that related party (Z) would be considered the primary beneficiary that consolidates X. The author reaches the conclusion that without any involvement of Z with X (VIE), Z would not be the primary beneficiary because Z would not have the power to direct X’s significant activities. That power would rest in the common owner, John.

Once Z has no power to direct X’s activities, the issue as to whether Z would absorb X’s losses or receive its residual returns would be moot.

The conclusion is that, even though Z has an implicit guarantee, the author believes Z would not be considered the primary beneficiary unless Z has some “involvement” with X through a lease, explicit guarantee, loan, etc.

**In determining whether an operating entity lessee “may be required” to fund the owner’s guarantee of the VIE’s debt (Condition 2), should one look into the personal net worth of the individual owner guarantor?**

An implicit guarantee is based on the premise that a related-party entity (e.g., operating entity lessee) may be called upon to pay for the owner’s guarantee of the VIE’s debt. That is, because the equity ownership of the operating company is an asset of the owner, that asset may be used to fund the guarantee.

For example, assume Company Y is an operating company lessee and X is the VIE lessor. John guarantees the bank debt of X. If X defaults and the bank calls John’s guarantee, would Y be required to fund John’s guarantee?

The answer depends on the ability of John to fund the guarantee through means other than Y’s assets, such as the use of other personal assets.
FSP-FIN 46(R)-5 is silent as to whether an assessment may be performed on the personal assets of the guarantor, John, in determining whether Y “may be required” to fund the guarantee. Literally, that would mean that even the smallest of probability of Y having to fund the guarantee would mean Y has an implicit guarantee.

However, the FSP does state that “the determination of whether an implicit variable interest exists should be based on all facts and circumstances in determining whether the reporting enterprise may absorb variability of the VIE or potential VIE.”

As previously discussed, in determining whether an enterprise has an implicit guarantee, questions that the enterprise should ask include:

1. Does the enterprise have the obligation to protect the VIE against loss?
2. Does the enterprise have an economic incentive to protect the VIE against loss?
3. Has the enterprise acted as a protector in similar situations in the past?
4. Would the enterprise acting as a protector of the VIE be a conflict of interest or be illegal?

The author believes that the determination of whether a related-party entity (Y in this example above) has an implicit guarantee of X’s debt, should take into account the likelihood that Y’s net assets would be used to fund that guarantee. In making that determination, a key factor is the significance of Y’s net assets to the total net assets of John, the guarantor. What this means is that it is reasonable to “look through” to the net assets of the guarantor, John. If Y’s net assets represent a significant portion of John’s net worth, clearly there is a high likelihood that Y’s net assets would be used to fund John’s guarantee of the VIE’s debt and Y may be assigned an implicit guarantee of X’s bank loan. Conversely, if the value of Y’s net assets is insignificant to the total value of other assets of John, a strong argument could be made that Y’s net assets would not be used to fund John’s guarantee, and that Y has no implicit guarantee of X’s debt. That is, Y would not have the “obligation” to protect X (VIE) in that Y’s assets would not be needed to fund John’s guarantee.

**Example 1:** John is the 100% owner of Company Y (operating company lessee) and Company X (real estate lessor VIE).

Y and X have an operating lease.

John has guaranteed X’s bank debt. Y has not guaranteed X’s bank debt.

The 100% equity in Y is John’s primary personal asset except for his home and a few personal investments.

**Conclusion:** Company Y has an implicit guarantee of X’s debt. The value of Y’s equity is a significant personal asset of John, resulting in the possibility that Y may be called upon to satisfy John’s guarantee of X’s debt.

Thus Y has a variable interest in X even though it has a market-value lease.
Example 2: Same facts as Example 1 except that John has numerous personal assets including valuable real estate and other liquid investments that could be used to fund John’s guarantee of X’s debt. The fair value of Y’s equity is insignificant to John’s total net asset value.

Conclusion: A strong argument can be made that Y does not have an implicit guarantee of X’s debt. Because John has numerous personal assets, it is unlikely that Y would be called upon to satisfy John’s guarantee of X’s debt. Thus, Y would not have the obligation to protect X because other assets of John would be used to fund the guarantee.

Breaking the Tie Between Two Related Party Entities – Implicit Guarantees

There may be instances where it is difficult to determine which related-party enterprise or individual is the primary beneficiary when there is an implicit guarantee.

Consider the following examples:

Example 1:

John is the 100% owner of three entities, the value of which represents a significant portion of John’s personal net worth:

- Company X is the real estate leasing company, which is a VIE.
- Company Y is a manufacturer and a lessee of X.
- Company Z is a marketing company that has no pecuniary involvement with X or Y.

Y and X have an operating lease.

John has guaranteed X’s bank debt. Y and Z have not guaranteed X’s bank debt.

John could not satisfy the guarantee of X’s debt without using his ownership in Y and Z.

Company Y has limited assets and could not entirely satisfy the guarantee of John.

Company Z has significant net assets and could easily satisfy the guarantee of John.

Conclusion:

Both Y and Z have implicit guarantees of X’s debt in that both Y and Z may be called upon to fund John’s guarantee, even though Y may not be able to fund the entire guarantee shortfall.

Thus, Y, Z and John all could be X’s primary beneficiary and must be tested under the tie breaker rules.

Next question is who is the primary beneficiary, which is the party that has:

1. Power to direct the activities of X that most significantly impact X’s economic performance, and

2. Obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X.
Who has the power to direct X’s significant activities?

Through its lease, relationship with John and implicit guarantee, it appears that Y has the power to direct the significant activities of X. Although John may have some power to direct X’s activities, through its lease, Y would been deemed to have the power to direct X’s significant activities involving the leased property. Note that shared power is not applicable to related parties.

Who has the obligation to absorb losses of X or the right to receive benefits from X that could potentially be significant to X?

It appears that Z and John have the obligation to absorb losses of X that could potentially be significant: Z through its implicit guarantees and John through his (explicit) guarantee and equity ownership. Because Y does not have significant assets, it would not have the obligation to absorb significant losses of X through its implicit guarantee.

Further, John has the right to receive benefits from X that could be potentially significant to X, through his equity ownership.

A summary of which parties satisfy the two criteria for determining the primary beneficiary follows:

<table>
<thead>
<tr>
<th>Criteria for Determining the Primary Beneficiary</th>
<th>Y</th>
<th>Z</th>
<th>John</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power to direct the activities of X that most significantly impact X’s economic performance</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Obligation to absorb losses of X that could potentially be significant to X</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Right to receive benefits from X that could potentially be significant to X</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

In this example, one related party (Y) has the power to direct X’s significant activities, and both Z and John have the obligation to absorb losses or right to receive benefits that are significant to X. Individually, no one related party satisfies both criteria for being a primary beneficiary but collectively, the related party group satisfies those criteria. The tie-breaker rule must be used to select the related party (Y, Z or John) as the primary beneficiary.

Under the tie-breaker rule, the related party that is designated to be the primary beneficiary is the party within the related party group, that is most closely associated with the VIE.

The determination of which party within the related party group is most closely associated with X requires judgment and should be based on an analysis of all relevant facts and circumstances including:

a. The existence of a principal-agency relationship between parties within the related party group.

b. The relationship and significance of the activities of the VIE to the various parties within the related party group.
c. A related party’s exposure to the variability associated with the anticipated economic performance of the VIE.

d. The design of the VIE, such as the purpose for which the entity was created.

The following analysis reflects the four factors noted above.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>The existence of a principal-agency relationship between parties within the related party group.</td>
<td>Not applicable as none of the related parties has a principal-agency relationship with X.</td>
</tr>
<tr>
<td>The relationship and significance of the activities of the VIE to the various parties within the related party group.</td>
<td>Favors Y being the primary beneficiary. Because X and Y have a lessor-lessee relationship, X’s activities are more significant to Y than any other party.</td>
</tr>
<tr>
<td>A related party’s exposure to the variability associated with the anticipated economic performance of the VIE.</td>
<td>Favors Z being the primary beneficiary. Because Z has significant value, it is most likely to absorb the guarantee. John cannot fund the guarantee without Z or Y.</td>
</tr>
<tr>
<td>The design of the VIE, such as the purpose for which the entity was created.</td>
<td>Favors Y being the primary beneficiary as X was purchased or developed for the purpose of leasing to Y.</td>
</tr>
</tbody>
</table>

Because Factors 2 and 4 favor Y being the primary beneficiary while Factor 3 favors Z being the primary beneficiary, Y is deemed the primary beneficiary that consolidates X.

Example 2:

Same facts as above except John has significant personal assets to satisfy the guarantee without using the equity ownership in Y or Z.

Conclusion:

Neither Y or Z have implicit guarantees of X’s debt as it is unlikely that either will have to fund John’s guarantee. Thus, John is the primary beneficiary in that John will absorb the expected losses of X.

Getting Around the Implicit Guarantee

In many instances, it may not be clear whether an implicit guarantee exists. For example, using the above scenario, John, the owner has some personal assets that include the equity in Y, the operating entity. Y, along with other related party entities, could be called upon to fund the guarantee of X’s debt.

The author suggests three ways around this issue to ensure that an implicit guarantee does not exist:

1. Bank carve out of the guarantee.
2. Indemnification agreement from a related party entity outside the reporting group.
3. Representation from common shareholder that he/she has sufficient assets to satisfy the guarantee.

One way to eliminate the risk that Y has an implicit guarantee is to have the bank specifically exclude from the guarantee the equity in Y, thereby ensuring that Y is not called upon to fund the guarantee.

A second way is to have Y sign an indemnification agreement with another entity owned by John. Under this agreement, the other related party entity agrees to indemnify Y for any losses it incurs from having to fund John’s guarantee.

**Example:** John is the 100% owner of Company Y (operating company lessee), Company X (VIE lessor), and Company Z. Z is a related party of both Y and X but has no direct involvement with either entity.

Z has significant net assets that are sufficient to fund the guarantee.

Y is concerned that it has an implicit guarantee of X’s debt because of its pecuniary involvement with X (through the lease) and that Y may be called upon to fund John’s guarantee of X’s debt.

Z and Y enter into an indemnification agreement whereby Z agrees to indemnify Y for any losses Y incurs if Y is called upon to fund John’s guarantee.

Y has the reporting enterprise while Z does not issue financial statements.

**Conclusion:** By having the indemnification agreement in place, Y will not absorb any losses from the guarantee and has no implicit guarantee. In essence, the risk of absorbing the losses from the guarantee has been shifted from Y to another related party entity that is outside the reporting group (Z).

A key factor in making this conclusion is an evaluation as to whether Z has sufficient assets to cover the indemnification agreement and guarantee.

A third way is to receive a representation from the common owner that he or she has sufficient personal assets to fund the guarantee without using equity in the operating lessee or other common entities.

**Example:** John Smith is the 100% owner of Company Y (lessee), and Company X (VIE lessor).

John has significant personal assets consisting of investments in securities, etc. that are sufficient to fund the guarantee.

Mary is the auditor of Company Y and is concerned that Y has an implicit guarantee of X and, thus may be the primary beneficiary that consolidates X.
Conclusion: Mary could receive a representation from John that he has sufficient personal assets, other than his equity investment in Y, that he agrees to use to fund any guarantee shortfall prior to allowing the lender to utilize the equity in Y to fund that guarantee.

**Representation of Common Owner**

I, John Smith, being the 100% shareholder of Company Y and sole member of Company X, LLC hereby represent the following:

a. I have sufficient personal liquid assets, other than my investment in Company Y, to fund the $1 million personal guarantee that I have with No Loan Bank (the Bank) related to its note dated XXXX with Company X.

b. I agree that in the event the Bank calls my guarantee, I will immediately use my personal liquid assets to fund that guarantee making it remote that the bank would require the use of the net assets of Company Y to fund the guarantee.

c. I agree that if my financial position changes on or before March 31, 20X0, so that my personal liquid assets are less than $1 million in fair value before that date, I will immediately notify you of this change.

Signed
John Smith
Date:
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. In order for an enterprise or individual to be a primary beneficiary of a VIE, that enterprise or individual must have which of the following:
   e) an equity ownership of more than 50% of the VIE  
   f) obligation to absorb more than 50% of the losses or right to receive more than 50% of the benefits of the VIE  
   g) power to direct all of the VIE’s activities  
   h) controlling financial interest in the VIE

2. Which of the following is true:
   a) there can be only one variable interest holder  
   b) there can be only one primary beneficiary  
   c) there can be only one variable interest  
   d) there can be only one variable interest entity

3. When an individual is the primary beneficiary:
   a) the individual may have a variable interest that will absorb very little of the VIE’s expected losses  
   b) the individual must consolidate the VIE into its personal financial statements  
   c) the individual must still perform a test to determine whether it is the primary beneficiary  
   d) the VIE will not be consolidated by the individual

4. Which of the following is correct with respect to how often a variable interest holder should test to determine whether it is a primary beneficiary:
   a) a variable interest holder is required to reconsider (retest) whether it is the primary beneficiary when there is a triggering event  
   b) a variable interest holder must reconsider (retest) at least once annually  
   c) a variable interest holder is required to continually reconsider (retest)  
   d) a variable interest holder is required to test once and not required to retest until the variable interest is disposed of
5. Which of the following situations would require the tie-breaker rule to be used:

   a) two unrelated parties, one of which satisfies the power criterion and the other satisfies the losses/benefits criterion
   b) two related parties, each of whom satisfies the power and losses/benefits criteria
   c) two related parties, one of which satisfies the power criterion and the other satisfies the losses/benefits criterion
   d) two parties, regardless of whether they are related or not, and neither party satisfies the power and losses/benefits criteria

6. A lease that has ______ is not a variable interest.

   a) market rate and terms
   b) a residual value guarantee
   c) an option to acquire leased assets
   d) a lease renewal option

7. John is the 100 percent shareholder of X (a lessor VIE) and Y (a lessee). John guarantees X’s loan. John’s primary assets consist of the equity in X and Y. What is the way in which this transaction should be accounted:

   a) Y has an implicit guarantee of X’s loan
   b) Y has an explicit guarantee of X’s loan
   c) John has an implicit guarantee of X’s loan
   d) Y has no guarantee of X’s loan
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A primary beneficiary has to have a variable interest which does not require ownership in a VIE.

   B: Incorrect. A primary beneficiary must meet the loss/benefits criterion which requires the enterprise to have the obligation to absorb losses of the VIE or right to receive benefits from the VIE that could potentially be significant to the VIE. There is no more than 50% threshold.

   C: Incorrect. To be a primary beneficiary, an enterprise must have the power to direct activities that are significant, but not necessarily all of the VIE’s activities.

   D: Correct. A primary beneficiary is that individual or enterprise that has a controlling financial interest in the VIE, achieved by satisfying both the power criterion and losses/benefits criterion.

   (See page 59 of the course material.)

2. A: Incorrect. There can be many variable interest holders.

   B: Correct. There can be only one primary beneficiary. If an enterprise, that primary beneficiary consolidates a VIE.

   C: Incorrect. There can be many variable interests in a VIE such as a guarantee, loan, and equity interest, among others.

   D: Incorrect. There are many variable interest entities (VIEs) and each entity is tested to determine whether it is a VIE.

   (See page 61 of the course material.)

3. A: Incorrect. A primary beneficiary must have either the obligation to absorb losses or right to receive benefits that are potentially significant to a VIE. Certainly, the term “significant” is greater than “very little.”

   B: Incorrect. An individual does not consolidate a VIE into its personal financial statements. The consolidation rules do not apply to personal financial statements.

   C: Incorrect. An individual does not perform a test to determine whether it is the primary beneficiary because the result has no impact on consolidation of the VIE.

   D: Correct. When an individual is the primary beneficiary, the VIE will not be consolidated. Only if an enterprise is the primary beneficiary will the VIE be consolidated.

   (See page 61 of the course material.)
4. A: Incorrect. The test to determine whether an entity is a VIE, and not whether a variable interest holder is a primary beneficiary, is based on whether there is a triggering event.

B: Incorrect. There is no annual retest required even though some companies may chose to perform an annual retest.

C: Correct. FIN 46R requires that a variable interest holder continually reconsider (retest) whether it is the primary beneficiary of a VIE.

D: Incorrect. Retesting is required on a continual basis.

(See page 62 of the course material.)

5. A: Incorrect. The tie breaker rule applies only to related parties.

B: Incorrect. The tie breaker rules applies only if there are two or more related parties, and individually none of the parties satisfy both criteria.

C: Correct. If there are two related parties, and one satisfies the power criterion while the other satisfies the losses/benefits criterion, but neither satisfies both criterion, the tie breaker rule applies.

D: Incorrect. The tie breaker rules applies only to related parties and also requires that individually some of the related parties must satisfy the criteria.

(See page 78 of the course material.)

6. A: Correct. A lease at a market rate and terms with no embedded features is not a variable interest.

B: Incorrect. A lease with a residual value guarantee is a variable interest.

C: Incorrect. An option to acquire leased assets at a fixed or predetermined price is a variable interest. It is not a variable interest if the price is at market value or variable.

D: Incorrect. A lease that has a renewal option at a fixed or predetermined lease rate for a period outside the base lease term is a variable interest. It is not a variable interest only if the lease rate is variable.

(See page 84 of the course material.)

7. A: Correct. Y has an implicit guarantee of X’s loan because John may have to call upon Y’s assets to satisfy John’s guarantee.

B: Incorrect. Y has no explicit guarantee as Y has not executed a formal contractual guarantee.

C: Incorrect. John has an explicit guarantee, not an implicit guarantee of X’s loan.

D: Incorrect. Because Y’s assets are a significant portion of John’s assets, Y has an implicit guarantee of X’s loan.

(See page 100 of the course material.)
SECTION 5:

I. Initial Test and Measurement of the VIE by the Primary Beneficiary

The rules for initial testing and measuring the VIE by the primary beneficiary vary depending on whether the VIE is under common control or not.

a. First step: Determining whether an entity is a VIE, and whether a variable interest holder is the primary beneficiary:

The test to determine whether an entity is a VIE, and whether a variable interest holder is the primary beneficiary is performed at the time the variable interest holder becomes involved with the VIE.

1. The term “involved” is not defined in FIN 46R, but presumably means the time at which an entity first develops a variable interest in the VIE that requires testing to determine whether the variable interest holder is the primary beneficiary of the VIE.

2. The initial test is done based on the fair value of the VIE’s assets and equity.

b. Second step: Initial measurement (consolidation) of the VIE by the primary beneficiary:

Once an entity determines that it is the primary beneficiary of a VIE (step 1 above), the next step is that it must consolidate the VIE into its financial statements. Note, that if the primary beneficiary is an individual, no action is required because an individual does not consolidate a VIE in the individual’s personal financial statements.

The initial measurement (consolidation) of the VIE’s financial statements into the primary beneficiary’s financial statements depends on whether the primary beneficiary is under common control with the VIE, or not.

1. Entities not under common control:

If the primary beneficiary and VIE are not under common control, the primary beneficiary of a VIE shall initially measure the assets, liabilities, and noncontrolling interests of a newly consolidated VIE at their fair values at the date the entity first becomes the primary beneficiary.

a. If the VIE is a business, the business combination rules found in FASB No. 141 (revised 2007), Business Combinations, should be followed:

- Assets, liabilities and noncontrolling interests are measured at fair value.
- Excess gain: If there is any excess of the fair values of the newly consolidated assets and the reported amount of assets transferred by the
primary beneficiary to the VIE, over the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, the resulting gain must be recognized on the income statement of the primary beneficiary, who acts as the acquirer.

- **Excess loss:** If there is any excess of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, over the fair value of newly consolidated identifiable assets and the reported amount of identifiable assets transferred by the primary beneficiary to the VIE, the resulting loss must be reported in the period in which the entity becomes the primary beneficiary as *goodwill*.

b. If the VIE is not a business, the following rules apply:

- The assets and liabilities of the VIE (exclusive of goodwill) are recorded at fair value using the business combination rules in FASB No. 141R.
- No goodwill is recognized.
- Any difference between the fair value of consideration and the fair value of the assets and liabilities shall be recognized as a gain or loss on the consolidated income statement.

2. **Entities under common control:**

If the primary beneficiary and the VIE *are under common control* (e.g., same majority shareholder or owners), the primary beneficiary must initially consolidate the VIE’s assets, liabilities and noncontrolling interests at their *carrying value* in the financial statements of the entity that controls the VIE – assuming that the entity’s financial statements were prepared on a GAAP basis.

- Assuming no other entity has been consolidating the VIE prior to the time the primary beneficiary must consolidate the VIE, the primary beneficiary consolidates the VIE’s *carrying value* (e.g., book value).
- Similarly, assets and liabilities transferred from the primary beneficiary to that VIE are transferred (at, after, or shortly before the date that the entity became the primary beneficiary) at the same value at which they were carried by the primary beneficiary. No gain or loss is recognized by the transfer even if the entity was not the primary beneficiary until shortly after the transfer occurred.

c. The principles of consolidation apply to the primary beneficiary’s accounting for the consolidated VIE.

- After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE are accounted for in the consolidated financial statements as if the entity were consolidated based on voting interests.
Specialized accounting requirements related to the type of business in which the VIE operates should be applied as they would be applied to a consolidated subsidiary.

Intercompany balances, transactions, income and expenses should be eliminated, and rules for consolidations found in ARB No. 51 should be followed.

Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE, and the resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not the noncontrolling interests) in the consolidated financial statements.

The VIE’s stockholders’ (or other) equity should be presented as a noncontrolling interest (or similar title) in the stockholders’ equity section of consolidated balance sheet, in accordance with FASB No. 160, Noncontrolling Interests.8

Note: Under FASB No. 160, the noncontrolling interest is reported in the consolidated balance sheet within the equity section, separately from the parent’s equity.

Intercompany eliminations are assigned to the primary beneficiary and not the VIE.

Observation: FIN 46R deviates from ARB No. 51 with respect to the elimination of intercompany profit and loss. ARB No. 51 states that the elimination of the intercompany profit or loss may be allocated proportionately between the majority and minority interests. Yet, FIN 46R follows a different tact by requiring the effect of any elimination to be eliminated fully against the primary beneficiary. Thus, the minority interest remains untouched.

Revenues, expenses, gains, losses, net income or loss, and other comprehensive income of the VIE are reported in the consolidated financial statements at the consolidated amounts, which include the amounts attributable to the owners of the parent and the noncontrolling interest in the VIE.

Net income or loss and comprehensive income or loss shall be attributed to the parent and the noncontrolling interest in the VIE.

The excess of any losses attributable to the parent and the noncontrolling interest over the equity interests shall be attributable to each interest, even if it results in a deficit noncontrolling interest balance.

---

8 FIN 46R does not state where the VIE’s stockholders’ equity should be presented in the consolidated balance sheet. Because there is no elimination of the equity against an investment account, the only logical place in which to present the VIE’s stockholders’ equity is to present it as part of a minority interest. The author has verified with the FASB Staff that they believe the VIE should be treated as a minority interest.
Example:

Presentation of consolidated balance sheet of primary beneficiary that consolidates a VIE:

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Balance Sheet</td>
<td>December 31, 20X2</td>
</tr>
</tbody>
</table>

**Current liabilities:**
- Accounts payable: $X
- Accrued expenses: X
- Current portion of long-term debt: X
- Total current liabilities: X

**Long-term liabilities:**
- Bank loans, net of current portion: X
- Deferred income taxes: X
- Total long-debt liabilities: X

**Stockholders’ equity:**
- Common stock: X
- Retained earnings: X
- Total XYZ Company stockholders’ equity: X
- Noncontrolling interest in variable interest entity: X (1)
- Total stockholders’ equity: X

(1) Includes total equity of the VIE.

Presentation of consolidated income statement of primary beneficiary that consolidates a VIE:

<table>
<thead>
<tr>
<th>XYZ Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Statement of Income and Retained Earnings</td>
<td>For the Year Ended December 31, 20X2</td>
</tr>
</tbody>
</table>

Net sales: $X
Cost of sales: X
Gross profit on sales: X
Operating expenses: X
Net operating income: X
Other income (expense): X
Net income before income taxes: X
Income taxes: X
Net income including noncontrolling interest: X

**Net income attributable to noncontrolling interest in variable interest entity** (X) (1)

Net income attributable to XYZ Company: X
Retained earnings:
- Beginning of year: X
- End of year: $X

(1): Net income of the VIE, net of tax effect, if any.
Observation: FASB No. 160, *Noncontrolling Interests (ASC 810)*, provides the guidance as to how a minority interest (noncontrolling interest) should be presented on the balance sheet. FASB No. 160 requires that the VIE’s equity be presented as a noncontrolling interest within the *equity section*, separately from the parent’s equity.

If the VIE’s equity is a negative amount (debit), that amount is present as a negative noncontrolling interest inside the stockholders’ equity section of the balance sheet.

On the income statement of the primary beneficiary, the VIE’s income statement is consolidated with the statement of the primary beneficiary. Intercompany transactions (e.g., rents, management fees, etc.) are eliminated. The net income of the VIE is backed out of the consolidated net income so that net income is the income of the primary beneficiary only. The net income of the VIE that is backed out of the consolidated net income should be net of the tax effect of the VIE’s income. In instances where the VIE is a pass-through entity such as a LLC or partnership, there may be no tax effect. Where the VIE is an S corporation, the tax effect may be limited to the state income taxes on the VIE’s income, inclusive of deferred state income taxes.

On the statement of cash flows, the minority interest is an adjustment to cash from operating activities.

II. Deconsolidation

If a primary beneficiary who has consolidated a VIE, is required to deconsolidate the VIE, that primary beneficiary must follow the guidance for deconsolidating subsidiaries found in FASB No. 160, *Noncontrolling Interests in Consolidated Financial Statements (ASC 810).*

<table>
<thead>
<tr>
<th>XYZ Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Statement of Cash Flows</td>
</tr>
<tr>
<td>For the Year Ended December 31, 20X2</td>
</tr>
<tr>
<td>Cash flow from operating activities:</td>
</tr>
<tr>
<td>Net income attributable to XYZ Company</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to cash flow</td>
</tr>
<tr>
<td>provided by operating activities:</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
</tr>
<tr>
<td>Gain on sale of assets</td>
</tr>
<tr>
<td><strong>Noncontrolling interest in variable interest entity</strong></td>
</tr>
<tr>
<td>Change in accounts receivable</td>
</tr>
<tr>
<td>Change in inventories</td>
</tr>
<tr>
<td>Change in prepaid assets</td>
</tr>
<tr>
<td>Change in accounts payable</td>
</tr>
<tr>
<td>Cash provided by operating activities</td>
</tr>
</tbody>
</table>
1. On the date of deconsolidation, the deconsolidation shall be accounted for with the parent recognizing a gain or loss in net income, measured as the difference between:

Add:
+ The fair value of any consideration received (a)
+ The fair value of any retained noncontrolling investment in the former VIE at the date the VIE is deconsolidated (b)
+ The carrying amount of any noncontrolling interest in the former VIE (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated (c)

= Subtotal
Deduct: The carrying amount of the VIE’s assets and liabilities

Equals: Gain or loss

2. The VIE’s income shall be included in the primary beneficiary’s income statement for the period up to the date of deconsolidation.

Observation: In many instances, a reporting enterprise that has been the primary beneficiary of a VIE will deconsolidate solely because it is no longer the primary beneficiary. Typically, the reason for deconsolidation is due to either:

a. The VIE is no longer a VIE, or
b. The primary beneficiary no longer has a controlling financial interest in the VIE (e.g., it is no longer the primary beneficiary) even though it continues to retain a variable interest in the VIE.

In such instances, the primary beneficiary does not receive any consideration such as in the case if the primary beneficiary had sold its interest in the VIE, if any. Further, the primary beneficiary may not have any retention of a noncontrolling interest in the VIE. The result is that the sum of (a), (b), and (c) in the above table would be zero. Zero minus the carrying value of the VIE’s net assets results in a loss equal to the carrying amount of the VIE’s net assets. The result is that a reporting enterprise (primary beneficiary) that deconsolidates a VIE that it previously consolidated, will likely record a loss on its income statement equal to the carrying value of the VIE’s net assets. In essence, the reporting enterprise is merely removing the net carrying amount of the VIE’s net assets from its balance sheet as there is no consideration received.

III. Updating the Primary Beneficiary Test

As discussed above, the initial test to determine whether an entity is a VIE and whether a variable interest holder is the primary beneficiary for consolidation, is done at the time the two entities are first involved with each other.

But what happens afterwards and when, if ever, must the test be updated? Previously in this chapter, the author discussed the reconsideration rules for a VIE; that is the triggering events that require a reconsideration of whether an entity is still a VIE.
To recap, each variable interest holder is required to reconsider whether or not an entity is still a VIE when any one of the triggering events occurs:

- The VIE’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity’s equity investment at risk.
- The VIE’s equity investment or some part thereof is returned to the equity investors, and other parties become exposed to expected losses.
- The VIE undertakes additional activities or acquires additional assets, (beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event), that increase the entity’s expected losses.
- The VIE receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases expected losses.
- Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance.

**Note:** FASB No. 167 added the fifth provision triggering event noted above.

An entity that previously was not subject to consolidation (e.g., not previously a VIE) under FIN 46R does not become subject to consolidation because its equity deteriorates due to subsequent losses incurred that reduce the equity investment.

As for a primary beneficiary, FASB No. 167 made a significant change to FIN 46R in connection with when a reporting enterprise who holds a variable interest in a VIE must reconsider (retest) whether it is the primary beneficiary of that VIE.

Prior to FASB No. 167, Interpretation 46R required a reporting enterprise who held a variable interest in a VIE to retest whether it was the primary beneficiary of a VIE, only if a triggering event occurred such as a change in the governing documents or if the primary beneficiary sold all or a part of its variable interest.

The new rules found in FASB No. 167 follow:

1. A variable interest holder is required to continuously reconsider whether it is the primary beneficiary of a VIE.

   **Note:** FASB No. 167 does not address how often a variable interest holder must reconsider whether it is the primary beneficiary. Most companies will perform a new assessment at least once per year and at an interval that gives the reporting enterprise sufficient time to make any necessary adjustment (consolidation or deconsolidation) to issue its annual financial statements.

2. The updated reconsideration of whether an entity is a primary beneficiary should be done using the fair value of the VIE at the date of the reconsideration.
3. A variable interest holder that previously was not the primary beneficiary, should update its test to determine if it is now the primary beneficiary.

**IV. Disclosures Under FIN 46R**

**General Disclosures:**

1. Disclosures required by FASB No. 167 have as principal objectives of providing financial statement users with the following information:
   
a. The significant judgments and assumptions made by a reporting enterprise in determining whether it must consolidate a variable interest entity and/or disclose information about its involvement in a variable interest entity.

b. The nature of restrictions on a consolidated VIE’s assets and on the settlement of its liabilities reported by a reporting enterprise in its balance sheet, including the carrying amounts of such assets and liabilities.

c. The nature of, and changes in, the risks associated with a reporting enterprise’s involvement with the VIE.

d. How a reporting enterprise’s involvement with the VIE affects the reporting enterprise’s financial position, financial performance, and cash flows.

2. In addition to disclosures required by other standards, a variable interest holder of a VIE must disclose the following information that is expected to achieve the above four objectives. The holder may have to supplement the required disclosures with additional information depending on the facts and circumstances.
   
a. Information about variable interest entities reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. Such information shall disclose how similar entities are aggregated and shall distinguish between:
      
      - VIEs that are not consolidated because the reporting enterprise is not the primary beneficiary but has a variable interest, and
      
      - VIEs that are consolidated.

   **Note:** In determining whether to aggregate VIEs, the variable interest holder should consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the reporting enterprise. Further, the disclosures should be presented in a way that clearly explains the nature and extent of a reporting enterprise’s involvement with VIEs.

3. A reporting enterprise that is a primary beneficiary of a VIE or is a variable interest holder that is not the primary beneficiary, shall disclose the following:
a. Its methodology for determining whether the reporting enterprise is the primary
beneficiary of a VIE, including significant judgments and assumptions made
including:

- Information about the types of investments a reporting enterprise considers
  significant, and how the significant involvements were considered in
determining whether the reporting enterprise is the primary beneficiary.

b. If facts and circumstances change such that the conclusion to consolidate a VIE
has changed in the most recent financial statements (such as the VIE was
previously consolidated and is not currently consolidated), the primary factors
that caused the change and the effect on the reporting enterprise's financial
statements.

c. Whether the reporting enterprise has provided financial or other support
(explicitly or implicitly) during the periods presented to the VIE that it was not
previously contractually required to provide or whether the reporting enterprise
intends to provide that support, including:

- The type and amount of support, including situations in which the reporting
  enterprise assisted the VIE in obtaining another type of support, and

- The primary reasons for providing the support.

d. Qualitative and quantitative information about the reporting enterprise’s
involvement (giving consideration to both explicit arrangements and implicit
variable interests with the VIE, including, but not limited to, the nature, purpose,
size, and activities of the VIE, and how the entity is financed).

e. A primary beneficiary of a VIE that is a business shall provide the disclosures
required by FASB No. 141R.

f. A primary beneficiary of a VIE that is not a business shall disclose the amount of
any gain or loss recognized on the initial consolidation of the VIE.

4. A primary beneficiary of a VIE shall disclose the following information:

a. The carry amounts and classifications of the VIE’s assets and liabilities in the
balance sheet that are consolidated, including qualitative information about the
relationship(s) between those assets and liabilities.

Example: If the VIE’s assets can be used only to settle obligations of the VIE, the
reporting enterprise shall disclose qualitative information about the nature of the
restrictions on those assets.

b. Lack of recourse if creditors (or beneficiary interest holders) of the consolidated
VIE have no recourse to the general credit of the primary beneficiary.

c. Terms of arrangements, giving consideration to both explicit arrangements and
implicit variable interests that could require the reporting enterprise to provide
financial support (such as liquidity arrangements and obligations to purchase
assets) to the VIE, including events and circumstances that could expose the
reporting enterprise to a loss.
5. A reporting enterprise that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary shall disclose:

a. The carrying amounts and classification of the assets and liabilities in the reporting enterprise’s balance sheet that relate to the reporting enterprise’s variable interest in the VIE.

b. The reporting enterprise’s maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting enterprise’s exposure to the VIE.

- If the maximum exposure to loss cannot be quantified, that fact should be disclosed.

c. A tabular comparison of the carrying amounts of the assets and liabilities that are required in 5(a) above, and the reporting enterprise’s maximum exposure to loss, as required by 5(b) above. A reporting enterprise shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the information in 5(a) and 5(b).

- The information should include the terms of the arrangements, (addressing both explicit arrangements and implicit variable interests), that could require the reporting enterprise to provide financial support to the VIE, such as liquidity arrangements and obligations to purchase assets, as well as exposure to a loss.

d. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting enterprise’s variable interest in the VIE is encouraged.

e. If applicable, significant factors considered and judgment made in determining that the power to direct the activities of the VIE that most significantly impact the entity’s economic performance is shared (shared power).

Note: The disclosures required by FIN 46R may be provided in more than one note to the financial statements, as long as the objectives of disclosure are satisfied. If the disclosures are provided in more than one note, the reporting enterprise shall provide a cross reference to the other notes that provide the disclosures prescribed in FIN 46R for similar entities.

6. A primary beneficiary shall present separately on the face of the balance sheet the following items:

a. Assets of a consolidated VIE that can be used only to settle obligations of the consolidated VIE, and

b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.

Observation: If a primary beneficiary consolidates a VIE into its balance sheet, in general, the VIE’s assets and liabilities lose their individual identity and in most cases are not identifiable separate and distinct from the primary beneficiary’s assets and liabilities.
FASB No. 167 added a requirement that on the consolidated balance sheet, certain assets and liabilities of the VIE be separately presented. For assets, it is those assets the value of which must be used to repay the VIE’s liabilities, such as real estate that is secured by the VIE’s mortgage note payable.

On the liability side, the primary beneficiary must separately present on the consolidated balance sheet those liabilities of the VIE that have no claim against the primary beneficiary. Typically, unless the primary beneficiary has guaranteed or cross collateralized a VIE liability, the creditors of the VIE have no recourse claim against the primary beneficiary. Thus, most if not all of the VIE’s liabilities will be presented separately on the balance sheet.

**Example:** Company PB is the primary beneficiary of Company X, a VIE, which is consolidated on the balance sheet of PB.

Company X’s balance sheet that is consolidated in with PB is as follows:

**X’s balance sheet prior to consolidation:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Land</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Building</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(500,000)</td>
</tr>
<tr>
<td></td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Trade payables</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Current portion of note payable</td>
<td>200,000</td>
</tr>
<tr>
<td>Mortgage note payable</td>
<td>3,300,000</td>
</tr>
<tr>
<td>Equity</td>
<td>1,000,000</td>
</tr>
<tr>
<td></td>
<td>$4,800,000</td>
</tr>
</tbody>
</table>

**Conclusion:** Even though X’s balance sheet is consolidated in with PB’s balance sheet, certain assets and liabilities of X must be disclosed separately on the face of the consolidated balance sheet. Assets that must be used to settle VIE liabilities should be shown separately, and liabilities that have no recourse against the primary beneficiary are also shown separately.

In this case, the real estate of X should be presented separately as it is secured by the mortgage note and must be used to settle the VIE’s obligations. Further, all of the liabilities should be shown separately because none have a claim against the primary beneficiary as PB has not guaranteed any X liabilities.
Company PB  
Consolidated Balance Sheet  
December 31, 20X2

<table>
<thead>
<tr>
<th>ASSETS:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$X</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>X</td>
</tr>
<tr>
<td>Inventories</td>
<td>X</td>
</tr>
<tr>
<td>Other current assets</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Property, plant and equity:</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Cost:</strong></td>
<td></td>
</tr>
<tr>
<td><em>Assets related to variable interest entity</em></td>
<td>X</td>
</tr>
<tr>
<td>Other</td>
<td>X</td>
</tr>
<tr>
<td><strong>Less Accumulated depreciation:</strong></td>
<td></td>
</tr>
<tr>
<td><em>Assets related to variable interest entity</em></td>
<td>X</td>
</tr>
<tr>
<td>Other</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total property, plant and equipment</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$X</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND EQUITY:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$X</td>
</tr>
<tr>
<td>Accounts payable related to variable interest entity</td>
<td>X</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>X</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Long-term liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Bank loans, net of current portion</td>
<td>X</td>
</tr>
<tr>
<td>Mortgage note payable related to variable interest entity</td>
<td>X</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total long-debt liabilities</strong></td>
<td>X</td>
</tr>
<tr>
<td><strong>Stockholders’ equity:</strong></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>X</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total XYZ Company stockholders’ equity</strong></td>
<td>X</td>
</tr>
<tr>
<td>Noncontrolling interest in variable interest entity</td>
<td>X</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>X</td>
</tr>
</tbody>
</table>

**Observation:** FASB No. 167 does not give any guidance as to how to present the selected assets and liabilities of the VIE on the consolidated balance sheet. The author believes that material assets and liabilities should be separated within their respective categorizes as shown in the above sample balance sheet.
Notice that cash is not shown separately. The reason is because there is no requirement that the cash be used to settle VIE obligations. On the other side, all of the liabilities are presented separately because there is no evidence that creditors have any recourse against the primary beneficiary for those liabilities.

Finally, FASB No. 167 requires that the VIE assets and liabilities be presented on the face of the balance sheet thereby negating the option to present that information in the notes to financial statements.

7. **Special Additional Disclosures – Exemption for Variable Interest Holders Who Have Difficulty Obtaining Information:**

As discussed in the first section of this chapter, the revised FIN 46R added a special exemption for certain entities that cannot obtain the necessary information to apply the rules.

For those entities subject to the exemption, FIN 46R requires additional disclosures as follows:

a. The number of entities to which FIN 46R is not being applied and the reason why the information required to apply FIN 46R is not available,

b. The nature, purpose, size (if available), and activities of the entity(ies) and the nature of the variable interest holder’s involvement with the entity(ies),

c. The reporting enterprise’s maximum exposure to loss because of its involvement with the entity(ies), and

d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the entity(ies) for all periods presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

Are there any required disclosures that must be included in the unconsolidated single financial statements of the VIE?

No. The disclosures must be included in the primary beneficiary’s consolidated financial statements only, or those of a variable interest holder that is not the primary beneficiary but holds a significant variable interest in a VIE. Otherwise, there are no disclosure requirements for the VIE if it issues its own financial statements.

**V. Effective Date and Transition Requirements of FIN 46R**

1. FASB No. 167 is effective as of the beginning of each reporting enterprise’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.
2. Transition disclosures:

   a. For public reporting enterprises, in periods after initial adoption, comparative disclosures for those disclosures that were not previously required by FASB SOP FAS 140-4 and FIN 46R-8, are required only for periods after the effective date. Comparative information for disclosures previously required by FSP FAS 140-4 and FIN 46R-8 that are also required by FASB No. 167 shall be presented.

   b. For nonpublic reporting enterprises, in periods after initial adoption, the reporting enterprise is required to present comparative disclosures for those disclosures that were not previously required by Interpretation 46R only for periods after the effective date.

   c. Further, comparative information for disclosures previously required by Interpretation 46R that are also required by FASB No. 167 shall be presented.

The rules for implementing FIN 46R’s requirements are confusing and difficult to apply.

3. New variable interests:

   a. An entity with a variable interest in another entity that is created after the effective date of FASB No. 167 (created after November 15, 2009) shall apply the provisions of FIN 46R to that entity immediately. The transition rules noted that follow do not apply.

   Example: On June 18, 2010, Company Y makes a loan guarantee for Company X.

   Conclusion: Because Y creates a variable interest in X after November 15, 2009, Y must apply the provisions of FIN 46R immediately. Specifically, on June 18, 2010, Y must do the following as it relates to X:

   a. Test X to determine whether it is a VIE using the fair value of X’s assets and equity at June 18, 2010.

   b. Identify all variable interest holders as of June 18, 2010.

   c. Determine whether Y is the primary beneficiary of X.

   Assuming that Y determines it is the primary beneficiary, immediately (as of June 18, 2010), Y must consolidate X. If Y and X are not under common control, Y will consolidate X at the fair value of X’s balance sheet at June 18, 2010. If they are under common control, Y will consolidate X based on the carrying value (book value) of X’s balance sheet on June 18, 2010. Y will include X’s income statement in its consolidated financial statements for the period June 18, 2010 to December 31, 2010, assuming Y has a calendar year end.

4. Transition initial test – existing entities:

   The initial test for consolidation done by an entity with a variable interest is performed in one of two ways:
Option 1: Look back approach:

The primary beneficiary must look back to a date as if it had consolidated retroactively with the VIE (look-back date).

The look-back date is the latter of:

- The date on which the primary beneficiary first became involved with the VIE, or
- The last date on which a reconsideration event would have occurred after the primary beneficiary first became involved with the VIE.

On the look-back date, the primary beneficiary should perform its test to:

- Determine if an entity in which it has a variable interest, is a VIE,
- Identify the variable interest holders, and
- Determine whether it is the primary beneficiary of the VIE.

a. The test is done based on the fair value of the VIE’s assets, liabilities and equity on the look back date.

If, based on the look-back date, the entity determines that it was the primary beneficiary and would have consolidated the VIE on the look-back date, the primary beneficiary should initially measure the consolidation of the VIE based on the carrying amounts of the VIE’s balance sheet on the look-back date.

b. The carrying amounts are the amounts at which the assets, liabilities and noncontrolling interests of the VIE would have been carried in the consolidated financial statements if FIN 46R had been effective when the entity first met the conditions to be considered a primary beneficiary.

- If the entities were not under common control on the look-back date, the carrying amount of the VIE would be the fair value of its balance sheet on that date.
- If the entities were under common control on the look-back date, the carrying amount of the VIE would be the book value of the VIE’s balance sheet on that date.

c. The carrying amounts at the look back date must be rolled forward to the implementation date to reflect activity that has occurred on the VIE’s balance sheet from the look-back date to the implementation date.

- The look-back balance sheet of the VIE must be adjusted for depreciation, amortization, acquisitions and sales of assets, etc.

Note: FIN 46R does not give any guidance as to how the retroactive look-back method should be applied. There are differing opinions as to what to do with the carrying value balance sheet of the VIE on the look back date in terms of rolling it forward to the implementation date. The author believes the carrying value of the VIE’s balance sheet on the look-back date must be adjusted to reflect all activity.
that has occurred from the look-back date to the implementation date. This approach is based on the logic inherent in the transition rules which is that FIN 46R should be applied retroactively as if the entities had consolidated in previous periods.

The look-back date is the later of the date the primary beneficiary first became involved with the VIE, and most recent reconsideration date (triggering event) that would have occurred had the entities consolidated retroactively. The theory behind use of these dates is to emulate the situation that would have occurred had the entities consolidated retroactively. For example, under a retroactive consolidation, upon a triggering event occurring, the reporting enterprise would have reconsidered (retested) whether the entity was a VIE. Therefore, the latter of the initial testing date and the most recent reconsideration date should reflect the scenario that would have existed had consolidation occurred retroactively.

**Option 2: Fair or carrying value of VIE’s balance sheet on the implementation date:**

If using the look-back method is *not practicable*, FIN 46R gives a second option of implementing the new rules.

Specifically, Option 2 applies the following rules, in lieu of the look-back method:

1. The primary beneficiary must perform the initial test of the VIE *as of the implementation date*:
   a. The initial test is based on the *fair value* of the VIE on the implementation date to:
      * Determine whether an entity is a VIE,
      * Identify variable interest holders, and
      * Determine whether it is the primary beneficiary that should consolidate the VIE.
   b. The implementation date is the beginning of each reporting enterprise’s first annual reporting period that *begins after November 15, 2009*.

2. If, on the implementation date, the primary beneficiary determines it should consolidate the VIE, the primary beneficiary consolidates the VIE *as of the implementation date* as follows:
   - *Entities that are not under common control on the implementation date:* Consolidate VIE based on the *fair value* of the VIE’s balance sheet on the implementation date.
   - *Entities that are under common control on the implementation date:* Consolidate VIE based on the *carrying amounts (book value)* of the VIE’s balance sheet on the implementation date.

3. If applicable, any difference between the net amount added to the balance sheet of the consolidating entity (primary beneficiary) and the amount of any previously recognized interest in the newly consolidated entity should be recognized as the *cumulative effect adjustment to retained earnings*.
4. The primary beneficiary is required to describe the transition method(s) used and shall disclose the amount and classification in the balance sheet of the consolidated assets or liabilities by the transition method(s) applied.

5. FIN 46R may be applied to prior years by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. Restatement is encouraged but not required.

FIN 46R, however, does allow (but does not require) the rules to be applied retroactively to prior years with a cumulative effect adjustment, if any, to the beginning retained earnings in the first year restated.

In performing the initial measurement for implementation, FIN 46R offers two options to measure the VIE’s assets: retroactive carrying amount to the look-back date (look-back method) or the fair value at the implementation date.

An entity is required to use the look-back method unless it is not practicable to do so. In that case, the initial test for implementation should be done on the implementation date based on the fair value of the VIE’s balance sheet.

5. Special rules for certain securitization activities
   a. FASB No. 167 provides a special transition rule for those entities engaged in activities related to securitization.

      The rule applies to entities that:

      • It is not practicable to obtain the carrying amounts of assets and liabilities,
      • The activities of the entity are primarily related to securitization or other forms of asset-backed financings, and
      • The assets of the entity can be used only to settle obligations of the entity.

   b. For those entities that satisfy the criteria above, the assets and liabilities of the entity may be measured at their unpaid principal balances (as an alternative to the fair value measurement) at the date FASB No. 167 is first applied.

   c. This measurement alternative does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or other-than-temporary impairment, as appropriate.

   d. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other standards, shall be measured at fair value.

6. Transition – deconsolidation of a VIE:

   FASB No. 167 provides transition guidance for a primary beneficiary of a VIE that deconsolidates due to the new rules.

   A reporting enterprise that is required to deconsolidate an entity as a result of the initial application of FASB No. 167 shall apply the following rules:
a. The deconsolidating reporting enterprise (primary beneficiary) shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the transition date (beginning of the first year beginning after November 15, 2009).

- The carrying amount is the amount at which any retained interest would have been carried in the reporting enterprise’s financial statements if FASB No. 167 had been effective when the reporting enterprise became involved with the entity or no longer met the conditions to be a primary beneficiary.

b. Any difference between the net amount removed from the balance sheet of the deconsolidating reporting enterprise and the amount of any retained interest in the newly deconsolidated entity shall be recognized as a cumulative effect adjustment to retained earnings.

- The cumulative effect adjustment due to deconsolidation shall be presented separately from any cumulative effect adjustment related to consolidation of VIEs.

7. Special transition rules – fair value option under FASB No. 159

FASB No. 167 provides transitional guidance for those entities that seek to elect the fair value option allowed under FASB No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (ASC 825).

Specifically, a reporting enterprise that is required to consolidate a VIE as a result of the initial application of FASB No. 167 may elect the fair value option under FASB No. 159 only if the election is made for all financial assets and liabilities of the VIE that are eligible for the option under FASB No. 159.

a. The election is made on an entity-by-entity basis.

b. The reporting enterprise (primary beneficiary) shall make the following disclosures:

- Typical disclosures required by FASB No. 159
- Management’s reasons for electing the fair value option for a particular entity or group of entities if the election is made for some entities and not others
- The reasons for the different elections, and
- Quantitative information by line item in the balance sheet indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option.

8. Special deferral for certain investment funds

a. In 2010, the FASB issued an ASU, Consolidation, (Topic 810), Amendments to Statement 167 for Certain Investment Funds. The ASU defers the effective date of FASB No. 167 indefinitely for a reporting enterprise’s (investment manager’s) interest in an entity that 1) has the attributes of an investment company, or 2) for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies. The effective date of Statement 167 will be deferred for certain funds until the joint IASB/FASB consolidations project is completed (late 2010).
Specifically, FASB No. 167 is not effective for the following:

1) A reporting enterprise’s interest in an entity, as long as that reporting enterprise and the entity meet all of the following conditions:

   a. The entity either:
      - Has all of the attributes specified in paragraph 946-10-15-2(a) through (d), Financial Services Investment Companies, or
      - Does not have all of the attributes but is an entity for which it is industry practice to apply guidance consistent with the measurement principles in Topic 946 for financial reporting purposes.

   Note: The attributes specified in paragraph 946-10-15-2(a) through (d) deal with whether an investment company is required to report its investment asset at fair value. Those four attributes are found in (a) through (d) are:
      - **Investment activity.** The investment company’s primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.
      - **Unit ownership.** Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.
      - **Pooling of funds.** The funds of the investment company’s owners are pooled to avail owners of professional investment management.
      - **Reporting enterprise.** The investment company is the primary reporting enterprise.

   b. The reporting enterprise does not have an obligation to fund losses of the entity that could potentially be significant to the entity. This condition should be evaluated considering any implicit or explicit guarantees by the reporting enterprise and its related parties, if any.

   c. The entity is not:
      - A securitization entity
      - An asset-backed financial entity
      - An entity that was formerly considered a qualifying special-purpose entity.

   Examples of entities that may meet the conditions noted above include:
      - Mutual or hedge fund
      - Mortgage real estate investment fund
      - Private equity fund, and
      - Venture capital fund.

2) A reporting enterprise’s interest in an entity that is required to comply with or operates in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. In performing the initial measurement of the VIE by the primary beneficiary with entities not under common control, if there is any excess of the fair values of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the VIE, the resulting gain must be reported:
   a) as an extraordinary gain, if the VIE is not a business
   b) as goodwill, if the VIE is a business
   c) on the income statement of the primary beneficiary
   d) in the period in which the entity becomes the primary beneficiary

2. A principle of consolidation that applies to the primary beneficiary’s accounting for the consolidated VIE is that ______ should be eliminated.
   a) intercompany income and expenses
   b) the assets of a consolidated VIE
   c) the liabilities of a consolidated VIE
   d) the noncontrolling interests of a consolidated VIE

3. When consolidating a VIE, the VIE’s stockholders’ equity should be presented as a:
   a) noncontrolling interest
   b) commingled part of the consolidated stockholders’ equity of the primary beneficiary
   c) current liability
   d) debit or credit to retained earnings of the primary beneficiary

4. Once a primary beneficiary is no longer required to consolidate a VIE, the proper treatment is to:
   a) deconsolidate the VIE as of the date the primary beneficiary is no longer the primary beneficiary
   b) have the new primary beneficiary wait until its new fiscal year to begin consolidation
   c) present income for the VIE following the date on which the consolidation ceases
   d) show the consolidated balance sheet through the end of the fiscal year
5. Which of the following entities is required to disclose the entity’s maximum exposure to loss as a result of its involvement with a VIE:

a) primary beneficiary of a VIE  
b) a VIE  
c) an entity that holds a variable interest in a VIE but is not the primary beneficiary  
d) an entity that has an investment in a VIE but holds no variable interest

6. A company is the primary beneficiary of a VIE. The VIE’s balance sheet consists of real estate and a mortgage secured by that real estate. How should the VIE’s real estate and mortgage be presented on the consolidated balance sheet:

a) combined in the assets and liabilities of the primary beneficiary  
b) presented separately on the balance sheet  
c) combined but disclosed separately in the notes  
d) presented on the balance sheet as one “net equity or deficit” number

7. If the entities were under common control on the look-back date, the carrying amount of the VIE would:

a) be rolled backward to the implementation date  
b) be the book value of its balance sheet on that date  
c) be the fair value of its balance sheet on that date  
d) not be adjusted for depreciation, amortization, acquisitions and sales of assets
1. A: Incorrect. If the VIE is not a business, any difference is recorded as a gain, but not an extraordinary gain.

B: Incorrect. If there is any excess of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, the resulting loss must be reported as goodwill, if the VIE is a business.

C: Correct. If there is any excess of the fair values of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the VIE, the resulting gain must be reported on the income statement of the primary beneficiary as if the primary beneficiary was the acquirer.

D: Incorrect. If there is any excess of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and noncontrolling interests, the resulting loss must be reported in the period in which the entity becomes the primary beneficiary.

(See pages 110 to 111 of the course material.)

2. A: Correct. Intercompany income and expense accounts, as well as other intercompany balances should be eliminated under the rules of consolidation.

B: Incorrect. The assets of the consolidated entity should not be eliminated unless they are eliminated against another intercompany account.

C: Incorrect. The liabilities of the consolidated entity should not be eliminated unless they are eliminated against another intercompany account.

D: Incorrect. A principle of consolidation that applies to the primary beneficiary’s accounting for the consolidated VIE is that the noncontrolling interests of a consolidated VIE are accounted for in the consolidated financial statements as if the entity were consolidated based on voting interests. Thus, there is no elimination of the noncontrolling interests.

(See page 112 of the course material.)

3. A: Correct. The VIE’s equity should be presented as a noncontrolling interest in the stockholders’ equity section of the consolidated balance sheet.

B: Incorrect. The VIE’s equity is not part of the equity of the primary beneficiary and thus should not be shown as a commingled part of the primary beneficiary’s equity.

C: Incorrect. The VIE’s equity is not a current liability.

D: Incorrect. The VIE’s equity is a noncontrolling interest which is not part of the primary beneficiary’s retained earnings.

(See page 112 of the course material.)
4. **A: Correct.** Once a primary beneficiary is no longer required to consolidate a VIE, the proper treatment is to deconsolidate the VIE as of the date that the primary beneficiary is no longer the primary beneficiary.

B: Incorrect. There is no rule in effect that suggests the new primary beneficiary should wait until its new fiscal year to begin consolidation.

C: Incorrect. The consolidated income statement of the primary beneficiary should present income for the VIE up to the date of deconsolidation, and not after.

D: Incorrect. When there is a deconsolidation, it occurs at the deconsolidation date and the balance sheet is deconsolidated at that date. Thus, there is no consolidated balance sheet until the end of the year.

(See page 115 of the course material.)

5. A: Incorrect. The maximum exposure to loss disclosure is not required for a primary beneficiary of a VIE.

B: Incorrect. The disclosure applies to a reporting enterprise and not the VIE.

**C: Correct.** The disclosure of the maximum exposure to loss is required for a reporting enterprise that holds a variable interest in a VIE, but is not the primary beneficiary.

D: Incorrect. An entity that has an investment in a VIE, but holds no variable interest, has no disclosures required under FIN 46R.

(See page 119 of the course material.)

6. A: Incorrect. Assets that must be used to settle liabilities are not combined with the assets and liabilities of the primary beneficiary.

**B: Correct.** Any assets that must be used to settle the liabilities of the VIE must be presented separately on the balance sheet along with the related liability. In this example, the real estate will be used to settle the mortgage obligation.

C: Incorrect. The asset and liability is not combined, and there is no requirement to disclose separately those items in the notes.

D: Incorrect. There is no requirement for the asset and liability to be presented on the balance sheet as one “net equity or deficit” number.

(See page 120 of the course material.)
7. **A:** Incorrect. The carrying amounts at the look-back date must be rolled forward to the implementation date to reflect activity that has occurred on the VIE’s balance sheet from the look-back date to the implementation date.

**B:** Correct. If the entities were under common control on the look-back date, the carrying amount of the VIE would be the book value of its balance sheet on that date.

**C:** Incorrect. If the entities were not under common control on the look-back date, the carrying amount of the VIE would be the fair value of its balance sheet on that date.

**D:** Incorrect. The look-back balance sheet of the VIE must be adjusted for depreciation, amortization, acquisitions and sales of assets, etc.

(See page 124 of the course material.)
CHAPTER 5

FASB No. 168: The *FASB Accounting Standards Codification* and the Hierarchy of Generally Accepted Accounting Principles (FASB ASC Topic 105)
FASB No. 168: The *FASB Accounting Standards Codification* and the Hierarchy of Generally Accepted Accounting Principles (FASB ASC Topic 105)

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I. Introduction

Issued: June 2009

Effective Date: Interim or annual financial periods ending after September 15, 2009 (nonpublic nongovernmental entities have certain modifications of the effective date).

Objective:

FASB No. 168 (ASC 105) replaces FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles. The Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy).

The objective of this Statement is to replace FASB No. 162 and to establish the FASB Accounting Standards Codification™ (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of GAAP financial statements. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

II. Background

Section 108(d) of Sarbanes-Oxley Act of 2002 required that the SEC initiate a study to evaluate ways to improve the quality of GAAP standards and the overall standard-setting process, including the conceptual framework, codification of existing GAAP standards, and convergence in FASB and IASB standards.

In July 2003, the SEC issued its study which included a recommendation that the FASB improve the GAAP hierarchy that existed in SAS No. 69, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.

The SAS No. 69 GAAP hierarchy had been criticized for many reasons that included:

- It was directed to the auditor instead of the entity,
- It was complex, and
- It ranked FASB Concept Statements below industry practices even though Concept Statements were subject to significant due process while industry practices were not.

The FASB concluded that it had established goals to address the concerns mentioned in the Study, which were to:

- Issue the GAAP hierarchy as a FASB standard,
- Recategorize the existing GAAP hierarchy into two levels of accounting literature (authoritative and nonauthoritative), and
• Elevate the conceptual framework within the GAAP hierarchy.

In response to the SEC Study, in May 2008, the FASB issued FASB No. 162, *The Hierarchy of Generally Accepted Accounting Principles*.

FASB No. 162 established the sources of GAAP in four categories ((a) through (d)) (plus other accounting literature) presented in descending order of authority as follows:

<table>
<thead>
<tr>
<th>PREVIOUS FASB NO. 162 HIERARCHY</th>
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<tbody>
<tr>
<td><strong>Category</strong></td>
</tr>
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</table>
| a | • FASB Statements of Financial Accounting Standards and Interpretations  
  • FASB Statement 133 Implementation Issues  
  • FASB Staff Positions  
  • AICPA Accounting Research Bulletins and APB Opinions that are not superseded by actions of the FASB |
| b | • FASB Technical Bulletins  
  • AICPA Industry Audit and Accounting Guides and Statements of Position, if cleared by the FASB |
| c | • AICPA Accounting Standards Executive Committee Practice Bulletins, if cleared by the FASB  
  • FASB Emerging Issues Task Force (EITF) consensus opinions  
  • Topics discussed in Appendix D of EITF Abstracts (EITF D-Topics) |
| d | • Implementation Guides (Q&As) published by the FASB staff  
  • AICPA Accounting Interpretations  
  • AICPA Industry Audit and Accounting Guides and Statements of Position, not cleared by the FASB  
  • Practices that are widely recognized and prevalent either generally or in the industry |
| Other accounting literature (1) | • FASB Concepts Statements  
  • AICPA Issues Papers  
  • International Financial Reporting Standards of the International Accounting Standards Board (IASB)  
  • Pronouncements of professional associations or regulatory agencies  
  • Technical Practice Aids  
  • Accounting textbooks, handbooks, and articles |

(1) The “other accounting literature” category is used only if the accounting treatment for a transaction or event is not specified by a pronouncement or established in practice within Categories (a) through (d).

A key change made by FASB No. 162 was that it removed the GAAP hierarchy from SAS No. 69 which was directed to the auditor and places it within GAAP where it was the responsibility of the entity.

Further, within the FASB No. 162 hierarchy, there were numerous problems that included:

• Existing GAAP was far too complex with too many standards issued by too many standard setters in different forms, and
• It was difficult to locate certain GAAP because each standard setter had a different filing system.

Thus, FASB chose to create a new codification to become the source of authoritative nongovernmental GAAP.

As a result, the FASB initiated the Codification project to replace FASB No. 162’s hierarchy and to organize and simplify authoritative GAAP literature. Its primary goals were to:

• Simplify user access by codifying all authoritative GAAP in one location.
• Ensure that the codified content accurately represented U.S. GAAP as of a snapshot date of July 1, 2009.
• Provide a codification research system that is up to date for the released results of standard-setting activity.

In March 2009, the FASB issued an exposure draft on FASB No. 168 that ended in the issuance of a final statement in June 2009.

The new Codification has the following attributes:

• The Codification simplifies user access to all authoritative GAAP by reorganizing GAAP into approximately 90 accounting topics.
• Relevant portions of SEC and SEC Staff Interpretations have been included for reference only for public companies.
• Updates to the Codification issued after the effective date of FASB No. 168 will serve only to update the Codification.
• At the effective date of FASB No. 168, all nongrandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed nonauthoritative and no longer updated.

III. Scope

1. The Statement applies to financial statements of nongovernmental entities that are presented in conformity with GAAP.

IV. Definitions

1. The following terms are used in this Statement with the following definitions:

   a. Nonpublic entity: Any entity that does not meet any of the following conditions:

      1) Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

      2) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

      3) It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

      4) It is required to file or furnish financial statements with the SEC.

      5) It is controlled by an entity covered by any of the criteria in (1) to (4), above.
b. **Nongovernmental entity:** An entity that is not required to issue financial reports in accordance with guidance promulgated by the Governmental Accounting Standards Board or the Federal Accounting Standards Advisory Board.

V. **The New FASB No. 168 GAAP Hierarchy**

1. FASB No. 168 establishes a new U.S. GAAP which is now split into two levels:
   - **Authoritative GAAP Guidance**
   - **Non-authoritative GAAP Guidance**

<table>
<thead>
<tr>
<th>Evolution of FASB No. 162 Hierarchy into New FASB No. 168 GAAP</th>
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<td>Category under Previous FASB No. 162 Hierarchy</td>
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<td>d</td>
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<tr>
<td>Other accounting literature</td>
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</table>

(1) The subcategory “practices that are widely recognized and prevalent either generally or in the industry” found in the previous Category (d) is excluded from the Authoritative GAAP Guidance and considered Non-authoritative GAAP.

(2) The entire category “Other accounting literature” is considered Non-authoritative GAAP under the new U.S. GAAP.

2. The following chart illustrates the items that are included in the authoritative and non-authoritative GAAP guidance:

<table>
<thead>
<tr>
<th><strong>Authoritative GAAP Guidance</strong></th>
<th><strong>Non-authoritative GAAP Guidance</strong></th>
</tr>
</thead>
</table>
| 1) FASB Accounting Standards Codification (FASB ASC). | 1) GAAP that is not included as part of the new FASB Accounting Standards Codification (ASC). Sources of *non-authoritative accounting guidance and literature* include:
| | • Practices that are widely recognized and prevalent either generally or in the industry (1)
| | • FASB Concepts Statements (2)
| | • AICPA Issues Papers (2)
| | • International Financial Reporting Standards of the International Accounting Standards Board (IASB) (2)
| | • Pronouncements of professional associations or regulatory agencies, (2)
| | • Technical Practice Aids (2)
| | • Accounting textbooks, handbooks, and articles (2) |
2) **SEC companies**: rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority.¹


(1) Previously part of Category (d) GAAP per FASB No. 162 hierarchy.

(2) Previously included in the “other accounting literature” category per FASB No. 162 hierarchy.

3. **FASB Accounting Standards Codification (FASB ASC):**

   a. FASB No. 168 establishes a new Codification (FASB Accounting Standards Codification (FASB ASC)) as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities.

      - FASB Statement No. 168 is the *final standard* that was issued by FASB in an individual statement format.

   b. The FASB ASC contains the authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

      1) Categories (a), (b), (c) and a portion of (d) of the FASB No. 162 hierarchy are included in the new FASB Codification.

         a) A portion of Category (d) related to “practices that are widely recognized and prevalent either generally or in the industry” and the “other accounting literature” are excluded from the FASB Codification and are considered nonauthoritative GAAP.

      c. The ASC is broken down by topics, rather than by pronouncements, segregated into five areas as follows:

---

¹ Note: In addition to the SEC’s rules and interpretive releases, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements, and it utilizes SEC Staff Announcements and Observer comments made at Emerging Issues Task Force (EITF) meetings to publicly announce its views on certain accounting issues for SEC registrants.
d. All FASB statements (FASB No. 1-168) and other GAAP in existence as of July 1, 2009 have been merged into the new FASB ASC.

1) Previous GAAP has lost its identity and is now referenced by the new Topic Code and not the original FASB statement number. Example: FASB No. 140 is no longer referenced within the FASB ASC.

**Note:** Although the original FASB reference number has been eliminated and replaced with a Topic Code, there is a Cross Reference feature that allows a user to insert a FASB statement number and find the corresponding place within the Topic Codes where that statement information is located.

**Note:** If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, the entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider non-authoritative guidance from other sources.

An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events when those accounting principles either prohibit the application of the accounting treatment to the particular transaction or indicate that the accounting treatment should not be applied by analogy. The appropriateness of other sources of GAAP depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

A more detailed analysis of the topics related to each of the five areas of the FASB ASC is presented in the following table:

<table>
<thead>
<tr>
<th>Area</th>
<th>Description</th>
<th>Topic Codes</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Principles</td>
<td>Relates to conceptual matters and includes GAAP</td>
<td>105-199</td>
</tr>
<tr>
<td>Presentation</td>
<td>Relates to presentation matters</td>
<td>205-299</td>
</tr>
<tr>
<td>Financial Statement</td>
<td>Includes assets, liabilities, equity, revenue and</td>
<td>305-700</td>
</tr>
<tr>
<td>Accounts</td>
<td>expenses</td>
<td></td>
</tr>
<tr>
<td>Broad Transactions</td>
<td>Includes business combinations, derivatives and other</td>
<td>805-899</td>
</tr>
<tr>
<td>Industry</td>
<td>Relates to accounting that is unique to an industry</td>
<td>905-999</td>
</tr>
<tr>
<td></td>
<td>or type of activity. Topics include airlines and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>financial services</td>
<td></td>
</tr>
<tr>
<td>AREA</td>
<td>General Principles</td>
<td>Presentation</td>
</tr>
<tr>
<td>----------</td>
<td>--------------------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>TOPICS</td>
<td>105</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td></td>
<td>205</td>
<td>Presentation of Financial Statements</td>
</tr>
<tr>
<td></td>
<td>210</td>
<td>Balance Sheet</td>
</tr>
<tr>
<td></td>
<td>215</td>
<td>Statement of Stockholder Equity</td>
</tr>
<tr>
<td></td>
<td>255</td>
<td>Changing Prices</td>
</tr>
<tr>
<td></td>
<td>270</td>
<td>Interim Reporting</td>
</tr>
<tr>
<td></td>
<td>274</td>
<td>Personal Financial Statements</td>
</tr>
<tr>
<td></td>
<td>275</td>
<td>Risks and Uncertainties</td>
</tr>
<tr>
<td></td>
<td>280</td>
<td>Segment Reporting</td>
</tr>
<tr>
<td></td>
<td>420</td>
<td>Exit or Disposal Cost Obligations</td>
</tr>
<tr>
<td></td>
<td>430</td>
<td>Deferred Revenue</td>
</tr>
<tr>
<td></td>
<td>440</td>
<td>Commitments</td>
</tr>
<tr>
<td>AREA</td>
<td>General Principles</td>
<td>Presentation</td>
</tr>
<tr>
<td>----------------------</td>
<td>--------------------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>TOPICS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>450</td>
<td>Contingencies</td>
<td>855 Subsequent Events</td>
</tr>
<tr>
<td>460</td>
<td>Guarantees</td>
<td>860 Transfers and Servicing</td>
</tr>
<tr>
<td>470</td>
<td>Debt</td>
<td></td>
</tr>
<tr>
<td>480</td>
<td>Distinguishing Liabilities from Equity</td>
<td></td>
</tr>
<tr>
<td>505</td>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>605</td>
<td>Revenue Recognition</td>
<td></td>
</tr>
<tr>
<td>705</td>
<td>Cost of Sales and Services</td>
<td></td>
</tr>
<tr>
<td>71X</td>
<td>Compensation</td>
<td></td>
</tr>
<tr>
<td>720</td>
<td>Other Expenses</td>
<td></td>
</tr>
<tr>
<td>730</td>
<td>Research and Development</td>
<td></td>
</tr>
<tr>
<td>740</td>
<td>Income Taxes</td>
<td></td>
</tr>
</tbody>
</table>
Observation: The above table shows the general structure of the ASC. As you will see, there are the five areas of:

- General Principles
- Presentation
- Financial Statement Accounts
- Broad Transactions
- Industry

Under each of the areas are numerous topics. Although not presented in the table, under each Topic there are Subtopics followed by Sections for each Subtopic.

Thus, the system looks like this:

<table>
<thead>
<tr>
<th>Topic</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subtopic</td>
<td>YY</td>
</tr>
<tr>
<td>Section</td>
<td>ZZ</td>
</tr>
</tbody>
</table>

A Section of GAAP would be referenced by a unique number as follows: XXX-YY-ZZ with the XXX being the Topic, YY being the Subtopic, and ZZ being the Section. Under the Section there are Paragraphs.

FASB ASC organizes accounting and reporting guidance without regard to the original standard from which the guidance was derived. FASB ASC uses a topical structure in which Topics, Subtopics, and Sections are numerically referenced.

Example: An accountant wishes to look up the general rule for accounting for loss contingencies previously presented in FASB No. 5, Accounting for Contingencies.

Conclusion: The general rule is found in FASB ASC 450-20-25-1 as follows:

1. Go to the Financial Statement Accounts area (one of the 5 areas).
2. Select Topic: ASC 450 to access the “Contingencies” topic.
3. Select Subtopic: ASC 450-20 to access the “Loss Contingencies.” (subtopic 20 of topic 450)
4. Select Section: ASC 450-20-25 to access the “Recognition” (section 25 of subtopic 450-20)
5. Select Paragraph: ASC 450-20-25-1 to access Paragraph 1 “General Rule” (paragraph 1 of section 450-20-25)

Once you get to Paragraph 1, the information is presented as follows:

FASB ASC 450-20-25-1

25-1 When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. As indicated in the definition of contingency, the term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses. The Contingencies Topic uses the terms probable, reasonably possible, and remote to identify three areas within that range.
Is there reference to the original FASB document within the FASB ASC?
No. Although the FASB documents (1-168) are available, their identity is eliminated within the FASB ASC. Therefore, in the above example dealing with loss contingencies, the authoritative guidance found in FASB No. 5 has been moved into FASB ASC under FASB ASC 450. Reference to the original FASB No. 5 has disappeared.

e. SEC companies:

1) For reference purposes, the Codification ASC includes a portion of the content issued by the SEC. That content includes:

- Regulation S-X
- Financial Reporting Releases and Accounting Series Releases
- Interpretive Releases
- SEC Staff guidance found in Staff Accounting Bulletins (SAB) and EITF Topic D and SEC Staff Observer comments

Note: Content contained in the SEC Sections of the Codification is provided for convenience and relates only to SEC registrants. The SEC Sections are not the authoritative sources of such content and do not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. Content in the SEC Sections is expected to change over time, and there may be delays between SEC and staff changes to guidance and Accounting Standards Updates. The Codification does not replace or affect guidance issued by the SEC or its staff for public entities in their filings with the SEC.

SEC Response to FASB ASC:

On August 18, 2009, the SEC issued Interpretive Release No. 33-9062A, Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification. The Release instructs SEC statement preparers, auditors, and investors that as of September 15, 2009, “references in the commission's rules and staff guidance to specific standards under U.S. GAAP should be understood to mean the corresponding reference in the FASB Codification.”

As a result of the launch of FASB ASC, the SEC said it plans to start a long-term project “to revise comprehensively specific references to specific standards under U.S. GAAP in the commission's rules and staff guidance.”

“The FASB Codification does not supersede commission rules or regulations,” said the SEC in Release No. 33-9062. “We understand that the FASB Codification, as a service to users, includes references to some commission rules and staff guidance. However, the FASB Codification is not the authoritative source for such content, nor does its inclusion in the FASB Codification affect how such content may be updated in the future.”

PCAOB Q&A:

In September 2009, the Public Company Accounting Oversight Board (PCAOB) published Staff Questions and Answers to address references to GAAP in PCAOB standards in light of the FASB Codification.

Following are the questions presented within the Q&A:

**Question 1:** Certain PCAOB standards include descriptions of and references to U.S. GAAP and accounting requirements. What is the status of those descriptions of and references to U.S. GAAP and accounting requirements upon the effective date of FASB ASC?

**Answer 1:** Certain PCAOB standards contain descriptions of and references to U.S. GAAP that existed prior to the Codification. …..

Auditors should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the Codification.

Auditors should look to the relevant sections of the Codification and to SEC requirements to identify the applicable accounting and reporting requirements for the company under audit.

**Question 2:** What is the auditor's responsibility if, in using FASB ASC, the auditor believes that an item in the financial statements should be accounted for differently under FASB ASC than under pre-Codification U.S. GAAP?

**Answer 2:** …. If an issuer reaches a different conclusion on an accounting matter, an auditor should evaluate management’s conclusion on whether the different accounting treatment is a change in accounting principle or an error…

**Question 3:** What are the other responsibilities of an auditor with respect to FASB ASC?

**Answer 3:** Auditors will need to become knowledgeable about using the Codification. Additionally, for reviews of interim financial information and audits of financial statements for periods ending after September 15, 2009, when referencing or including an excerpt from U.S. GAAP in audit documentation, the relevant Codification topic is the appropriate source for that reference or excerpt. It may be desirable, but not necessary, to update certain existing audit documentation (e.g., audit schedules, memoranda) containing previous references to U.S. GAAP prepared prior to the Codification.

**Question 4:** What consideration, if any, should an auditor give to descriptions of and references to U.S. GAAP in the standards of the PCAOB if he or she is auditing the financial statements of a foreign private issuer (FPI) prepared in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board?

**Answer 4:** In an audit of an FPI’s financial statements that are prepared in conformity with IFRS, the auditor needs to consider SEC requirements and IFRS to determine the applicable accounting and reporting requirements and should disregard descriptions of and references to U.S. GAAP in PCAOB standards.
f. Accounting Standards Updates (ASUs):

1) Subsequent to the effective date of the FASB ASC, all updates will be achieved through the issuance of Accounting Standards Updates (ASUs).

a) The ASUs:
   - Are not considered authoritative in their own right.
   - Serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification.

2) After the effective date of FASB No. 168, all non-grandfathered non-SEC accounting literature not included in the Codification is superseded and deemed non-authoritative.

3) The ASUs are organized into a format that includes the year (XXXX) followed by the sequential number for each accounting standard issued.

   Note: An example of the format for issuing an ASU is found with the August 2009 issuance of FASB Accounting Standards Update No. 2009-05, Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value. ASU No. 2009-05 is an amendment to Subtopic 10 of Topic 820, Fair Value Measurements and Disclosures - Overall.

   Note further that all new EITF Abstracts, FASB Staff Positions, etc. will be issued as ASUs instead of as EITFs or FASB Staff Positions.

4) Once an ASU is issued, it will be shown as “Pending Content” within the FASB ASC until the ASU becomes effective for all entities. At that time, the outdated guidance will be removed and the new amended ASU information will be inserted into the FASB ASC.

4. Grandfathered rules and excluded matters:

a. An entity that has followed, and continues to follow, an accounting treatment that was previously in category (c) or category (d) of the GAAP hierarchy as of March 15, 1992, is not required to change to an accounting treatment in a higher category ((b) or (c)) of that FASB No. 162 hierarchy (now included in the Codification in accordance with this Statement) if its effective date was before March 15, 1992.

   Example: A non-governmental entity that followed a prevalent industry practice (FASB No. 162, category (d)) as of March 15, 1992, does not have to change to an accounting treatment included in a standard that was in category (b) or category (c) (such as an accounting principle in a cleared AICPA Statement of Position or Accounting Standards Executive Committee Practice Bulletin that is now included in the Codification in accordance with this Statement) whose effective date is before March 15, 1992. For standards whose effective date is after March 15, 1992, and for entities initially applying an accounting principle...
after March 15, 1992 (except for EITF consensus positions issued before March 16, 1992, which become effective in the hierarchy for initial application of an accounting principle after March 15, 1993), an entity shall follow the guidance in the Codification.

b. Certain accounting standards have allowed for the continued application of superseded accounting standards for transactions that have an ongoing effect in an entity’s financial statements. That superseded guidance has not been included in the Codification, shall be considered grandfathered, and shall continue to remain authoritative for those transactions after the effective date of FASB No. 168. While not comprehensive, the following are examples of such grandfathered items:

- Pooling of interests in a business combination described in paragraph B217 of FASB Statement No. 141, Business Combinations
- Pension transition assets or obligations described in paragraph 77 of FASB Statement No. 87, Employers’ Accounting for Pensions
- Employee stock ownership plan shares, as described in paragraphs 97 and 102 of AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans
- Loans restructured in a troubled debt restructuring before the effective date of FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, described in paragraph 24 of FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures
- Stock compensation for nonpublic and other entities (originally addressed by FASB Statement No. 123, Accounting for Stock-Based Compensation, or APF Opinion No. 25, Accounting for Stock Issued to Employees) described in paragraph 83 of FASB Statement No. 123 (revised 2004), Share-Based Payment
- For nonpublic entities electing the deferral of FASB Statement No. 48, Accounting for Uncertainty in Income Taxes, FASB Statement No. 109, Accounting for Income Taxes, and related standards
- For business combinations with an acquisition date before the first annual reporting period beginning on or after December 15, 2008, Statement 141 and any other relevant standards
- For not-for-profit entities, pooling of interests as allowed for under Opinion 16, even though it has been superseded by Statement 141 until FASB Statement No. 164, Not-for-Profit Entities: Mergers and Acquisitions, is effective
- For goodwill and intangible assets arising from a combination between two or more not-for-profit entities or acquired in the acquisition of a for-profit business entity by a not-for-profit entity until Statement 164 is effective, Opinion 16 and APB Opinion No. 17, Intangible Assets

c. Although FASB No. 168 (and the FASB ASC) applies to financial statements of nongovernmental entities that are presented in conformity with GAAP, the FASB ASC does not include any guidance on the following matters:

1) Non-GAAP matters such as:
   - Other Comprehensive Basis of Accounting (OCBOA)
   - Cash basis
• Income tax basis
• Regulatory accounting principles

2) Governmental accounting standards.

3) References to audit guidance.

4) Nonessential material such as document summaries, basis for conclusions, and similar appendixes found in the original FASB documents.

5. Simplifying the language within the Codification

a. In writing the Codification, the FASB chose a simple, module writing style that was used consistently across the Codification.

Examples include:

• The term entity is used to replace terms such as company, organization, enterprise, firm, preparer, etc.

• The term intra-entity replaces the term intercompany.

• The terms shall, should, and would, are used in lieu of the terms, is required to, and must.

• Terms such as usually, ordinarily, and generally, have been eliminated from the Codification.

• Most acronyms as stand-alones without the underlying text have been eliminated.

• Footnotes from the original documents have been eliminated and are now part of the text within the Codification.

• A Master Glossary has been provided to look up any term along with a separate glossary within each subtopic.

6. Effective Date and Transition

a. FASB No. 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

1) Exception: The exception is for nonpublic non-governmental entities that have not followed the guidance included in the AICPA Technical Inquiry Service (TIS) Section 5100, “Revenue Recognition,” paragraphs 38-76. Those entities shall account for the adoption of that guidance as a change in accounting principle on a prospective basis for revenue arrangements entered into or materially modified in those fiscal years beginning on or after December 15, 2009, and interim periods within those years. If an accounting change results from the application of that guidance, an entity shall disclose the nature and reason for the change in accounting principle.
b. Date on which to start referencing the new Codification:

_nonpublic entities_. For nonpublic entities without interim filings, financial statements should start referencing FASB ASC for the first annual period ending after September 15, 2009.

_example_: A nonpublic entity with a December 31, 2009 year-end should reference FASB ASC in its financial statements.

_public entities_. For public entities, financial statements should reference FASB ASC starting for the first interim and annual periods ending after September 15, 2009.

_example_: A public entity filing financial statements for the quarter ended September 30, 2009 should reference FASB ASC in its financial statements.

c. On the effective date of this Statement, all then-existing non-SEC accounting and reporting standards are superseded, except FASB No. 164-168 as noted below. Concurrently, all non-grandfathered, non-SEC accounting literature not included in the Codification is deemed non-authoritative.

The following standards shall remain authoritative until such time that each is integrated into the Codification:

- FASB Statement No. 164, _Not-for-Profit Entities: Mergers and Acquisitions_
- FASB Statement No. 166, _Accounting for Transfers of Financial Assets_
- FASB Statement No. 167, _Amendments to FASB Interpretation No. 46(R)_
- FASB Statement No. 168, _The FAS Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles_

d. Subject to the exception noted in paragraph 6(a)(1) above, any effect of applying the provisions of this Statement shall be accounted for as a _change in accounting principle or correction of an error_, as applicable, in accordance with FASB Statement No. 154, _Accounting Changes and Error Corrections_ (new Section 250-10-50 of the Codification).

1) An entity shall follow the disclosure requirements of FASB No. 154 and disclose the accounting principles that were used before and after the application of the provisions of FASB No. 168 and the reason that applying this Statement resulted in a change in accounting principle or correction of an error.

VI. Applying the New FASB ASC

1. The FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force [EITF], and the AICPA) to organize them under approximately 90 topics.

2. The FASB ASC will be implemented under the following rules:

a. After the issuance of FASB No. 168, the Codification ASC will be the authoritative source of U.S. GAAP.
b. There will no longer be accounting standards issued in the form of statements, staff positions, EITF abstracts, or statements of position.

c. The FASB will issue Accounting Standards Updates (ASUs) which will serve only to update the FASB ASC.

- The ASUs will not be considered authoritative in their own right but will be supplements to the underlying authoritative guidance which is the FASB ASC.

- ASUs will be issued in the form of “ASU No. 20YY-XX (YY is the year and XX is the sequence number for each update).

  Example: ASU No. 2011-03 is the third update in the year 2011.

- The ASUs will provide background information about the guidance and the basis for conclusions made by the ASU to the FASB ASC.

Where do you find the FASB Codification?

On the FASB’s website, the FASB ASC is available in two versions: a Basic View and a Professional View. The Basic View offers users basic printing and topical browsing functionality, as well as a utility to identify the location of legacy standards, and is free. The Professional View offers expanded functionality for an annual fee (currently $850). Both views are available at http://asc.fasb.org/home.

The FASB has announced that it plans to issue the Codification in a print version, as well.

How do you locate previous GAAP standards within the FASB Codification?

Within the Codification is a Cross Reference feature which allows a user to look up information in one of two directions:

1. Cross reference a FASB standard to a Codification topic, subtopic, section or paragraph, or

2. Cross reference a Codification topic, subtopic, section or paragraph to a FASB Standard.

By inserting either a FASB standard number or a Codification number, the feature generates a report that lists the corresponding cross referenced material.

How should you reference FASB ASC and ASUs in financial statements?

When referencing FASB ASC in financial statements, such as in footnote disclosures, FASB recommends using a plain English approach to describe broad FASB ASC topic references such as:
NOTE X:

“As required by the Fair Value Measurements and Disclosures Topic of FASB ASC 820, ABC Entity is required to use its own credit spreads in determining the current value for its derivatives liabilities and all other liabilities for which it has elected the fair value option.”

In some cases entities may find it more useful for users to describe the specifics of the accounting policy applied rather than simply give the FASB reference. For example, a clear description of an entity’s accounting policies for share-based payment arrangements would often be more relevant to financial statement users than a general statement that the entity follows FASB ASC 718, Compensation – Stock Compensation.

**How should an accountant or auditor reference the FASB ASC in working papers or other memoranda?**

The FASB ASC *Notice to Constituents* (NTC) describes how to reference FASB ASC in financial statements and other documents, working papers, articles, textbooks, and related items. Audit, compilation, and review working papers associated with financial statements for a period ending after September 15, 2009 should reflect the FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

FASB recommends, but does not require, using the detailed numerical referencing system as described previously. For example:

**Sample documentation in working papers:**

“Under FASB ASC 820-10-35-18, ABC Entity is required to use its own credit spreads in determining the current value for its derivatives liabilities and all other liabilities for which it has elected the fair value option.”
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following was included in Category (d) of the FASB No. 162 GAAP Hierarchy:
   a) Implementation Guides (Q&As) published by the FASB staff
   b) FASB Technical Bulletins
   c) AICPA Industry Audit and Accounting Guides and Statements of Position, cleared by the FASB
   d) topics discussed in Appendix D of EITF Abstracts (EITF D-Topics)

2. Which of the following is correct as it relates to the evolution of FASB No. 162 GAAP hierarchy into the new FASB No. 168 hierarchy:
   a) FASB No. 162’s Category (a) became non-authoritative GAAP
   b) FASB No. 162’s Category (d) became both authoritative and non-authoritative GAAP
   c) FASB No. 162’s Other accounting literature became part of authoritative GAAP
   d) FASB No. 162’s Category (b) became part of non-authoritative GAAP

3. Which of the following is an example of authoritative GAAP guidance:
   a) an accounting textbook by a prominent author
   b) rules and interpretive releases of the SEC under federal securities laws
   c) pronouncements of professional associations or regulatory agencies
   d) Technical Practice Aids

4. Which of the following is an example of a topic that would be found under the Presentation area of the FASB ASC:
   a) Topic 310: Receivables
   b) Topic 805: Business Combinations
   c) Topic 270: Interim Reporting
   d) Topic 330: Inventories
5. With respect to the FASB ASC, under which area would one find the Topic 855, Subsequent Events:

a) Presentation
b) Industry
c) Broad Transactions
d) General Principles

6. Facts: GAAP within the FASB ASC has the following reference: 605-20-30-3. Which of the following is correct:

a) 605 is the section, 20 is the subtopic, 30 is the topic, and 3 is the paragraph
b) 605 is the subtopic, 20 is the topic, 30 is the section, and 3 is the paragraph
c) 605 is the topic, 20 is the subtopic, 30 is the section, and 3 is the paragraph
d) 605 is the paragraph, 20 is the topic, 30 is the section, and 3 is the subtopic

7. Which of the following is correct:

a) an ASU is shown as Pending Content within the FASB ASC until the ASU becomes effective for all entities
b) an ASU is immediately recorded as part of the FASB ASC when issued
c) an ASU remains a separate document permanently under an alternative reference system
d) an ASU is a non-authoritative document that is never integrated as part of GAAP

8. Which of the following is an example of how the FASB simplified the language within the FASB ASC:

a) they have added numerous acronyms such as SEC, ASB, etc.
b) a Master Glossary has been provided to look up any term along with a separate glossary within each subtopic
c) the terms is required to and must have replaced terms such as shall, should and would
d) the term enterprise is the new standard term used to describe an entity
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** Implementation Guides (Q&As) published by the FASB staff were part of Category (d) GAAP.

   B: Incorrect. FASB Technical Bulletins were included in Category (b), and not (d) GAAP.

   C: Incorrect. AICPA Industry Audit and Accounting Guides and Statements of Position cleared by the FASB were part of Category (b) GAAP, not Category (d).

   D: Incorrect. Topics discussed in Appendix D of EITF Abstracts (EITF D-Topics) were part of Category (c) GAAP and not Category (d).

   (See page 4 of the course material.)

2. **A: Incorrect.** Category (a) became part of authoritative GAAP.

   **B: Correct.** Category (d) became both authoritative and non-authoritative GAAP with the “practices that are widely recognized and prevalent…” being placed as non-authoritative GAAP and the remainder of Category (d) being considered authoritative GAAP.

   C: Incorrect. The “Other accounting literature” category became part of non-authoritative GAAP.

   D: Incorrect. Category (b) became part of authoritative GAAP.

   (See page 6 of the course material.)

3. **A: Incorrect.** An accounting textbook is part of non-authoritative GAAP regardless of how prominent the author may be.

   **B: Correct.** Rules and interpretive releases of the SEC under federal securities laws are sources of authoritative GAAP for SEC registrants.

   C: Incorrect. Pronouncements of professional associations or regulatory agencies are non-authoritative GAAP.

   D: Incorrect. Technical Practice Aids are part of non-authoritative GAAP.

   (See pages 6 to 7 of the course material.)
4. A: Incorrect. Topic 310: Receivables is part of the area called Financial Statement Accounts and not Presentation.

B: Incorrect. Topic 805: Business Combinations is part of the Broad Transactions area, and not the Presentation area.

C: Correct. Topic 270: Interim Reporting is part of the Presentation area.

D: Incorrect. Topic 330: Inventories is part of the area called Financial Statement Accounts and not Presentation.

(See page 8 of the course material.)

5. A: Incorrect. The Presentation area covers Topics 205-280 and does not include Topic 855: Subsequent Events.

B: Incorrect. The Industry area includes Topics 905-995 and does not include Topic 855: Subsequent Events.

C: Correct. The Broad Transactions area covers Topics 805-860, one of which is Topic 855: Subsequent Events.

D: Incorrect. The General Principles area includes Topic 105 and does not include Topic 855: Subsequent Events.

(See page 8 of the course material.)

6. A: Incorrect. 605 is not the section, 20 is not the subtopic, 30 is not the topic, and 3 is the paragraph.

B: Incorrect. 605 is not the subtopic, 20 is the topic, 30 is the section, and 3 is the paragraph.

C: Correct. 605 is the topic, 20 is the subtopic, 30 is the section, and 3 is the paragraph.

D: Incorrect. 605 is not the paragraph, 20 is not the topic, 30 is the section, and 3 is not the subtopic.

(See page 11 of the course material.)
7. **A: Correct.** An ASU is shown as Pending Content within the FASB ASC until the ASU becomes effective for all entities. At that time, the outdated guidance will be removed and the new amended ASU information will be inserted into the FASB ASC.

B: Incorrect. An ASU is not immediately recorded as part of the FASB ASC. It is recorded only once it becomes effective at which time the outdated guidance is removed and the new ASU is inserted into the FASB ASC.

C: Incorrect. An ASU is not permanently separated and there is no alternative reference system.

D: Incorrect. Although an ASU is not considered authoritative in its own right, it does update the FASB ASC and is ultimately integrated as part of the ASC.

(See page 14 of the course material.)

8. A: Incorrect. In fact the FASB has eliminated numerous acronyms such as SEC and ASB without eliminating the underlying text.

**B: Correct.** The FASB ASC now has a Master Glossary that allows for a user to look up any term along with a separate glossary that exists within each subtopic.

C: Incorrect. Just the opposite is true. The terms *shall*, *should* and *would* have replaced the terms *is required to* and *must*.

D: Incorrect. The FASB has standardized the ASC literature by using the term *entity* to replace terms such as *company, organization, enterprise, firm, preparer,* etc.

(See page 16 of the course material.)
CHAPTER 6

Current Developments –
Accounting and Financial Reporting
## Current Developments – Accounting and Financial Reporting

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Current Developments – Accounting and Financial Reporting

New FASB Accounting Standards Codification (FASB ASC):

Effective July 1, 2009, the FASB implemented its Accounting Standards Codification™ (Codification). The Codification is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied to nongovernmental entities. The Codification is effective for interim and annual periods ending after September 15, 2009. All previous level (a)-(d) U.S. GAAP standards issued by a standard setter are superseded. Level (a)-(d) U.S. GAAP refers to the previous accounting hierarchy. All other accounting literature not included in the Codification will be considered non-authoritative. The Codification structure is significantly different from the structure of previous standards.

Within this course, the author retains the original FASB or AICPA pronouncement followed by the corresponding new Accounting Standards Codification (ASC) topic number. The ASC topic number is parenthetically included the first time a standard is mentioned within a section.

I. FASB Staff Positions (FSPs) and Accounting Standards Updates (ASUs)

FASB Staff Position (FSP) FAS 115-2 and FAS 124-2: Recognition and Presentation of Other-Than-Temporary Impairments

Issued: April 2009

Objective:

The objective of an other-than-temporary impairment analysis under existing U.S. generally accepted accounting principles (GAAP) is to determine whether the holder of an investment in a debt or equity security for which changes in fair value are not regularly recognized in earnings (such as securities classified as held-to-maturity or available-for-sale) should recognize a loss in earnings when the investment is impaired. An investment is impaired if the fair value of the investment is less than its amortized cost basis.

This FASB Staff Position (FSP) amends the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities.

Background:

If the fair value of a debt security is less than its amortized cost basis at the measurement date, U.S. GAAP requires that an entity assess the impaired security to determine whether the impairment is other than temporary. Before this FSP, to conclude that an impairment was not other-than-temporary, an entity was required, among other considerations, to assert that it had the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value in accordance with SEC Staff Accounting Bulletin (SAB) Topic 5M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities, and other authoritative literature.
If the impairment was determined to be other-than-temporary, then an impairment loss was recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the Act) was signed into law. Section 133 of the Act mandated that the U.S. Securities and Exchange Commission (SEC) conduct a study on mark-to-market accounting standards. The SEC submitted its study, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, to Congress on December 30, 2008. One of the recommendations in the study was that the FASB reassess current impairment accounting models for financial instruments. The SEC recommended that the FASB “evaluate the need for modifications (or the elimination) of current OTTI [other-than-temporary impairment] guidance to provide for a more uniform system of impairment testing standards for financial instruments.” The SEC also noted that a model that would require that only credit losses be recognized in income with the remaining decline in fair value of an investment being recognized in other comprehensive income “has the potential to provide investors with both fair value information as well as transparent information regarding the cash flows management expects to receive by holding investments, rather than through accessing the market currently.”


However, constituents continued to express concerns that the requirements for recognition and measurement of impairment losses for investments in debt securities are different from those for loans. Those constituents also observed that financial statements do not provide users with sufficient information about the amount of cash the entity expects to collect by holding the asset. Some constituents asserted that current market conditions have caused temporary declines in value that go well beyond the cash flows that are no longer expected to be collected.

The FSP incorporates other-than-temporary impairment guidance for debt securities from SAB Topic 5M and other authoritative literature, modifies and expands it to address the unique features of debt securities, and clarifies the interaction of the factors that should be considered when determining whether a debt security is other than temporarily impaired.

Conclusions of the FSP:

1. The scope of the recognition guidance in the FSP applies to debt securities classified as available-for-sale and held-to-maturity that are subject to other-than-temporary impairment guidance within:
   - FASB No. 115 (ASC 320)
   - FSP FAS 115-1 and FAS 124-1 (ASC 320)
   - EITF Issue 99-20, as amended by FSP EITF 99-20-1 (ASC 325)
   - AICPA Statement of Position 03-3 (ASC 815)
2. For debt securities, the FASB is modifying the existing requirements that to avoid recognizing an other-than-temporary impairment an investor must assert that it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in its fair value to its amortized cost basis.

3. If the fair value of a debt security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary.

4. If either of the following conditions is met, an other-than-temporary impairment shall be considered to have occurred:
   a. An entity intends to sell the debt security (that is, it has decided to sell the security), or
   b. An entity more likely than not (more than 50% probability) will be required to sell the security before recovery of its amortized cost basis.

   **Note:** If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before a forecasted recovery occurs).

5. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis, even if it does not intend to sell the security. Therefore, in those situations, an other-than-temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a credit loss exists), and an other-than-temporary impairment shall be considered to have occurred.

6. In determining whether a credit loss exists, an entity shall use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in paragraphs 12-16 of FASB No. 114, *Accounting by Creditors for Impairment of a Loan*, for measuring an impairment on the basis of the present value of expected future cash flows. Paragraph 14 of FASB No. 114 provides guidance on this calculation. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

7. For debt securities that are beneficial interests in securitized financial assets within the scope of Issue 99-20, an entity shall determine the present value of cash flows expected to be collected by considering the guidance in paragraph 12(b) of Issue 99-20 for determining whether there has been a decrease in cash flows expected to be collected from cash flows previously projected. In other words, the cash flows estimated at the current financial reporting date shall be discounted at a rate equal to the current yield used to accrete the beneficial interest.
Chapter 6: Current Developments – 6
Accounting and Financial Reporting

**Note:** For debt securities accounted for in accordance with SOP 03-3, an entity shall consider that standard in estimating the present value of cash flows expected to be collected from the debt security. A decrease in cash flows expected to be collected on an asset-backed security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cash flows expected to be collected.

8. When estimating whether a credit loss exists and the period over which the debt security is expected to recover, there are several factors to consider which include some of the following:

a. The length of time and the extent to which the fair value has been less than the amortized cost basis.

b. Adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement).

c. The historical and implied volatility of the fair value of the security.

d. The payment structure of the debt security (for example, nontraditional loan terms as described in FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk* (ASC 275) and the likelihood of the issuer being able to make payments that increase in the future.

e. Failure of the issuer of the security to make scheduled interest or principal payments.

f. Any changes to the rating of the security by a rating agency.

g. Recoveries or additional declines in fair value subsequent to the balance sheet date.

9. In making its other-than-temporary impairment assessment, an entity shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected.

Such information generally should include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the entity should consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security.

**Note:** An entity also should consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract as discussed in paragraph 8 of FSP FAS 115-1 and FAS 124-1) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by nontraditional loans). Thus, an entity should consider whether a
security backed by currently performing loans will continue to perform when required payments increase in the future (including "balloon" payments). An entity also should consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, an entity needs to assess the effect of that decline on the ability of the entity to collect the balloon payment.

10. When an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

   a. If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date.

   Note: In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, an entity shall consider the factors in paragraph 8 above.

   b. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into two categories:

      Category 1: The amount representing the credit loss which shall be recognized in earnings, and

      Category 2: The amount related to all other factors (presented in other comprehensive income, net of applicable taxes).

11. Once written down, the previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment.

   a. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value.

   b. The amortized cost basis shall be adjusted for accretion and amortization.

12. Accounting for debt securities after an other-than-temporary impairment:

   An entity shall account for the other-than-temporarily-impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized in earnings.

   a. For debt securities for which other-than-temporary impairments were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted in accordance with existing
guidance as interest income. An entity shall continue to estimate the present value of cash flows expected to be collected over the life of the debt security.

b. For debt securities accounted for in accordance with EITF Issue 99-20, an entity should look to that standard to account for changes in cash flows expected to be collected. For all other debt securities, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with SOP 03-3, even if the debt security would not otherwise be within the scope of that standard.

**Note:** This FSP does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security.

**Debt Securities Classified as Available-for-Sale:** Subsequent increases and decreases (if not an additional other-than-temporary impairment) in the fair value of available-for-sale securities shall be included in other comprehensive income.

**Debt Securities Classified as Held-to-Maturity:** The other-than-temporary impairment recognized in other comprehensive income for debt securities classified as held-to-maturity shall be accreted from other comprehensive income to the amortized cost of the debt security over the remaining life of the debt security in a prospective manner on the basis of the amount and timing of future estimated cash flows.

- The accretion increases the carrying value of the security and shall continue until the security is sold, the security matures, or there is an additional other-than-temporary impairment that is recognized in earnings.

- If the security is sold, paragraphs 8 and 11 of FASB No. 115 provide guidance on the effect of changes in circumstances that would not call into question the entity’s intent to hold other debt securities to maturity in the future.

13. Presentation:

a. In periods in which an entity determines that a security’s decline in fair value below its amortized cost basis is other than temporary, the entity shall present the total other-than-temporary impairment in the statement of earnings with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income in accordance with paragraph 30, if any.

Following is an example of the presentation on the face of the statement of earnings:
Total other-than-temporary impairment losses $(10,000)

Portion of loss recognized in other comprehensive income (before taxes) 4,000

Net impairment losses recognized in earnings $(6,000)

b. An entity also shall separately present, in the financial statement where the components of accumulated other comprehensive income are reported, amounts recognized therein related to held-to-maturity and available-for-sale debt securities for which a portion of an other-than-temporary impairment has been recognized in earnings.

14. Disclosures:

a. An entity shall disclose information for interim and annual periods that enables users of its financial statements to understand the types of available-for-sale and held-to-maturity debt and equity securities held, including information about investments in an unrealized loss position for which an other-than-temporary impairment has or has not been recognized.

In addition, for interim and annual periods, an entity shall disclose information that enables users of financial statements to understand the reasons that a portion of an other-than-temporary impairment of a debt security was not recognized in earnings and the methodology and significant inputs used to calculate the portion of the total other-than-temporary impairment that was recognized in earnings.

b. An entity shall identify major security types consistent with how it manages, monitors, and measures its securities on the basis of the nature and risks of the security.

c. An entity shall consider the (shared) activity or business sector, vintage, geographic concentration, credit quality, or economic characteristic in determining whether disclosure for a particular security type is necessary and whether it is necessary to separate further a particular security type in greater detail. When complying with the disclosure requirements in paragraph 19 of FASB No. 115, a financial institution shall include the following major security types, although additional types also may be necessary: equity securities (segregated by industry type, company size, or investment objective); debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies; debt securities issued by states of the United States and political subdivisions of the states; debt securities issued by foreign governments; corporate debt securities; residential mortgage-backed securities; commercial mortgage-backed securities; collateralized debt obligations; and other debt obligations. For purposes of this requirement, the term financial institutions includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies.
d. For securities classified as available-for-sale or held-to-maturity, an entity shall disclose the following:

1) The amortized cost basis by major security type that the entity discloses in accordance with FASB No. 115 as of each date (interim and annual) for which a statement of financial position is presented.

2) All disclosures required by FASB No. 115 on a quarterly basis.

e. An entity shall disclose, by major security type, the information required by FSP FAS 115-1 and FAS 124-1 for each interim and annual reporting period presented.

Note: The information required by paragraph 17 of FSP FAS 115-1 and FAS 124-1 also shall be presented for debt securities for which an other-than-temporary impairment was recognized and only the amount related to a credit loss was recognized in earnings.

f. For periods in which an other-than-temporary impairment of a debt security is recognized and only the amount related to a credit loss was recognized in earnings, an entity shall disclose, by major security type, the methodology and significant inputs used to measure the amount related to the credit loss.

Examples of significant inputs include, but are not limited to:

- Performance indicators of the underlying assets in the security (including default rates, delinquency rates, and percentage of nonperforming assets)
- Loan to collateral value ratios
- Third-party guarantees
- Current levels of subordination
- Vintage
- Geographic concentration, and
- Credit ratings

g. For each interim and annual reporting period presented, an entity shall disclose a tabular roll forward of the amount related to credit losses recognized in earnings, which shall include at a minimum:

1) The beginning balance of the amount related to credit losses on debt securities held by the entity at the beginning of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income.

2) Additions for the amount related to the credit loss for which an other-than-temporary impairment was not previously recognized.

3) Reductions for securities sold during the period (realized).

4) Reductions for securities for which the amount previously recognized in other comprehensive income was recognized in earnings because the entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis.
5) Additional increases to the amount related to the credit loss for which an other-than-temporary impairment was previously recognized when the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis.

6) Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security.

7) The ending balance of the amount related to credit losses on debt securities held by the entity at the end of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income.

15. Effective Date and Transition:


b. If an entity elects to adopt early either FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, or FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, the entity also is required to adopt early this FSP. Additionally, if an entity elects to adopt early this FSP, it is required to adopt FSP FAS 157-4. This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

c. This FSP shall be applied to existing and new investments held by an entity as of the beginning of the interim period in which it is adopted (for example, as of April 1, 2009, if an entity adopts the FSP for periods ending after June 15, 2009). For debt securities held at the beginning of the interim period of adoption for which an other-than-temporary impairment was previously recognized, if an entity does not intend to sell and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis (after considering the guidance in paragraphs 19–26 of this FSP), the entity shall recognize the cumulative effect of initially applying this FSP as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income.

d. The cumulative effect on retained earnings shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraphs 23 and 24 with the amortized cost basis of the debt security as of the beginning of the interim period in which this FSP is adopted. The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.
e. The amortized cost basis of a security for which an other-than-temporary impairment was previously recognized shall be adjusted by the amount of the cumulative-effect adjustment before taxes. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted in accordance with existing guidance as interest income.

f. In the period of adoption, an entity shall provide the disclosures required by FASB No. 154, Accounting Changes and Error Corrections (ASC 250), for changes in accounting principles.

FASB Staff Position (FSP) FAS 107-1 and APB 28-1: Interim Disclosures about Fair Value of Financial Instruments

Issued: April 2009

Objective:

This FSP amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments (ASC 825), to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The FSP also amends APB Opinion No. 28, Interim Financial Reporting (ASC 270), to require those disclosures in summarized financial information at interim reporting periods.

Background:

The FASB received extensive input from constituents (such as financial statement users, preparers, auditors, and regulators) on financial reporting issues related to the measurement and impairment of financial instruments. Most users indicated that measuring financial instruments at fair value is more relevant than other measurements (such as amortized cost) in helping to assess the effect of current economic events on an entity on a timely basis. Other constituents asserted that fair value is not as relevant when financial markets are inactive or distressed.

The Board acknowledges that the number and variations of measurement attributes for financial instruments create complexity. The Board recently added to its agenda a comprehensive joint project with the International Accounting Standards Board (IASB) to address the complexity related to recognition and measurement of financial instruments.

However, to expeditiously address the concerns raised about the lack of comparability resulting from the use of different measurement attributes for financial instruments, the Board decided that increasing the frequency of the disclosures about fair value would improve the transparency and quality of information provided to users of financial statements. The Board determined that, along with reported non-fair-value amounts on the face of the financial statements, fair value disclosures would allow for more timely and robust discussions between users and preparers of financial statements about current financial instrument valuations.
Conclusions of the FSP:

The FSP amends FASB No. 107 to do the following:

1. FASB No. 107 is expanded to apply the fair value disclosures to publicly traded companies for interim reporting periods, as defined by APB No. 28.
   a. The disclosures for interim reporting periods, like those for annual reporting periods, do not apply to nonpublic entities.

2. An entity shall disclose in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by FASB No. 107.

3. Fair value information disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amount relates to what is reported in the statement of financial position.

4. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments and shall describe changes in method(s) and significant assumptions, if any, during the period.

Effective Date and Transition

The FSP is effective for interim reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity may early adopt this FSP only if it also elects to early adopt FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, and FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments.

This FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

FASB Staff Position (FSP) FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly

Issued: April 2009

Objective:

This FSP provides additional guidance for estimating fair value in accordance with FASB Statement No. 157, Fair Value Measurements (ASC 820), when the volume and level of activity for the asset or liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly.
This FSP emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability, and, regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.


**Background:**

FASB No. 157 was issued in 2006 and establishes a single definition of fair value and a framework for measuring fair value in GAAP. The goal of FASB No. 157 is to improve consistency and comparability about fair value measurements to improve the quality of information provided to users.

FASB No. 157 establishes a fair value hierarchy for inputs used in the valuation process, consisting of three tiers of inputs:

- **Level 1**: Inputs consisting of quoted prices in active markets for identical assets that the preparer has access to on the measurement date.

- **Level 2**: Inputs other than quoted prices that are observable either directly or indirectly including quoted prices in active and less active markets for similar assets, observable inputs such as interest rates, credit risk, default rates, yield curves, or other inputs derived from market data via methods such as correlation analysis.

- **Level 3**: The weakest of the three levels, consisting of inputs that are unobservable. Level 3 inputs are used when observable inputs (levels 1 and 2) are not available. Level 3 inputs may include the entity’s own assumptions about the assumptions market participants would use in pricing the asset or the entity’s own data and models; includes use of discounted cash flows.

FASB No. 157 also expands disclosures about fair value measurements, thereby improving the quality of information provided to users of financial statements. FASB No. 157 does not require any new fair value measurements.

The FASB received requests for additional authoritative guidance on the application of FASB No. 157. Some constituents indicated that FASB No. 157 and FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, do not provide sufficient guidance on how to determine whether a market for a financial asset that historically was active is no longer active (including guidance on when to make a significant adjustment to a transaction or quoted price) and whether a transaction is not orderly.

Some constituents observed an emphasis on the use of the so-called last transaction price (or quoted price) as the sole or primary basis of fair value even when a significant adjustment to the transaction price (or quoted price) may be required or when other valuation techniques should be considered. They indicated that this emphasis has resulted in a misapplication of Statement 157 when estimating the fair value of certain financial assets.
Paragraph 7 of FASB No. 157 states that:

“a fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)” (emphasis added).

The notion that a transaction resulting from a forced liquidation or distressed sale does not represent fair value also is discussed in paragraphs 10 and 17 of Statement 157.


One of the recommendations in the study stated that “additional measures should be taken to improve the application and practice related to existing fair value requirements (particularly as they relate to both level 2 and level 3 estimates).” This recommendation further noted that “fair value requirements should be improved through development of application and best practices guidance for determining fair value in illiquid or inactive markets.”

The SEC’s suggestions for additional guidance included:

a. How to determine when markets become inactive and thus potentially require significant adjustment to transactions or quoted prices, and

b. How to determine if a transaction or group of transactions is forced or distressed (that is, not orderly). The guidance included in this FSP addresses the recommendations specific to these issues in the SEC’s study on mark-to-market accounting.

The primary concern of many constituents when estimating fair value for an asset or liability is determining when a transaction or quoted price in a market that is not active should be significantly adjusted (for example, by considering multiple valuation techniques).

This FSP provides additional guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased when compared with normal market activity for the asset or liability (or similar assets or liabilities). In the Board’s view, a significant decrease in the volume and level of activity for the asset or liability is an indication that transactions or quoted prices may not be determinative of fair value because in such market conditions there may be increased instances of transactions that are not orderly. In those circumstances, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB No. 157.
Conclusions of the FSP:

1. Scope:
   a. This FSP applies to all assets and liabilities within the scope of accounting pronouncements that require or permit fair value measurements, except as discussed in paragraphs 2 and 3 of FASB No. 157.
   b. The FSP does not apply to quoted prices for an identical asset or liability in an active market (that is, a level 1 input).

   For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

2. Determining Fair Value When the Volume and Level of Activity for an Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly:
   a. A reporting entity should evaluate the following factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for the asset or liability (or similar assets or liabilities). The factors include, but are not limited to:

      - There are few recent transactions.
      - Price quotations are not based on current information.
      - Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
      - Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
      - There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities) for observed transactions or quoted prices when compared with the reporting entity’s estimate of expected cash flows, considering all available market data about credit and other nonperformance risk for the asset or liability.
      - There is a wide bid-ask spread or significant increase in the bid-ask spread.
      - There is a significant decline or absence of a market for new issuances (that is, a primary market) for the asset or liability or similar assets or liabilities.
      - Little information is released publicly (for example, a principal-to-principal market).

   b. A reporting entity shall evaluate the significance and relevance of the previous factors to determine whether, based on the weight of the evidence, there has been a significant decrease in the volume and level of activity for the asset or liability.

3. If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for
the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value (for example, there may be increased instances of transactions that are not orderly).

a. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB No. 157.

b. Significant adjustments also may be necessary in other circumstances (for example, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is stale).

4. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Circumstances that may indicate that a transaction is not orderly include, but are not limited to:

a. There was not adequate exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities under current market conditions.

b. There was a usual and customary marketing period, but the seller marketed the asset or liability to a single market participant.

c. The seller is in or near bankruptcy or receivership (that is, distressed), or the seller was required to sell to meet regulatory or legal requirements (that is, forced).

d. The transaction price is an outlier when compared with other recent transactions for the same or similar asset or liability.

Note: FASB No. 157 does not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value. Paragraphs 18–20 of FASB No. 157 discuss the use of valuation techniques in estimating fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique).

When weighting indications of fair value resulting from the use of multiple valuation techniques, a reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

Even in circumstances where there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the
measurement date under current market conditions. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. However, a reporting entity’s intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

5. A reporting entity shall evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence.

6. The determination of whether a transaction is orderly (or not orderly) is more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. Accordingly, a reporting entity shall consider the following guidance:

a. If the weight of the evidence indicates the transaction is not orderly, a reporting entity shall place little, if any, weight (compared with other indications of fair value) on that transaction price when estimating fair value or market risk premiums.

b. If the weight of the evidence indicates the transaction is orderly, a reporting entity shall consider that transaction price when estimating fair value or market risk premiums. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances such as the volume of the transaction, the comparability of the transaction to the asset or liability being measured at fair value, and the proximity of the transaction to the measurement date.

c. If a reporting entity does not have sufficient information to conclude that the transaction is orderly or that the transaction is not orderly, it shall consider that transaction price when estimating fair value or market risk premiums. However, that transaction price may not be determinative of fair value (that is, that transaction price may not be the sole or primary basis for estimating fair value or market risk premiums). A reporting entity shall place less weight on transactions on which a reporting entity does not have sufficient information to conclude whether the transaction is orderly when compared with other transactions that are known to be orderly.

7. In its determinations, a reporting entity need not undertake all possible efforts, but shall not ignore information that is available without undue cost and effort. A reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is a party to the transaction.

8. Regardless of the valuation technique(s) used, a reporting entity shall include appropriate risk adjustments.

a. A fair value measurement should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

b. Risk premiums should be reflective of an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date under current market conditions.
9. When estimating fair value, FASB No. 157 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when a reporting entity has determined that the quoted prices provided by those parties are determined in accordance with FASB No. 157.

a. When there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks).

b. In weighting a quoted price as an input to a fair value measurement, a reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions.

c. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

10. Disclosures

The FSP amends FASB No. 157 to require that a reporting entity:

a. Disclose in interim and annual periods the inputs and valuation technique(s) used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

b. Define major category for equity securities and debt securities to be major security types as described in paragraph 19 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (as amended by FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments), (ASC 320), which states in part:

Major security types shall be based on the nature and risks of the security. An enterprise should consider the (shared) activity or business sector, vintage, geographic concentration, credit quality, or economic characteristic in determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail. In complying with this requirement, financial institutions shall include in their disclosure the following major security types, though additional types also may be necessary:

- Equity securities (segregated by industry type, company size, or investment objective)
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- Debt securities issued by states of the United States and political subdivisions of the states
- Debt securities issued by foreign governments
• Corporate debt securities
• Residential mortgage-backed securities
• Commercial mortgage-backed securities
• Collateralized debt obligations
• Other debt obligations [footnote reference omitted.]

Note: This requirement applies to all equity and debt securities measured at fair value even if the equity securities or debt securities are not within the scope of FASB No. 115. For example, this requirement includes those securities measured at fair value on a recurring basis in accordance with the AICPA Audit and Accounting Guide, Investment Companies.

11. Effective Date and Transition

The FSP is effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009 is not permitted.

a. If a reporting entity elects to adopt early either FSP FAS 115-2 and FAS 124-2 or FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, the reporting entity also is required to adopt early this FSP.

b. If the reporting entity elects to adopt early this FSP, FSP FAS 115-2 and FAS 124-2 also must be adopted early.

c. The FSP does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, this FSP requires comparative disclosures only for periods ending after initial adoption.

d. Revisions resulting from a change in valuation technique or its application shall be accounted for as a change in accounting estimate (paragraph 19 of FASB No. 154, Accounting Changes and Error Corrections) (ASC 250). In the period of adoption, a reporting entity shall disclose a change, if any, in valuation technique and related inputs resulting from the application of this FSP, and quantify the total effect of the change in valuation technique and related inputs, if practicable, by major category.

FASB Staff Position (FSP) FAS 141(R)-1: Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies

Issued: April 2009

Objective:

This FSP amends and clarifies FASB Statement No. 141R, Business Combinations (ASC 805), to address application issues raised by preparers, auditors, and members of the legal profession on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination.
Background:

FASB No. 141R was issued in December 2007 and is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. As issued, Statement 141R required that all contractual contingencies and all noncontractual contingencies that are more likely than not to give rise to an asset or liability as defined in FASB Concepts Statement No. 6, Elements of Financial Statements, be recognized at their acquisition date fair value.

All noncontractual contingencies that do not meet the more-likely-than not criterion as of the acquisition date would be accounted for in accordance with other U.S. generally accepted accounting principles (GAAP), as appropriate, including FASB No. 5, Accounting for Contingencies (ASC 450).

Absent new information about the possible outcome of a contingency, FASB No. 141R required that an asset or a liability arising from a contingency that was recognized at fair value as of the acquisition date continue to be reported at its acquisition-date fair value.

FASB No. 141R required that when new information is obtained, a liability be measured at the higher of its acquisition-date fair value and the amount that would be recognized by applying FASB No. 5. An asset would be measured at the lower of its acquisition-date fair value and the best estimate of its future settlement amount. An asset or liability arising from a preacquisition contingency would be derecognized only when the contingency is resolved.

Subsequent to the issuance of FASB No. 141R, preparers, auditors, and members of the legal profession expressed concerns about the application of FASB No. 141R to assets and liabilities arising from contingencies in a business combination.

Application issues included the following:

a. Determining the acquisition-date fair value of a litigation-related contingency
b. Supporting the recognition and measurement of liabilities arising from legal contingencies when supporting information may be subject to attorney-client privilege
c. Distinguishing between a contractual and noncontractual contingency
d. Dealing with situations in which a target entity may have determined that a loss contingency should be recognized in accordance with FASB No. 5 because the entity intends to settle out of court but the liability does not meet the more-likely-than-not threshold for recognition of a noncontractual contingency
e. Derecognizing a liability arising from a contingency recognized as of the acquisition date
f. Disclosing potentially prejudicial information in financial statements
g. Determining whether to account for contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination in accordance with the guidance for contingent consideration or in accordance with the guidance for other assets and liabilities arising from contingencies.

In response to the application issues raised, a project was added to the Board’s agenda in October 2008 to amend the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination.
Conclusions of the FSP:

1. **Scope:** The FSP applies to all assets acquired and liabilities assumed in a business combination that arise from contingencies that would be within the scope of FASB No. 5 if not acquired or assumed in a business combination, except for assets or liabilities arising from contingencies that are subject to specific guidance in FASB No. 141R.¹

2. **Initial Recognition and Measurement**

   a. An acquirer shall recognize at fair value, at the acquisition date, an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. For example, the acquisition-date fair value of a warranty obligation often can be determined.

   b. If the acquisition-date fair value of an asset acquired or a liability assumed in a business combination that arises from a contingency cannot be determined during the measurement period, an asset or a liability shall be recognized at the acquisition date if both of the following criteria are met:

      - Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur, and
      
      - The amount of the asset or liability can be reasonably estimated.

   **Note:** Criteria (a) and (b) shall be applied using the guidance in Statement 5 and in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, for application of similar criteria in paragraph 8 of Statement 5.

   c. If neither of the criteria found in 2(a) or 2(b) above are met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date.

      - In periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including FASB No. 5, as appropriate.

   d. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in FASB No. 141R.

¹ Paragraphs 29, 30, 64, 41, 42, 65, and A57 of FASB 141R provide specific guidance and are not covered by this FSP.
3. **Subsequent Measurement and Accounting**

   a. An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.

   b. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 65 of FASB No. 141R.

4. **Disclosures**

   a. An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effects of a business combination that occurs either during the current reporting period or after the reporting period but before the financial statements are issued.

   b. For each business combination that occurs during the reporting period, an acquirer shall disclose the following in the footnote that describes the business combination:

      1) For assets and liabilities arising from contingencies recognized at the acquisition date:
         - The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with FASB No. 5 and Interpretation 14).
         - The nature of the contingencies. An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

      2) For contingencies that are not recognized at the acquisition date, the disclosures required by Statement 5 if the criteria for disclosures in that Statement are met.

5. **Effective Date and Transition**

   a. This FSP shall be effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

**Accounting Standards Updates (ASUs):**

Effective July 1, 2009, changes to the source of authoritative U.S. GAAP, the *FASB Accounting Standards Codification™* (FASB Codification) are communicated through an Accounting Standards Update (ASU). ASUs will be published for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to release of the FASB Codification (e.g., FASB Statements, EITF Abstracts, FASB Staff Positions, etc.). ASUs also will be issued for amendments to the SEC content in the FASB Codification as well as for editorial changes.
An ASU is a transient document that (1) summarizes the key provisions of the project that led to the ASU, (2) details the specific amendments to the FASB Codification, and (3) explains the basis for the Board’s decisions. Although ASUs will update the FASB Codification, the FASB does not consider ASUs as authoritative in their own right.

Prior to the release of the FASB Codification as the single source of authoritative U.S. GAAP, the FASB amended pre-Codification standards and issued them in an “as amended” form. The FASB will not amend ASUs. It will only amend the FASB Codification.

Following is a summary of the ASUs issued in 2009 and 2010.

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<th>ASU Description</th>
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<tr>
<td><strong>Accounting Standards Update No. 2009-01</strong></td>
<td>This Accounting Standards Update amends the FASB Accounting Standards Codification for the issuance of FASB Statement No. 168, <em>The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles</em>. This Accounting Standards Update includes Statement 168 in its entirety, including the accounting standards update instructions contained in Appendix B of the Statement.</td>
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<tr>
<td><strong>Accounting Standards Update No. 2009-02</strong></td>
<td>This Accounting Standards Update represents technical corrections to various Topics addressing feedback received.</td>
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<tr>
<td><strong>Accounting Standards Update No. 2009-03</strong></td>
<td>This Codification Update represents technical corrections to various Topics containing SEC Staff Accounting Bulletins to update cross-references to Codification text.</td>
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<tr>
<td><strong>Accounting Standards Update No. 2009-04</strong></td>
<td>This Accounting Standards Update represents an update to Section 480-10-S99, &quot;Distinguishing Liabilities from Equity,&quot; per EITF Topic D-98, &quot;Classification and Measurement of Redeemable Securities.&quot;</td>
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<tr>
<td><strong>Accounting Standards Update No. 2009-05</strong></td>
<td>This Accounting Standards Update amends Subtopic 820-10, Fair Value Measurements and Disclosures, to provide guidance on the fair value measurement of liabilities.</td>
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<td><strong>Accounting Standards Update No. 2009-06</strong></td>
<td>The Board is issuing this Update to provide additional implementation guidance on accounting for uncertainty in income taxes and to eliminate the disclosures required by paragraph 740-10-50-15(a) through (b) for nonpublic entities.</td>
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<tr>
<td><strong>Accounting Standards Update No. 2009-07</strong></td>
<td>This Codification Update represents technical corrections to various Topics containing SEC guidance based on external comments received.</td>
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<td><strong>Accounting Standards Update No. 2009-08</strong></td>
<td>This Codification Update represents technical corrections to Topic 260-10-S99, Earnings per Share, based on EITF Topic D-53, “Computation of Earnings Per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock” and EITF Topic D-42, “The Effect of the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock.”</td>
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<tr>
<td>Accounting Standards Update No. 2009-09</td>
<td>This Accounting Standards Update represents a correction to Section 323-10-S99-4, <em>Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee</em>. Section 323-10-S99-4 was originally entered into the Codification incorrectly.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-10</td>
<td>This Accounting Standards Update codifies the Observer comment in paragraph 17 of EITF 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management.”</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-11</td>
<td>This Accounting Standards Update represents a technical correction to the SEC Observer comment in EITF 90-22, “Accounting for Gas-Balancing Arrangements.”</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-12</td>
<td>This Accounting Standards Update amends Subtopic 820-10, Fair Value Measurements and Disclosures, to provide guidance on the fair value measurement of investments in certain entities that calculate net asset value per share (or its equivalent).</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-13</td>
<td>The objective of this Update is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-14</td>
<td>The objective of this Update is to address concerns raised by constituents relating to the accounting for revenue arrangements that contain tangible products and software.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-15</td>
<td>The purpose of this Update is to address the accounting for own-share lending arrangements entered into in contemplation of a convertible debt issuance or other financing.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-16</td>
<td>This Accounting Standards Update amends the FASB Accounting Standards Codification for the issuance of FASB Statement No. 166, <em>Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140</em>. The amendments in this Accounting Standards Update improve financial reporting by eliminating the exceptions for qualifying special-purpose entities from the consolidation guidance and the exception that permitted sale accounting for certain mortgage securitizations when a transferor has not surrendered control over the transferred financial assets. In addition, the amendments require enhanced disclosures about the risks that a transferor continues to be exposed to because of its continuing involvement in transferred financial assets. Comparability and consistency in accounting for transferred financial assets will also be improved through clarifications of the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2009-17</td>
<td>This Accounting Standards Update amends the FASB Accounting Standards Codification for the issuance of FASB Statement No. 167, <em>Amendments to FASB Interpretation No. 46(R)</em>. The amendments in this Accounting Standards Update replace the quantitative-based risks and rewards calculation for determining which reporting entity, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which reporting entity has the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and: (1) the obligation to absorb losses of the entity, or (2) the right to receive benefits from the entity. An approach that is expected to be primarily qualitative will be more effective for identifying which reporting entity has a controlling financial interest in a variable interest entity. The amendments in this Update also require additional disclosures about a reporting entity’s involvement in variable interest entities, which will enhance the information provided to users of financial statements.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2010-01</td>
<td>The amendments in this Update clarify that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend for purposes of applying Topics 505 and 260 (Equity and Earnings Per Share).</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2010-02</td>
<td>This update provides amendments to Subtopic 810-10 and related guidance within U.S. GAAP to clarify the scope of the decrease in ownership provisions of the Subtopic and related guidance. The amendments in this Update also clarify that the decrease in ownership guidance does not apply to certain transactions, even if they involve businesses.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2010-03</td>
<td>The objective of the amendments included in this Update is to align the oil and gas reserve estimation and disclosure requirements of Extractive Activities – Oil and Gas (Topic 932) with the requirements in the Securities and Exchange Commission's final rule, Modernization of the Oil and Gas Reporting Requirements (the Final Rule). The Final Rule was issued on December 31, 2008.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2010-04</td>
<td>This Accounting Standards Update represents technical corrections to SEC guidance in various Topics.</td>
</tr>
<tr>
<td>Accounting Standards Update No. 2010-05</td>
<td>This Accounting Standards Update codifies EITF Topic D-110, <em>Escrowed Share Arrangements and the Presumption of Compensation</em>, from the June 18, 2009 EITF meeting.</td>
</tr>
</tbody>
</table>
Accounting Standards Update No. 2010-06

This update provides amendments to Topic 820 that will provide more robust disclosures about: (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in level 3 fair value measurements, and (4) the transfers between levels 1, 2, and 3.

Accounting Standards Update No. 2010-07

This Accounting Standards Update amends the Accounting Standards Codification for the issuance of FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions*. The amendments in this Accounting Standards Update provide guidance on accounting for combinations of not-for-profit entities. Those transactions or other events include mergers of two or more not-for-profit entities and acquisitions by a not-for-profit entity that result in its initially recognizing another not-for-profit entity, a business, or a nonprofit activity in its financial statements.

Accounting Standards Update No. 2010-08

From time to time, the Board reviews its standards to determine if any provisions in U.S. generally accepted accounting principles (GAAP) are outdated, contain inconsistencies, or need clarifications to reflect the Board’s original intent. The amendments in this Update eliminate those inconsistencies and outdated provisions and provide the needed clarifications. The related changes to U.S. GAAP are generally nonsubstantive in nature.

**Selected ASUs:**

Following is an analysis of selected ASUs issued in 2009 and 2010.


**Issued:** September 2009

**Objective:**

The FASB issued ASU 2009-06 to provide additional implementation guidance on the accounting for uncertainties in income taxes (FIN 48). The ASU addresses the following questions:

1. Is the income tax paid by the entity attributable to the entity or its owners?
2. What constitutes a tax position for a pass-through entity or a tax-exempt not-for-profit entity?
3. How should accounting for uncertainty in income taxes be applied when a group of related entities comprise both taxable and nontaxable entities?

Further, the FASB decided to eliminate certain disclosures required found in FIN 48 for nonpublic entities.
Background:

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (now included in ASC 740) (FIN 48), was issued in June 2006 and was effective for fiscal years beginning after December 15, 2006.

FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes (ASC 740). Further FIN 48 applies to not-for-profit organizations, pass-through entities and entities whose tax liability is subject to 100 percent credit for dividends paid (for example, real estate investment trusts and registered investment companies) that are potentially subject to income taxes.

FIN 48 did not provide examples of how it applies to not-for-profit entities or pass-through entities, such as S Corporations or partnerships.

Questions remain about how to apply FIN 48 to pass-through entities and not-for-profit entities. In response to those concerns, the Board issued FSP FIN 48-3, Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises (also now included in Subtopic 740-10), in December 2008. That FSP extended the deferral of the effective date of FIN 48 to annual financial statements for fiscal years beginning after December 15, 2008. The FASB concluded that the effective date deferral provided by FSP FIN 48-3 would give the Board the time necessary to develop guidance on the implementation of FIN 48 to pass-through entities and tax-exempt not-for-profit entities.

Conclusions of the ASU:

1. Scope:

The ASU applies to financial statements of nongovernmental entities that are presented in conformity with U.S. generally accepted accounting principles (GAAP). The disclosure amendments will apply only to nonpublic entities as defined in ASC 740-10-20.

2. Amendments made to FIN 48:

   a. FIN 48 is amended to include the following within the definition of a tax position and within the scope of FIN 48:
      - Pass-through entities
      - Tax-exempt not-for-profit entities
      - Entities taxed in a manner similar to pass-through entities such as REITs and registered investment companies

Note: If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for consistent with the guidance for uncertainty in income taxes in FIN 48 (ASC 740). If income taxes paid by the entity are attributable to the owners, the transaction should be recorded as a transaction with owners and not subject to FIN 48. The determination of attribution should be made for each jurisdiction where the entity is subject to income taxes.

A reporting entity must consider the tax positions of all entities within a related party group of entities regardless of the tax status of the reporting entity.
b. Nonpublic entities are exempt from certain disclosures required under FIN 48.

Topic 740-10-50-15A requires that public entities only (not non public entities) shall disclose both of the following at the end of each annual reporting period presented:

1) A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, which shall include at a minimum:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
- The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.
- The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities.
- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

2) The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

3. Transition – ASU 2009-06:

a. The following represents the transition and effective date information related to ASU 2009-06.

- For entities that are currently applying the standards for accounting for uncertainty in income taxes, the ASU content shall be effective for interim and annual periods ending after September 15, 2009.
- For those entities that have deferred the application of accounting for uncertainty in income taxes, the ASU changes shall be effective upon adoption of those standards.
- The effective date guidance does not affect the effective date guidance for certain nonpublic entities in 740-10-65-1.

4. New Examples provided by the ASU:

ASC 2009-06 amends FIN 48 to include new Examples 33-38 as presented below, as modified by the author.

Example 33: Definition of a Tax Position

**Facts:** Entity S converted to an S Corporation from a C Corporation effective January 1, 20X0. In 20X7, Entity S disposed of assets subject to built-in gains and reported a tax liability on its 20X7 tax returns.

**Conclusion:** Tax positions to consider related to the built-in gains tax include, but are not limited to:
a. Whether other assets were sold subject to the built-in gains tax.
b. Whether the income associated with the calculation of the taxable amount of the built-in gains is correct.
c. Whether the basis associated with the built-in gains calculation is correct.
d. Whether or not Entity S is subject to the built-in gains tax.

Example 34: Definition of a Tax Position

Facts: Entity N, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income.

Conclusion: Tax positions to consider include, but are not limited to:

a. Entity N’s characterization of its activities as related or unrelated to its exempt purpose.
b. Entity N’s allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income.
c. The allocation of Entity N’s expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities.
d. Whether N qualifies as a tax-exempt not-for-profit entity.

Example 35: Attribution of Income Taxes to the Entity or Its Owners

Facts: Entity A, a partnership with two partners – Partner 1 and Partner 2 – has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A’s income tax payment as a credit (that is, payment against the tax liability of the owners).

Conclusion: Because the owners may file a tax return and utilize Entity A’s payment as a payment against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J’s laws whether or not the owners file an income tax return.

Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners. The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners.

Example 36: Attribution of Income Taxes to the Entity or Its Owners

Facts: Assume the fact pattern in Example 35 above changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2.

Conclusion: Income taxes are attributed to Entity A on the basis of Jurisdiction J’s laws and are accounted for based on the guidance in this FIN 48.
Example 37: Attribution of Income Taxes to the Entity or Its Owners

**Facts:** Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that if payment is made by Entity S, the payments are made on behalf of the owners.

**Conclusion:** Because the laws and regulations attribute the income tax to the owners regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners and not subject to FIN 48.

Example 38: Financial Statements of a Group of Related Entities

**Facts:** Entity A, a partnership with 2 partners, owns a 100 percent interest in Entity B and is required to issue consolidated financial statements.

Entity B is a taxable entity that has unrecognized tax positions and a related liability for unrecognized tax benefits.

**Conclusion:** Because entities within a consolidated or combined group should consider the tax positions of all entities within the group regardless of the tax status of the reporting entity, Entity A should include in its financial statements the assets, liabilities, income, and expenses of both Entity A and Entity B, including those relating to the implementation of FIN 48 to Entity B. This is required even though Entity A is a pass-through entity.

Accounting Standards Update 2009-12: Fair Value Measurements and Disclosures – Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (ASC 820)

**Issued:** September 2009

**Objective:**

This ASU provides amendments to ASC Subtopic 820-10, *Fair Value Measurements and Disclosures – Overall*, for the fair value measurement of investments in certain entities that calculate net asset value per share (or its equivalent).

The amendments in this Update permit a reporting entity to measure the fair value of an investment that is within the scope of the amendments in this ASU on the basis of the net asset value per share of the investment (or its equivalent) if the net asset value of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of ASC 946, *Financial Services – Investment Companies*.

The ASU also require disclosures by major category of investment about the attributes of investments within the scope of the ASU.
Background:

An investor may invest in entities that permit the investor to redeem its investments directly with the investee or receive distributions from the investee at times specified under the terms of the investee’s governing documents. Many of these investments do not have readily determinable fair values (for example, those investments are not listed on national exchanges or over-the-counter markets such as the National Association of Securities Dealers Automated Quotation System).

Examples of these investees (also referred to as alternative investments) include hedge funds, private equity funds, real estate funds, venture capital funds, and offshore fund vehicles.

Some of these investees provide their investors with a net asset value per share (or its equivalent, for example, member units or an ownership interest in partners’ capital if the investee is a partnership to which a proportionate share of net assets is attributed) that has been calculated in a manner consistent with ASC 946.

Among other requirements, ASC 946 requires that the investee measure its underlying investments at fair value in accordance with ASC 820, *Fair Value Measurements*.

If fair value of the investment is not readily determinable, and the net asset value per share of the investment (or its equivalent) is calculated as of the measurement date, it is common for investors to estimate the fair value of their investment using the net asset value per share (or its equivalent) provided by the investee without further adjustment. In some cases, this is because the investee regularly stands ready (without significant restriction) to redeem the investment for net asset value per share (or its equivalent) and, thus, the net asset value per share (or its equivalent) provided by the investee is a reasonable indication of the price the investor would receive to sell its investment in an orderly transaction (fair value).

If there are restrictions to redemption, or the investment is designed for redemption to occur through distributions from the investee, many investors indicated that, in their view, the key consideration when relying on net asset value per share (or its equivalent) provided by the investee without further adjustment is that the investee’s underlying investments are measured at fair value at the investor’s measurement date. However, the net asset value per share (or its equivalent) provided by the investee may not represent the fair value of the investor’s investment in all circumstances. Certain attributes of the investment and the presence of principal-to-principal or brokered transactions for the investment may indicate that it is necessary to make adjustments to the net asset value per share (or its equivalent) provided by the investee to estimate the fair value of the investment.

In January 2009, the AICPA’s Accounting Standards Executive Committee and Alternative Investments Task Force issued a draft Issues Paper, “FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments” (ASC 820). The draft paper includes proposed nonauthoritative guidance on estimating the fair value of investments in certain alternative investments.
The draft paper indicates that when estimating fair value using the net asset value per share, an investor should consider other attributes of the investment in addition to the investee’s net asset value per share. Those considerations include attributes of the investment such as:

- Redemption restrictions and unfunded commitments,
- The intangible benefits of the investment (such as access to certain types of investments or investment strategies), and
- The presence of principal-to-principal or brokered transactions for the investment.

There have been concerns voiced to the FASB about the requirement that investors adjust the net asset value per share (or its equivalent) for certain attributes of the investment. In particular, those parties have questioned which attributes of the investment would require an adjustment to net asset value per share and whether an adjustment would be an increase or decrease to net asset value per share.

Moreover, some adjustments may be increases to net asset value per share (for example, for access to certain types of investments or investment strategies and for access to a particular investment manager), while other adjustments, such as the imposition of a gate, may be decreases to net asset value per share (for example, for preventing an otherwise redeemable investment from being redeemed for a period of time).

Other parties have asserted that principal-to-principal or brokered transactions are uncommon for the types of investments within the scope of the ASU and often involve a distressed seller. Consequently, in their view, in many circumstances principal-to-principal or brokered transactions are not relevant observable inputs to a fair value measurement of an alternative investment within the scope of the amendments in this ASU because the investment is designed to be (a) redeemed with the investee at net asset value per share (or its equivalent) or (b) exited through distributions from the investee at times specified under the terms of the investee’s governing documents, generally when the underlying investments of the investee are sold.

Because of these complexities and practical difficulties in estimating the fair value of alternative investments, the FASB decided to provide guidance on using the net asset value per share provided by the investee to estimate the fair value of an alternative investment.

1. **Scope**

   a. The amendments in this ASU should apply to an investment that meets both of the following criteria as of the reporting entity’s measurement date:

      1) Does not have a readily determinable fair value and
      2) Is an investment in an entity that has all four of the attributes specified as an investment company (in ASC 946-10-15-2), or
3) If one or more of the investment company attributes are not present, is an investment in an entity for which it is industry practice to issue financial statements consistent with the measurement principles in Topic 946.

**Example:** Certain investments in real estate funds that measure investment assets at fair value on a recurring basis.

b. The *four attributes* of an investment company found in ASC 946-10-15-2 follow:

1) Investment activity. The entity’s primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.

2) Unit ownership. Ownership in the entity is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.

3) Pooling of funds. The funds of the entity’s owners are pooled to avail owners of professional investment management.

4) Reporting entity. The entity is the primary reporting entity.

2. **Investments in certain entities that calculate net asset value per share:**

a. Classification within the fair value hierarchy of a fair value measurement of an investment within the scope of this ASU that is measured at net asset value per share (or its equivalent, for example member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) requires judgment, with consideration of the following:

1) If a reporting entity has the ability to redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date, the fair value measurement of the investment shall be categorized as a level 2 fair value measurement.

2) If a reporting entity will never have the ability to redeem its investment with the investee at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a level 3 fair value measurement.

3) If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized as a level 2 or a level 3 fair value measurement.

For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a level 3 fair value measurement.
3. Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

a. A reporting entity is permitted to estimate the fair value of an investment within the scope of the ASU using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

- The decision about whether to apply the guidance in (3)(a) above shall be made on an investment-by-investment basis and shall be applied consistently to the fair value measurement of a reporting entity’s entire position in a particular investment, unless it is probable at the measurement date that a reporting entity will sell a portion of an investment at an amount different from net asset value per share (or its equivalent). In those situations, the reporting entity shall account for the portion of the investment that is being sold in accordance with other provisions.

b. If the net asset value per share of the investment is not as of the reporting entity’s measurement date or is not calculated in a manner consistent with the measurement principles of Topic 946, the reporting entity shall consider whether an adjustment to the most recent net asset value per share is necessary.

- The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

c. A reporting entity is not permitted to estimate the fair value of an investment (or a portion of the investment) using the net asset value per share of the investment (or its equivalent) if, as of the reporting entity’s measurement date, it is probable that the reporting entity will sell the investment for an amount different from the net asset value per share (or its equivalent). A sale is considered probable only if all of the following criteria have been met as of the reporting entity’s measurement date:

- Management, having the authority to approve the action, commits to a plan to sell the investment.
- An active program to locate a buyer and other actions required to complete the plan to sell the investment have been initiated.
- The investment is available for immediate sale subject only to terms that are usual and customary for sales of such investments (for example, a requirement to obtain approval of the sale from the investee or a buyer’s due diligence procedures).
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.
4. Disclosures:

a. For investments that are within the scope of the ASU and measured at fair value on a recurring or nonrecurring basis during the period, the reporting entity shall disclose information that enables users of its financial statements to understand the nature and risks of the investments and whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed).

b. To meet that objective, to the extent applicable, the reporting entity shall disclose all of the following information for each interim and annual period separately for each major category of investment (major category of investment shall be determined on the basis of the nature and risks of the investments in a manner consistent with the guidance for major security types):

- The fair value of the investments in the major category, and a description of the significant investment strategies of the investee(s) in the major category.

- For each major category of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity’s estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.

- The amount of the reporting entity’s unfunded commitments related to investments in the major category.

- A general description of the terms and conditions upon which the investor may redeem investments in the major category (for example, quarterly redemption with 60 days’ notice).

- The circumstances in which an otherwise redeemable investment in the major category (or a portion thereof) might not be redeemable (for example, investments subject to a lockup or gate). Also, for those otherwise redeemable investments that are restricted from redemption as of the reporting entity’s measurement date, the reporting entity shall disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the reporting entity shall disclose that fact and how long the restriction has been in effect.

- Any other significant restriction on the ability to sell investments in the major category at the measurement date.

- If a reporting entity determines that it is probable that it will sell an investment(s) for an amount different from net asset value per share (or its equivalent), the reporting entity shall disclose the total fair value of all investments that meet that criteria and any remaining actions required to complete the sale.
• If it is probable that a group of investments would otherwise be sold for an amount different from net asset value per share, but the individual investments to be sold have not been identified (for example, if a reporting entity decides to sell 20 percent of its investments in private equity funds but the individual investments to be sold have not been identified), the reporting entity shall disclose its plans to sell and any remaining actions required to complete the sale(s).

Case D: Disclosure—Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

For investments that are within the scope of this ASU measured at fair value on a recurring or nonrecurring basis during the period, in addition to the disclosures required elsewhere, this ASU requires disclosure of information that enables users to understand the nature and risk of the investments by major category and whether the investments are probable of being sold at amounts different from net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed).

That information may be presented as follows.

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<thead>
<tr>
<th>Category</th>
<th>Fair value in millions</th>
<th>Unfunded commitments</th>
<th>Redemption frequency, if currently eligible</th>
<th>Redemption notice period</th>
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<td>Quarterly</td>
<td>30-60 days</td>
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<td>Event driven hedge funds</td>
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<td>Quarterly and annually</td>
<td>30-60 days</td>
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<td></td>
<td>Quarterly</td>
<td>30-45 days</td>
</tr>
<tr>
<td>quarterly 30-45 days</td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Multi-strategy hedge</td>
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<td></td>
<td>Quarterly</td>
<td>30-60 days</td>
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<td>Real estate funds</td>
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<td>$20</td>
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<td></td>
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<td>Private equity Funds – international</td>
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<tr>
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<td>265</td>
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</tr>
</tbody>
</table>

5. Effective date:

a. The amendments in this ASU are effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. If an entity elects to early adopt the measurement amendments in this ASU, the entity is permitted to defer the adoption of the disclosure provisions until periods ending after December 15, 2009.
Accounting Standards Update 2009-13: Revenue Recognition Multiple-Deliverable Revenue Arrangements – a Consensus of the FASB Emerging Issues Task Force (ASC 605)

Issued: October 2009

Objective:

The objective of this ASU is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately, rather than as a combined unit. Vendors often provide multiple products or services to their customers. Those deliverables often are provided at different points in time or over different time periods.

Background:

Subtopic 605-25, Revenue Recognition – Multiple-Element Arrangements, establishes the accounting and reporting guidance for arrangements under which the vendor will perform multiple revenue-generating activities. Specifically, this Subtopic addresses how to separate deliverables and how to measure and allocate arrangement consideration to one or more units of accounting.

Existing U.S. generally accepted accounting principles (GAAP) requires a vendor to use vendor-specific objective evidence or third-party evidence of selling price to separate deliverables in a multiple-deliverable arrangement. Vendor-specific objective evidence of selling price is the price charged for a deliverable when it is sold separately or, for a deliverable not yet being sold separately, the price established by management with the relevant authority. Third-party evidence of selling price is the price of the vendor’s or any competitor’s largely interchangeable products or services in standalone sales to similarly situated customers. If a vendor does not have vendor-specific objective evidence or third-party evidence of selling price for the undelivered elements in an arrangement, the revenue associated with both delivered and undelivered elements are combined into one unit of accounting. Any revenue attributable to the delivered products is then deferred and recognized as the undelivered elements are delivered by the vendor. An exception to this guidance exists if the vendor has vendor-specific objective evidence or third-party evidence of selling price for the undelivered elements in the arrangement but not for the delivered elements. In those situations, the vendor uses the residual method to allocate revenue to the delivered element, which results in the allocation of the entire discount in the arrangement, if any, to the delivered element.

Constituents have raised concerns that this guidance results in financial reporting that does not reflect the underlying economics of transactions.

1. Scope:

The amendments in this ASU affect accounting and reporting for all vendors that enter into multiple-deliverable arrangements with their customers when those arrangements are within the scope of ASC Subtopic 605-25.

   a. The amendments affect vendors that are affected by the guidance in Accounting Standards Update No. 2009-13, Software (ASC 985): Certain Revenue Arrangements That Include Software Elements, which affect vendors that sell tangible products that include software.
b. The amendments do not affect arrangements for which industry-specific allocation and measurement guidance exists, such as ASC Subtopic 605-35 for long-term construction contracts and ASC 985 for software transactions.

2. Amendments by ASU:

a. The ASU amends the criteria in ASC Subtopic 605-25 for separating consideration in multiple-deliverable arrangements.

Multiple-deliverable arrangements will be separated in more circumstances than under existing U.S. GAAP.

b. The amendments establish a selling price hierarchy for determining the selling price of a deliverable.

The selling price used for each deliverable is based on the following hierarchy:

First, use vendor-specific objective evidence if available, then

Second, third-party evidence if vendor-specific objective evidence is not available, then

Third, estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available.

c. The amendment replace the term *fair value* in the revenue allocation guidance with *selling price* to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant.

d. The amendment eliminates use of the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method.

- Relative selling price method allocates any discount in the arrangement proportionally to each deliverable on the basis of each deliverable’s selling price.

- A vendor determines its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis.

*Note:* The ASU does not prescribe any specific methods that vendors must use to accomplish this objective; however, examples have been provided to illustrate the concept of estimated selling price and the relative selling price method.

3. Disclosures:

a. The ASU expands the disclosures related to a vendor’s multiple-deliverable revenue arrangements. A vendor is required to disclose the following information by similar type of arrangement:
• A description of the entity’s multiple-deliverable arrangements, which includes the nature and terms of the arrangement.
• The significant deliverables within its arrangements.
• The general timing of their delivery or performance of deliverables.
• The significant factors and estimates used to determine vendor-specific objective evidence, third-party evidence, or estimated selling price, and significant changes in the selling price or the methodology or the assumptions used to estimate selling price.
• The general timing of revenue recognition for separate units of accounting.

b. In the year of adoption, vendors are required to disclose information that enables users of its financial statements to understand the effect of adopting the amendments in this ASU. To satisfy that objective, vendors are required to disclose at a minimum the following qualitative information by similar types of arrangements:

• A description of any change in the units of accounting.
• A description of the change in how a vendor allocates the arrangement consideration to various units of accounting.
• A description of the changes in the pattern and timing of revenue recognition.
• Whether the adoption of this Update is expected to have a material effect on financial statements in periods after the initial adoption.

c. If the adoption of the amendments in this Update does have a material effect on financial statements, vendors will be required to supplement the qualitative information with quantitative information to satisfy the objective of describing the effect of the change in accounting principle. Depending on a vendor’s facts and circumstances, the following are examples of methods (but not the only potential methods) that may individually or in combination provide quantitative information to satisfy that objective:

• Disclosure of the amount of revenue that would have been recognized in the year of adoption if the related arrangements entered into or materially modified after the effective date were subject to the measurement requirements of Subtopic 605-25 (before the amendments in this Update).

• Disclosure of the amount of revenue that would have been recognized in the year preceding the year of adoption if the arrangements accounted for under Subtopic 605-25 (before the amendments in this Update) were subject to the measurement requirements of the amendments in this Update.

• Disclosure of the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the reporting period from applying (a) the guidance in Subtopic 605-25 (before the amendments in this Update) and (b) the amendments in this Update.
Accounting Standards Update 2009-14: Software Certain Revenue Arrangements That Include Software Elements – a Consensus of the FASB Emerging Issues Task Force (ASC 985)

Issued: October 2009

Objective:

The objective of this Update is to address concerns raised by constituents relating to the accounting for revenue arrangements that contain tangible products and software.

Currently, products that contain software that is “more than incidental” to the product as a whole are within the scope of the software revenue guidance in ASC Subtopic 985-605, Software – Revenue Recognition.

Background:

ASC Subtopic 985-605 requires a vendor to use vendor-specific objective evidence of selling price to separate deliverables in a multiple-element arrangement.

A vendor must sell, or intend to sell, a particular element separately to assert vendor-specific objective evidence for that element. If a vendor does not have vendor-specific objective evidence for the undelivered elements in an arrangement, the revenue associated with both the delivered and undelivered elements is combined into one unit of accounting. Any revenue attributable to the delivered products is then deferred and recognized at a later date, which in many cases is as the undelivered elements are delivered by the vendor.

There have been concerns that:

- The current accounting model does not appropriately reflect the economics of the underlying transactions because no revenue is recognized for products for which the vendor has already completed the related performance, and

- The guidance in ASC Subtopic 985-605 was originally developed primarily for traditional software arrangements when more software enabled products now fall or will fall within the scope of that guidance than originally intended because of ongoing technological advances.

1. Amendments of the ASU:

The amendments affect vendors that sell or lease tangible products in an arrangement that contains software that is more than incidental to the tangible product as a whole. The amendments clarify what guidance should be used in allocating and measuring revenue.

The amendments do not provide guidance on when revenue should be recognized even though it is likely that vendors affected by the amendments recognize revenue earlier than they had previously because of the different allocation, measurement, and recognition guidance that exists in different revenue guidance including the amendments resulting from Accounting Standards Update No. 2009-13, Revenue Recognition (ASC...
605): Multiple-Deliverable Revenue Arrangements (A Consensus of the FASB Emerging Issues Task Force), as further described below.

The amendments do not affect:

- Software revenue arrangements that do not include tangible products, and
- Software revenue arrangements that include services if the software is essential to the functionality of those services.

The ASU amendments do the following:

1. They change the accounting model for revenue arrangements that include both tangible products and software elements:
   a. Tangible products containing software components and non-software components that function together to deliver the tangible product’s essential functionality are no longer within the scope of the software revenue guidance in ASC Subtopic 985-605.
   b. Hardware components of a tangible product containing software components are always excluded from the software revenue guidance.

2. They provide additional guidance on how to determine which software, if any, relating to the tangible product also would be excluded from the scope of the software revenue guidance.

3. If the software contained on the tangible product is essential to the tangible product’s functionality, the software is excluded from the scope of the software revenue guidance.

   Note: This exclusion includes essential software that is sold with or embedded within the product and undelivered software elements that relate to that tangible product’s essential software.

   Example: If a vendor sells a computer that includes an operating system that is deemed essential to that computer’s functionality and also sells post-contract customer support services for that operating system, both the operating system and the support services in the arrangement are excluded from the scope of the software revenue guidance.

4. Following are factors to consider in determining whether the tangible product contains software that works together with the non-software components of the tangible product to deliver the tangible product’s essential functionality:
   a. If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.
   b. A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar
products is that one product includes software that the other product does not, they will be considered the same product for the purpose of evaluating factor (b) above.

c. A vendor may sell software on a standalone basis. The vendor also may sell a tangible product containing that same software. The separate sale of the software does not lead to a presumption that the software is not essential to the functionality of the tangible product.

d. Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.

e. The non-software elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

5. The amendments provide guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software.

   a. If a tangible product contains software that is not essential to the product's functionality, that nonessential software and any other deliverables within the arrangement (other than the non-software components of the tangible product) that relate to that nonessential software are within the scope of the software revenue guidance in Subtopic 985-605.

   b. If an undelivered element relates to a deliverable within the scope of Subtopic 985-605 and a deliverable excluded from the scope of Subtopic 985-605, the undelivered element shall be bifurcated into a software deliverable and a non-software deliverable.

      • The software deliverable is within the scope of Subtopic 985-605 and the non-software deliverable is not within the scope of Subtopic 985-605. The amendments also provide further guidance on how to allocate arrangement consideration when an arrangement includes deliverables both included and excluded from the scope of the software revenue guidance.

2. Disclosures:

Vendors that are affected by the amendments in this Update are required to provide disclosures that are included within the amendments in ASU 2009-13, which was issued concurrently with this Update. The amendments in ASU 2009-13 significantly expand the disclosure requirements for multiple-deliverable revenue arrangements.

3. Effective date of the ASU:

The amendments in the ASU are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted.
a. If a vendor elects early adoption and the period of adoption is not the beginning of
the vendor’s fiscal year, the vendor is required to apply the amendments in this ASU
retrospectively from the beginning of the vendor’s fiscal year.

b. A vendor may elect, but is not required, to adopt the amendments in this ASU
retrospectively to prior periods. In order to apply this ASU retrospectively to a period,
it must not be impracticable for a vendor to report the change through retrospective
application to that prior period.

c. A vendor is required to adopt the amendments in this Update in the same period
using the same transition method that it uses to adopt the amendments in ASU

**ASU 2010-02: Accounting Standards Update (ASU) 2010-02: Consolidation-
Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope
Clarification (ASC 810)**

**Issued:** January 2010

**Objective:**

The objective of ASU 2010-02 is to address implementation issues related to the
changes in ownership provisions in the Consolidation – Overall Subtopic (Subtopic 810-
10) of the *FASB Accounting Standards Codification™*, originally issued as FASB

**Background:**

Subtopic 810-10 establishes the accounting and reporting guidance for noncontrolling
interests and changes in ownership interests of a subsidiary.

The general rule is as follows:

1. An entity is required to deconsolidate a subsidiary when the entity ceases to
have a controlling financial interest in the subsidiary.

2. Upon deconsolidation of a subsidiary, an entity recognizes a gain or loss on the
transaction in the income statement and measures any retained investment in
the subsidiary at fair value. The gain or loss includes any gain or loss associated
with the difference between the fair value of the retained investment in the
subsidiary and its carrying amount at the date the subsidiary is deconsolidated.

3. If, instead, there is a decrease in the ownership interest of a subsidiary that does
not resolve in a change of control of the subsidiary, the offset to the decrease is
an equity transaction and does not impact the income statement.

Although Subtopic 810-10 provides general guidance on accounting for the decreases in
ownership of a subsidiary, including a deconsolidation, some constituents raised
concerns that the guidance appears to conflict with the gain or loss treatment or
derecognition criteria of other U.S. generally accepted accounting principles (GAAP),
such as the guidance for sales of real estate, transfers of financial assets, conveyances
of oil and gas mineral rights, and transactions with equity method investees.
Some constituents also questioned whether the Board intended for the decrease in ownership provisions of Subtopic 810-10 to apply to all entities because a subsidiary is defined as an entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. Those constituents were concerned that such an interpretation could result in the accounting for a transaction being driven by its form rather than its substance. For example, different accounting might be applied to a transaction involving the same underlying assets depending on whether those assets were transferred in asset or entity form.

Conclusions of ASU:

1. Scope of the ASU:

The ASU provides amendments to Subtopic 810-10 and related guidance within U.S. GAAP to clarify that the scope of the decrease in ownership provisions of the Subtopic and related guidance applies to the following:

   a. A subsidiary or group of assets that is a business or nonprofit activity.
   b. A subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture.
   c. An exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture).

The ASU does not apply to the following transactions even if they involve businesses with:

   a. Sales of in substance real estate. Entities should apply the sale of real estate guidance in Subtopics 360-20 (Property, Plant, and Equipment) and 976-605 (Retail/Land) to such transactions.
   b. Conveyances of oil and gas mineral rights. Entities should apply the mineral property conveyance and related transactions guidance in Subtopic 932-360 (Oil and Gas – Property, Plant, and Equipment) to such transactions.

Note: The amendments clarify, but do not necessarily change, the scope of current U.S. GAAP. The FASB thought that by clarifying the decrease in ownership provisions of Subtopic 810-10, it would remove the potential conflict between guidance in that Subtopic and asset derecognition and gain or loss recognition guidance that may exist in other U.S. GAAP.

2. Rules:

   a. Decrease in ownership in a subsidiary that is not a business or nonprofit activity:

      1) If a decrease in ownership occurs in a subsidiary that is not a business or nonprofit activity, an entity first needs to consider whether the substance of the transaction causing the decrease in ownership is addressed in other U.S. GAAP, such as transfers of financial assets, revenue recognition, exchanges of nonmonetary assets, sales of in substance real estate, or conveyances of oil and gas mineral rights, and apply that guidance as applicable.
2) If no other guidance exists, an entity should apply the guidance in Subtopic 810-10, below.

b. **Decrease in ownership in a subsidiary that is a business or nonprofit activity:** (Guidance of Subtopic 810-10):

   1) If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in Subtopic 845-10, *(Nonmonetary Transactions)*, and not 810-10 applies.

   2) Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets by recognizing a gain or loss in net income attributable to the parent, measured as the difference between (A) and (B), below:

   \[
   (A) = \text{The aggregate of all of the following:}
   \begin{align*}
   &1. \text{The fair value of any consideration received.} \\
   &2. \text{The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized.} \\
   &3. \text{The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.}
   \end{align*}
   \]

   \[
   (B) \text{ The carrying amount of the former subsidiary’s assets and liabilities or the carrying amount of the group of assets.}
   \]

   \[
   (A) - (B) = \text{GAIN OR LOSS (PART OF NET INCOME)}
   \]

3. **Disclosures:**

   a. The amendments in the ASU expand the disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of Subtopic 810-10.

   b. In addition to existing disclosures, an entity should disclose the following for such a deconsolidation or derecognition:

   - The valuation techniques used to measure the fair value of any retained investment in the former subsidiary or group of assets and information that enables users of its financial statements to assess the inputs used to develop the measurement.
   - The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized.
   - Whether the transaction that resulted in the deconsolidation of the subsidiary or the derecognition of the group of assets was with a related party, or whether the former subsidiary or entity acquiring the group of assets will be a related party after deconsolidation.
c. An entity also should disclose the valuation techniques used to measure an equity interest in an acquiree held by the entity immediately before the acquisition date in a business combination achieved in stages.

4. Effective date:

a. The amendments in this Update are effective beginning in the period that an entity adopts FASB No. 160 (now included in Subtopic 810-10).

b. If an entity has previously adopted FASB No. 160 as of the date the amendments in this ASU, the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this Update should be applied retrospectively to the first period that an entity adopted FASB No. 160.

5. Interrelation with international standards:

a. The amendments in this ASU may result in differences in accounting and between U.S. GAAP and IFRS.

Note: IFRS guidance on accounting for decreases in ownership of subsidiaries is similar to guidance in U.S. GAAP. IFRS guidance, however, applies to all subsidiaries, even those that are not businesses or nonprofit activities or those that involve sales of in substance real estate or conveyances of oil and gas mineral rights. The decrease in ownership guidance in IFRS also does not address whether that guidance should be applied to transactions involving nonsubsidiaries that are businesses or nonprofit activities. Despite those potential differences, the FASB concluded that the guidance should be clarified so that it is applied consistently and does not conflict with other guidance in U.S. GAAP.

Accounting Standards Update 2010-06: Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements (ASC 820)

Issued: January 2010

Objective:

The objective of this ASU is to improve disclosure requirements related to Fair Value Measurements and Disclosures – Overall Subtopic (Subtopic 820-10) of the FASB Accounting Standards Codification, originally issued as FASB Statement No. 157, Fair Value Measurements.

Background:

U.S. GAAP requires that a reporting entity provide disclosures about fair value measurements used in financial statements. Most of those requirements are set out in Subtopic 820-10.

Various third parties have asked the FASB to enhance the disclosures for fair value measurements.
a. During 2008, the Securities and Exchange Commission’s (SEC) Division of Corporation Finance issued letters to some public companies that encouraged additional disclosures in the management’s discussion and analysis (MD&A) section of their SEC filings about the application of the fair value measurement standards in U.S. GAAP.

b. In October 2008, in responding to FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, some financial statement users urged the Board to enhance the disclosure requirements in U.S. GAAP on fair value measurements.

c. In October 2008, the International Accounting Standard Board’s (IASB) Expert Advisory Panel issued a report titled Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active. On the basis of that report, the IASB issued proposals to improve the fair value disclosures in IFRS 7.

d. In December 2008, the SEC released its Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting. This report recommended that the FASB consider enhancing the disclosure requirements in U.S. GAAP on fair value measurements.

e. In February 2009, the FASB’s Valuation Resource Group met to discuss various issues on the implementation of fair value disclosure requirements in U.S. GAAP and suggested additional disclosures.

f. In March 2009, the International Monetary Fund issued the Working Paper, Procyclicality and Fair Value Accounting. The authors of that Paper recommend that fair value measurements be supplemented with adequate disclosures.

g. In March 2009, the IASB issued Improving Disclosures about Financial Instruments (Amendments to IFRS 7). The amendments require some new disclosures and improve convergence with the fair value hierarchy and the related disclosures in Subtopic 820-10.

In response, the FASB concluded that changes were needed to provide a greater level of disaggregated information and more robust disclosures about valuation techniques and inputs to fair value measurements.

Amendments by the ASU:

1. The ASU applies to all entities that are required to make disclosures about recurring or nonrecurring fair value measurements.

2. The ASU amends Subtopic 820-10 by requiring new disclosures as follows:

   a. Transfers in and out of levels 1 and 2: A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.

   b. Activity in level 3 fair value measurements: In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).
3. The ASU amends Subtopic 820-10 to clarify existing disclosures as follows:

a. **Level of disaggregation:** A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.

b. **Disclosures about inputs and valuation techniques:** A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

4. The ASU includes conforming amendments to the guidance on employers’ disclosures about postretirement benefit plan assets (Subtopic 715-20). The amendments to Subtopic 715-20 change the terminology from **major categories** of assets to **classes** of assets and provide a cross reference to the guidance in Subtopic 820-10 on how to determine appropriate classes to present fair value disclosures.

**Effective date:**

1. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Under FSP FAS 115-2 and FAS 124-2 (ASC 320) with respect to a debt security, in order to avoid recognizing an other-than-temporary impairment, an investor must assert that it has ______ to hold a security for a period of time sufficient to allow for an anticipated recovery in its fair value to its amortized cost basis.

   a. the ability
   b. the intent
   c. the financial strength
   d. both the intent and ability

2. Which of the following must occur in order for an entity to be required to assess whether a debt security impairment is other than temporary:

   a) the amortized cost basis is equal to or less than fair value
   b) there is a reduction in fair value that lasts at least one operating cycle
   c) the fair value is less than its amortized cost basis
   d) the entity plans to sell the security

3. FSP FAS 107-1 expands the fair value disclosures of FASB No. 107 (ASC 825) to which of the following:

   a) private companies for annual financial statements
   b) publicly traded companies for annual financial statements
   c) private companies for interim reporting periods
   d) publicly traded companies for interim reporting periods

4. In determining the fair value under FASB No. 157 (ASC 820), if there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity, which of the following is correct:

   a) quoted prices shall be determinative of fair value
   b) quoted prices may not be determinative of fair value
   c) using the fair value of similar assets is sufficient to use as the fair value
   d) recent transactions are the basis for determining fair value
5. Which of the following would be an example of a circumstance indicating that a transaction is not orderly with respect to fair value accounting:

a) the seller marketed the asset or liability to several market participants
b) the asset or liability was marketed for an adequate period of time before the measurement date
c) the transaction price is comparable with other recent transactions
d) the seller is in or near bankruptcy

6. During the measurement period, the acquisition-date fair value of an asset assumed in a business combination that arises from a contingency cannot be determined. Which of the following is the correct treatment:

a) the acquirer shall recognize at fair value the asset acquired in all circumstances
b) the acquirer shall recognize at fair value the asset acquired if the amount of the asset can be reasonably estimated
c) the acquirer shall recognize the asset at book value of the acquiree
d) the acquirer shall recognize at fair value the asset acquired if certain criteria are met

7. Facts: An entity is an S corporation that pays state income taxes on behalf of the entity. Which of the following is correct as it relates to FIN 48 (ASC 740):

a) the state income taxes are not covered by FIN 48
b) the state income taxes are covered by FIN 48 only if they relate to the owners of the S corporation
c) the state income taxes are included within the scope of FIN 48
d) the state income taxes are not covered by FIN 48 because the entity is a non-public entity

8. Under the fair value rules, a reporting entity is permitted to estimate the fair value of an investment using the ______ if the net asset value per share is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

a) net asset value per share
b) book value per share
c) present value method
d) quoted market price
9. Under ASU 2009-13, which of the following correctly identifies the selling price hierarchy for a deliverable in a multiple-element arrangement:

   a) estimated selling price, then third-party evidence, then vendor-specific objective evidence  
   b) third-party evidence, then estimated selling price, then vendor-specific objective evidence  
   c) vendor-specific objective evidence, then third-party evidence then estimated selling price  
   d) vendor-specific objective evidence, then estimated selling price, then third-party evidence

10. Which of the following is covered under the guidance in ASU 2010-02 with respect to decrease in ownership of a subsidiary:

   a) sales of in substance real estate  
   b) conveyances of oil and gas mineral rights  
   c) an exchange of a group of assets that does not constitute a business for a noncontrolling interest in an entity  
   d) a subsidiary that is a business

11. ASU 2010-06 amends disclosures for fair value measurements to include transfers:

   a) in and out of level 3 fair value measurements  
   b) in and out of level 1 and 2 fair value measurements  
   c) in, but not out of levels 1, 2 and 3 fair value measurements  
   d) out, but not in of levels 1, 2 and 3 fair value measurements
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Ability is fine but not enough to satisfy the FSP.
   B: Incorrect. An investor’s intent, by itself, is not sufficient to meet the requirements of the FSP.
   C: Incorrect. The FSP does not use financial strength as a benchmark.
   D: Correct. An investor must have both the intent and ability to hold the security to satisfy the requirements of the FSP.

   (See page 3 of the course material.)

2. A: Incorrect. If amortized cost basis is equal to or less than fair value, there is no impairment to assess.
   B: Incorrect. There is no requirement that a reduction in fair value last for at least one operating cycle.
   C: Correct. If the fair value is less than its amortized cost basis, the entity is required to assess whether the impairment is other than temporary.
   D: Incorrect. Planning to sell the security is a factor to consider in determining whether the impairment is other than temporary. It is not a factor to consider in determining whether an assessment is needed.

   (See page 5 of the course material.)

3. A: Incorrect. Private companies are exempt from FASB 107 fair value disclosures.
   B: Incorrect. Publicly traded companies are already subject to FASB No. 107 disclosure requirements for annual financial statements.
   C: Incorrect. Regardless of the reporting period, private companies are exempt from the application of FASB No. 107 for fair value disclosures.
   D: Correct. The FSP expands the fair value disclosures to publicly traded companies for interim reporting periods.

   (See page 12 of the course material.)
4. A: Incorrect. Quoted prices shall not be determinative of fair value and further analysis is needed.

**B: Correct.** Quoted prices may not be determinative of fair value. Further analysis may be needed and a significant adjustment may be necessary to estimate fair value.

C: Incorrect. The fair value of similar assets may be used but may require significant adjustment to make it more comparable to the asset being measured.

D: Incorrect. Transactions as well as quoted prices are generally not determinative of fair value if there has been a significant decrease in the volume and level of activity.

*(See page 17 of the course material.)*

5. A: Incorrect. A circumstance indicating that a transaction is not orderly is where the asset or liability is marketed to a single market participant.

B: Incorrect. An indication that a transaction is not orderly is when the seller markets the asset or liability for an inadequate period prior to the measurement date.

C: Incorrect. If the transaction price is an outlier and not comparable with other recent transactions, it may be an indication that the transaction is not orderly.

**D: Correct.** On indication of a lack of orderly is if the seller is in or near bankruptcy or receivership indicating that the transaction is distressed.

*(See page 17 of the course material.)*

6. A: Incorrect. If the fair value cannot be determined, the acquirer shall not recognize at fair value the asset acquired, in all circumstances. Instead, certain criteria must be met.

B: Incorrect. Not only must the amount be reasonably estimated, but also the information must indicate that it is probable that an asset existed at the acquisition date.

C: Incorrect. The acquirer shall recognize the asset at book value under any circumstances. Fair value is the measurement basis.

**D: Correct.** If the acquisition-date fair value cannot be determined, the asset is recognized if two criteria are met. One is that information indicates that it is probable that an asset existed at the acquisition date. Second, the amount of the asset can be reasonably estimated.

*(See page 22 of the course material.)*
7. **A:** Incorrect. ASU 2009-06 amends FIN 48 to include pass-through entities within the scope of FIN 48.

**B:** Incorrect. Taxes paid on behalf of the owners are not covered under FIN 48.

**C:** Correct. Pass-through entities and the taxes they paid (e.g., state income taxes) are included within the scope of FIN 48.

**D:** Incorrect. FIN 48 applies to nonpublic entities, even though there are certain disclosures that apply to public entities only.

(See page 28 of the course material.)

8. **A:** Correct. The net asset value per share may be used to determine fair value when the fair value is not readily available by other means.

**B:** Incorrect. Because fair value is the goal, using book value per share is useless.

**C:** Incorrect. Use of the present value method may be applicable in some fair value model but not in connection with transactions covered by Topic 946.

**D:** Incorrect. Quoted market prices are not readily available, thereby requiring another method to arrive at fair value.

(See page 35 of the course material.)

9. **A:** Incorrect. Estimated selling price is third, third-party evidence is second, and vendor-specific objective evidence is supposed to be first in the hierarchy.

**B:** Incorrect. Third-party evidence should be second, estimated selling price should be third, and vendor-specific objective evidence should be first.

**C:** Correct. Vendor-specific objective evidence is first, third-party evidence is second, and estimated selling price is third, which is correctly stated.

**D:** Incorrect. Vendor-specific objective evidence is correct but estimated selling price should be third, and third-party evidence should be second.

(See page 39 of the course material.)
10. A: Incorrect. Sales of in substance real estate are not covered by the ASU.

B: Incorrect. Conveyances of oil and gas mineral rights are not covered by the ASU.

C: Incorrect. An exchange of a group of assets that does constitute a business for a noncontrolling interest in an entity is covered under the scope, but not a group of assets that does not constitute a business.

D: Correct. A subsidiary or a group of assets that is a business is included within the scope of the ASU.

(See page 45 of the course material.)

11. A: Incorrect. Activity in level 3 is required to be disclosed, but not transfers.

B: Correct. The new disclosure requires transfers in and out of level 1 and 2 fair value measurements.

C: Incorrect. The disclosures include transfers in and out.

D: Incorrect. The disclosures include transfer both in and out of levels 1 and 2, but not level 3.

(See page 48 of the course material.)
II. Latest Developments on the Accounting Front

A. REPORTING INFORMATION ABOUT THE FINANCIAL PERFORMANCE OF BUSINESS ENTERPRISES

1. FASB Looks at Changing Financial Performance Reporting

What is clear from recent challenges in the financial markets is that investors do not understand or believe the financial information that is presented to them. Over the past decade, rampant fraud and a series of bankruptcies have resulted in record-breaking financial losses to investors and third parties. In most cases, numerous warning signs were visible for several consecutive years, yet investors and other third parties ignored them. Either the information was not clearly presented, or the investors were not sophisticated enough to understand the very complex transactions and structures in which companies operate today. Perhaps, there is a little of both truths that have led to the present situation in which the financial markets find themselves.

Recent developments with the FASB:

The FASB and Europe’s IASB are simultaneously working on their own respective financial performance reporting projects. Because both organizations seek a convergence of international standards, the FASB and IASB have developed a Joint Working Group consisting of members of the FASB, IASB, and the UK’s Accounting Standards Board (ASB) staff to reconcile differences between the two projects.

The two Boards decided to segregate the financial statement presentation project into three phases as follows:

- **Phase A**: Addresses the statements that constitute a complete set of financial statements and the periods for which they are required to be presented.

- **Phase B**: Addresses more fundamental issues relating to presentation and display of information in the financial statements, including aggregating and disaggregating information in each primary financial statements, defining totals and subtotals, and reconsidering the use of the direct or an indirect method of presenting operating cash flows in the statement of cash flows.

- **Phase C**: Addresses the presentation and display of interim financial information in U.S. GAAP. The IASB may also reconsider the requirements found in its own IAS 34, *Interim Financial Reporting*.

**Phase A**:

Both Boards completed their deliberations of Phase A that resulted in the IASB issuing a revised IAS 1, *Presentation of Financial Statements*, to reflect the Phase A changes. The FASB has chosen to wait to issue any final guidance on Phase A conclusions until Phase B is completed.

Following are the conclusions reached by both Boards in Phase A of the Project:
Chapter 6: Current Developments – 58
Accounting and Financial Reporting

1. A full set of financial statements shall include the following statements:

   **Statement of Financial Position** (showing both beginning and end of the period assets, liabilities, and equity) (3 years comparative: two at end of the year and one at the beginning of the first year presented)²

   **Statement of Earnings (Income) and Comprehensive Income**: Shows the changes in assets and liabilities other than those arising from transactions with owners in their capacity as owners. (2 years comparative)

   **Statement of Changes in Equity**: Showing the changes in assets and liabilities arising from transactions with owners in their capacity as owners (2 years comparative)

   **Statement of Cash Flows** (2 years comparative)

2. A single statement of income and comprehensive income shall be required that presents a total for nonowners’ changes in financial position and a required subtotal for net income/loss.

3. There will be the requirement to continue the presentation of basic and diluted EPS on the face of the statement of earnings and comprehensive income.

4. Disclosure of basic and diluted comprehensive income per share in the notes will be permitted but not required.

5. Disclosure of the weighted average number of shares used as the denominator in calculating per-share metrics in the notes will continue to be required.

6. There will be permitted, but not required, the voluntary presentation of financial information beyond the required minimum (e.g., information beyond a complete set of financial statements and beyond the two years comparative).

**Phase B:**

In October 2008, the FASB and IASB started Phase B of the financial statement presentation project with the issuance of a joint Discussion Paper entitled *Preliminary Views on Financial Statement Presentation*. Although the Discussion Paper is preliminary and subject to an extensive comment process, it does provide general information as to the direction in which the two Boards are headed in changing the financial statement presentation format.

Following are some of the general concepts that are included in the Discussion Paper.

In Phase B, the Boards have developed three objectives for financial statement presentation. In general, information should be presented in the financial statements in a manner that:

² Since concluding on Phase A, the IASB changed the requirement for a third balance sheet (as of the beginning of the year) so that it will only be required if there is a change in accounting policy applied retrospectively. The FASB has not reached a conclusion as to whether it will eliminate the requirement for a beginning balance sheet.
1. **Portrays a cohesive financial picture of an entity’s activities** that includes the relationship between items across financial statements and one in which the financial statements complement each other.

2. **Disaggregates information to help predict an entity’s future cash flows** in terms of assessing the amount, timing, and uncertainty of future cash flows with information disaggregated into reasonably homogeneous groups of items, and

3. **Helps users assess an entity’s liquidity and financial flexibility** in terms of its ability to meet financial commitments when due and to invest in business opportunities and respond to unexpected needs.

Phase B would apply to all entities except:

- Not-for-profit entities,
- Nonpublic entities, and
- Benefit plans within FASB No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* (ASC 960).

**Observations:** As for non-profit entities, the FASB stated that significant additional research and analysis is needed to determine the extent to which the conclusions in the Phase B would be meaningful to non-profit entities. The author believes that in the end, the FASB will exclude non-profits from the scope of the Project and deal with changes to the financial statement presentation of non-profits (currently covered by FASB No. 116 (ASC 720) and FASB No. 117 (ASC 958)) in a separate project.

Both Boards have not reached conclusions as to whether the project’s scope will include nonpublic entities. The FASB noted that it wants to wait until it sees the results of the letters of comment to assess whether the needs of users of non-public entity financial statements are different enough to warrant a drastic change to the new proposed format. The issue of whether nonpublic entities will be spared from these changes is uncertain at this point in time. Although at the inception of most FASB projects, the Board appears to have good intentions in trying to save non-public entities from the dire impact of many of the proposed FASB changes, in the end typically the FASB falls short by dragging nonpublic entities with the scope of the financial statements. What is clear is that preparers and users of financial statements for nonpublic entities should not assume that they will be exempted from the financial statement presentation project changes.

Key proposed changes include:

1. **Statement of Financial Position (Balance Sheet):**
   
   a. The balance sheet would group assets and liabilities together by similar categories (operating, investing, financing), instead of by the current approach segregated into assets, liabilities and equity.

   b. Assets and liabilities would be disaggregated into short-term and long-term subcategories within each category.
c. An entity would be required to display subtotals for total assets, total liabilities, short-term assets, short-term liabilities, long-term assets, and long-term liabilities.

2. **Statement of Comprehensive Income:**

   a. The proposal eliminates the choice of presenting components of income and expense in an income statement and a statement of comprehensive income (two-statement approach) or presenting comprehensive income as part of the statement of changes in equity.

   b. All entities would present a single statement of comprehensive income that would include a subtotal of *profit or loss or net income*, and a total for *comprehensive income*, and a category for *other comprehensive income*.

   **Note:** The FASB-IASB indicate that the new format would provide less emphasis on a net income number on the income statement. Too many accounting scandals have been the result of manipulating one number, which is net income.

3. **Statement of Cash Flows:**

   a. Under the proposal, the direct method would be required, thereby eliminating the choice of using the indirect method.

   b. Cash receipts and cash payments line items would be required in the operating category.

   c. An indirect reconciliation of operating income to operating cash flows would be required in the notes to financial statements.

4. **Changes in equity:**

   a. The statement of changes in equity should present the beginning and ending amount of each component of equity and how each amount changed during the period.

   b. Items that should be included in the statement of changes in equity include:

   - Total comprehensive income for the period.
   - By component of equity, at the earliest period presented, the effects of any retrospective application or restatement in accordance with GAAP.
   - For each component of equity, a reconciliation of the beginning and ending balance separately disclosing the portion of the change from net income, each item of other comprehensive income, and transactions with owners.

5. **Separating (disaggregating) information into categories:**

   All statements shall be separated into five main categories as follows:

   a. **Business activities:** Includes assets and liabilities (and the related changes) that management views as part of its continuing business activities with the intention to create value, such as producing goods and providing services, including transactions with customers, suppliers, and employees.
Business activities are further broken down into:

**Operating activities**: Day-to-day activities that management views related to the central purpose for which the entity is in business.

**Investing activities**: Business activities that management views as generating non-revenue income and create no significant synergies from combined assets. Such activities are unrelated to the central purpose for which the entity is in business including investing to generate dividends, interest or capital gain but not for the primary revenue and expense-generating activities.

**Financing arising from operating activities**: Includes long-term liabilities tied to operating activities such as net pension liability (or asset) and an asset retirement obligation. Cash flows related to items in this category should be presented on the statement of cash flows in a category labeled “operating activities and financing arising from operating activities.”

b. **Financing activities**: Financing assets and liabilities that in management’s view are part of the financing of the entity’s business and other activities such as activities involving bank loans, leases, and issuance of bonds.

Financing activities will include items that are part of an entity’s activities to obtain (or repay) capital and consist of two categories: debt and equity.

**Debt category**: includes liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising (or repaying) capital.

**Equity category**: includes equity as defined in either IFRS or U.S. GAAP.

c. **Income taxes section**: Includes all current and deferred income tax assets, liabilities, and the activity related thereto. Income tax assets, liabilities and related cash flows should be presented in one separate section in the statements of financial position and cash flows, but should be allocated to the various categories in the statement of comprehensive income.

d. **Discontinued operations**: Includes all assets and liabilities related to discontinued operations and all changes in those assets and liabilities.

e. **Equity section**: Includes all items that meet the definition of equity. In the balance sheet, that would include common shares, treasury shares, and retained earnings. In the statement of cash flows, all cash flows related to equity would be presented in the equity section.

6. **Changes to notes to financial statements**:

a. Disclosure explaining the bases for classifying assets and liabilities in the operating, investing and financing categories, and any changes in such classifications.

b. Disclosure of the operating cycle if it is longer than one year.
c. Disclosure about repatriation limitations and other restrictions on cash (and short-term investments similar to cash) in the notes to financial statements.

d. Disclosure about significant noncash activities unless that information is presented elsewhere in the financial statements.

7. Other proposed changes:

a. The use of the term “cash equivalents” would be eliminated in the statement of cash flows and statement of financial position and replaced with the term “cash.”

- The statement of cash flows would reconcile down to cash and not to cash and cash equivalents.
- Cash on the statement of financial position would exclude any cash equivalents that would be presented in another category such as short-term investments.

b. The option of having an unclassified statement of financial position would be eliminated. Assets and liabilities in each of the five categories would be further classified into short- and long-term subcategories.

- Short-term: Based on a fixed period of one year.
- Long-term: Asset or liability that does not meet the definition of short-term.

c. Bank overdrafts would be presented in the debt category of the financing section of the statement of financial position.
|---------------------------------|-----------------------------------------------|------------------------|
| **Business:** All assets and liabilities that management views as part of the entity’s continuing business activities. | **Business:** Operating income Investing income | **Business:** Operating cash flows  
• Definition of cash equivalent would be eliminated |
| **Operating assets and liabilities:** Assets and liabilities that management views as related to the central purpose of the entity’s business are integral to the business activities it is currently engaged in and unrelated to financing those activities. Includes: Accounts receivable Accounts payable Inventory PP&E Intangible assets Pension obligations • Shown short-term and long-term | | Investing cash flows  
• Shown short- and long-term |
<table>
<thead>
<tr>
<th><strong>Investing assets and liabilities:</strong> Assets and liabilities that management views as related to the entity’s investing activities: committing money or capital with the expectation of earning a financial return. Includes: held-to-maturity financial instruments and financial instruments held to hedge items included in the investing category. • Shown short- and long-term</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Discontinued operations:</td>
<td>Discontinued operations: Profit or loss from discontinued operations and any gain or loss from measurement to fair value or disposal would be combined on the face of the statement of comprehensive income, net of tax</td>
<td>Discontinued operations: Total cash flows related to the discontinued operations would be combined on the statements of cash flows.</td>
</tr>
<tr>
<td>Income taxes:</td>
<td>Income taxes: Would be allocated to the various five categories on the statement of comprehensive income.</td>
<td>Income taxes:</td>
</tr>
</tbody>
</table>
| Short-term                     | Financing: Financing assets and liabilities that are part of the financing of the entity’s business activities:  
  • Shown short-term and long-term  
  • Examples of financial assets and liabilities:  
    Cash  
    Bank loans  
    AFS securities  
    Bonds  
    Leases  
    Financial instruments held to hedge any of the above items.  
| Long-term                      | Financing: Financing asset income  
  Financing liability expenses | Financing: Financing asset cash flows  
  Financing liability cash flows  
  Equity cash flows |
| Equity                          | Other comprehensive income, net of tax | Equity |

**FASB proposes to eliminate use of the term “cash equivalents”**

FASB No. 95, *Statement of Cash Flows* (ASC 230) uses the term “cash equivalents” and defines it as certain liquid assets with a maturity of three months or less.

As part of its financial statement presentation project, the FASB has voted to eliminate the term “cash equivalents” from the statement cash flow and GAAP in general. Such a move is part of the FASB’s effort to simplify financial statements. The FASB staff has recommended that the statement of cash flows should present only cash flow related to
cash and exclude cash equivalents. A primary reason for the recommended change is because the three-month definition of cash equivalents is arbitrary and cash equivalents only become liquid if they are sold.

Similarly, cash on the balance sheet would not include any cash equivalents which would be presented in another category such as short-term investments.

**What would be the implications of a drastic change in the format of financial statements?**

What is clear is that the proposed changes in the financial statement presentation would be one of the most sweeping changes to GAAP in recent years.

Some of the most obvious impacts would be:

1. The cost of such a change would be significant.
   - Everything from textbooks to internal and external financial statement formats would have to be changed.
   - The change to the direct method alone would be costly.

2. There could be significant fluctuations in comprehensive income from year to year as more items are brought onto that statement that were not on the income statement before.

3. Contract formulas for bonuses, joint ventures, etc. that are based on GAAP net income would have to be rewritten.

4. Tax return M-1 reconciliations would differ.

**Concerns about management’s manipulation of the functional categories**

One concern that has been mentioned by users is that the new format is subject to manipulation by management. Recall that the proposal calls for categorization of transactions based on “management’s view” of how those transactions fall into the entity’s business. With extensive latitude given to management to decide how to categorize certain transactions, it is likely that management might be motivated to manipulate the categories to create a more positive result for its company. For example, shifting a positive transaction from investing to operating within the business category will increase the operating category. Moreover, with management’s subjectivity inserted into the mix, companies with similar transactions may have those transactions presented in different financial statement categories.

**Sample of FASB’s proposed new financial statement format:**

Following are examples of financial statement formats that reflect the FASB’s proposal, as modified by the author. They are unofficial and subject to change. Required items are noted in **BOLD.**

---

### Statement of Financial Position – Proposed New Format

#### BUSINESS:

<table>
<thead>
<tr>
<th>Operating assets and liabilities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$XX</td>
</tr>
<tr>
<td>Less allowance for bad debts</td>
<td>(XX)</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>XX</td>
</tr>
<tr>
<td>Inventory</td>
<td>XX</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>XX</td>
</tr>
<tr>
<td>Total short-term assets</td>
<td>XX</td>
</tr>
<tr>
<td>Leased asset</td>
<td>XX</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>XX</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(XX)</td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>XX</td>
</tr>
<tr>
<td>Investment in X</td>
<td>XX</td>
</tr>
<tr>
<td>Goodwill</td>
<td>XX</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>XX</td>
</tr>
<tr>
<td>Total long-term assets</td>
<td>XX</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(XX)</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>(XX)</td>
</tr>
<tr>
<td>Advances from customers</td>
<td>(XX)</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>(XX)</td>
</tr>
<tr>
<td>Accrued stock compensation</td>
<td>(XX)</td>
</tr>
<tr>
<td>Current portion of lease liability</td>
<td>(XX)</td>
</tr>
<tr>
<td>Total short-term liabilities</td>
<td>(XX)</td>
</tr>
<tr>
<td>Lease liability (excluding current portion)</td>
<td>(XX)</td>
</tr>
<tr>
<td>Accrued pension liability</td>
<td>(XX)</td>
</tr>
<tr>
<td>Total long-term liabilities</td>
<td>(XX)</td>
</tr>
</tbody>
</table>

| Net operating assets before financing arising from operating | XX |

#### Financing arising from operating:

| Accrued pension liability       | XX |
| Current portion of lease liability | XX |
| Interest payable on lease liability | XX |
| Lease liability (excluding current portion) | XX |
| Decommissioning liability       | XX |
| Total financing arising from operating | XX |

| Net operating assets            | XX |

#### Investing assets and liabilities:

| Available-for-sale financial assets (short-term) | XX |
| Investment in affiliate                  | XX |

| Total investing assets                | XX |

#### NET BUSINESS ASSETS

<p>| NET BUSINESS ASSETS | XX |</p>
<table>
<thead>
<tr>
<th><strong>DISCONTINUED OPERATIONS:</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets held for sale</td>
<td>XX</td>
</tr>
<tr>
<td>Liabilities related to assets held for sale</td>
<td>(XX)</td>
</tr>
</tbody>
</table>

**NET ASSETS HELD FOR SALE**: XX

<table>
<thead>
<tr>
<th><strong>INCOME TAXES:</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Short-term:</strong></td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>XX</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>(XX)</td>
</tr>
<tr>
<td><strong>Long-term:</strong></td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>XX</td>
</tr>
</tbody>
</table>

**TOTAL INCOME TAXES**: XX

<table>
<thead>
<tr>
<th><strong>FINANCING:</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debt:</strong></td>
<td></td>
</tr>
<tr>
<td>Short-term debt</td>
<td>(XX)</td>
</tr>
<tr>
<td>Interest payable</td>
<td>(XX)</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>(XX)</td>
</tr>
<tr>
<td>Total short-term debt</td>
<td>(XX)</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>(XX)</td>
</tr>
<tr>
<td><strong>Total debt</strong></td>
<td>(XX)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Equity:</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>(XX)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(XX)</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>(XX)</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>(XX)</td>
</tr>
</tbody>
</table>

**TOTAL FINANCING**: (XX)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total short-term assets</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total long-term assets</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total short-term liabilities</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total long-term liabilities</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>XX</td>
</tr>
</tbody>
</table>
## Statement of Comprehensive Income – Proposed New Format

**BUSINESS:**

<table>
<thead>
<tr>
<th>Operating:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$XX</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(XX)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>XX</td>
</tr>
<tr>
<td>Selling expenses</td>
<td></td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>(XX)</td>
</tr>
<tr>
<td>Gain on disposal of property, plant and equipment</td>
<td>XX</td>
</tr>
<tr>
<td>Interest income on cash balances</td>
<td>XX</td>
</tr>
<tr>
<td>Realized gain on future contracts</td>
<td>XX</td>
</tr>
<tr>
<td>Loss on sale of receivables</td>
<td>(XX)</td>
</tr>
<tr>
<td>Impairment loss on goodwill</td>
<td>(XX)</td>
</tr>
<tr>
<td><strong>Operating before financing arising from operating</strong></td>
<td>XX</td>
</tr>
<tr>
<td>Financing costs arising from operating activities</td>
<td>(XX)</td>
</tr>
<tr>
<td><strong>Total operating income</strong></td>
<td>XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investing:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in earnings of affiliate</td>
<td>XX</td>
</tr>
<tr>
<td>Dividend income</td>
<td>XX</td>
</tr>
<tr>
<td>Realized gain on available-for-sale securities</td>
<td>XX</td>
</tr>
<tr>
<td>Gain on equity of affiliate B</td>
<td>XX</td>
</tr>
<tr>
<td><strong>Total investing income</strong></td>
<td>XX</td>
</tr>
<tr>
<td><strong>TOTAL BUSINESS INCOME</strong></td>
<td>XX</td>
</tr>
</tbody>
</table>

**FINANCING:**

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>(XX)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TOTAL FINANCING EXPENSE</strong></td>
<td>(XX)</td>
</tr>
<tr>
<td>Income from continuing operations before taxes</td>
<td>XX</td>
</tr>
</tbody>
</table>

**INCOME TAXES:**

<table>
<thead>
<tr>
<th>Income tax expense</th>
<th>(XX)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net income from continuing operations</strong></td>
<td>XX</td>
</tr>
</tbody>
</table>

**DISCONTINUED OPERATIONS:**

| Loss on discontinued operations | (XX) |
| Tax benefit                   | XX  |
| **NET LOSS ON DISCONTINUED OPERATIONS** | (XX) |

| **NET INCOME** | XX |

**OTHER COMPREHENSIVE INCOME (after tax):**

| Foreign currency translation adjustment – consolidated subsidiary | XX |
| Actuarial gain on pension obligation | XX |
| Unrealized gain on available-for-sale securities | XX |
| Unrealized gain on futures contract | XX |
| **TOTAL OTHER COMPREHENSIVE INCOME** | XX |
| **TOTAL COMPREHENSIVE INCOME** | $XX |

<p>| Earnings per common share | $XX |
| Earnings per common share assuming dilution | XX |</p>
<table>
<thead>
<tr>
<th>Statement of Cash Flows – Proposed New Format</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BUSINESS:</strong></td>
</tr>
<tr>
<td>Cash flows from operating activities:</td>
</tr>
<tr>
<td>Cash collected from customers</td>
</tr>
<tr>
<td>Cash paid for labor</td>
</tr>
<tr>
<td>Cash paid for materials</td>
</tr>
<tr>
<td>Other business related cash outflows</td>
</tr>
<tr>
<td>Lease payments</td>
</tr>
<tr>
<td>Pension outflows</td>
</tr>
<tr>
<td>Capital expenditures</td>
</tr>
<tr>
<td>Interest received on cash balances</td>
</tr>
<tr>
<td>Disposal of property, plant and equipment</td>
</tr>
<tr>
<td>Settlement of cash flow hedge</td>
</tr>
<tr>
<td>Sale of receivables</td>
</tr>
<tr>
<td><strong>Net cash from operating activities</strong></td>
</tr>
<tr>
<td>Cash flows from investing activities:</td>
</tr>
<tr>
<td>Purchase of investment in affiliate</td>
</tr>
<tr>
<td>Purchase of available-for-sale investments</td>
</tr>
<tr>
<td>Sale of available-for-sale investments</td>
</tr>
<tr>
<td>Dividends received</td>
</tr>
<tr>
<td><strong>Net cash used in investing activities</strong></td>
</tr>
<tr>
<td><strong>NET CASH USED IN BUSINESS ACTIVITIES</strong></td>
</tr>
<tr>
<td>CASH FLOWS FROM FINANCING ACTIVITIES:</td>
</tr>
<tr>
<td>Dividends paid</td>
</tr>
<tr>
<td>Interest paid</td>
</tr>
<tr>
<td>Proceeds from issuance of short-term debt</td>
</tr>
<tr>
<td>Proceeds from issuance of long-term debt</td>
</tr>
<tr>
<td><strong>NET CASH FROM FINANCING ACTIVITIES</strong></td>
</tr>
<tr>
<td>Net cash from continuing operations before taxes</td>
</tr>
<tr>
<td>CASH FLOWS FROM INCOME TAXES:</td>
</tr>
<tr>
<td>Cash paid for current tax expense</td>
</tr>
<tr>
<td>Change in cash from continuing operations</td>
</tr>
<tr>
<td>CASH FLOWS FROM DISCONTINUED OPERATIONS:</td>
</tr>
<tr>
<td>Cash outflows from discontinued operations</td>
</tr>
<tr>
<td>Effect of Foreign Exchange</td>
</tr>
<tr>
<td>Changes in cash</td>
</tr>
<tr>
<td><strong>Beginning cash</strong></td>
</tr>
<tr>
<td><strong>Ending cash</strong></td>
</tr>
</tbody>
</table>

(a): See tie in to Reconciliation of Operating Income to Operating Cash Flows schedule.
Observation: Notice that items that were previously included in investing or financing activities (such as sales of PP&E, capital expenditures, and cash paid on lease liabilities; see (b)) would now be included as part of operating cash flows.

### Statement of Changes in Equity – Proposed New Format

<table>
<thead>
<tr>
<th></th>
<th>Common stock/APIC</th>
<th>Treasury stock</th>
<th>Retained earnings</th>
<th>Accumulated OCI</th>
<th>Total SE equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance December 31, 20X1</td>
<td>$XX $(XX) $XX $XX $XX</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue of share capital</td>
<td>XX</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>(XX)</td>
<td>(XX)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance December 31, 20X2</td>
<td>$XX $(XX) $XX $XX $XX</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Supplementary Cash Flows Disclosure: Note to Financial Statements:

**Reconciliation of Operating Income to Operating Cash Flows:**

<table>
<thead>
<tr>
<th>Operating earnings</th>
<th>$XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustments to reconcile operating earnings to cash flow from operating activities of continuing operations:</td>
<td></td>
</tr>
<tr>
<td>Realized loss (gain) on future contracts</td>
<td>XX</td>
</tr>
<tr>
<td>Loss (gain) on disposal of property, plant and equipment</td>
<td>(XX)</td>
</tr>
<tr>
<td>Interest expense on decommissioning obligation</td>
<td>XX</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>XX</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>XX</td>
</tr>
<tr>
<td>Loss on obsolete and damaged inventory</td>
<td>XX</td>
</tr>
<tr>
<td>Impairment loss on goodwill</td>
<td>XX</td>
</tr>
<tr>
<td>Litigation expense</td>
<td>XX</td>
</tr>
</tbody>
</table>

Net change in selected assets and liabilities:

| Accounts receivable, trade | XX |
| Inventory | (XX) |
| Advances from customers | XX |
| Accounts and salaries payable | (XX) |
| Other assets and liabilities | XX |
| Pension liability | (XX) |

Cash inflows and outflows from other operating activities:

| Settlement of cash flow hedge contract | XX |
| Sale of property, plant and equipment | XX |
| Capital expenditures | (XX) |
| Cash paid on lease liability | (XX) |

CASH FLOW FROM OPERATING ACTIVITIES $X (a)

(a) agrees with net cash from operating activities on the statement of cash flows.
Observations:

Notice that items that were previously included in investing or financing activities (such as sales of PP&E, capital expenditures, and cash paid on lease liabilities; see (b)) would now be included as part of operating cash flows.

B. REVENUE RECOGNITION

Revenue recognition has been an important issue and primary concern in recent cases of fraud and accounting violations noted by the SEC. Traditional accounting rules for recognizing revenue have become outdated as more complex revenue transactions have become the norm.

According to the AICPA, revenue recognition issues account for approximately 50 percent of all financial statement frauds. Some of the more important revenue issues discussed by the AICPA and SEC follow:

1. Recognition of revenue prematurely such as:
   - “Channel stuffing” (shipping inventory in excess of orders, or giving customers incentives to purchase more goods than they need in exchange for future discounts or other benefits)
   - Reporting revenue after goods are ordered but before they are shipped
   - Reporting revenue when significant services have not been performed
   - Improper use of the percentage-of-completion method
   - Improper year-end cutoff procedures

2. Recognition of revenue that has not been earned including:
   - Recognizing revenue on bill and hold transactions, consignment sales, sales subject to contingencies, and those with the right to return goods, sales coupled with purchase discounts or credits, and other side agreements.

3. Reporting sales to fictitious or nonexistent customers.

4. Sales to related parties in excess of market value.

5. Recognizing transactions at fair value that relate to exchanges of similar assets.

6. Reporting peripheral or incidental transactions, such as nonrecurring gains.4

In addition to traditional revenue manipulation strategies, there are numerous methods that a company can use to recognize revenue, subject to certain limitations, including:

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4 Financial Statement Fraud, Integrity of Financial Information Continue to Be Burner Issues (AICPA).
• Traditional sales method
• Percentage completion method
• Completed contract method
• Installment sales method

Thus, it is clear that there are simply too many variations in both methods and applications related to such a key financial statement item such as revenue.

Background:

Revenue recognition continues to be at the top of the list of the FASB’s top issues based on the annual survey of the Financial Accounting Standards Advisory Council (FASAC).

Revenue is usually the largest single item in the financial statements. According to the FASB, studies confirm that revenue is the single largest category of financial statement restatements. As a result, issues related to revenue recognition are important to tackle.

There is no general standard for revenue recognition although there are more than 200 separate pieces of authoritative literature scattered throughout GAAP. The result is that there is a gap between broad conceptual guidance in the FASB concept statements, and the more detailed guidance. Most of the detailed authority offers industry-specific guidance, rather than a broader-based guidance. Further, authority is scattered among APB Opinions, FASB Statements, AICPA Auditing and Accounting Guides, AICPA Statements of Position (SOP), FASB Interpretations and Emerging Issues Task Force (EITF) Issues, SEC Staff Accounting Bulletins (SABs), and other pronouncements.

In 1999, the SEC issued Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements. SAB No. 101 concludes that revenue should not be recognized until it is realized.

Realization occurs when four criteria have been met:

1. Persuasive evidence of an arrangement exists.
2. Delivery has occurred.
3. The seller's price to the buyer is fixed and determinable.
4. Collectibility is reasonably assured.

The four criteria mirrored the criteria for revenue recognition of software revenue noted in SOP 97-2, Software Revenue Recognition (ASC 985).

Subsequent to its issuance, SAB No. 101 was criticized for applying the standards for one particular industry (software) across the board to all industries. Further, because the SEC issued the SAB guidance, SAB No. 101 was not given the full due process that is provided by the FASB rule-making process.

The FASB EITF has also issued guidance on revenue recognition, particularly guidance related to e-commerce and revenue arrangements with multiple deliverables. However, because there is no general standard for revenue recognition, the EITF has been in a position to interpret, rather than establish, GAAP for revenue.

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Why create the Revenue project?

The FASB cites several reasons for the project including:

a. Much of the existing U.S. GAAP for revenue was developed before the Conceptual Framework.
b. U.S. GAAP contains no comprehensive standard for revenue recognition that is generally applicable.
c. U.S. GAAP for revenue recognition consists of more than 200 pronouncements by various standard setting bodies that is hard to retrieve and sometimes inconsistent.
d. Despite the large number of revenue recognition pronouncements, there is little guidance for service activities, which is the fastest growing part of the U.S. economy.
e. Revenue recognition is a primary source of restatements due to applicable errors and fraud. Those restatements decrease investor confidence in financial reporting.
f. Users face noncomparability among entities and industries, with little information to assist in identifying and adjusting for the differences.
g. Accounting policy disclosures are too general to be informative.
h. Revenue data are highly aggregated, and users say they would like more detail about specific revenue-generating activities.
i. The IFRSs have even fewer standards on revenue recognition than U.S. GAAP and needs further guidance.

Status of project:

In 2002, the FASB added to its agenda a comprehensive revenue project to develop general standards on revenue recognition that apply to all business entities. The FASB’s goal is to resolve many of the revenue recognition issues that have arisen and will arise in the future.

Due to the FASB’s international standards convergence project, the FASB is working simultaneously with the International Accounting Standards Board (IASB) at developing new standards for revenue recognition.

The FASB has decided that the revenue recognition project should result in the issuance of statements that:

- Eliminate inconsistencies in existing accounting literature,
- Fill voids that have emerged in revenue recognition guidance in recent years,
- Simplify the preparation of financial statements by reducing the number of standards to which companies must refer, and
- Improve comparability of revenue across companies and geographical boundaries.

When issued, the revenue recognition statements will supersede existing GAAP for revenue, will be developed for broad categories of arrangements (such as rights of use, services, and products), and will include both guidance specific to the broad category and any additional guidance necessary for the individual types of arrangements that are classified within each category.
In December 2008, the FASB and IASB issued a Discussion Paper entitled *Preliminary Views on Revenue Recognition in Contracts with Customers*. The Paper is subject to a comment period and reflects some of the general concepts the FASB and IASB expect to utilize in crafting final statements on revenue recognition.

Following is a summary of the preliminary views noted in the Discussion Paper:

1. The proposed revenue recognition model would apply to contracts with customers; that is, an agreement between two or more parties that creates enforceable obligations.

2. Revenue should be recognized on a basis of increases in an entity’s net position in a contract with a customer.
   - When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position.

3. Revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two), as a result of an entity satisfying an obligation (a performance obligation) in the contract.

4. An entity’s performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. The contract promise can be explicit (in writing or oral) or implicit.

5. When an entity promises to provide a good or service, it is promising to transfer an asset to the customer.

6. An entity accounts for performance obligations separately if the promised assets for goods or services are transferred to the customer at different times.
   - **Note:** The objective of separating performance obligations is to ensure that an entity’s revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

7. An entity satisfies a performance obligation and recognizes revenue when it transfers a promised asset, such as a good or service to the customer.
   - If there is a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the customer’s asset (e.g., typically when the customer takes physical possession of the good).
   - If there is a service performed, the obligation is satisfied when the service is the customer’s asset (e.g., when the customer has received the promised service).

8. Activities an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer.
   - **Example:** In a contract to construct an asset for a customer, an entity satisfies a performance obligation during the construction only if assets are transferred to the
customer throughout the construction process. Such would be the case if the customer controls the partially constructed asset so that it is the customer’s asset because it is being constructed.

9. Performance obligations initially should be measured at the transaction price, that is the customer’s promised consideration.

- If a contract consists of more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative standalone selling prices of the goods and services underlying those performance obligations.

- Subsequent measurement of the performance obligations should depict the decrease in the entity’s obligation to transfer goods and services to the customer.

- The measurement of the performance obligation should not be updated unless that performance obligation is considered onerous (e.g., the expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation).

What will be the impact of ultimately implementing the proposed new revenue recognition model on present practice?

The FASB suggests that for most contracts, the proposed changes would have minimal impact.

However, in some instances, applying the proposed model would result in differences from present practice:

1. *Use of a contract-based revenue recognition*: An entity would recognize revenue from increases in its net position in the contract with a customer as a result of satisfying a performance obligation. Increases in other assets such as cash, inventory in the absence of a contract, and inventory under a contract with a customer (but not yet transferred to the customer) would not trigger revenue recognition.

   **Example:** Entities that currently recognize revenue for construction-type contracts would recognize revenue during construction only if the customer controls the asset as it is constructed, which is normally not the case.

2. *Identification of performance obligations*: In present practice, entities may account for similar contractual promises differently. For example, some warranties and other post-delivery services are accounted for as cost accruals instead of as deliverables in or components of a contract. The proposed model would provide for an entity accounting for those obligations as performance obligations and would recognize revenue as they are satisfied.
3. **Use of estimates**: Some existing GAAP limits the use of standards more than the FASB’s proposed model would. For example, in some instances an entity would not recognize revenue for a delivered item if there is no objective and reliable evidence of the selling price of the undelivered items (for example, ASC 605 and ASC 985 (EITF Issues 00-21 and SOP 97-2)). In contrast, the proposed revenue model would provide for entities estimating the standalone selling prices of the undelivered goods and services and recognize revenue when goods and services are delivered to the customer.

4. **Capitalization of costs**: Under present practice, entities sometimes capitalize the costs of obtaining contracts. The proposed model would provide that such costs would be capitalized only if they qualify for capitalization under other GAAP standards. One example is where commissions are paid to a salesperson for obtaining a contract with a customer. Typically such commissions do not create an asset qualifying for recognition in accordance with other GAAP. Therefore, an entity would recognize such costs as expenses as incurred, which may not be the same period in which revenue is recognized.

The revenue recognition project will go through several years of deliberations with an exposure draft scheduled for 2010 and a final statement scheduled to be issued in 2011.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Under the proposed financial statement changes, business activities that management views as generating non-revenue income and create no significant synergies from combined assets would be categorized as:

   a) operating activities
   b) financing activities
   c) investing activities
   d) financing arising from operating activities

2. Which of the following is correct with respect to the suggested implications of the proposed change in the format of financial statements would be:

   a) contract formulas would remain the same
   b) comprehensive income would be stable from year to year
   c) textbooks would have to be changed
   d) most tax return information would not change

3. What reason does FASB cite as a need for the revenue project:

   a) accounting policy disclosures are too general to be informative
   b) there is too much guidance for service activities making it confusing
   c) U.S. GAAP contains a comprehensive standard for revenue recognition that is generally applicable
   d) U.S. GAAP for revenue recognition consists of only 15 pronouncements by various standard setting bodies
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Day-to-day activities that management views related to the central purpose of the entity’s business are considered operating activities.

   B: Incorrect. Those assets and liabilities that are part of the financing of the entity’s business are considered financing activities.

   C: Correct. Investing activities that generate non-revenue income and create no significant synergies from combined assets are categorized as investing activities. Examples include generating dividends, interest or capital gain.

   D: Incorrect. Financing arising from operating activities includes long-term liabilities tied to operating activities and does not relate to generating non-revenue income.

   (See page 61 of the course material.)

2. A: Incorrect. Many contract formulas for bonuses, joint ventures, etc. that are based on GAAP income would change.

   B: Incorrect. Comprehensive income would fluctuate from year to year because more items would be included in the new statement than previously included in the statement of income.

   C: Correct. Textbooks, as well as internal and external financial statement formats, would have to be changed.

   D: Incorrect. Certain tax return information would be impacted including the M-1 reconciliation as the reconciling items would change.

   (See page 65 of the course material.)

3. A: Correct. FASB cites that accounting policy disclosures are too general to be informative. The revenue project will help alleviate some of the generality related to revenue disclosures.

   B: Incorrect. FASB cites that despite the large number of revenue recognition pronouncements, there is little guidance for service activities, which is the fastest growing part of the U.S. economy.

   C: Incorrect. FASB cites that U.S. GAAP contains no comprehensive standard for revenue recognition that is generally applicable.

   D: Incorrect. FASB cites that U.S. GAAP for revenue recognition consists of more than 200 pronouncements by various standard setting bodies that is hard to retrieve and sometimes inconsistent.

   (See page 73 of the course material.)
C. INTERNATIONAL ACCOUNTING STANDARDS CONVERGENCE

**International Financial Reporting Standards:**

Effective in 2005, a new set of International Financial Reporting Standards (IFRS) was adopted in Europe. The IFRS project is the first step at trying to internationalize global accounting standards to be used by all companies both inside and outside the United States.

Presently, United Kingdom companies are governed by the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Effective 2005 (2007 for United States SEC companies), all companies listed on European stock exchanges (approximately 8,000 total) adopted IASB standards. As of 2009, 113 countries required or allowed their companies to adopt the new international standards including the UK, Australia, Japan, and New Zealand. Chile and South Korea adopted IFRS in 2009, Brazil in 2010, Canada and India in 2011, and Mexico in 2012. A total of 12,000 companies are now using IFRS worldwide.

The United States has not yet adopted the IFRS standards but is working with Europe’s International Accounting Standards Board (IASB) at converging U.S. and International Standards over the next few years. Until then, with the new IFRS being issued, U.S. SEC companies that also report in Europe will be required to report under two sets of standards: United States GAAP and the IFRS.

By 2015, it is highly likely that all countries, including the United States, will adopt the IFRS format in a move to globalize standards.

**The First Step: The IASB-GAAP agreement to converge standards:**

In 2002, both the IASB and FASB signed the “Norwalk Agreement” under which they agreed that convergence of both standards into one set of global standards is important. Both organizations included a convergence project onto their agendas. The current move is for United States companies (including closely held entities), to adopt IFRS, rather than the other way around. Under the Norwalk Agreement, both sides agreed to move toward to:

- Removing differences between existing U.S. and IFRS in the short-term convergence project, and
- Converging future programs, either through joint or concurrent projects (long-term convergence project).

A key difference between United States GAAP and IFRS is that **IFRS standards are less rules-based and more principles-based.** As discussed previously in this chapter, the difference between the two concepts (rules versus principles) is pervasive and requires a dramatic change in the approach to accounting. According to the IASB, the IFRS are principles-based standards that depend more on subjective determination and judgment of companies and their auditors in determining whether a transaction “faithfully represents” the economics of the transaction. In fact, the entire codification of the IFRS fits into one volume as compared with the multiple volumes of information that encompasses U.S. GAAP. The result is that there is a great diversity in accounting and auditing under the IFRS system as compared with United States GAAP.6

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6 As noted in *Accounting’s White Knight* (Fortune).
The IASB-FASB convergence project currently has two phases to it:

**Phase one – short-term convergence project** – Phase One is close to being complete and has had as its objective the removal of a variety of small, individual differences between U.S. GAAP and the IFRS that are not within the scope of other major projects that are already in progress.

   a. The short-term convergence project is limited to those GAAP issues that both sides could resolve in the short-term.
   
   b. To date the FASB has issued three of the four statements that are included within the short-term convergence project.

**Phase two – joint and concurrent projects**: The second phase is referred to as the long-term convergence project and consists of both organizations either working jointly or concurrently on larger more complex projects that include:

- Revenue recognition
- Stock options
- Consolidations and off-balance sheet entities
- Financial performance reporting

In each of these projects, both sides are working together to ensure that whatever final document issued is consistent with the direction taken by the other side. In following this cooperative effort, both sides can ensure that the differences between each side’s GAAP do not expand beyond those presently in existence.

**The short-term convergence project:**

In December 2003, the FASB took a significant first step toward modifying U.S. GAAP to be consistent with IASB GAAP by issuing three statements to revise existing U.S. GAAP. Those three GAAP standards were issued as follows:

   a. **FASB No. 154: Accounting Changes and Error Corrections – A Replacement of APB No. 20 and FASB No. 3 (FASB ASC 250)**: Eliminates the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change, replacing it with a required restatement of financial statements, applied retroactively.

   b. **FASB No. 153: Exchanges of Productive Assets – An Amendment of APB Opinion No. 29 (ASC 845)**: Eliminates the use of a book-value approach to account for the exchange of similar productive assets (e.g., real estate exchanged for real estate) in situations in which the transaction does not have commercial substance.

   c. **FASB No. 151: Inventory Costs – An Amendment of ARB No. 43, Chapter 4 (ASC 330)**: Amends the language in ARB No. 43 to be consistent with IAS 2, with respect to inventory costs.

**IASB changes:**

On the other side, the IASB has issued a series of statements that cleaned up international standards to not only converge with the FASB, but also as part of the IFRS convergence that took place. The following chart presents the framework of the FASB-IASB short-term convergence project and long-term international standards project.
Move Toward International Standards – FASB-IASB’s Norwalk Agreement

FASB Changes Existing GAAP

Changes toward IFRS:
- FASB No. 154: Changes
  APB No. 20: Accounting Changes and Error Corrections (ASC 250)
- FASB No. 153: Changes
  APB No. 29- Exchanges in Production Assets (ASC 845)
- FASB No. 151: Changes
  ARB No. 43- Inventory Costs (ASC 330)

IASB Pending Changes – Existing Accounting Standards

Changes for IFRS:
- Presentation of FS
- Inventories
- Accounting Changes in Estimates, Errors
- PP&E
- Leases
- Foreign Exchange Rates
- Related Party Disclosures
- Consolidations
- Investments
- Joint Ventures
- EPS
- Investment Property
- Financial Instruments (2)

Changes toward FASB:
- Non-Current Assets Held for Disposal-Disc. Operations
- Contingent Liab/Assets
- Termination Benefits
- Government Grants
- Income Taxes

FASB-IASB Long-Term Project

Major Long-Term Projects – Joint

- Revenue Recognition
- Consolidations
- Financial Instruments
- Leases
- Business Combinations (FASB No. 141R) (ASC 845) and Noncontrolling Interests (FASB No. 160) (ASC 810) (issued 2007/2008)
- Derecognition
- Financial Statement Presentation
**Why should small businesses care about the move toward international standards?**

Many accountants may look at the move toward international standards as an event that has no impact on their local, domestic clients. But nothing could be further from the truth. The international standards will affect all companies, large and small, domestic and international, for two reasons:

1. The change toward international standards will ultimately result in one set of standards to be used by all companies inside and outside of the United States, regardless of size and whether they are publicly or nonpublicly held.

2. The short-term convergence project has resulted in the FASB amending many commonly used FASB statements to bring GAAP in line with the IFRS.

Presently, the FASB has issued three statements that amend U.S. GAAP under the short-term convergence project:

<table>
<thead>
<tr>
<th>FASB Changes – Short-Term Convergence Project</th>
<th>Previous GAAP</th>
<th>Change in GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accounting Changes and Error Corrections (FASB No. 154) (ASC 250)</strong></td>
<td>Changes in accounting principles were generally treated as a cumulative effect of an accounting change, net of tax, on the income statement.</td>
<td>A voluntary change in an accounting principle requires a restatement of all financial statements presented.</td>
</tr>
<tr>
<td><strong>Exchange of Productive Assets (FASB No. 153) (ASC 845)</strong></td>
<td>An exchange of similar assets was recorded at the book value of the asset given plus boot, with no gain recognized.</td>
<td>An exchange of similar assets should be recorded at the fair value of the exchange with a gain or loss recognized unless the fair value is not determinable, or the transaction lacks commercial substance.</td>
</tr>
<tr>
<td><strong>Inventories (FASB No. 151) (ASC 330)</strong></td>
<td>GAAP was silent on the issue of abnormal amounts of idle capacity and spoilage costs.</td>
<td>Abnormal amounts of idle capacity and spoilage costs should be excluded from the cost of inventory and expensed as incurred.</td>
</tr>
</tbody>
</table>

**Is the convergence working?**

Apparently so. At its inception, critics stated that the project was doomed for failure for numerous reasons including the political and cultural difference between the Boards. Yet, it appears that both sides have succeeded at a pace not expected.

Consider the following:

1. In five years since its inception, the IASB has been able to get 113 countries (at least 25 of them in the EU) to adopt one set of international standards, with the goal of having 150 countries on board by the end of 2010.

2. In a relatively short period of time, both sides have adopted new standards that reflect the other side’s existing standards.
Presently, the FASB has issued three statements that amend U.S. GAAP under the short-term convergence project:

<table>
<thead>
<tr>
<th>Status of FASB – IASB Convergence Project</th>
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<tbody>
<tr>
<td><strong>Project</strong></td>
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<tr>
<td><strong>Short-term project:</strong></td>
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<tr>
<td>Nonmonetary exchanges</td>
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<td>Voluntary accounting changes</td>
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<td><strong>Long-term project:</strong></td>
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<td>Liabilities and equity</td>
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<td>Postretirement benefits</td>
</tr>
<tr>
<td>Leases</td>
</tr>
<tr>
<td>Intangibles</td>
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</tbody>
</table>

(1): One board performs one part of the project and the other board completes it.

In November 2009, the FASB and IASB issued an update of their original Norwalk Agreement with the issuance of the joint statement entitled, *FASB and IASB Reaffirm Commitment to Memorandum of Understanding*. In the 2009 document, both organizations stated that their goal is to complete all major joint projects by 2011 including revenue recognition, leases, consolidations, and any other significant areas that will facilitate the United States moving toward a full adoption of IFRS. The overall goal of the two organizations is for all major capital markets to be in position to adopt IFRS by 2013. The United States is expected to adopt IFRS no earlier than 2015.

**The Second Phase: United States Move Toward Adopting IFRS**

Although the short- and long-term convergence project between the FASB and IASB is a first step toward trying to globalize standards, recent developments by the FASB, SEC and Congress appear to be accelerating the United States toward adopting IFRS standards in lieu of United States GAAP.

This rapid action by the United States has many commentators shocked to think that the U.S. GAAP, considered the gold standard, would be replaced by what some consider an inferior IFRS for the sake of globalizing accounting standards.

Yet, a recent survey of executives by the AICPA, 55 percent of those surveyed stated that they were preparing in some way for IFRS adoption.7

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Following is a quick analysis of what is going on at the IFRS front.

**U.S. and international support to move toward global acceptance of IFRS:**

2009 and 2008 were years that created the impetus for IFRS to replace U.S. GAAP. In 2008, leaders from the G20 countries stated that there was universal support for a single set of high-quality global accounting standards. In September 2009, the G20 reaffirmed their previous conclusions by agreeing for:

> “international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011.”

With continued support from Congress and the FASB, the SEC went public with its support, as well.

In 2008, the SEC issued two proposals related to IFRS:

- One proposal that stops requiring certain foreign companies from having to reconcile their financial statements prepared under IFRS with GAAP.
- A second proposal would give U.S. companies the choice between using U.S. GAAP or IFRS to prepare financial statements.


The Roadmap represented the first time that the SEC has embraced the possibility that U.S. issuers ultimately would be required to adopt IFRS.

Specifically, the Roadmap outlines seven milestones that must be met for the U.S. to move toward acceptance of IFRS. The seven milestones require:

1. Improvements in accounting standards
2. The accountability and funding of the IASC Foundation
3. The improvement in the ability to use interactive data for IFRS reporting
4. Education and training relating to IFRS
5. Limited early use of IFRS where this would enhance comparability for U.S. investors
6. The anticipated timing of future rulemaking by the SEC
7. The implementation of a mandatory use of IFRS by U.S. issuers

In its Roadmap, the SEC stated that in 2011, it would assess whether the seven milestones had been achieved. If so, the SEC would decide whether to proceed with rulemaking that would require U.S. issuers to use IFRS beginning in 2014. In February 2010, the SEC moved the 2014 date to 2015.

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8 Leaders’ Statement, The Pittsburgh Summit, September 24-25, 2009 (G20).
In addition, the SEC noted in its Roadmap that beginning with filings in 2010, the SEC would permit early use of IFRS by a limited number of U.S. issuers where its industry uses IFRS as the basis of financial reporting more than any other set of standards.

In 2009, through a series of speeches, the SEC reaffirmed its commitment to assess the IFRS by 2011.\(^9\)

**What would be the impact of U.S. companies being required to adopt IFRS?**

The impact of U.S. companies adopting IFRS would be significant because U.S. GAAP and IFRS are quite different. However, as the FASB and IASB work on their convergence project, the major differences between GAAP and IFRS will gradually diminish.

Nevertheless, consider some of the more significant elements that would be impacted by the IFRS conversion:

1. U.S. companies would be required to adopt new IFRS accounting standards.
2. Accounting systems would have to be changed to capture revised IFRS data in order to be ready for 2015.
3. U.S. accountants, auditors, actuaries, and other parties would be required to receive extensive education and training in IFRS versus GAAP.
   
   **Observation:** There is already talk that IFRS will be tested as part of the CPA examination starting in 2012.
4. Costs to implement the IFRS would likely be significant.

**What would be the key differences between GAAP and IFRS?**

Although the list may change by 2015, based on current GAAP, the major differences between the two sets of standards include:

- IFRS does not permit use of LIFO inventory while GAAP does.
- There are differences in the way inventory lower of cost or market is computed for IFRS versus GAAP.
- In performing a test of impairment of long-lived assets, IFRS uses a one-step approach while FASB No. 144 uses a two-step approach.
- IFRS uses a different probability threshold for contingencies than GAAP.
- IFRS does not allow for debt covenant violations to be cured after year end while GAAP does.
- IFRS guidance on revenue recognition is limited.
- There are differences in the accounting for stock option expense, income tax liabilities, uncertain tax positions, and certain financial instruments and derivatives.
- Disclosures vary including the extent to which the summary of significant accounting policies is presented.

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\(^9\) For example, October 2009 speech by James Kroeker, SEC Chief Accountant.
Additionally, because IFRS is a principles-based system, the amount of authoritative literature for IFRS is small relative to the volumes of GAAP. Also, IFRS has minimal industry-specific guidance while GAAP has an abundance of industry guidance.

**The LIFO issue**

One key change that would be made if U.S. companies convert to IFRS would be the elimination of the last-in, first-out (LIFO) inventory method. IFRS does not permit use of LIFO while GAAP does.

Although some companies will argue that they use LIFO to better match revenues and expenses, the reality is that LIFO is used because it saves taxes. In a perfect situation, companies would prefer to use LIFO for tax purposes and use FIFO or average cost for GAAP. In doing so, they could have the best of both situations: a lower taxable income and a higher GAAP income.

However, use of LIFO is one of the few examples of accounting methods where the Internal Revenue Code interferes with GAAP by way of the IRC Section 472’s LIFO Conformity Requirement.

In general, the LIFO Conformity Requirement states that if an entity uses LIFO for income tax purposes, it must also use it for GAAP to clearly reflect its income. Over the years, the Section 472 regulations have watered down the LIFO Conformity Requirement to allow non-LIFO disclosures and supplementary information. However, the current regulations allow for the following if LIFO is used for tax purposes:

- The primary income statement must be presented on LIFO.
- The balance sheet may be presented on a non-LIFO (e.g., FIFO) basis.
- Supplementary information and footnotes can present non-LIFO information such as in the case of presenting an income statement on a FIFO basis as a supplementary schedule.
- Interim income statements may be presented on a non-LIFO basis as long as the total of the interim statements does not aggregate one annual statement (e.g., three, quarterly non-LIFO income statements may be presented but not four quarterly statements).

So now what happens when GAAP LIFO is eliminated for IFRS FIFO or average cost? What happens to the IRC 472 LIFO Conformity Requirement?

The issue is more political than technical. The technical answer is that assuming no action is taken to change Section 472, companies that adopt IFRS and convert to a non-LIFO method for financial statement purposes, also will be required to convert to a non-LIFO method (e.g., FIFO) for tax purposes and pay the tax on the LIFO reserve recapture.

One study suggested that a conversion of LIFO for both IFRS and income tax purposes would have the following impact based on a sample of 30 U.S. firms reviewed:

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10 *The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence* (Georgia Tech College of Management).
### Impact of Converting from LIFO to Non-LIFO: Sample 30 U.S. Companies

<table>
<thead>
<tr>
<th>Change in:</th>
<th>Average Change Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income</td>
<td>11.97%</td>
</tr>
<tr>
<td>Net income</td>
<td>7.42%</td>
</tr>
<tr>
<td>Inventory</td>
<td>46.0% of total assets</td>
</tr>
<tr>
<td>Stockholder’s equity</td>
<td>34.2%</td>
</tr>
<tr>
<td>Current ratio</td>
<td>26.2%</td>
</tr>
<tr>
<td>Debt/equity ratio</td>
<td>(23.1)%</td>
</tr>
</tbody>
</table>

Source: The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence (Georgia Tech College of Management).

In addition, there would be other impacts including the fact that financial covenants, compensation plans, and contracts driven by income would be impacted by a higher non-LIFO income. Some of the drawbacks of using LIFO such as the ability to manage earnings through liquidating LIFO layers would be eliminated through a conversion to a non-LIFO method.

**Would Congress step in to save LIFO?**

Although a conversion from LIFO to a non-LIFO inventory method would clearly make most financial statements improve as shown in the above table, the tax effects would severely impact cash flow. In essence, companies would be required to pay federal and state income taxes on the entire LIFO reserve. In some industries, such as oil and gas, the tax effect would be in the billions. Consider Exxon Mobil’s inventory at December 31, 2007:

- **FIFO inventory** $34.3 billion
- **LIFO reserve** (25.4) billion
- **LIFO inventory** $8.9 billion

Using the Exxon example, assuming a 40% federal and state income tax rate, Exxon would have a current federal and state tax bill of approximately $10 billion ($25.4 billion LIFO reserve @ 40%) that negatively impacts that entity’s cash flow. The overall tax revenue pickup from companies converting from LIFO to a non-LIFO basis would be sizeable and welcomed by Congress at a time where it desperately needs tax revenue. Further, Congress does not have to do anything to raise this tax revenue because the mere conversion to IFRS creates the tax revenue.

The bet is that Congress does not save LIFO and allows the conversion to IFRS to raise tax revenue without Congress doing anything.

**Will IFRS impact non-public entities?**

No. The proposed changes to convert to IFRS are directed at public companies only so that non-public entities would not be impacted. However, a larger issue is who would

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11 The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence (Georgia Tech College of Management).
promulgate U.S. GAAP for nonpublic entities if accounting principles for public entities rest with IFRS. The details of how GAAP for nonpublic entities would be managed will have to be resolved.

Some nonpublic entities that are conducting business internationally, may wish to adopt IFRS to allow for their financial statements to be submitted to third parties across international lines.

D. CHANGES COMING TO FASB NO. 13 (ASC 840) LEASE ACCOUNTING

FASB No. 13, Accounting for Leases (ASC 840), divides leases into two categories, operating and capital leases. Capital leases are capitalized while operating leases are not. In order for a lease to qualify as a capital lease, four criteria must be met:

1. The present value of the minimum lease payments must equal or exceed 90% or more of the fair value of the asset.
2. The lease term must be at least 75% of the remaining useful life of the leased asset.
3. There is a bargain purchase at the end of the lease.
4. There is a transfer of ownership.

In practice, it is common for lessees and lessors to structure leases to ensure they do not qualify as capital leases, thereby removing both the leased asset and obligation from the lessee’s balance sheet. This approach is typically used by restaurants, retailers, and other multiple-store facilities.

Consider the following example.

Facts:

**Lease 1**: The present value of minimum lease payments is 89% and the lease term is 74% of the remaining useful life of the asset.

**Lease 2**: The present value of minimum lease payments is 90% or the lease term is 75% of the remaining useful life of the asset.

**Conclusion**: Lease 1 is an operating lease not capitalized, while Lease 2 is a capital lease under which both the asset and lease obligation are capitalized.

**SEC push toward changes in lease accounting**:

As previously noted in this chapter, in its report entitled, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuer, the SEC targeted lease accounting as one of the areas that resulted in significant liabilities being off-balance sheet.
According to the SEC Report focused on U.S. public companies:

a. 63% of companies record operating leases while 22% record capital leases.

b. Companies have approximately $1.25 trillion in operating lease obligations that are off-balance sheet.

In its Report, the SEC noted that because of FASB No. 13’s bright line tests (90%, 75%), small differences in economics can completely change the accounting (capital versus operating lease).

Keeping leases off-balance sheet while still retaining tax benefits is an industry unto itself. So-called synthetic leases are commonly used to get the tax benefits of a lease while not capitalizing the lease for GAAP purposes.

In addition, lease accounting abuses have been the focus of restatements with approximately 270 companies, mostly restaurants and retailers that restated or adjusted their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Large retailers have the largest amount of lease obligations outstanding as noted in the following table:

<table>
<thead>
<tr>
<th>Retailer</th>
<th>Lease Obligations (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CVS</td>
<td>$19,875</td>
</tr>
<tr>
<td>Home Depot</td>
<td>9,131</td>
</tr>
<tr>
<td>Kroger</td>
<td>7,549</td>
</tr>
<tr>
<td>Walgreen</td>
<td>26,086</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>10,446</td>
</tr>
</tbody>
</table>

Source: Company annual reports as reported by CFO.com

**FASB adds lease project to agenda**

The FASB has focused on standards that enhance transparency of transactions and eliminates off-balance-sheet transactions, the most recent of which is the issuance of FIN 46R, *Consolidation of Variable Interest Entities* (ASC 810). Because the abuses in lease accounting result in significant assets and liabilities being kept off the balance sheet, in July 2006, the FASB added to its agenda a joint project with the IASB that would replace existing FASB No. 13 (ASC 840) and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007 and expects to issue an exposure draft in 2010 with a final statement in 2011.

In March 2009, the FASB and IASB issued a joint discussion paper on the lease project entitled, *Leases: Preliminary Views*.

Preliminary conclusions reached by the FASB and IASB include a key change under which all leases would be treated as capital leases thereby eliminating the operating
lease concept. Following are some of the concepts that the FASB and IASB have published as their preliminary views of the new lease model:

a. The “right of use” model would be followed under which the leased item is an asset to the lessee and the related obligation to pay rentals is a liability. Therefore, all leases would result in the lessee recognizing both an asset for the right to use the leased item and a liability for the rental obligations.

b. The lessee’s right-of-use asset would be measured initially at cost (present value of the lease payments discounted using the lessee’s incremental borrowing rate) and then subsequently amortized over the shorter of the lease term and the economic life of the leased item.

c. The lessee’s lease obligation to pay rentals would be measured initially at the present value of the lease payments discounted using the lessee’s incremental borrowing rate. Subsequent measurement would be on an amortized cost basis.

d. Assets and liabilities recognized by a lessee would be based on the most likely lease term. For example, in a 10-year lease that includes an option to extend for an additional five years, the lessee would have to decide whether the lease term is 10 years or 15 years.

e. The lease term would have to be reassessed at each reporting date with changes in the obligation from a reassessment of the lease term recognized as an adjustment to the carrying amount of the right-of-use leased asset.

f. Contingent rental and residual value guarantee payments would be included in the determination of the liability.

What will be the impact of changes to lease accounting?

The proposed lease accounting changes would be devastating to many companies and would result in many more leases being capitalized which would impact all financial statements. 12

If leases of retailers, for example, are capitalized, the impact on financial statements would be significant, as noted below:

- Lessee’s balance sheets would be grossed up for the recognized lease assets and the lease obligations for all leases.
- Lessee’s income statements would be adversely affected with higher lease expense in the earlier years of new leases.

Note: Even though total lease expense is the same over the life of a lease, lease expense under a capital lease is higher in the earlier years as compared with lease expense under an operating lease.

12 Georgia Tech Financial Analysis Lab study.
On average, a 10-year lease will incur approximately 15-20% higher annual lease expense in the earlier years if capitalized as compared with an operating lease. That higher lease amount will reverse in the later years.

- On the statement of cash flows, there would be a positive shift in cash from operations from cash from financing activities. A portion of rent expense previously deducted in arriving at cash from operations would now be deducted as principal payments in cash from financing activities. Thus, companies would have higher cash from operating activities and lower cash from financing activities.

- In most cases, lease expense for GAAP (interest and depreciation) would not match lease expense for income tax purposes thereby resulting in deferred income taxes.

Changes to both the balance sheets and income statements of companies would have rippling effects on other elements of the lessee companies.

1. On the positive side, a lessee’s EBITDA may actually increase as there is a shift of rent expense under operating leases to interest and depreciation under capital leases. Both interest and depreciation are not deducted in arriving at EBITDA while rent expense is.

   a. Changes in EBITDA may affect existing agreements related to compensation, earn outs, bonuses, and commissions.

2. On the negative side, debt-equity ratios are affected with entities carrying significantly higher lease obligation debt than under existing GAAP. Higher debt-equity ratios could put certain loan agreements into default. Moreover, net income would be lower in the earlier years of the lease term due to higher interest and depreciation expense replacing rental expense.

How significant would the change to all capital leases be for U.S. companies?

As previously quoted in the SEC’s report, there is approximately $1.25 trillion of operating lease obligations that are not recorded on public company balance sheets. Consider the following estimated impacts of shifting those operating leases to capital leases:

a. Earnings of retailers would decline significantly. One recent study suggested that there would be a median drop in EPS of 5.3 percent and a median decline in return on assets of 1.7 percent.

b. Balance sheets would be loaded with significant lease obligations that would impact debt-equity ratios.\(^{13}\)

   - Aggregate debt of nonfinancial S&P 500 companies would increase by 17 percent if all leases were capitalized.

\(^{13}\) Bear Stearns research study.
• Return on assets would decline as total assets (the denominator) would increase by approximately 10 percent.

Having to capitalize all leases may have a significant effect on the lease versus purchase decision that some companies make. In some instances, lessees may chose to purchase the leased asset rather than lease it, if the accounting is the same. In particular, the purchase scenario may be more appealing for longer-term leases that have significant debt obligations on the lessee balance sheets. Lessees with shorter-term leases will not be burdened with the extensive debt obligations and, therefore, may choose not to purchase the underlying lease asset.

E. FASB MOVES GOING CONCERN INTO GAAP

Currently, the rules for going concern are found in auditing literature in SAS No. 59, Going Concern, which requires an auditor to assess whether an entity has the ability to continue as a going concern for at least one year from the balance sheet date. Because going concern is a GAAP issue, it belongs within accounting literature, not auditing standards.

In 2007, the FASB added the going concern project with the goal to develop a new GAAP standard that will directly deal with going concern. Instead of the auditor making the decision as to whether there is a going concern problem, that onus will be placed on management. Thus, management will be responsible for evaluating whether its company can continue as a going concern.

In October 2008, the FASB issued an exposure draft entitled Going Concern. The proposed statement would:

a. Provide guidance on the preparation of financial statements as a going concern and on management’s responsibility to evaluate a reporting entity’s ability to continue as a going concern.

b. Require disclosures when either financial statements are not prepared on a going concern basis or there is substantial doubt as to an entity’s ability to continue as a going concern.

c. Require that management of a reporting entity assess the reporting entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so.

d. In making the assessment management shall take into account all available information about the future, which is at least, but not limited to, 12 months from the end of the reporting period.
Based on comment letters, in its January 2010 meeting, the FASB has decided on the following elements for the going concern project:

1. The project will provide guidance that defines a going concern.

2. The project will clarify that the time period for the going concern assessment is not a bright-line 12 months, but also is not intended to be an indefinite look-forward period.

3. The scope of the project shall be broadened to address three additional areas:
   a. Enhance disclosures of short-term and long-term risks, including risks for which there is more-than-remote likelihood of occurrence.
   b. Define substantial doubt in terms of an entity’s ability to continue as a going concern.
   c. Develop guidance surrounding the adoption and application of the liquidation basis of accounting.

The current plan is for the FASB to issue a revised Expose Draft in mid-2010 with a final statement issued at the end of 2010.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. The FASB issued three statements to revise existing U.S. GAAP to be consistent with IASB GAAP. One modification:
   a) amends the language in ARB No. 43 to be consistent with IAS 2 with respect to inventory costs
   b) makes several changes to the computation of earnings per share (EPS)
   c) requires the use of a book-value approach to account for the exchange of similar productive assets
   d) requires the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change

2. Under FASB No. 13, Accounting for Leases (ASC 840), in order for a lease to qualify as a capital lease which one of the following conditions must be satisfied:
   a) the future value of the minimum lease payments must be equal to or exceed 10% or more of the fair value of the asset
   b) the lease term must be no more than 50% of the remaining useful life of the leased asset
   c) there must be a bargain purchase at the end of the lease
   d) there must not be a transfer of ownership
SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct.** FASB No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*, amends the language in ARB No. 43 to be consistent with IAS 2 with respect to *inventory costs*.

   B: Incorrect. No changes have been made to the computation of EPS.

   C: Incorrect. FASB No. 153, *Exchanges of Productive Assets – An Amendment of APB Opinion No. 29* (ASC 845), eliminates the use of a book-value approach to account for the exchange of similar productive assets (e.g., real estate exchanged for real estate) in situations in which the transaction does not have commercial substance.

   D: Incorrect. FASB No. 154, *Accounting Changes and Error Corrections – A Replacement of APB No. 20 and FASB No. 3* (ASC 250), eliminates the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change, replacing it with a required restatement of financial statements, applied retroactively.

   (See page 80 of the course material.)

2. **A: Incorrect.** In order for a lease to qualify as a capital lease, the present value of the minimum lease payments must be equal to or exceed 90% or more of the fair value of the asset.

   B: Incorrect. In order for a lease to qualify as a capital lease, the lease term must be at least 75% of the remaining useful life of the leased asset.

   **C: Correct.** In order for a lease to qualify as a capital lease, there must be a bargain purchase at the end of the lease.

   D: Incorrect. If there is a transfer of ownership, the lease qualifies as a capital lease.

   (See page 88 of the course material.)
CHAPTER 7
Compilation and Review Update
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SSARS No. 19: Compilation and Review Engagements

Introduction:

In January 2010, the AICPA’s Accounting and Review Services Committee (ARSC) issued SSARS No. 19, *Compilation and Review Engagements*.

SSARS No. 19 makes far-reaching changes to most of the previous body of SSARSs and supersedes most of the previously issued SSARSs.

In general, SSARS No. 19 is effective for years ending on or after December 15, 2010.

Background:

SSARS No. 19 represents the culmination of several years of work done by the ARSC to make radical changes to the compilation and review rules since the issuance of compilation and review engagements in 1978.

In 2008, the ARSC, in conjunction with the AICPA’s Private Companies Practice Section (PCPS), formed a Task Force to work on the AICPA Reliability Project. The Task Force was comprised of various diverse parties including CPA practitioners, financial statement preparers, bankers, and members of the various AICPA standard-setting committees and bodies.

The Task Force worked on the ARSC Reliability Project and in 2008 made recommendations to the ARSC that included the following:

1. The financial reporting process may be enhanced by the performance of nonattest services by CPAs for their clients including those where the CPA performs control activities or other internal control procedures for their client. Maintaining a stance that accountants cannot express some level of assurance if they do not comply with the existing independence model (in which they play no role in the client’s internal control) is not practicable for some smaller entities.

2. Maintaining “relationship-based” independence (for example, an immediate family member of the CPA is not in a key management position at the client) and “financial-interest” independence (for example, no direct investments in the client) should, at a minimum, trigger reporting requirements in compilation engagements and should continue to be a precondition to performing a review level service.

3. If independence is impaired because the accountant performs certain nonattest services such as bookkeeping, payroll or other accounting services, or certain other activities with respect to internal control over financial reporting, the accountant should be able to still express limited assurance on the client’s financial statements provided they can demonstrate how they maintained their objectivity and provided reliable services.

4. The ARSC should proceed with the development of a Statement on Standards for Accounting and Review Services (SSARS) that would be based on a
framework for the performance and reporting of compilation and review engagements where the maintenance of independence would not necessarily be a prerequisite.

5. The profession would be well served if ARSC considers a new standard that would permit a limited assurance engagement, even when a CPA’s independence is impaired by the performance of “control services.”

In April 2009, the ARSC issued an exposure draft for a proposed revision of the SSARSs. A key element within the exposure draft was a link between the SSARSs and the independence rules under which an accountant would be permitted to issue a review report when an accountant’s independence was impaired by performing nonattest services (e.g., bookkeeping and write-up services). Relationship-based and financial-interest based independence impairments would remain unchanged whereby the accountant would still not be permitted to issue a review report.

Another important theme within the exposure draft was to harmonize the SSARSs with the International Auditing and Assurance Standards Board’s (IAASB) review standard ISRE No. 2400.

In November 2009, the ARSC approved SSARS No. 19 which was issued in January 2010.

SSARS No. 19 supersedes most of the existing SSARSs found in AR section 20, 50, and 100.

Key changes made by SSARS No. 19 include:

1. Permitting an accountant to include a description in the compilation report regarding the reason(s) for which his or her independence is impaired.

2. Recodifying the SSARSs into separate sections for compilation and review engagements.

3. Introducing a new term “review evidence” to review engagements.

4. Discussing how to tailor review procedures based on the accountant’s understanding of the client’s industry, knowledge of the client, and awareness of risk.

5. Introducing the concept of materiality to a review engagement.

6. Requiring an accountant to document his or her establishment of an understanding with management through a written communication (e.g., engagement letter) regarding the services to be performed.

7. Establishing enhanced documentation requirements for compilation and review engagements.

8. Changing the format of the compilation and review reports.
Although the final standard includes most of the changes proposed within the exposure draft, two particular changes did not make the final document. First, the ARSC’s attempt to replace the concept of limited assurance with a broader moderate assurance was eliminated. Thus, limited assurance is still the threshold for performing a review engagement.

Second, the attempt to allow a review engagement if an accountant also performs a nonattest service (e.g., bookkeeping or write-up services) was not approved in the final SSARS. The ARSC announced that they will address this issue separately.

SSARS No. 19 is separated into three sections as follows:

- **Section I** Framework for Performing and Reporting on Compilation and Review Engagements
- **Section II** Compilation Engagements
- **Section III** Review Engagements

This standard is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Early application of SSARS No. 19 is not permitted except with respect to the lack of independence provision related to compilation engagements.

I. Framework for Performing and Reporting on Compilation and Review Engagements

1. **Introduction:**

   This section provides a framework and defines and describes the objectives and elements of compilation and review engagements.

2. **Definitions:**

   SSARS No. 19 provides a series of terms that are used throughout the document. The author has scattered those definitions throughout this chapter and placed each one in the appropriate topic area.

   There are a few definitions that need to be reviewed at this juncture of the course.

   - **Assurance engagement:** An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

   - **Attest engagement:** An engagement that requires independence, as defined in AICPA Professional Standards.
**Nonissuer:** All entities except for those defined in Section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c], the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that are required to file reports under Section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

3. Objectives and Limitations of Compilation Engagements:

A compilation is a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. Although a compilation is not an assurance engagement, it is an attest engagement.

A compilation does not provide a basis for obtaining or providing any assurance regarding the financial statements, and differs significantly from a review or an audit of financial statements in several ways that include:

a. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review.

b. A compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit.

4. Objectives and Limitations of Review Engagements:

The objective of a review engagement is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. In a review engagement, the accountant should accumulate *review evidence* to obtain a *limited level of assurance*. Like an audit engagement, a review engagement is an assurance engagement, as well as an attest engagement.

A review differs significantly from an audit of financial statements in several ways:

a. *An audit obtains a high level of assurance while a review is designed to obtain only limited assurance:*

In an audit, the auditor obtains a high level of assurance (expressed in the auditor’s report as obtaining reasonable assurance) that the financial statements are free of material misstatement. A review is designed to obtain only limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. Accordingly, in a review, the accountant does not obtain assurance that he or she will become aware of all significant matters that would be disclosed in an audit.
b. An audit contemplates obtaining audit evidence while a review is limited to obtaining review evidence primarily through inquiry and analytical procedures:

An audit requires obtaining audit evidence through an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit.

Conversely, a review engagement involves obtaining review evidence through the performance of inquiry and analytical procedures.

5. Professional Requirements:

SSARSs contain professional requirements, together with related guidance, in the form of explanatory material. Accountants performing a compilation or review have a responsibility to consider the entire text of a SSARS in carrying out their work on an engagement and in understanding and applying the professional requirements of the relevant SSARSs.

Not every paragraph of a SSARS carries a professional requirement that the accountant is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in SSARSs.

SSARSs use two categories of professional requirements identified by specific terms to describe the degree of responsibility they impose on accountants, as follows:

- **Unconditional requirements.** The accountant is required to comply with an unconditional requirement in all cases where the circumstances exist to which the unconditional requirement applies. SSARSs use the words “must” or “is required” to indicate an unconditional requirement.

- **Presumptively mandatory requirements.** The accountant also is required to comply with a presumptively mandatory requirement in all cases where the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the accountant may depart from a presumptively mandatory requirement provided that the accountant documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SSARSs use the word “should” to indicate a presumptively mandatory requirement.

**Note:** If a SSARS provides that a procedure or action is one that the accountant “should consider,” the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of a SSARS are to be understood and applied in the context of the explanatory material that provides guidance for their application. The specific terms used to define professional requirements are not intended to apply to interpretative publications issued under the authority of the ARSC because interpretative publications are not SSARSs.
Explanatory material is defined as the text within a SSARS (excluding any related appendices or interpretations) that may do the following:

- Provide further explanation and guidance on the professional requirements
- Identify and describe other procedures or actions relating to the activities of the accountant

Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (when not otherwise self-evident); it explains why the accountant might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the accountant to consider in exercising professional judgment in performing the engagement.

Explanatory material that identifies and describes other procedures or actions relating to the activities of the accountant is not intended to impose a professional requirement for the accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the accountant's attention and understanding; how and whether the accountant carries out such procedures or actions in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words “may”, “might”, and “could” are used to describe these actions and procedures.

6. Hierarchy of Compilation and Review Standards and Guidance for Compilation and Review Standards:

SSARS No. 19 outlines the hierarchy of authority for performing compilation and review engagements.

a. Compilation and review standards:

An accountant must perform a compilation or review engagement of a nonissuer in accordance with the SSARSs, except for certain reviews of interim financial information. SSARSs provide a measure of quality and the objectives to be achieved in both a compilation and review engagement.

Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202), requires an AICPA member who performs compilations or reviews to comply with standards promulgated by the ARSC. The ARSC develops and issues standards in the form of SSARSs through a due process that includes deliberations in meetings open to the public, public exposure of proposed SSARSs, and a formal vote. Finalized SSARSs are codified.

b. Interpretative publications:

The accountant should consider interpretative publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretative publication, the accountant should be prepared to explain how he or she complied with the provisions of SSARSs addressed by such guidance.
Interpretative publications consist of the following:

- Compilation and review interpretations of SSARSs,
- Appendices to SSARSs,
- Compilation and review guidance included in AICPA Audit and Accounting Guides, and
- AICPA Statements of Position, to the extent that those statements are applicable to compilation and review engagements.

**Note:** Interpretative publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued under the authority of the ARSC after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with SSARSs.

c. **Other compilation and review publications:**

Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply SSARSs. An accountant is not expected to be aware of the full body of other compilation and review publications.

Other compilation and review publications include:

- AICPA accounting and review publications not referred to previously,
- The AICPA’s annual *Compilation and Review Alert,*
- Compilation and review articles in the *Journal of Accountancy* and other professional journals,
- Compilation and review articles in the AICPA’s *The CPA Letter,*
- Continuing professional education programs and other instructional materials, textbooks, guide books, compilation and review programs, and checklists, and
- Other compilation and review publications from state CPA societies, other organizations, and individuals.

**Note:** If an accountant applies the guidance included in another compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. In determining whether another compilation and review publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying SSARSs and the degree to which the issuer or author is recognized as an authority in compilation and review matters. Other compilation and review publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.

7. **Ethical Principles and Quality Control Standards:**

In addition to SSARSs, AICPA members who perform compilation and review engagements are governed by:
a. The AICPA’s Code of Professional Conduct (Code), which expresses the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. The principles of the code guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The principles call for a commitment to honorable behavior, even at the sacrifice of personal advantage.

b. Statements on Quality Control Standards (SQCSs), which establish standards and provide guidance on a firm’s system of quality control.

The Code establishes the fundamental ethical principles that all AICPA members are required to observe. When performing a compilation or review engagement, the code requires an accountant to maintain objectivity and integrity and comply with all other applicable provisions.

An accountant has the responsibility to adopt a system of quality control in conducting an accounting practice. Thus, a firm should establish quality control policies and procedures to provide reasonable assurance that personnel comply with SSARSs in compilation and review engagements. The nature and extent of a firm’s quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

SSARSs relate to the conduct of individual compilation and review engagements; SQCSs relate to the conduct of a firm’s accounting practice. Thus, SSARSs and SQCSs are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of an individual engagement and the firm’s accounting practice as a whole. However, deficiencies in, or instances of noncompliance, with a firm’s quality control policies and procedures do not, in and of themselves, indicate that a particular review or compilation engagement was not performed in accordance with SSARSs.

8. Elements of a Compilation or Review Engagement:

SSARS No. 19 addresses the following elements of a compilation and review engagement:

a. A three-party relationship involving management, an accountant, and intended users
b. An applicable financial reporting framework
c. Financial statements or financial information
d. In a review, sufficient appropriate review evidence
e. A written communication or report

9. Three-Party Relationship:

A compilation or review engagement involves three parties:

- Management (or the responsible party),
- An accountant in the practice of public accounting, as defined by the AICPA code, and
- Intended users of the financial statements or financial information.
Management (Responsible Party)

Management must be identified in a compilation or review engagement. In particular, management takes responsibility for:

- The preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- Designing, implementing, and maintaining internal control
- The identification of the applicable financial reporting framework and the preparation and presentation of the financial statements in accordance with that framework.

Note: A basic assumption underlying the performance of a compilation or review engagement is that the accountant is performing an attest service on subject matter that is the responsibility of the client’s management. Therefore, an accountant is precluded from issuing an unmodified compilation report or a review report on financial statements when management is unwilling to accept responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework or to take responsibility for the design, implementation, and maintenance of internal control.

During the performance of a compilation or review engagement, the accountant may make suggestions about the form or content of the financial statements or prepare them, in whole or in part, based on information that is the representation of management. However, the ultimate responsibility must rest with management.

Accountant in the Practice of Public Accounting

If an accountant is not in the practice of public accounting, he or she is precluded from issuing a compilation or review report under the SSARSs.

In performing a compilation or review engagement, an accountant is required to possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable the accountant to compile or review financial statements that are appropriate in form for an entity operating in that industry.

Note: An accountant should not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases, this requirement can be satisfied by the accountant using the work of persons from other professional disciplines, referred to as experts. In such cases, the accountant should be satisfied that those persons carrying out aspects of the engagement possess the requisite skills and knowledge, and that the accountant has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.
**Intended Users of the Financial Statements or Financial Information**

In many cases, management and the intended users may be the same. Intended users may be from different entities (for example, a banker or potential investor) or the same entity.

The intended users are the person(s) or class of persons who understand the limitations of the compilation or review engagement and financial statements. The accountant has no responsibility to identify the intended users.

**Note:** In some cases, intended users (such as bankers and regulators) may impose a requirement on or request the client to arrange for additional procedures to be performed for a specific purpose. For example, a banker may request that certain agreed-upon procedures be performed with respect to the entity’s accounts receivable in addition to the financial statements being compiled. An accountant may perform additional services in conjunction with the compilation or review, as long as he or she adheres to professional standards with respect to those additional services.

10. **An Applicable Financial Reporting Framework:**

SSARS No. 19 introduces the concept of the applicable financial reporting framework which includes U.S. GAAP, OCBOA (income tax basis, cash basis, etc.), and other frameworks.

Management and, when applicable, those charged with governance are responsible for the selection of the entity’s applicable financial reporting framework, as well as individual accounting policies when the financial reporting framework contains acceptable alternatives. The financial reporting framework encompasses financial accounting standards established by an authorized or recognized standards setting organization.

The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

Examples of financial reporting frameworks include:

- U.S. GAAP (accounting principles generally accepted in the United States of America, as promulgated by the Financial Accounting Standards Board)
- OCBOA (Other comprehensive basis of accounting)
- U.S. Governmental GAAP (principles issued by the Governmental Accounting Standards Board)
- Accounting principles generally accepted in the United States of America, as promulgated by the Federal Accounting Standards Advisory Board, and
- IFRSs issued by the International Accounting Standards Board.
11. Financial Statement or Financial Information:

An accountant may be engaged to compile or review a complete set of financial statements or an individual financial statement (for example, balance sheet only). The financial statements may be for an annual period or for a shorter or longer period, depending on management’s needs.

The requirements of the applicable financial reporting framework determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of an entity. For example, for U.S. GAAP, a complete set of financial statements might include a balance sheet, an income statement, a statement of retained earnings, a cash flow statement, and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

12. Evidence:

When performing a compilation engagement, the accountant has no responsibility to obtain any evidence about the accuracy or completeness of the financial statements. As a result, a compilation does not provide a basis for obtaining any level of assurance on the financial statements being compiled.

In connection with the performance of a review engagement, SSARS No. 19 introduces the concept of review evidence.

When performing a review engagement, the accountant should perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. Review evidence obtained through the performance of analytical procedures and inquiries ordinarily will provide the accountant with a reasonable basis for obtaining limited assurance.

The accountant should apply professional judgment in determining the specific nature, timing, and extent of review procedures. Such procedures should be tailored based on the accountant’s understanding of the industry in which the client operates and the accountant’s knowledge of the entity. The nature, timing, and extent of procedures for gathering review evidence are deliberately limited relative to an audit.

13. Compilation and Review Reports:

If the accountant performs a compilation, a report or written communication is required unless the accountant withdraws from the engagement.
If the accountant is not independent, he or she may issue a compilation report, provided that the accountant complies with the compilation standards.

If the accountant performs a review, a written review report is required unless the accountant withdraws from the engagement.

14. Materiality:

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the accountant in determining whether there are any material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the accountant with such a frame of reference.

The accountant’s determination of materiality is a matter of professional judgment and is affected by the accountant’s perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the accountant to assume that users:

a. Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information in the financial statements with reasonable diligence;

b. Understand that financial statements are prepared, presented, and reviewed to levels of materiality;

c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and

d. Make reasonable economic decisions on the basis of the information in the financial statements.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following is correct:
   a) a compilation is both an assurance and attest engagement
   b) a review is both an assurance and attest engagement
   c) a compilation is an assurance but not an attest engagement
   d) a review is an attest but not an assurance engagement

2. Which one of the following would be performed as part of obtaining review evidence:
   a) assessing fraud risk
   b) confirmations
   c) inquiry
   d) examination of source documents

3. Which of the following words, when used in the SSARSs, requires an accountant to comply with it as an unconditional requirement:
   a) the word "may"
   b) the word “should”
   c) the words “should consider”
   d) the word “must”

4. An accountant is performing a compilation or review engagement. Which of the following would be an example of guidance that has no authoritative status within the hierarchy:
   a) appendices to SSARSs
   b) compilation and review interpretations of SSARSs
   c) AICPA’s annual Compilation and Review Alert
   d) the SSARSs
5. In a compilation or review engagement, which of the following is management responsible for:

   a) testing internal control
   b) preparation of the financial statements
   c) determining the accountant’s procedures to perform
   d) preparing the accountant’s report

6. Which of the following is not required in order for an accountant to perform a compilation engagement under the SSARSs:

   a) is independent
   b) is in the practice of public accounting
   c) level of knowledge of the entity’s industry
   d) level of knowledge of the industry accounting principles
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A compilation is an attest engagement but is not an assurance engagement.

   B: Correct. A review is both an assurance and attest engagement.

   C: Incorrect. A compilation is an attest engagement but is not an assurance engagement.

   D: Incorrect. A review is both an attest and an assurance engagement.

   (See page 7 of the course material.)

2. A: Incorrect. Assessing fraud risk is part of an audit engagement and not part of review evidence.

   B: Incorrect. Confirmations are part of an audit engagement and not part of review evidence.

   C: Correct. Inquiry is a procedure performed as part of review evidence.

   D: Incorrect. Examination of source documents is performed in an audit engagement and not part of review evidence.

   (See page 8 of the course material.)

3. A: Incorrect. The word “may” is an example of explanatory material and not an unconditional requirement.

   B: Incorrect. The word “should” is a presumptively mandatory requirement, not an unconditional one.

   C: Incorrect. The words “should consider” represent a presumptively mandatory requirement as to the procedure or action.

   D: Correct. The word “must” means the procedure is an unconditional requirement.

   (See page 8 of the course material.)
4. A: Incorrect. The Appendices to SSARSs are considered interpretive publications and the accountant should consider such documents to be applicable to the compilation or review engagement.

B: Incorrect. Compilation and review interpretations of SSARSs are interpretative publications that the accountant should consider in performing a compilation or review engagement.

C: Correct. AICPA’s annual *Compilation and Review Alert* is considered other compilation and review publications that have no authoritative status but may help the accountant understand and apply the SSARSs.

D: Incorrect. The SSARSs are authoritative at the highest level of the hierarchy.

(See page 10 of the course material.)

5. A: Incorrect. Management is responsible for designing, implementing and maintaining internal control, but not testing it.

B: Correct. Management is responsible for the preparation and fair presentation of the financial statements.

C: Incorrect. The accountant, not management, is responsible for determining the accountant’s procedures to perform.

D: Incorrect. The accountant is responsible for preparing his or her report, not management.

(See page 12 of the course material.)

6. A: Correct. An accountant does not have to be independent provided he or she discloses the lack of independence in the compilation report.

B: Incorrect. An accountant must be in the practice of public accounting to perform a compilation engagement.

C: Incorrect. An accountant must have a general level of knowledge of the entity’s industry to perform a compilation engagement.

D: Incorrect. An accountant must have a level of knowledge of the industry accounting principles to perform a compilation engagement.

(See page 15 of the course material.)
II. Compilation Engagements

1. Establishing an Understanding (an engagement letter):

SSARS No. 19 makes a change by requiring an accountant to establish an understanding with management regarding the services to be performed for a compilation engagement.

The understanding must be in the form of an engagement letter and should include:

- The objectives of the engagement
- Management’s responsibilities
- Accountant’s responsibilities
- Limitations of the engagement

Details of elements that should be included in the engagement letter include:

Required elements:

- The objective of a compilation is to assist management in presenting financial information in the form of financial statements.

- The accountant utilizes information that is the representation of management (owners) without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.

- Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

- Management is responsible to prevent and detect fraud.

- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

- Management is responsible for making all financial records and related information available to the accountant.

- The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.
• A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the financial statements.

• The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

• The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant’s attention during the performance of compilation procedures that fraud or an illegal act may have occurred. The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

• The effect of any independence impairments on the expected form of the accountant’s compilation report, if applicable.

Additional matters that may be discussed include:

• Fees and billings

• Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)

• Conditions under which access to compilation documentation may be granted to others

• Additional services to be provided relating to regulatory requirements

What if compiled financial statements are not expected to be used by a third party and the accountant does not expect to issue a compilation report on the financial statements?

In an instance in which compiled statements are not expected to be used by a third party and a compilation report is not going to be issued, the accountant should include in the engagement letter an acknowledgement of management’s representation and agreement that the financial statements are not to be used by a third party.

Further, the engagement letter should include the following additional matters:

• Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed;
• Substantially all disclosures (and the statement of cash flow, if applicable) required by applicable financial reporting framework may be omitted; and

• Reference to supplementary information.

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**Standard Engagement Letter for a Compilation**
* (From Exhibit A of SSARS No. 19, as modified by the author)

Mr. John Smith  
President  
Smith Manufacturing, LLC  
100 Main Street  
Nowhere, MA 02110

Dear Mr. Smith:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the annual [and interim, if applicable] financial statements of XYZ Company as of December 31, 20XX, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.
We are responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

If, during the period covered by the engagement letter, the accountant’s independence is or will be impaired, insert the following:

We are not independent with respect to XYZ Company. We will disclose that we are not independent in our compilation report.

If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of accountant]

Acknowledged:
XYZ Company

_______________________
President

_______________________
Date
Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use
(From Exhibit A of SSARS No. 19, as modified by the author)

Mr. John Smith
President
Smith Manufacturing, LLC
100 Main Street
Nowhere, MA 02110

Dear Mr. Smith:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will compile, from information you provide, the [monthly, quarterly, or other frequency] financial statements of XYZ Company for the year 20XX.

The objective of a compilation is to assist you in presenting financial information in the form of financial statements. We will utilize information that is your representation without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.

We are responsible for conducting the engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other
procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion or provide any assurance regarding the financial statements being compiled.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. However, we will inform the appropriate level of management of any material errors, and of any evidence or information that comes to our attention during the performance of our compilation procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

The financial statements will not be accompanied by a report and are for management’s use only and are not to be used by a third party.

If, during the period covered by the engagement letter, the accountant’s independence is or will be impaired, insert the following:

We are not independent with respect to XYZ Company.

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

________________________________
[Signature of accountant]

Acknowledged:
XYZ Company

______________________
President

______________________
Date

2. Compilation Performance Requirements:

SSARS No. 19 outlines the performance requirements necessary for a compilation engagement.

In a compilation engagement, the accountant must:
a. **Have an understanding of the industry:** The accountant should possess an understanding of the client’s industry, including the accounting principles and practices generally used in that industry, so that the accountant can compile financial statements that are appropriate in form for an entity operating in that industry.

b. **Have knowledge of the client:** The accountant should have knowledge of the client including:

   - An understanding of the client’s business, including its organization, operating characteristics, and the nature of its assets, liabilities, revenues, and expenses.

   - An understanding of the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. Such an understanding may include matters such as changes in accounting practices and principles, and differences in the client’s business model in comparison with normal industry practices.

   **Note:** An accountant should be aware of unusual accounting policies and procedures that come to his or her attention as a result of his or her knowledge of the industry.

c. **Read the financial statements:** Prior to submitting the financial statements, the accountant should read them and consider whether such financial statements appear to be appropriate in form and free from obvious material errors.

   **Note:** An error is defined as a mistake in the preparation of financial statements, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including inadequate disclosure.

d. **Other procedures:** If, through making inquiries or performing other procedures, the accountant gains knowledge that may suggest that information supplied is incorrect, incomplete, or otherwise unsatisfactory, or that fraud or an illegal act may have occurred, the accountant should request that management consider the effect of such matters on the financial statements and communicate the results of such consideration to the accountant.

   The accountant should also consider the effect of management’s conclusions regarding such matters on the accountant’s compilation report. If the accountant believes the financial statements may be materially misstated, he or she should obtain additional or revised information. If the client refuses to provide such additional or revised information, the accountant should withdraw from the engagement.

3. **Documentation in a Compilation Engagement:**

SSARS No. 19 expands the documentation requirements for a compilation engagement. The SSARS requires an accountant to prepare documentation in sufficient detail to provide a clear understanding of the work performed.
An accountant’s documentation should include:

a. An engagement letter documenting the understanding with the client.

b. Any findings or issues that, in the accountant’s judgment, are significant.

Example: The results of compilation procedures that indicate that the financial statements could be materially misstated, actions taken to address such findings, the extent to which the accountant had any questions or concerns as a result of the procedures, and how those issues were resolved.

c. Communications (oral or written), to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention, if any.

Note: Prior to the issuance of SSARS No. 19, the documentation requirements for a compilation engagement were limited to documenting a) the understanding with the client as to the type of engagement to be performed, and b) communications to management regarding fraud or illegal acts, if any, that come to the accountant’s attention.

SSARS No. 19 introduces a third requirement which is to document any findings or issues that, in the accountant’s judgment, are significant (item 2 above).

4. Revised Reporting Requirements for Compilation Engagement:

a. Compilation report:

SSARS No. 19 changes the language for a compilation report with most of the elements found in the previous compilation report being retained in the new compilation report format, albeit in different locations within the report.

The SSARS requires that a compilation report have the following basic elements:

Title and addressee:

a. Title. The compilation report should have a title that clearly indicates that it is the accountant’s compilation report. The accountant may indicate that he or she is independent in the title, if applicable.

Appropriate titles include:

“Accountant’s Compilation Report” or
“Independent Accountant’s Compilation Report”

b. Addressee. The accountant’s report should be addressed as appropriate in the circumstances of the engagement.

Introductory paragraph:

The introductory paragraph in the accountant’s report should do the following:
• Identify the entity whose financial statements have been compiled
• State that the financial statements have been compiled
• Identify the financial statements that have been compiled
• Specify the date or period covered by the financial statements, and
• Include a statement that the accountant has not audited or reviewed the financial statements and, accordingly, does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.

**Management’s responsibility for the financial statements and for internal control over financial reporting:**

The report should have a statement that management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

**Accountant’s responsibility:**

The report should have the following statements:

- A statement that the accountant’s responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA.

- A statement that the objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

**Signature of the accountant and date of report:**

The report should have:

- The manual or printed signature of the accounting firm or the accountant, as appropriate, and

- The date of the compilation report (the date of completion of the compilation should be used as the date of the accountant’s report).

**Note:** The report should not describe the procedures that the accountant might have performed as part of the compilation engagement.
<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Old Compilation Report</th>
<th>New Compilation Report- SSARS No. 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title</td>
<td>None.</td>
<td>Compilation report should have a title such as “Accountant's Compilation Report” or “Independent Accountant's Compilation Report.”</td>
</tr>
<tr>
<td>First</td>
<td>I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.</td>
<td>I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.</td>
</tr>
<tr>
<td>Second</td>
<td>None.</td>
<td>Management (owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.</td>
</tr>
<tr>
<td>Third</td>
<td>A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.</td>
<td>My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.</td>
</tr>
</tbody>
</table>
Illustrative Standard Compilation Report
US GAAP

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (Owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)
Illustrative Standard Compilation Report
Income Tax Basis

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying statement of assets and liabilities- income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (Owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)

b. Reporting on financial statements that omit substantially all disclosures:

SSARS No. 19 essentially retains the previous reporting requirement when substantially all disclosures are omitted. The omission can apply to both disclosures and the statement of cash flows.

The accountant may compile financial statements that omit substantially all the disclosures required by an applicable financial reporting framework, including those disclosures that might appear in the body of the financial statements.

The accountant may compile such financial statements provided that the omission of such disclosures is not, to his or her knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements.

Such a report should include the following elements in a paragraph after the paragraph that describes the accountant’s responsibility:
• A statement that management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by the applicable financial reporting framework (or ordinarily included in the financial statements if the financial statements are prepared in accordance with an OCBOA).

• A statement that if the omitted disclosures (and statement of cash flows, if applicable) were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows (or equivalent for presentations other than accounting principles generally accepted in the United States of America).

• A statement that, accordingly, the financial statements are not designed for those who are not informed about such matters.

When the entity wishes to include disclosures about only a few matters in the form of notes to such financial statements, such disclosures should be labeled as follows:

“Selected Information – Substantially All Disclosures Required by [identify the applicable financial reporting framework (for example, “Accepted Accounting Principles Generally accepted in the United States of America”) Are Not Included.”
Illustrative Standard Compilation Report
Management Elects to Omit Substantially All Disclosures and the Statement of Cash Flows Required by U.S. GAAP

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income and retained earnings for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (Owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the cash basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[Insert fourth paragraph]

Management has elected to omit substantially all of the disclosures (and the statement of cash flows) required by accounting principles generally accepted in the United States of America. If the omitted disclosures and statement of cash flows were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)
Illustrative Standard Compilation Report
Management Elects to Omit Substantially All Disclosures Ordinarily Included in Income Tax Basis of Accounting

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying statement of assets and liabilities- income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses- income tax basis for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Management (Owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared in accordance with the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)

c. Reporting when an accountant is not independent:

One of the most significant changes made by SSARS No. 19 is the way in which an accountant may report when he or she is not independent. Previously, an accountant was required to disclose when he or she was not independent with respect to a client, but was precluded from disclosing the reason why the accountant lacked independence.
SSARS No. 19 makes a change by allowing an accountant to disclose the reason why he or she is not independent with respect to a client which is the subject of the compilation report.

- When the accountant is issuing a report with respect to a compilation of financial statements for an entity, with respect to which the accountant is not independent, the accountant’s report should be modified by indicating his or her lack of independence in the final paragraph of the compilation report.

  An example:

  *I am (We are) not independent with respect to XYZ Company.*

- The accountant is permitted (but not required) to disclose a description about the reason(s) that his or her independence is impaired.

Examples included in SSARS No. 19, as modified, follow:

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) *had a direct financial interest in XYZ Company.*

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an *individual of my immediate family* (an immediate family member of one of the members of the engagement team) *was employed by XYZ Company* Or,

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) *performed certain bookkeeping and payroll tax services* (the accountant may include a specific description of those services) that impaired my (our) independence.

**Note:** If an accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that *all reasons* are included in the description.
Illustrative Standard Compilation Report
US GAAP
Accountant Lacks Independence

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (Owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

Last paragraph:
I am (We are) not independent with respect to XYZ Company.

or

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.

or

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an individual of my immediate family (an immediate family member of one of the members of the engagement team) was employed by XYZ Company.

or

I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain bookkeeping and payroll tax services (the accountant may include a specific description of those services) that impaired my (our) independence.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)
AICPA Q&A: Lack of Independence

In January 2010, the AICPA issued a Q&A entitled Significant Change to Compilation Reporting Requirements When Independence Is Impaired, to address some of the issues surrounding the lack of independence in a compilation engagement.

Following are excerpts from that Q&A:

**Question**—When may I start describing the reasons for lack of independence in my compilation report?

**Answer**—You may use the provision in paragraph 2.21 with respect to any compilation report that you issue after December 30, 2009 (the official issuance date of SSARS No. 19).

**Question**—May I disclose the reasons for the lack of independence only for December 2009 compilations and subsequent periods, or may I use it for earlier compilations (for example, November 2009 compilations)?

**Answer**—You may disclose the reasons for a lack of independence in a November (or earlier) compilation report as long as your report is released (or reissued) after the official issuance of SSARS No. 19, which is December 30, 2009.

**Question**—What constitutes “official issuance,” and how will I know that date?

**Answer**—Official issuance is the date on which a standard is first made public and, therefore, available for use. A standard is first made available electronically through the AICPA’s subscription services. Even if you do not subscribe to an electronic subscription, you can still use this provision once the standard is issued. After the standard is issued, the AICPA’s Audit and Attest Standards Team will send a blast e-mail to members about the issuance date. Notification also will be made public through many other AICPA publication processes.

**Question**—May I use the new standard compilation report illustrated in SSARS No. 19 after the standard is issued?

**Answer**—No. The effective date of SSARS No. 19 is for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Early implementation of the new standard is not permitted, except for the one paragraph permitting disclosure of the reasons for a lack of independence in the compilation report. Therefore, you cannot use the new standard compilation report until SSARS No. 19 becomes effective.

**Question**—Does SSARS No. 19 require me to state the reasons why I am not independent with respect to a compilation client?

**Answer**—No. SSARS No. 19 permits, but does not require, the accountant to disclose the reasons. You may simply state that you are not independent with respect to the client without disclosing the reasons.
**Question**—May I disclose the reasons for the lack of independence in one period and then not disclose the reasons in a subsequent period for the same client?

**Answer**—Yes. Each period for which a compilation report is issued for a client is treated as a separate compilation. For example, you may decide to disclose the reasons in a compilation report on financial statements for the period ended March 31, 2010, and then decide to not disclose the reasons in a compilation report on financial statements for the period ended June 30, 2010, or vice versa.

**Question**—Are there factors that I should consider before deciding to disclose the reason(s) for the impairment?

**Answer**—An accountant should exercise his or her professional judgment in making that decision. That judgment might include consideration of such factors as the number of reasons for independence impairment or the ability of the user of the compiled financial statements to understand the nature of the impairments.

Paragraph 2.21 of SSARS No. 19 states in part, “If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description.” Therefore, if the accountant’s independence is impaired for three reasons (for example, ownership, nonattest services, and family relationships), the accountant may decide that describing all three would make the report too lengthy or too confusing. Consequently, the accountant might decide to stay with the extant language and merely say that he or she is not independent. On the other hand, an accountant who is providing a nonattest service that impairs independence may feel that this information would be beneficial for users to know. Therefore, that accountant may decide to disclose the reason.

**Question**—Are there any limitations on what the report may say?

**Answer**—No. The ARSC did not prescribe any requirements except that if an election is made to disclose, then all the reasons for the impairment must be described. That means that an accountant could, if he or she chooses, write a paragraph three pages long to describe the reasons for the impairment. Although that length certainly isn’t expected, the ARSC anticipates and expects that some accountants will go into far greater detail than will others.

**Question**—Assuming an accountant is not independent for two reasons (for example, a family relationship and ownership) does each reason need to be in a separate paragraph?

**Answer**—No. An accountant may combine the reasons into a single paragraph. For example, assuming the accountant held an ownership interest in the client and the accountant’s spouse was the CFO of the company, a description paragraph may be drafted, such as the following:

*I am not independent with respect to XYZ Company as of and for the year ended December 31, 2010, because I am a minority shareholder in XYZ Company and my spouse is an officer of XYZ Company.*
d. Reporting when compiled financial statements are not expected to be used by a third party:

When an accountant submits compiled financial statements to his or her client that are not expected to be used by a third party, the accountant is not required to issue a compilation report.

Instead, the accountant should follow the following rules:

- The accountant should include a reference on each page of the financial statements restricting their use, such as:

  * Restricted for Management’s Use Only, or
  * Solely for the Information and Use by the Management of XYZ Corporation and not intended to be and should not be used by any other party.

- If the accountant becomes aware that the financial statements have been distributed to third parties, the accountant should discuss the situation with the client and determine the appropriate course of action, including requesting that the client have the financial statements returned.

- If, after the accountant requests that the statements be returned, the client does not comply with that request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third party use, preferably in consultation with his or her attorney.

e. Emphasis of a matter:

An accountant may, but is not required to, emphasize in his or her report, a matter that is disclosed in the financial statements. The matter should be presented in a separate paragraph of the accountant’s report.

a. Emphasis paragraphs are optional at the sole discretion of the accountant.
b. Examples of matters that the accountant may wish to emphasize include the following:

- Uncertainties
- That the entity is a component of a larger business enterprise
- That the entity has had significant transactions with related parties
- Unusually important subsequent events
- Accounting matters, exclusive of those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.

Is an accountant permitted to include an emphasis of a matter paragraph in a compilation report that omits substantially all disclosures?

An emphasis of matter paragraph should not be used in lieu of management disclosures. Therefore, the accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless that matter is also disclosed in the financial statements.

f. Departures from the Applicable Financial Reporting Framework:

An accountant who is engaged to compile financial statements may become aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements.

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation 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. For example, U.S. GAAP or the income tax basis of accounting would be examples of applicable financial reporting framework.

- If an accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if the effects have been determined by management or are known due to the accountant’s procedures.

- The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

- If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, the accountant should withdraw from the engagement, provide no further services with respect to those financial statements, and possibly consult with the accountant’s legal counsel.

Example (next page)
Illustrative Standard Compilation Report
US GAAP Departure

Accountant’s Compilation Report

[Appropriate Salutation]

I (We) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management (Owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. During our compilation, I (we) did become aware of a departure (certain departures) from accounting principles generally accepted in the United States of America that is (are) described in the following paragraph.

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed me (us) that the company has stated its land at appraised value and that, if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders’ equity would have been decreased by $500,000.

Or

A statement of cash flows for the year ended December 31, 20XX, has not been presented. Accounting principles generally accepted in the United States of America require that such a statement be presented when financial statements purport to present financial position and results of operations.

[Signature of accounting firm or accountant, as appropriate]
[Date] (date of completion of compilation engagement)
g. Restricted use versus general use compilation report:

Accountant’s compilation reports are separated into two categories, *general (unrestricted) use* and *restricted use*, as follows:

**General (unrestricted) use:**
Applies to accountant’s reports that are not restricted to specified parties. Reports on financial statements that are prepared in conformity with an applicable financial reporting framework ordinarily are general (unrestricted) use.

An accountant is not precluded from restricting the use of any report even if the report would otherwise be general use.

**Restricted use:**
Restricted use reports are those reports intended only for one or more specified third parties. The restriction may be the result of numerous circumstances that include:

- The purpose of the report, and
- The potential risk that the report might be misunderstood when taken out of the context in which it was intended to be used.

1) When a report is issued on subject matter or a presentation based on a measurement or disclosure criteria contained in a contractual agreement or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the use of the report because:

- The basis, assumptions, or purpose of the presentations (contained in such an agreement or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions.
- The subject matter, or presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

2) If an accountant issues a single combined report covering both subject matter that requires a restriction on use to specified parties, and subject matter that ordinarily does not require a restriction (e.g., general use), the use of the single combined report should be restricted to the specified parties.

3) If, as required by law or regulation, a separate restricted use report is included in a document that also contains a general use report, the inclusion of a separate restricted use report in the document does not affect the intended use of either report. The restricted use report remains restricted for use, and the general use report continues to get unrestricted.

4) Subsequent to the completion of an engagement that has a restricted use report, the accountant may be asked to add other parties as specified parties. If this is the case, an accountant is permitted to add other parties provided the accountant:

a) Considers several factors that include:

- Identity of the other parties
- Their knowledge of the basis of the measurement or disclosure criteria
- The intended use of the report.
b) Obtains **affirmative acknowledgment**, preferably in writing, from the other parties as to their understanding of the nature of the engagement, and the measurement or disclosure criteria used in the engagement and related report.

**Note:** If the other parties are added after the accountant issues his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, the acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

5) **Report language – restricted use:**

The accountant’s report that is restricted should contain a separate paragraph at the end of the report that includes the following information:

- A statement indicating that the report is intended solely for the information and use of the specified parties.

- An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

*How does an accountant guarantee that restricted use reports are not distributed by the client to parties beyond the specified parties?*

SSARS No. 19 states that in connection with a restricted use report, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to nonspecified parties. The accountant is not precluded from reaching an understanding with the client that the intended use of the report will be restricted and from obtaining the client’s agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

The SSARS also states that the accountant is not responsible for controlling a client’s distribution of restricted use reports. A restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

h. **Other reporting requirements – compilation engagement:**

**Legend:** Each page of the financial statements compiled by the accountant should include a reference, such as:

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“See accountant’s compilation report” or
“See independent accountant’s compilation report”
```
OCBOA financial statements: Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include:

- A description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from generally accepted accounting principles (GAAP). The effects of the differences need not be quantified.

- Informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

5. Entity’s ability to continue as a going concern:

During the performance of a compilation engagement, an accountant may obtain information that indicates that an uncertainty may exist about an entity’s ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements).

In such circumstances, the accountant should take the following steps:

a. Request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for disclosure.

b. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions, including the adequacy of the related disclosures, if applicable.

c. If the accountant determines that management’s conclusions are unreasonable or the disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is not adequate, the accountant should follow the guidance of a departure from an applicable financial reporting framework.

d. The accountant may emphasize an uncertainty about an entity’s ability to continue as a going concern, provided that the uncertainty is also disclosed in the financial statements.

6. Subsequent events:

A subsequent event may have a material effect on compiled financial statements and may come to the attention of the accountant in one of two ways:

a. During the performance of compilation procedures, or
b. Subsequent to the date of the accountant’s compilation report but prior to the release of the report.1

Regardless of the way in which the accountant discovers the subsequent event, the accountant should request that management consider the possible effects on the financial statements, including whether there is adequacy of disclosure.

If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or notes, the accountant should treat the transaction as a departure from GAAP, or other applicable financial reporting framework.

In addition, an accountant may wish to include an explanatory paragraph of a subsequent event in the report as an emphasis of a matter. The accountant may add an additional paragraph as long as the matter is also disclosed in the financial statements.

7. Subsequent Discovery of Facts Existing at the Date of the Compilation Report:

Subsequent to the date of the report on the compiled financial statements, the accountant may become aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

SSARS No. 19 provides the following guidance in connection with such a situation:

a. General rule: The general rule is that after the date of the accountant’s compilation report, the accountant has no obligation to perform other compilation procedures with respect to the financial statements, unless new information comes to his or her attention.

b. Exception to the general rule: The exception is when the accountant becomes aware of information that relates to financial statements previously reported on by him or her but that was not known to the accountant at the date of the report (and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the compilation). In such a case, the accountant:

- Should undertake to determine whether the information is reliable and whether the facts existed at the date of the report.
- Should discuss the matter with the client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary.
- May choose to discuss the matter with those other than management including those parties charged with governance.

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1 If an accountant compiles financial statements with no report, the submission date of the compiled financial statements is the equivalent of the accountant’s compilation or review report date.
• Should consider the time elapsed since the financial statements were issued.

• May wish to consult with his or her legal counsel.

c. The accountant should obtain additional or revised information if the nature and effect of the matter are such that:

• The accountant's report or the financial statements would have been affected if the information had been known to the accountant at the accountant’s compilation report date and had not been reflected in the financial statements, and

• The accountant believes that persons are currently using or are likely to use the financial statements and those persons would attach importance to the information, the accountant should obtain additional or revised information.

d. When the accountant has concluded that action should be taken to prevent further use of the accountant's report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements.

When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances. The accountant should take whatever steps he or she considers necessary to satisfy himself or herself that the client has made the necessary disclosures, under the following guidance:

1) If the effect of the subsequently discovered information on the accountant’s report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant’s report.

• The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant’s report.

   Note: In general, only the most recently issued compiled financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

2) When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements, pursuant to subparagraph (1).

3) When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In such a situation, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of:
• The client notifying persons who are known to be using or who are likely to use the financial statements that the statements should not be used; that revised financial statements will be issued; and, when applicable, that the accountant’s report will be issued as soon as practicable.

e. If the client refuses to make the disclosures, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as outlined subsequently to prevent further use of the financial statements and, if applicable, the accountant’s report.

Note: The steps that can appropriately be taken will depend upon the degree of certainty of the accountant’s knowledge that persons exist who are currently using or who will use the financial statements and, if applicable, the accountant’s report and who would attach importance to the information and the accountant’s ability as a practical matter to communicate with them. Unless the accountant’s attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

1) Notify the client that the accountant’s report must no longer be associated with the financial statements.

2) Notify the regulatory agencies having jurisdiction over the client that the accountant’s report should no longer be used.

3) Notify each person known to the accountant to be using the financial statements that the financial statements and the accountant’s report should no longer be used.

Note: In most situations, it will not be practicable for the accountant to give appropriate individual notification to all persons. For example, it may be difficult to notify all stakeholders whose identities ordinarily are unknown to the accountant.

Instead, notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

f. Details on required disclosure: The content of any disclosure of information subsequently discovered to persons other than the accountant’s client should follow these guidelines:

1) The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

2) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose of the disclosure.
**Note:** The disclosure should not include any comments concerning the conduct or motives of any person. If the client has not cooperated, the accountant's disclosure need not detail the specific information but can merely indicate that the client has not cooperated with the accountant's attempt to substantiate information that has come to the accountant's attention and that, if the information is true, the accountant believes that the compilation report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant's compilation report should not be used.

**8. Supplementary Information:**

When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the following rules should be applied:

a. The accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to such information.

b. When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should refer to the other data, or the accountant can issue a separate report on the other data.

c. If a separate report is issued, the report should state that the other data accompanying the financial statements are presented only for the purposes of additional analysis and that the information has been compiled from information that is the representation of management, without audit or review, and that the accountant does not express an opinion or provide any assurance on such data.

**9. Communicating to Management and Others:**

If an accountant obtains evidence or other information during his or her performance of compilation procedures, that fraud or an illegal act may have occurred, that matter should be brought to the attention of the appropriate level of management using the following rules:

a. The accountant is not required to report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

b. When such fraud or an illegal act involves senior management, the accountant should report the matter (either orally or in writing) to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance.

1) Any communication that is done orally should be documented by the accountant.

c. When such fraud or an illegal act involves an owner of the business, the accountant should consider resigning from the engagement.
Note: There may be instances where there are potential conflicts between the accountant’s ethical and legal obligations for confidentiality of client matters. In such circumstances, the accountant may wish to consult with legal counsel before discussing matters involving fraud or illegal acts with parties outside the client.

d. An accountant should consult with his or her legal counsel whenever any evidence or information comes to his or her attention during a compilation engagement that fraud or an illegal act may have occurred, unless an illegal act is clearly inconsequential.

e. The accountant is not required to disclose any evidence or information about a fraud or illegal act to parties other than the client’s senior management (or those changed with governance).

However, in the following instances, a duty may exist for the accountant to disclose to parties outside of the entity:

- To comply with certain legal and regulatory requirements
- To a successor accountant when the successor decides to communicate with the predecessor accountant regarding acceptance of the engagement to compile or review the financial statements of a nonissuer
- In response to a subpoena

10. Change in an Engagement from an Audit or Review to a Compilation:

There may be instances in which an accountant, who has been engaged to audit or review financial statements, before the completion of the audit or review, is asked to change the engagement to a compilation.

a. There may be numerous reasons for the change in the engagement, whether imposed by the client or by circumstances, as follows:

- There may be a change in circumstances affecting the entity’s requirement for an audit or a review,
- There could be a misunderstanding as to the nature of the type of engagement, or
- There might be a restriction on the scope of an audit or review.

Note: A change in circumstances that affects the entity’s requirement for an audit or review or a misunderstanding concerning the nature of an audit, review, or compilation would ordinarily be considered a reasonable basis for requesting a change in the engagement.

Before an accountant agrees to change the engagement to a compilation, the accountant should consider all of the following issues:

- The reason given for the client’s request and its implications of a restriction on the scope of the audit or review, whether imposed by the client or by circumstances
• The additional audit or review effort required to complete the audit or review
• The estimated additional cost to complete the audit or review.

b. If the audit or review procedures are substantially complete, or the cost to complete such procedures is relatively insignificant, the accountant should consider whether it is appropriate to accept a change in the engagement to a compilation.

**Note:** The accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. When an accountant has been engaged to audit an entity’s financial statements, the accountant typically would be precluded from issuing a compilation report if:

• The accountant has been prohibited by the client from corresponding with the entity’s legal counsel, or
• The client does not provide the accountant with a signed representation letter.

c. If the accountant concludes that reasonable justification exists to change the engagement to a compilation, and if the accountant complies with the standards for a compilation engagement, the accountant should issue a compilation report.

The report should not reference:

1) The original engagement (audit or review), or

2) Any audit or review procedures that may have been performed.

**Observation:** If an accountant does change from an audit or review engagement to a compilation engagement, implicit in that change is that the accountant will comply with the standards required to perform a compilation engagement.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Under SSARS No. 19, in connection with a compilation engagement, communication of an understanding of the engagement must be done:
   a) orally or in writing at the option of the accountant
   b) in writing with an engagement letter
   c) orally if properly documented in the working papers
   d) in writing but not through a signed engagement letter

2. If an accountant is performing a compilation engagement, he or she must perform which of the following procedures:
   a) analytical procedures
   b) inquiry
   c) confirmation
   d) understand the client’s business

3. Which one of the following is an expansion of the documentation requirements for a compilation engagement under SSARS No. 19:
   a) documenting the understanding with the client
   b) documenting communications to the appropriate level of management regarding fraud or illegal acts
   c) documenting findings or issues that are significant
   d) documenting analytical procedures performed

4. Which of the following is a new element required for a compilation report under SSARS No. 19:
   a) state that the financial statements have been compiled
   b) specify the date or period covered by the financial statements
   c) have a report title
   d) state that the accountant’s responsibility is to conduct the compilation in accordance with SSARSs issued by the AICPA
5. Assume an accountant issues a compilation report covering comparative financial statements for the years ended December 31, 20X1 and 20X2, and the accountant lacks independence in both fiscal years. Which of the following is correct:

a) the accountant is required to disclose the reason(s) for the lack of independence in both years
b) the accountant may decide to disclose the reason(s) for lack of independence in one year and not disclose the reasons in the other year
c) the accountant is not allowed to disclose the reason(s) for the lack of independence in either year
d) the accountant is permitted to disclose the reason(s) for the lack of independence and if so, must disclose those reasons in both years or not at all

6. How should an accountant report when compiled financial statements are not expected to be used by a third party:

a) the accountant should issue a standard compilation report
b) the accountant should include a reference on each page of the financial statements restricting their use
c) the accountant should place a restriction in the engagement letter with no modification required in the report or financial statements
d) a modified compilation report is required with a paragraph that stipulates the limitation for third party use

7. Which of the following would be a reason why an accountant may wish to restrict the use of a compilation report:

a) the accountant wishes to limit his or her risk that misstatements may exist and be uncovered by third parties
b) the client wishes to keep information confidential
c) there is a potential risk that the report might be misunderstood
d) the client wants a lower cost compilation and has only one third party

8. Facts: An accountant becomes aware of information that relates to financial statements previously reported on but that was not known at the date of the report. What should the accountant do:

a) ignore it as it is not the responsibility of the accountant once the financial statements are issued
b) insist that the client revise the financial statements to reflect the information
c) consider the time elapsed since the financial statements were issued
d) contact all known third parties and demand that the financial statements be retrieved
9. An accountant is asked to change an engagement from a review to a compilation before the accountant completes the review engagement. If the accountant agrees to change the engagement to a compilation, which of the following actions is appropriate:

a) the compilation report should reference the original review engagement
b) the compilation report should identify the review procedures that were performed prior to converting to a compilation engagement
c) the accountant should perform the compilation engagement only if the cost to complete the original review engagement is insignificant
d) the accountant must comply with the standards for a compilation engagement
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Oral communication is not an option under SSARS No. 19.
   B: Correct. SSARS No. 19 requires the use of an engagement letter.
   C: Incorrect. The communication must be in writing.
   D: Incorrect. An engagement letter signed by the client must be used.
   (See page 20 of the course material.)

2. A: Incorrect. Analytical procedures are performed in a review engagement, not a compilation engagement.
   B: Incorrect. Inquiry is performed in a review engagement, not a compilation engagement.
   C: Incorrect. Confirmation is not required in a compilation engagement, but is typically a procedure for an audit.
   D: Correct. An accountant must understand the client’s business in performing a compilation engagement. That understanding includes understanding its organization, operating characteristics, and the nature of its assets, liabilities, revenues, and expenses.
   (See page 26 of the course material.)

3. A: Incorrect. Documenting the understanding with the client had previously existed and is not a new documentation requirement.
   B: Incorrect. Communications to the appropriate level of management regarding fraud or illegal acts was required prior to SSARS No. 19.
   C: Correct. Documenting findings or issues that are significant is a new requirement under SSARS No. 19.
   D: Incorrect. Analytical procedures are not a requirement for compilation engagements and certainly do not have to be documented.
   (See page 27 of the course material.)
4. A: Incorrect. There has always been a requirement to state that the financial statements have been compiled.

B: Incorrect. Prior to SSARS No. 19, the compilation report had to specify the date or period covered by the financial statements.

C: Correct. SSARS No. 19 requires that the compilation report have a title which was not a requirement previously.

D: Incorrect. Previously, the report stated that the accountant’s responsibility is to conduct the compilation in accordance with SSARSSs issued by the AICPA.

(See page 29 of the course material.)

5. A: Incorrect. The accountant is permitted, but not required to disclose the reason(s) for the lack of independence in either or both years.

B: Correct. The accountant may decide to disclose the reason(s) for lack of independence in one year and not disclose the reasons in the other year. Disclosure in both years is not required.

C: Incorrect. SSARS No. 19 allows the accountant to disclose the reason(s) for the lack of independence in either year or both years.

D: Incorrect. The accountant is permitted to disclose the reason(s) for the lack of independence but is not required to disclose it in both years or at all. Each year stands on its own.

(See pages 37 to 38 of the course material.)

6. A: Incorrect. A compilation report is not required.

B: Correct. The accountant should include a reference on each page of the financial statements restricting their use such as “Restricted for Management’s Use Only.”

C: Incorrect. Although the engagement letter should identify the third party limitation, there is a modification required to the financial statements with a reference on each page restricting the use of the financial statements.

D: Incorrect. A compilation report is not required in this situation.

(See page 39 of the course material.)
7. A: Incorrect. There is nothing found in the SSARSs that provides that the accountant may use a restricted use report to limit his or her risk that misstatements may exist and be uncovered by third parties.

B: Incorrect. Having a goal of keeping information confidential is not a reason for issuing a restricted use report.

C: Correct. One reason for issuing a restricted use report is the potential risk that the report might be misunderstood particularly when the subject matter is narrow and understood by a few individuals.

D: Incorrect. Because an accountant must perform the same amount of work for a restricted use versus a general use report, cost savings is not a factor to consider.

(See page 42 of the course material.)

8. A: Incorrect. The accountant cannot ignore the information even if the financial statements are issued.

B: Incorrect. The accountant should undertake to determine whether the information is reliable and whether the facts existed at the date of the report. Then, the accountant should discuss the matter with the client and request cooperation in whatever investigation may be necessary. Nothing requires the accountant to insist on revising the financial statements.

C: Correct. In making an appropriate determination as to what to do, the accountant should consider the time that has lapsed since the financial statements were issued. The longer the time, the less important the additional information becomes.

D: Incorrect. Only as a last resort would the accountant contact the third parties directly and only after other actions were taken.

(See pages 45 to 46 of the course material.)

9. A: Incorrect. The compilation report should not make reference to the original review engagement.

B: Incorrect. The compilation report should not identify the review procedures that were performed prior to converting to a compilation engagement.

C: Incorrect. The accountant should not perform the compilation if the cost to complete the original review engagement is insignificant.

D: Correct. To perform the compilation engagement, the accountant must comply with the standards for a compilation engagement.

(See page 50 of the course material.)
III. Review Engagements

Like compilation engagements, SSARS No. 19 makes several changes to the existing codification related to review engagements.

1. General Rules for Performing a Review Engagement:

An accountant is required to comply with the following rules whenever he or she has been engaged to review financial statements, except for reviews of interim financial information, if the following is true:

a. The entity's latest annual financial statements have been audited by the accountant or a predecessor.

b. The accountant has been engaged to audit the entity's current year financial statements, or the accountant audited the entity's latest annual financial statements and expects to be engaged to audit the current year financial statements.

c. The client prepares its interim financial information in accordance with the same financial reporting framework as the one used to prepare the annual financial statements.

An accountant is precluded from performing a review engagement if the accountant's independence is impaired for any reason.

Observation: In the exposure draft to SSARS No. 19, the ARSC had a proposed provision that would have allowed an accountant to perform a review engagement if his or her independence was impaired because the accountant performed nonattest services such as bookkeeping or writeup work.

2. Establishing an Understanding:

The accountant is required to establish an understanding with management regarding the services to be performed for a review engagement and must document that understanding through a written communication (engagement letter) with management.

An engagement letter with management and, if applicable, those charged with governance should include the following matters:

Required matters:

- The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
• Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

• Management is responsible to prevent and detect fraud.

• Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

• Management is responsible for making all financial records and related information available to the accountant.

• Management will provide the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

• The accountant is responsible for conducting the engagement in accordance with SSARSs issued by the AICPA.

• A review includes primarily applying analytical procedures to management’s financial data and making inquiries of company management.

• 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. A review does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion regarding the financial statements as a whole.

• The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

• The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant’s attention during the performance of review procedures that fraud or an illegal act may have occurred. The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

Other matters the accountant may wish to include in the letter:

• Fees and billings

• Any limitation of or other arrangements regarding the liability of the accountant or the client, such as indemnification to the accountant for liability arising from knowing misrepresentations to the accountant by management (regulators may restrict or prohibit such liability limitation arrangements)
• Conditions under which access to review documentation may be granted to others

• Additional services to be provided relating to regulatory requirements.

Other matters that should be addressed if applicable:

• Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.

• Reference to supplementary information.

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**Review Illustrative Engagement Letter**  
*(Exhibit A of SSARS No. 19)*

[Appropriate Salutation]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the financial statements of XYZ Company as of December 31, 20XX, and issue an accountant’s report thereon in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants (AICPA).

The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

You are responsible for:

a. The preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

c. Preventing and detecting fraud.

d. Identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

e. Making all financial records and related information available to us.
Providing us, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

We are responsible for conducting the engagement in accordance with SSARSSs issued by the AICPA.

A review includes primarily applying analytical procedures to your financial data and making inquiries of company management. 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. A review does not contemplate obtaining an understanding of the entity’s internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. Accordingly, we will not express an opinion regarding the financial statements as a whole.

Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our review procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

Our fees for these services . . . .

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[Signature of accountant]

Acknowledged:
XYZ Company

_______________________  _____________
President  Date

3. Performance Requirements – Review Engagement:

In performing a review engagement, an accountant is required to perform procedures designed to accumulate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made
to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework (e.g., GAAP, OCBOA, etc.).

*Review evidence* is a new term introduced by SSARS No. 19 and is defined as “information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.”

In obtaining review evidence, an accountant must perform the following procedures:

**Performance procedures:**

a. Understanding of the industry in which the client operates  
b. The accountant’s knowledge of the entity  
c. Understand *review risk*

**Review procedures:**

a. Analytical procedures  
b. Inquiries and other review procedures

**Understanding the industry:**

The accountant is required to possess an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry, sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed.

**Note:** The accountant is not precluded from accepting an engagement for a client in an industry in which the entity operates and for which the accountant has no previous experience. However, the accountant is required to obtain the necessary level of knowledge. The accountant may do so, for example, by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

**Knowledge of the client:**

The accountant is required to obtain knowledge about the client sufficient to assist the accountant with determining the specific nature, timing, and extent of review procedures to be performed. Such knowledge includes:

- An understanding of the client’s business  
- An understanding of the accounting principles and practices used by the client

In obtaining an understanding of the client’s business, the accountant should have a general understanding of the client’s organization; its operating characteristics; and the nature of its assets, liabilities, revenues, and expenses. The accountant’s understanding of an entity’s business is ordinarily obtained through experience with the entity or its industry and inquiry of the entity’s personnel.
The accountant should understand the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant may obtain an understanding of the accounting policies and procedures used by management through inquiry, the review of client prepared documents, or experience with the client.

In obtaining this understanding of the client's accounting policies and practices, the accountant should be alert to unusual accounting policies and procedures that come to the accountant’s attention as a result of his or her knowledge of the industry.

**Understand review risk:**

One of the performance requirements for a review engagement is that an accountant understand review risk. Review risk is the risk that the accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated.

The accountant is not required to perform risk assessment procedures as would be required in an audit.

**Observation:** In the final SSARS No. 19, the document includes a description of the concept of review risk but eliminated the specific term. The exposure draft explicitly mentioned “review risk.” In the final document, the definition of review risk is provided but the actual term is not included in that document.

**Review procedures:**

Based on the accountant’s performance procedures to gather review evidence (understanding of the industry, knowledge of the entity, and understanding review risk), the accountant is required to perform review procedures. In performing review procedures, the accountant should design and perform analytical procedures and inquiries and other review procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

**Note:** Review evidence obtained through the performance of analytical procedures and inquiry will ordinarily provide the accountant with a reasonable basis for obtaining limited assurance. However, the accountant should perform additional procedures if the accountant determines such procedures to be necessary to obtain limited assurance that the financial statements are not materially misstated.

a. The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of misstatements.

b. The results of the accountant’s analytical procedures and inquiries may modify the accountant’s risk awareness. For example, the response to an inquiry that cash has not been reconciled for several months may revise the accountant’s awareness of risks relative to the cash account.
Analytical procedures:

The accountant is required to understand financial and nonfinancial relationships in evaluating the results of analytical procedures. Generally such an understanding requires the accountant to have knowledge of the client and the industry in which the client operates.

An understanding of the purposes of analytical procedures and the limitations of those procedures also is important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the accountant.

1. Analytical procedures involve comparisons of expectations developed by the accountant to recorded amounts or ratios developed from recorded amounts.

2. The accountant is required to develop such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant’s understanding of the industry in which the client operates and knowledge of the client.

Examples of sources of information for developing expectations include:

a. Financial information for comparable prior period(s), giving consideration to known changes.

b. Anticipated results (for example, budgets or forecasts, including extrapolations from interim or annual data).

c. Relationships among elements of financial information within the period.

d. Information regarding the industry in which the client operates (for example, gross margin information).

e. Relationships of financial information with relevant nonfinancial information (for example, payroll costs to number of employees).

3. Analytical procedures may be performed at the financial statement level or at the detailed account level. The nature, timing, and extent of the analytical procedures are a matter of professional judgment.

4. If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the accountant should investigate these differences by inquiring of management and performing other procedures as necessary in the circumstances.

Note: Review evidence relevant to management’s responses may be obtained by evaluating those responses, taking into account the accountant’s understanding of the entity and its environment, along with other review evidence obtained during the course of the review. Although the accountant is not required to corroborate management’s responses with other evidence, the accountant may need to perform other procedures when, for example, management is unable to provide an
Inquiries and other review procedures:

The accountant is required to perform inquiries and other review procedures in obtaining review evidence. Such procedures include:

a. Inquire of members of management who have responsibility for financial and accounting matters concerning the following:

- Whether the financial statements have been prepared in conformity with the applicable financial reporting framework
- The entity’s accounting principles and practices and the methods followed in applying them and the entity’s procedures for recording, classifying, and summarizing transactions and accumulating information for disclosure in the financial statements
- Unusual or complex situations that may have an effect on the financial statements
- Significant transactions occurring or recognized near the end of the reporting period
- The status of uncorrected misstatements identified during the previous engagement
- Questions that have arisen in the course of applying the review procedures
- Events subsequent to the date of the financial statements that could have a material effect on the financial statements
- Their knowledge of any fraud or suspected fraud affecting the entity involving fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements (for example, communications received from employees, former employees, or others)
- Significant journal entries and other adjustments
- Communications from regulatory agencies

Note: In addition to members of management who have responsibility for financial and accounting matters, the accountant may determine to direct inquiries to others within the entity and those charged with governance, if appropriate.

b. Inquire concerning 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.
c. Read the financial statements to consider, on the basis of information coming to the accountant’s attention, whether the financial statements appear to conform to the applicable financial reporting framework.

d. Obtain reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees.

**Note:** The accountant ordinarily is not required to corroborate management’s responses with other evidence; however, the accountant should consider the reasonableness and consistency of management’s responses in light of the results of other review procedures and the accountant’s knowledge of the client’s business and the industry in which it operates.

4. **Incorrect, Incomplete, or Otherwise Unsatisfactory Information:**

If, during the performance of review procedures, the accountant becomes aware that information is incorrect, incomplete, or otherwise unsatisfactory, the accountant should request that management consider the effect of these matters on the financial statements. After such consideration, management should communicate the results to the accountant.

If the accountant believes the financial statements may be materially misstated, the accountant should perform additional procedures to obtain limited assurance that there are no material modifications required for the financial statements to be in conformity with the applicable financial reporting framework.

If the statements are materially misstated, the accountant should treat the misstatement as a departure from the applicable financial reporting framework.

5. **Management Representations:**

The accountant is required to obtain written representations from management for all financial statements and periods covered by the accountant’s review report.

a. If comparative financial statements are reported on, the representations should address all periods reported on, including the previous years.

b. If current management was not present during all periods covered by the accountant’s review report, the accountant should obtain written representations from current management for all such periods.

**Note:** If management was not present for a previous period, one way to deal with the issue is to include language “to the best of my knowledge and belief” in with the representations covering the previous period.

c. The accountant should request that management provide written representation for the following matters:
• Management’s acknowledgment of its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework

• Management’s belief that the financial statements are fairly presented in accordance with the applicable financial reporting framework

• Management’s acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements

• Management’s acknowledgement of its responsibility to prevent and detect fraud

• Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others

• Management’s full and truthful response to all inquiries

• Completeness of information

• Information concerning subsequent events

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**Review Engagement**

**Management Representation Letter**

*(Exhibit B of SSARS No. 19)*

[Date]2

To [the Accountant]

We are providing this letter in connection with your review of the [identification of financial statements] of [name of entity] as of [dates (for example, December 31, 20X1, and December 31, 20X2)] and for the [periods of review (for example, for the years then ended)] for the purpose of obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]. We confirm that we are responsible for the fair presentation of the financial statements in accordance with [the applicable financial reporting framework] and the selection and application of the accounting policies.

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2 The date should be the date the client presents and signs the representation letter. The letter should not be presented and signed prior to the date of the accountant’s review report.
Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person using the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, (as of [the date of the accountant’s review report]) the following representations made to you during your review:

1. The financial statements referred to previously are fairly presented in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

2. We have made the following available to you:
   a. financial records and related data.
   b. minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. No material transactions exist that have not been properly recorded in the accounting records underlying the financial statements.

4. We acknowledge our responsibility for the preparation and fair presentation of the financial statements in accordance with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)].

5. We acknowledge our responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

6. We acknowledge our responsibility to prevent and detect fraud.

7. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.

8. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.

9. No material losses exist (such as from obsolete inventory or purchase or sales commitments) that have not been properly accrued or disclosed in the financial statements.

10. None of the following exist:
    a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 450, Contingencies.³

³ If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

“We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Codification 450, Contingencies, and we have not consulted a lawyer concerning litigation, claims, or assessments.”
c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

11. The company has satisfactory title to all owned assets, and no liens or encumbrances on such assets exist, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.

12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

13. The following have been properly recorded or disclosed in the financial statements:
   a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
   b. Guarantees, whether written or oral, under which the company is contingently liable.
   c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the FASB ASC 275, Risks and Uncertainties. [Significant estimates are estimates at the balance sheet date that could change materially with the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

[Add additional representations that are unique to the entity’s business or industry.]

14. We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company’s accounts (if applicable).

15. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.4

16. We have responded fully and truthfully to all inquiries made to us by you during your review.

[Name of Owner or Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title, when applicable]

Note: Management’s representations within the representation letter should be made as of the date of the accountant’s review report. The accountant does not have to have physical receipt of the management representation letter as of the date of the accountant’s review report, provided that management has acknowledged that they will sign the representation letter without modification and it is received prior to the release of the report.

4 If the accountant dual dates the report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.
The representation letter should be addressed to the accountant and should be signed by those members of management whom the accountant believes are responsible for and knowledgeable about (directly or through others in the organization) the matters covered in the representation letter. Typically, the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter.

d. Updated representation letter:

In certain circumstances, the accountant should consider the need to obtain an updated representation letter. Examples of such circumstances include:

- There is a significant period of time between obtaining a representation letter and issuing the review report.

- A material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original representation letter.

- A predecessor accountant is requested to reissue the report for a prior period and those financial statements are to be presented on a comparative basis with reviewed statements of a subsequent period.

The updating management representation letter should state the following:

- Whether any information has come to management’s attention that would cause management to believe that any of the previous representations should be modified, and

- Whether any events have occurred subsequent to the balance sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.
**Review Engagement**  
**Updated Management Representation Letter**

[Date]⁵  
To [Accountant]

In connection with your review(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods of review] for the purpose of obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with [the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)], you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the accountant or date of previous representation letter] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

________________________________
[Name of Owner or Chief Executive Officer and Title]

________________________________
[Name of Chief Financial Officer and Title, when applicable]

**Note:** In the Updated Management Representation Letter noted above, management need not repeat all of the representations made in the original representation letter.

If matters exist that should be disclosed to the accountant, they may be indicated by listing them following the representation. For example, if an event subsequent to the date of the accountant's review report is disclosed in the financial statements, the final paragraph could be modified as follows: “To the best of our knowledge and belief, except as discussed in note X to the financial statements, no events have occurred…”

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⁵ The accountant has two methods available for dating the report when a subsequent event requiring disclosure occurs after the completion of the review, but before issuance of the report on the related financial statements. The accountant may use dual dating (for example, “February 16, 20XX, except for note Y, as to which the date is March 1, 20XX.”) or may date the report as of the later date.
6. Documentation Required in a Review Engagement:

Documentation prepared by an accountant in a review engagement should be sufficient to:

a. Provide the principal support for the representation in the accountant’s review report that the accountant performed the review in accordance with SSARSs

b. Provide the principal support for the conclusion that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework

Specific documentation should include:

• The engagement letter documenting the understanding with the client.

• The analytical procedures performed, including:
  - The expectations, when the expectations are not otherwise readily determinable from the documentation of the work performed, and the factors considered in the development of the expectations
  - Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts
  - Management’s responses to the accountant’s inquiries regarding fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount

• Any additional review procedures performed in response to significant unexpected differences arising from analytical procedures and the results of such additional procedures.

• The significant matters covered in the accountant’s inquiry procedures and the responses thereto. The accountant may document the matters covered by the accountant’s inquiry procedures and the responses thereto through a memorandum, checklist, or other means.

• Any findings or issues that, in the accountant’s judgment, are significant (for example, the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached). Significant unusual matters that the accountant considered during the performance of the review procedures, including their disposition.

• Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant’s attention.

• The representation letter.
Note: The accountant is not prevented from supporting the review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement files (e.g., compilation or nonattest services) or quality control files (for example, consultation files) and, in limited situations, oral explanations. Oral explanations on their own do not represent sufficient support for the work the accountant performed or conclusions the accountant reached but may be used by the accountant to clarify or explain information contained in the documentation.

7. Reporting on a Review of Financial Statements:

Report content:

Financial statements reviewed by an accountant should be accompanied by a written report the basic elements of which should include:

a. Title. The accountant’s review report should have a title that clearly indicates that it is the accountant’s review report and includes the word independent. An appropriate title would be:

   “Independent Accountant’s Review Report.”

b. Addressee. The accountant’s report should be addressed as required by the circumstances of the engagement.

c. Introductory paragraph. The introductory paragraph in the accountant’s report should:

   • Identify the entity whose financial statements have been reviewed
   • State that the financial statements have been reviewed
   • Identify the financial statements that have been reviewed
   • Specify the date or period covered by the financial statements
   • Include a statement that a review includes primarily applying analytical procedures to management’s (owners’) financial data and making inquiries of company management (owners), and
   • Include a statement that 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, and that, accordingly, the accountant does not express such an opinion.

d. Management’s responsibility for the financial statements. A statement that management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

e. Accountant’s responsibility. A statement that the accountant’s responsibility is to conduct the review in accordance with SSARSs issued by the AICPA.
• A statement that those standards require the accountant to perform the procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.

• A statement that the accountant believes that the results of his or her procedures provide a reasonable basis for his or her report.

f. *Results of engagement.* A statement that, based on his or her review, the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report.

g. *Signature of the accountant.* The manual or printed signature of the accounting firm or the accountant, as appropriate.

h. *Date of the accountant’s report.* The date of the review report (the accountant’s review report should not be dated earlier than the date on which the accountant has accumulated review evidence sufficient to provide a reasonable basis for concluding that the accountant has obtained limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework).

**Emphasis of a matter:**

An accountant may, but is not required to, emphasize in his or her report, a matter that is disclosed in the financial statements. The matter should be presented in a separate paragraph of the accountant’s review report.

a. Emphasis paragraphs are optional at the sole discretion of the accountant.

b. Examples of matters that the accountant may wish to emphasize include the following:

• Uncertainties
• That the entity is a component of a larger business enterprise
• That the entity has had significant transactions with related parties
• Unusually important subsequent events
• Accounting matters, exclusive of those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.
<table>
<thead>
<tr>
<th>Paragraph or Title</th>
<th>Previous Review Report</th>
<th>New Review- SSARS No. 19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title</td>
<td>None.</td>
<td>Must have a title and include the word “independent”, such as “Independent Accountant’s Review Report”</td>
</tr>
<tr>
<td>First</td>
<td>We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of XYZ Company.</td>
<td>I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. 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.</td>
</tr>
<tr>
<td>Second</td>
<td>None.</td>
<td>Management (Owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.</td>
</tr>
<tr>
<td>Third</td>
<td>A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.</td>
<td>My (Our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.</td>
</tr>
<tr>
<td>Fourth</td>
<td>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 conformity with generally accepted accounting principles.</td>
<td>Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.</td>
</tr>
</tbody>
</table>
Review report on OCBOA financial statements:

Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include the following:

a. A description of the OCBOA, including a summary of significant accounting policies and a description of the primary differences from GAAP. The effects of the differences need not be quantified.

b. Informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

Legend on financial statements:

Each page of the financial statements reviewed by the accountant should include a reference, such as:


Departures from the Applicable Financial Reporting Framework:

An accountant who is engaged to review financial statements may become aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements.

a. If an accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if the effects have been determined by management or are known due to the accountant’s procedures.

b. The accountant is not required to determine the effects of a departure if management has not done so, provided that the accountant states in the report that such determination has not been made.

c. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, the accountant should withdraw from the engagement, provide no further services with respect to those financial statements, and possibly consult with the accountant’s legal counsel.

What if the accountant is unable to perform the necessary inquiry and/or analytical procedures needed for a review engagement?

When the accountant is unable to perform the inquiry and analytical procedures he or she considers necessary to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework or the client does not provide the accountant with a representation letter, the review will be incomplete. A review that is incomplete does not provide an adequate basis for issuing a review report.
**Is an accountant permitted to issue a review report on one financial statement?**

Yes. The accountant may be asked to issue a review report on one financial statement, such as a balance sheet, and not on other related financial statements, such as the statements of income, retained earnings, and cash flows. The accountant may do so if the scope of his or her inquiry and analytical procedures has not been restricted.

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**Review Engagement**

**Standard Review Report**

**From Exhibit D of SSARS No. 19**

**Independent Accountant's Review Report**

*Appropriate Salutation*

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. 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 (Owners) is (are) 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 designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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

*Signature of accounting firm or accountant, as appropriate*

*Date*
Review Engagement
Standard Review Report
Income Tax Basis of Accounting
From Exhibit D of SSARS No. 19

Independent Accountant’s Review Report

[Appropriate Salutation]

I (We) have reviewed the accompanying statement of assets, liabilities, and equity – income tax basis of XYZ Company as of December 31, 20XX, and the related statement of revenue and expenses – income tax basis for the year then ended. 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 (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the income tax basis for accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provides a reasonable basis for our report.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis of accounting, as described in note X.

[Signature of accounting firm or accountant, as appropriate]

[Date]
Review Engagement
Illustrative Standard Review Report
GAAP Departure
From Exhibit D of SSARS No. 19

Independent Accountant’s Review Report

[Appropriate Salutation]

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. 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 (Owners) is (are) responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, with the exception of the matter(s) described in the following paragraph(s), 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 conformity with accounting principles generally accepted in the United States of America.

As disclosed in note X to the financial statements, accounting principles generally accepted in the United States of America require that inventory cost consist of material, labor, and overhead. Management has informed me (us) that the inventory of finished goods and work in process is stated in the accompanying financial statements at material and labor cost only, and that the effects of this departure from accounting principles generally accepted in the United States of America on financial position, results of operations, and cash flows have not been determined. or

As disclosed in note X to the financial statements, the company has adopted [description of newly adopted method], whereas it previously used [description of previous method]. Although the [description of newly adopted method] is in conformity with accounting principles as generally accepted in the United States of America, the company does not appear to have reasonable justification for making a change as required by Financial Accounting Standards Board Accounting Standards Codification 250, Accounting Changes and Error Corrections.

[Signature of accounting firm or accountant, as appropriate]     [Date]
Restricted use versus general use compilation report:

Accountant’s review reports are separated into two categories, general (unrestricted) use and restricted use, as follows:

**General (unrestricted) use:**
Applies to accountant’s reports that are not restricted to specified parties. Reports on financial statements that are prepared in conformity with an applicable financial reporting framework ordinarily are general (unrestricted) use.

An accountant is not precluded from restricting the use of any report even if the report would otherwise be general use.

**Restricted use:**
Restricted use reports are those reports intended only for one or more specified third parties. The restriction may be the result of numerous circumstances that include:

- The purpose of the report, and
- The potential risk that the report might be misunderstood when taken out of the context in which it was intended to be used.

a. When a report is issued on subject matter or a presentation based on a measurement or disclosure criteria contained in a contractual agreement or regulatory provisions that are not in conformity with an applicable financial reporting framework, the accountant should restrict the use of the report because:

- The basis, assumptions, or purpose of the presentations (contained in such an agreement or regulatory provisions) are developed for, and directed only to, the parties to the agreement or regulatory agency responsible for the provisions.
- The subject matter, or presentation may be misunderstood by those who are not adequately informed of the basis, assumptions, or purpose of the presentation.

b. If an accountant issues a single combined report covering both subject matter that requires a restriction on use to specified parties, and subject matter that ordinarily does not require a restriction (e.g., general use), the use of the single combined report should be restricted to the specified parties.

c. If, as required by law or regulation, a separate restricted use report is included in a document that also contains a general use report, the inclusion of a separate restricted use report in the document does not affect the intended use of either report. The restricted use report remains restricted for use, and the general use report continues to be unrestricted.

d. Subsequent to the completion of an engagement that has a restricted use report, the accountant may be asked to add other parties as specified parties. If this is the case, an accountant is permitted to add other parties provided the accountant:
1) Considers several factors that include:

- Identity of the other parties
- Their knowledge of the basis of the measurement or disclosure criteria
- The intended use of the report.

2) Obtains affirmative acknowledgment, preferably in writing, from the other parties as to their understanding of the nature of the engagement, and the measurement or disclosure criteria used in the engagement and related report.

**Note:** If the other parties are added after the accountant issues his or her report, the report may be reissued, or the accountant may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the accountant provides written acknowledgment that the other parties have been added as specified parties, the acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

e. **Report language – restricted use:**

The accountant’s report that is restricted should contain a separate paragraph at the end of the report that includes the following information:

- A statement indicating that the report is intended solely for the information and use of the specified parties.

- An identification of the specified parties to whom use is restricted. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

*How does an accountant guarantee that restricted use reports are not distributed by the client to parties beyond the specified parties?*

SSARS No. 19 states that in connection with a restricted use report, the accountant should consider informing his or her client that restricted use reports are not intended for distribution to nonspecified parties. The accountant is not precluded from reaching an understanding with the client that the intended use of the report will be restricted and from obtaining the client’s agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

The SSARS also states that the accountant is not responsible for controlling a client’s distribution of restricted use reports. A restricted use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.
8. Entity’s Ability to Continue as a Going Concern:

During the performance of a review engagement, an accountant may obtain information that indicates that an uncertainty may exist about an entity’s ability to continue as a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements).

In such circumstances, the accountant should take the following steps:

a. Request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for disclosure.

b. After management communicates to the accountant the results of its consideration of the possible effects on the financial statements, the accountant should consider the reasonableness of management’s conclusions, including the adequacy of the related disclosures, if applicable.

c. If the accountant determines that management’s conclusions are unreasonable or the disclosure of the uncertainty regarding the entity’s ability to continue as a going concern is not adequate, the accountant should follow the guidance of a departure from an applicable financial reporting framework.

d. The accountant may emphasize an uncertainty about an entity’s ability to continue as a going concern, provided that the uncertainty is also disclosed in the financial statements.

9. Subsequent Events:

A subsequent event may have a material effect on compiled financial statements and may come to the attention of the accountant in one of two ways:

   a. During the performance of compilation procedures, or

   b. Subsequent to the date of the accountant’s compilation report but prior to the release of the report.6

Regardless of the way in which the accountant discovers the subsequent event, the accountant should request that management consider the possible effects on the financial statements, including whether there is adequacy of disclosure.

If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or notes, the accountant should treat the transaction as a departure from GAAP, or other applicable financial reporting framework.

In addition, an accountant may wish to include an explanatory paragraph of a subsequent event in the report as an emphasis of a matter. The accountant may add an additional paragraph as long as the matter is also disclosed in the financial statements.

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6 If an accountant compiles financial statements with no report, the submission date of the compiled financial statements is the equivalent of the accountant’s compilation or review report date.
10. Subsequent Discovery of Facts Existing at the Date of the Review Report:

Subsequent to the date of the report on the reviewed financial statements, the accountant may becomes aware that facts may have existed at that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

SSARS No. 19 provides the following guidance in connection with such a situation:

a. **General rule**: The general rule is that after the date of the accountant’s review report, the accountant has no obligation to perform other compilation procedures with respect to the financial statements, unless new information comes to his or her attention.

b. **Exception to the general rule**: The exception is when the accountant becomes aware of information that relates to financial statements previously reported on by him or her but that was not known to the accountant at the date of the report (and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the compilation). In such a case, the accountant:

   - Should undertake to determine whether the information is reliable and whether the facts existed at the date of the report.
   - Should discuss the matter with the client at whatever management levels the accountant deems appropriate and request cooperation in whatever investigation may be necessary.
   - May choose to discuss the matter with those other than management including those parties charged with governance.
   - Should consider the time elapsed since the financial statements were issued.
   - May wish to consult with his or her legal counsel.

c. The accountant should obtain additional or revised information if the nature and effect of the matter are such that:

   - The accountant’s report or the financial statements would have been affected if the information had been known to the accountant at the accountant’s review report date and had not been reflected in the financial statements and
   - The accountant believes that persons are currently using or are likely to use the financial statements and those persons would attach importance to the information, the accountant should obtain additional or revised information.

d. When the accountant has concluded that action should be taken to prevent further use of the accountant’s report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts.
and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements.

When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances. The accountant should take whatever steps he or she considers necessary to satisfy himself or herself that the client has made the necessary disclosures, under the following guidance:

1) If the effect of the subsequently discovered information on the accountant’s report or the financial statements can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, when applicable, the accountant’s report.

- The reasons for the revision usually should be described in a note to the financial statements and, when applicable, referred to in the accountant’s report.

Note: In general, only the most recently issued reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

2) When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements, pursuant to subparagraph (1).

3) When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In such a situation, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of:

- The client notifying persons who are known to be using or who are likely to use the financial statements that the statements should not be used; that revised financial statements will be issued; and, when applicable, that the accountant’s report will be issued as soon as practicable.

e. If the client refuses to make the disclosures, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or those charged with governance, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as outlined subsequently to prevent further use of the financial statements and, if applicable, the accountant’s report.

Note: The steps that can appropriately be taken will depend upon the degree of certainty of the accountant’s knowledge that persons exist who are currently using or who will use the financial statements and, if applicable, the accountant’s report and who would attach importance to the information and the accountant’s ability as a practical matter to communicate with them. Unless the accountant’s attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:
1) Notify the client that the accountant’s report must no longer be associated with the financial statements.

2) Notify the regulatory agencies having jurisdiction over the client that the accountant’s report should no longer be used.

3) Notify each person known to the accountant to be using the financial statements that the financial statements and the accountant’s report should no longer be used.

**Note:** In most situations, it will not be practicable for the accountant to give appropriate individual notification to all persons. For example, it may be difficult to notify all stakeholders whose identities ordinarily are unknown to the accountant.

Instead, notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

f. **Details on required disclosure:** The content of any disclosure of information subsequently discovered to persons other than the accountant’s client should follow these guidelines:

1) The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

2) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose of the disclosure.

**Note:** The disclosure should not include any comments concerning the conduct or motives of any person. If the client has not cooperated, the accountant’s disclosure need not detail the specific information but can merely indicate that the client has not cooperated with the accountant’s attempt to substantiate information that has come to the accountant’s attention and that, if the information is true, the accountant believes that the review report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant’s review report should not be used.

11. **Supplementary Information – Review Engagement:**

When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to such information.

When the accountant has reviewed the basic financial statements, an explanation should be included in the review report or in a separate report on the other data. The report should state that the review has been made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial
statements in order for them to be in conformity with the applicable financial reporting framework and that either:

a. The other data accompanying the financial statements are presented only for purposes of additional analysis and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or

b. The other data accompanying the financial statements are presented only for purposes of additional analysis and have not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or provide any assurance on such data.

12. Communicating to Management and Others:

If an accountant obtains evidence or other information during his or her performance of review procedures that fraud or an illegal act may have occurred, that matter should be brought to the attention of the appropriate level of management using the following rules:

a. The accountant is not required to report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

b. When such fraud or an illegal act involves senior management, the accountant should report the matter (either orally or in writing) to an individual or group at a higher level within the entity, such as the manager (owner) or those charged with governance.

1) Any communication that is done orally should be documented by the accountant.

c. When such fraud or an illegal act involves an owner of the business, the accountant should consider resigning from the engagement.

Note: There may be instances where there are potential conflicts between the accountant’s ethical and legal obligations for confidentiality of client matters. In such circumstances, the accountant may wish to consult with legal counsel before discussing matters involving fraud or illegal acts with parties outside the client.

d. An accountant should consult with his or her legal counsel whenever any evidence or information comes to his or her attention during a review engagement that fraud or an illegal act may have occurred, unless an illegal act is clearly inconsequential.

e. The accountant is not required to disclose any evidence or information about a fraud or illegal act to parties other than the client’s senior management (or those charged with governance).
However, in the following instances, a duty may exist for the accountant to disclose to parties outside of the entity:

- To comply with certain legal and regulatory requirements.
- To a successor accountant when the successor decides to communicate with the predecessor accountant regarding acceptance of the engagement to compile or review the financial statements of a nonissuer.
- In response to a subpoena.

13. Change in an Engagement from an Audit to a Review:

There may be instances in which an accountant, who has been engaged to audit financial statements, before the completion of the audit, is asked to change the engagement to a review.

a. There may be numerous reasons for the change in the engagement, whether imposed by the client or by circumstances, as follows:

- There may be a change in circumstances affecting the entity’s requirement for an audit,
- There could be a misunderstanding as to the nature of the type of engagement, or
- There might be a restriction on the scope of an audit.

**Note:** A change in circumstances that affects the entity’s requirement for an audit, or a misunderstanding concerning the nature of an audit would ordinarily be considered a reasonable basis for requesting a change in the engagement.

Before an accountant agrees to change the engagement to a review, the accountant should consider all of the following issues:

- The reason given for the client’s request and its implications of a restriction on the scope of the audit, whether imposed by the client or by circumstances
- The additional audit effort required to complete the audit
- The estimated additional cost to complete the audit.

b. If the audit procedures are substantially complete, or the cost to complete such procedures is relatively insignificant, the accountant should consider whether it is appropriate to accept a change in the engagement to a review.

**Note:** The accountant should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. When an accountant has been engaged to review an entity’s financial statements the accountant typically would be precluded from issuing a review report if:
• The accountant has been prohibited by the client from corresponding with the entity’s legal counsel, or

• The client does not provide the accountant with a signed representation letter.

c. If the accountant concludes that reasonable justification exists to change the engagement to a review, and if the accountant complies with the standards for a review engagement, the accountant should issue a review report.

The report should not reference:

1) The original audit engagement, or

2) Any audit procedures that may have been performed.

14. Effective Date and Implementation:

SSARS No. 19 is effective for compilation and review engagements for periods ending on or after December 15, 2010. Early application is permitted with respect to the lack of independence disclosure provision for compilation engagements.

1. Transition for lack of independence provision for compilation engagements:

Early application of SSARS No. 19 is not permitted except with respect to the lack of independence provision related to compilation engagements.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. In performing a review engagement, an accountant is not required to perform which of the following procedures:
   a) understand the industry in which the client operates
   b) have knowledge of the entity
   c) perform analytical procedures
   d) perform a fraud risk assessment

2. In performing analytical procedures, an accountant should compare ______ to ______.
   a) budgeted amounts, prior period’s amounts
   b) expected amounts, recorded amounts
   c) budgeted amounts, computed amounts
   d) estimated amounts, budgeted amounts

3. In obtaining a management representation letter for a review engagement for comparative financial statements, the representations should address:
   a) only the current period
   b) both periods
   c) the current period with limited representations for the prior period
   d) either the current period or both periods at the option of the accountant

4. Which of the following would be an example of circumstances in which an accountant may wish to obtain an updated representation letter in a review engagement:
   a) there is a short period of time between obtaining a representation letter and issuing the review report
   b) a predecessor account is requested to reissue the report for a prior period
   c) management changes after the review engagement is completed
   d) a material subsequent event occurs after the report is released
5. In performing a review engagement, which of the following is correct as it relates to oral inquiries received from management:

   a) oral explanations do represent sufficient support for the work the accountant performed
   b) oral explanations, if received from upper management, carry sufficient weight for the accountant to rely on them as sufficient support for the work the accountant performed
   c) oral explanations do not represent sufficient support for the work the accountant performed or conclusions reached but may be used to clarify or explain information
   d) oral explanations carry no value unless accompanied by written documentation to carry any weight

6. Which of the following would be an appropriate title for an accountant’s review report:

   a) Accountant’s Review Report
   b) Review Report
   c) Independent Accountant’s Review Report
   d) Accountant’s Report

7. One important change to the content of the accountant’s review report is:

   a) the revised report now states that the financial statements are the representation of management
   b) the revised report removes the limited assurance language
   c) the revised report includes management’s responsibility for the preparation of the financial statements
   d) the revised report removes a title

8. If there is a restricted use report, what action might the accountant perform to guarantee that the report is not distributed by the client to parties beyond the specified parties:

   a) consider communicating with all of the specified parties
   b) consider informing the client about the restricted distribution
   c) audit the distribution list to ensure that there is no unauthorized distribution
   d) make sure there is sufficient language in the report noting the restriction

9. An accountant is permitted to emphasize an uncertainty about an entity’s ability to continue as a going concern in the review report provided:

   a) certain codified language is included in the report
   b) the uncertainty is also disclosed in the notes to financial statements
   c) the uncertainty expires within one year of the balance sheet date
   d) a review report is issued and not a compilation report
10. With respect to subsequent events, the general rule is that after the date of the accountant's review report, the accountant:

   a) must perform review procedures up to the date on which the report is released
   b) has no obligation to perform other procedures unless new information comes to his or her attention
   c) must perform review procedures after the report is released if additional information comes to the accountant's attention
   d) has no obligation to perform other procedures

11. Which of the following acts is an accountant not required to report:

   a) fraud that is inconsequential
   b) illegal acts that are inconsequential
   c) illegal acts that are consequential
   d) fraud that is consequential
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. An accountant is required to obtain an understanding of the industry in which the client operates.

   B: Incorrect. An accountant is required to have knowledge of the entity in performing a review engagement.

   C: Incorrect. An accountant must perform analytical procedures in a review engagement.

   D: Correct. An accountant is not required to perform a fraud risk assessment in a review engagement. That procedure is required in an audit.

   (See page 61 of the course material.)

2. A: Incorrect. Comparing budgeted amounts to prior period’s amounts is generally not part of the analytical procedures.

   B: Correct. The accountant should compare expected amounts with recorded amounts.

   C: Incorrect. Comparing budgeted amounts to computed amounts does not assist the accountant in dealing with the current year recorded amounts.

   D: Incorrect. Comparing estimated amounts with budgeted amounts does not address the current recorded amounts.

   (See page 63 of the course material.)

3. A: Incorrect. The representations should cover both periods and not only the current period.

   B: Correct. The accountant is required to obtain written representations from management for all financial statements and periods covered by the accountant’s review report.

   C: Incorrect. There is no provision dealing with limited representations. Both periods have the same amount of representations.

   D: Incorrect. The accountant does not have the choice between either the current period or both periods. If the report covers two periods, the representations should cover those same two periods.

   (See page 65 of the course material.)
4. A: Incorrect. An example would be where there is a significant period of time between obtaining a representation letter and issuing the review report.

**B: Correct.** An updated representation letter may be needed where a predecessor account is requested to reissue the report for a prior period and the financial statements are to be presented on a comparative basis with reviewed statements of a subsequent period.

C: Incorrect. The fact that management changes after the review engagement is completed is not a situation in which an updated letter would be needed.

D: Incorrect. A material subsequent event that occurs after the completion of inquiry and analytical procedures, but before the report is released, might warrant an updated letter.

(See page 69 of the course material.)

5. A: Incorrect. SSARS No. 19 states that oral explanations do not, by themselves, represent sufficient support for the work the accountant performed.

B: Incorrect. The fact that oral explanations are received from upper management has no impact on the weight of the information.

**C: Correct.** Oral explanations, on their own, do not represent sufficient support for the work the accountant performed or conclusions reached but may be used to clarify or explain information.

D: Incorrect. Oral explanations do carry some value in that they can be used to help the accountant clarify and explain information that is contained in the documentation.

(See page 72 of the course material.)

6. A: Incorrect. The title must have the word independent in it.

B: Incorrect. The report must not only indicate that it is the accountant’s report but also have the word “independent.”

**C: Correct.** The term “Independent Accountant’s Review Report” is the appropriate title that references the word “accountant” and “independent.”

D: Incorrect. The report must reference that it is a review report and must have the word “independent.”

(See page 72 of the course material.)

B: Incorrect. There is no change in the limited assurance language.

C: Correct. The revised report now includes language about management’s responsibility for the preparation and fair presentation of the financial statements.

D: Incorrect. The revised report now includes a title.

(See page 74 of the course material.)

8. A: Incorrect. The goal of finding unauthorized parties is not achieved by communicating with all of the specified parties.

B: Correct. Although there is no guaranteed way to restrict use, the accountant should consider informing the client about the restricted distribution.

C: Incorrect. The accountant is not responsible for controlling a client’s distribution of restricted use reports and has no requirement to audit the distribution.

D: Incorrect. Simply making sure there is sufficient language in the report noting the restriction is not going to ensure that the report is not distributed. All this action will do is let the parties know that it is restricted.

(See page 80 of the course material.)

9. A: Incorrect. SSARS No. 19 does not require certain codified language to be included in the report.

B: Correct. In order to emphasize an uncertainty in a review report, SSARS No. 19 requires that there also be a disclosure in the notes to financial statements.

C: Incorrect. SSARS No. 19 does not have a one-year provision with respect to the ability to emphasize an uncertainty.

D: Incorrect. The rules do not differentiate between a review and compilation report as long as the uncertainty is also disclosed in the notes.

(See page 81 of the course material.)
10. A: Incorrect. There is no obligation to perform review procedures up to the date on which the report is released.

B: Correct. The accountant has no obligation to perform other procedures after the date of the accountant’s review report, unless new information comes to his or her attention.

C: Incorrect. Once the report is released, the accountant has no obligation to perform review procedures.

D: Incorrect. There is no obligation to perform other procedures unless new information comes to the accountant’s attention.

(See page 82 of the course material.)

11. A: Incorrect. All fraud must be reported by the accountant even if it is inconsequential.

B: Correct. The accountant is not required to report illegal acts that are inconsequential.

C: Incorrect. Illegal acts that are consequential must be reported.

D: Incorrect. All fraud must be reported.

(See page 85 of the course material.)
CHAPTER 8

New Auditing Standards
and Other Auditing Developments
# New Auditing Standards and Other Auditing Developments

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New Auditing Standards and Other Auditing Developments

I. Newly Issued Auditing Standards

SAS No. 115: Communicating Internal Control Related Matters Identified in an Audit

Issued: October 2008

Effective date: This Statement is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

Objective: SAS No. 115 replaces SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit, which was issued in 2006. The SAS establishes standards and provides guidance on communicating matters related to an entity’s internal control over financial reporting identified in an audit of financial statements.

SAS No. 115 applies whenever an auditor expresses an opinion on financial statements, including a disclaimer of opinion. Specifically, SAS No. 115 does the following:

a. Defines the terms deficiency in internal control, significant deficiency and material weakness,

b. Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements, and

c. Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

Previously, when SAS No. 112 was issued, it replaced SAS No. 60, Communication of Internal Control Related Matters Noted in an Audit, which used the term reportable conditions as a benchmark of communicating internal control related matters. In general, SAS No. 115 retains most of the provisions found in its predecessor, SAS No. 112.

The primary differences between SAS No. 115 and SAS No. 112 are that SAS No. 115:

- Changes the definitions of significant deficiencies and material weaknesses,
- Changes the process used to make the determination of whether a deficiency rises to the level of significant deficiency or material weakness,
- Revises the list of deficiencies in internal control that are indicators of material weaknesses, and
- Contains a revised illustrative written communication to management and those charged with governance of material weaknesses and significant deficiencies.

Following is a table that compares the key changes in definitions found in SAS No. 115 versus SAS No. 112.
### Comparison of Terms Found in SAS No. 115 Versus SAS No. 112

<table>
<thead>
<tr>
<th>Old SAS No. 112</th>
<th>New SAS No. 115</th>
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<tr>
<td><strong>Control deficiency:</strong> Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis</td>
<td><strong>Deficiency in internal control:</strong> Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions to prevent or detect and correct misstatements on a timely basis</td>
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<td><strong>Significant deficiency:</strong> A significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected</td>
<td><strong>Significant deficiency:</strong> A deficiency or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance</td>
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<td><strong>Material weakness:</strong> A control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a material misstatement of the entity’s financial statements is inconsequential and will not be prevented or detected</td>
<td><strong>Material weakness:</strong> A deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented or detected and corrected on a timely basis</td>
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<tr>
<td>Provides a list of deficiencies in internal control that are indicators of significant deficiencies and material weakness</td>
<td>Provides a revised list of deficiencies in internal control that are indicators of material weaknesses. Eliminates the list of deficiencies that would ordinarily be considered significant deficiencies</td>
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<td>Provides the auditor with less flexibility in using professional judgment in identifying significant deficiencies</td>
<td>Provides the auditor with more flexibility to use professional judgment in identifying significant deficiencies</td>
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<tr>
<td>Provides an illustrative written communication</td>
<td>Provides a revised illustrative written communication</td>
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The SAS is not applicable if the auditor is engaged to report on the effectiveness of an entity’s internal control over financial reporting under the SSAEs per AT section 501, *An Examination of an Entity’s Internal Control over Financial Reporting*.

**Observation:** SAS No. 115 represents another example of where the non-public sector has been impacted by Sarbanes-Oxley. In 2007, the Public Company Accounting Oversight Board (PCAOB) issued AS5, *An Audit of Internal Control Over Financial Reporting that Is Integrated with an Audit of Financial Statements*. AS5, which applies only to audits of SEC companies, redefines the definitions for “significant deficiencies” and “material weaknesses” in internal controls in accordance with the requirements of Sarbanes-Oxley. In issuing SAS No. 115, the Auditing Standards Board adopted the AS5 definitions of significant deficiencies and material weaknesses.
Requirements:

1. In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of deficiencies in internal control while performing certain functions that include:

   - Obtaining an understanding of the entity and its environment, including its internal control,
   - Assessing the risks of material misstatement due to error or fraud,
   - Performing further audit procedures to respond to assessed risks,
   - Communicating with management or others (for example, internal auditors or governmental authorities), or otherwise.

   The auditor’s awareness of deficiencies in internal control varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

2. Following are terms used within SAS No. 115 related to internal control:

   a. **Deficiency**: least severe weakness in internal control
   b. **Significant deficiency**: next level of weakness in internal control
   c. **Material weakness**: most severe weakness in internal control

3. A deficiency may be considered just a deficiency, or more severe referred to as a significant deficiency or a material weakness.

   a. A **deficiency** can exist in either the design or operation of an internal control.

   - A **deficiency in design** exists when:
     - A control necessary to meet the control objective is missing, or
     - An existing control is not properly designed so that even if the control operates as designed, the control objective would not be met.

   - A **deficiency in operations** exists when:
     - A properly designed control does not operate as designed, or
     - The person performing the control does not possess the necessary authority or competence to perform the control effectively.

   b. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

   **Note:** SAS No. 115 does not provide much guidance or examples as to what rises to the level of a significant deficiency. Instead, a significant deficiency is defined as a deficiency that is not a material weakness.
c. A **material weakness** is a deficiency, or combination of deficiencies, in internal control, such that there is a **reasonable possibility**\(^1\) that a **material misstatement** of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

Consider the following chart:

<table>
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<th>Probability of a misstatement</th>
<th>Extent of financial statement misstatement that could occur</th>
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<tr>
<td></td>
<td>Immaterial</td>
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<tr>
<td>Reasonably possible</td>
<td>Material weakness – no Significant deficiency – maybe (1)</td>
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(1) In assessing whether a deficiency is a significant deficiency, the driving factor is whether the deficiency is important enough to merit attention by those charged with governance.

(2) A material weakness must satisfy both the material misstatement and the reasonably possible thresholds.

**Observation:** In order for a deficiency to be elevated to a material weakness, two elements must be present in a deficiency. First, it must meet the reasonable possibility threshold in that it is reasonably possible that a misstatement of the entity’s financial statements will not be prevented, detected and corrected timely. Second, the misstatement must be material to the financial statements. If both the reasonably possible and material thresholds are not met, the deficiency will not be elevated to being a material weakness, but it could be a significant deficiency.

For example, if it is reasonably possible that an immaterial misstatement could occur, or it is remote that a material misstatement could occur, the deficiency could rise to being a significant deficiency, but not a material weakness.

Therefore, in categorizing a deficiency, the first step is to ask whether the deficiency is a material weakness (e.g., does it meet the reasonably possible and material misstatement thresholds). If yes, it is a material weakness. If not, then the next question is whether the deficiency is a significant deficiency. In assessing whether a deficiency is a significant deficiency, a more qualitative look has to be done. The key factor in evaluating whether a deficiency is a significant deficiency is whether it is “important enough to merit attention by those charged with governance.”

**What if a deficiency has already occurred and been detected as part of the audit?**

If a misstatement has been discovered as part of the audit, the reasonably possible threshold is moot since it already occurred. The only threshold that needs to be

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\(^1\) The term “reasonably possible” is based on the meaning as defined in FASB No. 5, *Accounting for Contingencies*. In general, that definition provides that reasonably possible means that the chance of a future event occurring is more than remote but less than likely.
assessed is whether the deficiency (misstatement) that was discovered was material to the financial statements. If material, the deficiency is a material weakness. If not material, the deficiency "may" be a significant deficiency if the auditor determines that the issue is important enough to merit attention by those charged with governance.

**What if fraud is discovered?**

The SAS makes an exception to the materiality threshold in the case of fraud committed by senior management. If a fraud is committed by senior management, whether or not material, that event is considered a material weakness. If the fraud is performed by parties other than senior management, the fraud is a deficiency that would be considered a material weakness only if it resulted in a material misstatement.

3. **Evaluating deficiencies identified as part of the audit**

   a. The auditor should evaluate the severity of each deficiency in internal control identified during the audit to determine whether the deficiency, individually or in combination, is a significant deficiency or a material weakness.

   b. The severity of a deficiency (whether a significant deficiency or a material weakness) depends on various factors such as:

      - **Materiality threshold**: the magnitude of the potential misstatement resulting from the deficiency or deficiencies, and
      - **Reasonably possible threshold**: whether there is a reasonable possibility that the entity’s controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure.

      **Note**: The severity of a deficiency does not depend on whether a misstatement actually occurred. For example, if an auditor identifies a deficiency that has not resulted in a misstatement due to the deficiency, that fact does not necessarily mean that the deficiency is not a significant deficiency or a material weakness. Instead, the auditor should consider the impact that the deficiency could have on misstatements not identified related to the audited financial statements.

   c. **Materiality threshold**: In evaluating the magnitude (materiality) of the potential misstatement, the maximum, amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger.

      Factors that affect the magnitude of a misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

      - The financial statement amounts or total of transactions exposed to the deficiency, and
      - The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.
d. **Reasonably possible threshold**: Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved,
- The susceptibility of the related asset or liability to loss or fraud,
- The subjectivity, complexity, or extent of judgment required to determine the amount involved,
- The interaction or relationship of the control with other controls,
- The interaction among the deficiencies, and
- The possible future consequences of the deficiency.

**Note**: The evaluation of whether a deficiency presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases the probability of a small misstatement will be greater than the probability of a large misstatement.

Multiple deficiencies that affect the same significant account or disclosure, relevant assertion or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a significant deficiency or a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a significant deficiency or a material weakness.

e. **Existence of compensating controls**: There may be instances in which there is a deficiency, the risk of which is mitigated by the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or a material weakness.

Although the auditor is not required to consider the effects of compensating controls, the auditor may consider the effects of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but do not eliminate the deficiency itself.

**Example**: An auditor discovers that there is a poor segregation of duties within a small business accounting department so that the same person reconciles cash and writes checks for payment to vendors. The auditor discovers that there is a compensating control in effect in that the sole shareholder-officer reviews all supporting documentation related to all checks, signs all checks personally, and receives all bank statements directly from the bank for his review prior to giving them to the accountant who reconciles the cash.

**Conclusion**: Although there is a deficiency in internal control in that there is a poor segregation of duties, the auditor may conclude that the compensating
controls (the shareholder-officer’s mitigating procedures) are enough to conclude that the deficiency does not rise to the level of being a significant deficiency or a material weakness. However, in order to rely on the operating effectiveness of the controls, the auditor must test the controls’ effectiveness. The compensating controls do not eliminate the fact that there is still a deficiency in internal control.

f. Examples of indicators of material weaknesses in internal control include any of the following:

- Identification of fraud, committed by senior management, whether or not material,
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud,
- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity’s internal control, and
- Ineffective oversight of the entity’s financial reporting and internal control by those charged with governance.

Note: If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

Although the SAS does not define the term “prudent officials,” the term appears to be synonymous with the “reasonable person” threshold used in common law. In this case, the auditor should ask himself or herself whether another auditor, with knowledge of the same facts, would reach the same conclusion that the deficiency is not a material weakness.

Observation: Notice that the SAS provides examples of deficiencies that might be considered material weaknesses but does not provide a similar list of those that might be considered significant deficiencies. Remember that the revised definition of a significant deficiency found in SAS No. 115 states that a significant deficiency is a deficiency that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. Absent examples of significant deficiencies, auditors that conclude that a deficiency is not a material weakness have the burden of having to decide whether that deficiency is a significant deficiency or not.

4. Examples of Circumstances That May Be Deficiencies, Significant Deficiencies, or Material Weaknesses

The Appendix to SAS No. 115 provides examples of circumstances in which a deficiency may be elevated to a significant deficiency or material weakness. Below is the list of examples from SAS No. 115:
Deficiencies in the design of controls:

- Inadequate design of internal control over the preparation of the financial statements being audited
- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the components of internal control
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting)
- Inadequate design of information technology general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs
- Employees or management who lack the qualifications and training to fulfill their assigned functions
  
  Example: If an entity prepares financial statements in accordance with GAAP, the person responsible lacks skills and knowledge to apply GAAP in recording the entity’s financial transactions or preparing its financial statements
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity’s internal control over time
- The absence of an internal process to report deficiencies in internal control to management on a timely basis

Failures in the operation of internal control:

- Failure in the operation of effectively designed controls over a significant account or process. Example: The failure of a control such as dual authorization for significant disbursements within the purchasing process
- Failure of the information and communication component of the internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy. Example: The failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation
• Failure to perform reconciliations of significant accounts on a timely basis, such as a receivable or payable subsidiary ledger not being reconciled to the general ledger account in a timely or accurate manner

• Undue bias or lack of objectivity by those responsible for accounting decisions such as a consistent understatement of expenses and overstatement of allowances at the direction of management

• Misrepresentation by client personnel to the auditor, which may be an indicator of fraud

• Management override of controls

• Failure of an application control caused by a deficiency in the design or operation of an IT general control

Example: An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. Example: An auditor designs a test in which he or she selects a sample and expects no deviations. The finding of one deviation is a non-negligible deviation rate because, based on the results of the auditor’s test of the sample, the desired level of confidence was not obtained.

Note: The above are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

Source: Exhibit B of SAS No. 115.

Observation: The above list does not categorize the examples into thresholds such as those that are deficiencies, significant deficiencies and those that are material weaknesses. By not providing such guidance, the auditor must apply much greater professional judgment than he or she had to apply under the previously issued SAS No. 112.

The above list provides some challenges for auditors of smaller companies. The Auditing Standards Board has stated that deficiencies in internal control that rise to the level of being a material weakness may include:

1. Employees or management who lack the qualifications and training to fulfill their assigned functions, such as the inability of a bookkeeper or internal accountant to prepare financial statements under GAAP,

2. Failure to perform reconciliations of significant accounts on a timely basis, such as a receivable or payable subsidiary ledger not being reconciled to the general ledger account in a timely or accurate manner, and

3. Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
Many, if not most, small businesses have weaknesses in their internal control that would require significant additional cost to rectify.

Examples include:

- A bookkeeper or internal accountant who does not have the expertise or competency to prepare GAAP (or OCBOA) financial statements and related notes,
- A bookkeeper who does not regularly reconcile subsidiary accounts (e.g., accounts receivable or accounts payable) to the general ledger,
- A poor segregation of duties in the accounting function that can only be rectified by hiring more accounting personnel at significant cost, and
- A weak safeguarding of assets such as not maintaining a perpetual inventory during the year or not using pre-numbered inventory tags during a physical inventory.

For many small businesses, the shareholders-officers are not likely to spend the additional funds to correct the above-noted deficiencies. Yet, if the risk of loss is high enough that it is reasonably possible that there could be a material misstatement to the financial statements, the auditor may have to consider any of the above deficiencies to be a material weakness that must be communicated.

What if there are compensating controls that mitigate the risks from the deficiencies?

Such a deficiency as one noted in the previous example may not be elevated to a material weakness or significant deficiency if the auditor can identify and test a compensating control that mitigates the risk associated with the deficiency.

If an auditor can identify a compensating control that mitigates the risk of material misstatement from the deficiency, the auditor can test the effectiveness of the control, make sure it is working as expected, and conclude that the deficiency has not risen to the level of being a significant deficiency or material weakness. Thus, there is a deficiency but no reporting required because it is not considered a significant deficiency or material weakness.

Example: A company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting.

Conclusion: Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Because the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control (such as not having inventory tags) will not result in a significant deficiency or material weakness if the detective control (physical inventory observation) prevents a misstatement of the financial statements.

A material weakness relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct a material misstatement of the financial statements.
5. Communications:

An auditor is required to communicate significant deficiencies and material weaknesses, in writing, to management and those charged with governance as a part of each audit.

a. The written communication of significant deficiencies and material weaknesses is best made by the Report Release Date, which is the date the auditor grants the entity permission to use the auditor’s report in connection with the financial statements, but should be made no later than 60 days following the Report Release Date.

b. The communication shall include significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

c. For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, the auditor may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies and material weaknesses should ultimately be included in a written communication, even if such significant deficiencies or material weaknesses were remediated during the audit.

d. The auditor’s responsibility to communicate significant deficiencies and material weaknesses exists regardless of whether the existence of significant deficiencies or material weaknesses may already be known to management.

Note: In some cases, management may have chosen not to rectify an identified significant deficiency or material weakness and instead, to make a conscious decision to accept the risk associated with the deficiencies because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. Even if management knows about the deficiency or material weakness and has not corrected it, the auditor must continue to communicate the significant deficiency or material weakness.

e. The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include:

- A statement that indicates the purpose of the auditor’s consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity’s internal control,
- A statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control,

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2 See paragraph 23 of AU section 339, Audit Documentation, AICPA, Professional Standards, vol. 1 for additional guidance related to the report release date.
A statement that indicates that the auditor’s consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses,

The definition of the term material weakness and, where relevant, the definition of the term significant deficiency,

A statement that identifies the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses, and

A statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity’s internal control. For example, the auditor may communicate:

- Matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls, and
- Deficiencies that are not significant deficiencies or material weaknesses.

**Note:** If other matters are communicated orally, the auditor should document the communication. The auditor may include additional statements in the communications regarding the general inherent limitations of internal control, including the possibility of management override of controls, or the specific nature and extent of the auditor’s consideration of internal control during the audit.

g. Management or those charged with governance may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements.

The general rules follow:

- An auditor may, but is not required to, issue a communication indicating that there were no material weaknesses identified during the audit.

- An auditor is **not permitted** to issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such communication.

**Note:** Management may wish to, or may be required by a regulator to, prepare a written response to the auditor’s communication regarding significant deficiencies or material weaknesses identified during the audit. Such management communications may include a description of corrective actions taken by the entity, the entity’s plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material
weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor’s written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor may add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph:

ABC Company’s written response to the significant deficiencies [and material weaknesses] identified in our audit was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

6. Effective Date:

This SAS is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

7. Examples:

SAS No. 115 provides no concrete examples of situations in which an auditor may conclude that a deficiency is a significant deficiency or material weakness. In its non-authoritative guide, Communicating Internal Control Related Matters in an Audit – Understanding SAS No. 115 (the Guide), the AICPA provides several case studies that illustrate the methodology that an auditor should follow in evaluating deficiencies in internal control.

In this section, the author presents several examples that illustrate the application of SAS No. 115. Some of these examples are based on the facts offered in the AICPA case studies within the Guide. The author has modified the facts and some of the conclusions reached which may differ from those found in the Guide.

Example 1: Deficiency in Internal Control: Lack of Segregation of Duties

Facts:
1. Company X is a small closely held business that has one bookkeeper in charge of its accounting and reporting functions.
2. By definition, there is a poor segregation of duties (which is a deficiency in internal control) as the bookkeeper performs all significant accounting and bookkeeping functions.
3. Even though there is a poor segregation of duties, X has several compensating controls in place. Harry, the 100% shareholder, sole board member and president performs the following compensating control functions:
   • Signs all checks and reviews all invoices attached to those checks before payment.
   • Receives the bank statements directly at his home, opens the bank statement, and reviews all cancelled checks for payee, signature and endorsement, and then gives the bank statement to the bookkeeper for reconciliation.

Conclusion:
If the auditor tests the controls and concludes that they are in effect, the deficiency (poor segregation of duties) most likely does not rise to the level of being a significant deficiency or material weakness.
Change the facts:
The auditor tests the controls and concludes that only some, but not all of the controls are being performed by Harry. For example, Harry does sign all the checks, but rarely reviews invoices individually less than $10,000. He does receive the bank statement at his home, but sometimes does not review the canceled checks within the statement.

Conclusion:
The deficiency (poor segregation of duties) might rise to being a significant deficiency or material weakness depending on whether the auditor believes it is reasonably possible that a material misstatement could occur and not be prevented, detected and corrected on a timely basis.

Change the facts again:
The auditor tests the controls and concludes that Harry is actually performing none of the controls even though he said he does.

Conclusion:
Because there are no compensating controls to mitigate the risk from the deficiency (segregation of duties), the auditor would most likely conclude that there is a reasonable possibility of a material misstatement not being prevented, detected and corrected on a timely basis. Thus, the poor segregation of duties would be a material weakness to be conveyed in a written communication.

Example 2: Pre-Signed Checks

Facts:
Same facts as Example 1 except that Harry goes on vacation from time to time and leaves blank checks, signed by Harry, in the hands of the bookkeeper for emergency purposes. To mitigate the risks associated with having those checks given to the bookkeeper, Harry hires the auditor to perform quarterly procedures that include a review of the bank reconciliation that is prepared by the bookkeeper.

Conclusion:
An auditor or outside accountant cannot be part of management’s internal control. Thus, the auditor’s review of the bank reconciliations is not considered a compensating control. The result is that it is reasonably possible that due to the deficiency (leaving signed blank checks with the bookkeeper) with a lack of oversight, a material misstatement could occur, requiring the auditor to communicate to the company a material weakness in internal control.

Example 3: Lack of Client Expertise in Financial Accounting and Reporting

Facts:
Company Y has a controller who is proficient in most aspects of the general ledger.

The controller has the auditor compute the annual depreciation and gain and loss on sale of assets using the auditor’s fixed asset software program. The auditor makes the proposed depreciation entry during the audit.

After the auditor prepares the depreciation and gain or loss, the controller reviews and approves the schedule so that there are no independence issues under Ethics Interpretation 101-3 (e.g., accountant/auditor may not be part of management).
The client believes it is more cost effective for the auditor to compute the depreciation instead of having the client purchase a separate fixed asset program. If the auditor did not compute the depreciation, the auditor believes that the controller has the competency to compute depreciation even though he chooses not to do so.

The depreciation entry is material to the financial statements.

The client believes that the deficiency (controller not computing depreciation) would be detected by the auditor so that there is no risk of material misstatement.

**Conclusion:**
It is true that if the auditor were not involved in computing depreciation, the auditor would most likely detect and correct the misstatement on a timely basis through his or her year-end audit adjustments. However, the auditor cannot be part of the client’s internal controls. Therefore, the auditor must look for other controls the client has to prevent, detect and correct the depreciation misstatement on a timely basis under the client’s system of internal control. If the depreciation entry were not made, is it reasonably possible that the material misstatement (depreciation) would not be prevented, detected and corrected by the system of internal control?

Because the auditor believes the controller has the competency to compute the depreciation and the controller has demonstrated a history of reviewing depreciation and related calculations, the auditor would likely conclude that the deficiency of not recording depreciation is not a material weakness. As to whether the deficiency is a significant deficiency, the auditor would have to consider whether the deficiency is “important enough to merit attention by those charged with governance.” In most cases, the author believes that the auditor would conclude that the facts given do not warrant elevating the deficiency to being a significant deficiency.

**Example 4: Lack of Proficiency in Preparing Financial Statements**

**Facts:**
Company C has a bookkeeper who is not proficient in preparing financing statements and related footnotes in accordance with GAAP.

Typically, the auditor prepares the financial statements and footnotes and gives them to the client to review for accuracy and approve them. However, it is clear that if the auditor did not prepare the financial statements for the client, the bookkeeper and all other management of C do not have the competency to prepare GAAP financial statements.

**Conclusion:**
The SAS states that a deficiency in internal control may come from “employees or management who lack the qualifications and training to fulfill their assigned functions.” One such example is if the company does not have anyone with the skills and knowledge to apply GAAP in recording the entity’s financial transactions or preparing its financial statements. In this example, the auditor would conclude that there is a material weakness that must be communicated.

**Change the facts:**
Even though the auditor prepares the financial statements, the auditor believes that management does have the expertise to prepare financial statements and related
footnotes but chooses to have the auditor prepare them. Additionally, historically, the auditor knows that the client does review and approve the auditor-prepared financial statements to ensure the completeness of the disclosures and accuracy of the financial statements.

**Conclusion:**
In this example, the auditor would most likely conclude that it is not reasonably possible that a material misstatement in preparing the financial statements would not be prevented, detected and corrected on a timely basis. Thus, no material weakness exists and probably no significant deficiency.

**Example 5: Lack of Expertise in Accounting Functions**

**Facts:**
Mary, the bookkeeper, appears to be proficient in the basic day-to-day accounting functions of Company D. The major accounting functions such as cash, accounts receivable and accounts payable are handled properly and timely.

However, when it comes to one-time, non-recurring transactions, she appears lost and typically does not make the correct entry. Instead, she waits for the auditor to come in and make the entry that is needed. For example during the current year-end audit, the auditor had to make correcting entries for the following items because Mary did not know how to record the transactions: a) the sale of fixed assets including a motor vehicle trade in, b) a new capital lease, and c) depreciation and amortization.

Collectively, the correcting entries were material to the financial statements.

There is no one else within Company D that has any expertise in the accounting function.

**Conclusion:**
There is clearly a deficiency in internal control in that material misstatements were not prevented, detected and corrected on a timely basis by the company's internal control.

Mary lacks the qualifications and training to fulfill her assigned function of being a bookkeeper and there are no compensating controls to mitigate that deficiency. The fact that the auditor makes correcting entries at year end cannot be considered in evaluating whether it is reasonably possible that material misstatements would be prevented, detected and corrected on a timely basis.

Consequently, the auditor would conclude that there is a material weakness in internal control that should be communicated.

**Change the facts:**
Assume that whenever there is an entry that Mary does not know how to make, she calls the auditor and seeks technical advice on how to record the entry. After she receives the advice from the auditor, Mary makes the necessary entries.

**Conclusion:**
The fact that the client demonstrated the ability to exercise controls to detect a potential misstatement and to gain the needed competency may be a factor (a compensating
control) that mitigates the deficiency of not having the expertise to make the needed entry. Contacting the auditor for technical advice is not the same as waiting for the auditor to discover and correct the misstatement at year end.

Consequently, the auditor may be able to conclude that even though there is a deficiency (e.g., a bookkeeper that lacks proficiency), there is a compensating control in that the client is able to identify a complex accounting issue and obtain the needed technical advice to resolve it. The result is that the auditor may conclude that the deficiency is not a material weakness. Whether he or she considers the deficiency to be a significant deficiency requires judgment.

**Observation:** The above-noted example is not addressed within the body of SAS No. 115. In the AICPA practice aid\(^3\), the AICPA suggests that the fact that the bookkeeper contacts the auditor for technical advice may be considered a compensating control. The author believes that the key factor is that the client identified that there was a misstatement that required correction and that outside expertise was needed. The fact that the client sought expertise from the auditor and corrected the entry on a timely basis suggests that there is a compensating control that mitigates the client’s shortfall in accounting expertise.

**Example 6: Deficiencies in Bookkeeping Functions**

**Facts:**
Joe Auditor is auditing Company F.

During the audit, Joe discovers the following:

- The cash reconciliation shows a reconciling item of $10,000 going back six months and still unresolved.
- Both the accounts receivable and accounts payable subsidiary agings have not been reconciled to the general ledger for the past three months but that the client is working on the reconciliations which will be ready during the audit.

During the audit, the client completes the reconciliations of cash, receivables and payables and the correcting entries are immaterial.

**Conclusion:**
SAS No. 115 states that an indication of a deficiency in internal control is where there is a failure to perform reconciliations of significant accounts on a timely basis, such as a receivable or payable subsidiary ledger not being reconciled to the general ledger account in a timely or accurate manner.

In this example, the client clearly has a deficiency with cash, receivables and payables not being reconciled and differences resolved on a timely basis. Because cash, receivables and payables are material to the financial statements, it would be reasonably possible that a material misstatement might not be prevented, detected, and corrected on a timely basis due to the deficiency in internal control.

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\(^3\) Communicating Internal Control Related Matters in an Audit- Understanding SAS No. 115 (AICPA 2008).
The auditor would most likely conclude that there is a material weakness that should be communicated.

**Example 7: Inventory Controls**

**Facts:**
Company G is a large car dealership. G lacks strong controls over tracking the quantities of parts inventory but does perform a quarterly physical inventory.

Through the performance of one of its quarterly inventories, G discovered a shortfall in the parts inventory and uncovered a fraud being committed by the parts manager, who confessed to stealing.

**Conclusion:**
Although there is a deficiency in internal control (lack of controls over tracking quantities), there is a compensating control of taking a physical inventory on a quarterly basis. In fact, there is evidence that the compensating control worked because it uncovered the fraud.

Is it reasonably possible that a material misstatement in the financial statements would not be prevented, detected and corrected on a timely basis? Probably not because the compensating control (taking a physical inventory) would detect the material misstatement. Thus, the auditor would most likely conclude that there is no material weakness and probably no significant deficiency.

However, the auditor would be required to bring the fraud to the attention of management as required by SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*
Illustrative Written Communications
There is either a significant deficiency and/or a material weakness

Date: (no later than 60 days after the report release date)

Board of Directors and Management
ABC Company

Ladies and Gentlemen:

In planning and performing our audit of the financial statements of ABC Company (the “Company”) as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses [and other deficiencies that we consider to be significant deficiencies].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

We consider the following deficiencies in the Company’s internal control to be material weaknesses.
[Describe the material weaknesses that were identified.]

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than material weaknesses, yet important enough to merit attention by those charged with governance.

We consider the following deficiencies in the Company’s internal control to be significant deficiencies.
[Describe the significant deficiencies that were identified.]

This communication is intended solely for the information and use of management, the Board of Directors [identify any other body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

James J. Fox & Company, CPA
There is no material weakness in internal control

Date: (no later than 60 days after the report release date)

Board of Directors and Management
ABC Company

Ladies and Gentlemen:

In planning and performing our audit of the financial statements of ABC Company (the “Company”) as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company’s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Company’s internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, the Board of Directors [identify any other body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

James J. Fox & Company, CPA

Note: The above illustrative communication states that no material weaknesses were identified, but does not state that no significant deficiencies were identified. The SAS specifies that an auditor is precluded from issuing a letter that states that no significant deficiencies were identified even though he or she may issue a letter stating that no material weaknesses were identified.
SAS No. 116: Interim Financial Information
Amendment to AU Section 722, Interim Financial Information

Issued: February 2009

Effective date: This Statement is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.

Objective: SAS No. 116 amends AU section 722, Interim Financial Information, to accommodate reviews of interim financial information of nonissuers, including companies offering securities under SEC Rule 144A or participating in private equity exchanges.

For example, a nonissuer may, on a quarterly basis, prepare interim financial statements that conform to the requirements of Article 10 of SEC Regulation S-X.

Requirements:

1. The Statement applies when the interim financial information is intended to provide a periodic update to year-end reporting, and:

   a. The entity’s latest annual financial statements have been audited by the accountant or a predecessor.

   b. The accountant has been engaged to audit the entity’s current year financial statements, or the accountant audited the entity’s latest annual financial statements and expects to be engaged to audit the current year financial statements.

   c. The client prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements, interim financial information is condensed information, and certain criteria are met.

   d. If the interim financial information is condensed information, all of the following conditions are met:

      • The condensed interim financial information purports to conform with an appropriate financial reporting framework, which includes appropriate form and content of interim financial statements; for example, APB No. 28, Interim Financial Reporting, and Article 10 of SEC Regulation S-X with respect to U.S. GAAP or IAS 34, Interim Financial Reporting, with respect to IFRS issued by the IASB may be appropriate financial reporting frameworks for interim financial information.

      • The condensed interim financial information includes a note that the financial information does not represent complete financial statements and should be read in conjunction with the entity’s latest annual audited financial statements.
• The condensed interim financial information accompanies the entity’s latest audited annual financial statements or such audited annual financial statements are made readily available by the entity. The financial statements are deemed to be readily available if a third party user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity’s web site may be considered readily available, but being available upon request is not considered readily available).

The Statement also clarifies that if the conditions in a) and b) above are not met, reviews of interim financial information of nonissuers should be performed in accordance with the SSARSs.

2. Establishing an understanding with the client:

   a. SAS No. 116 requires that an accountant should document his or her understanding of the services to be performed through a written communication with the client (e.g., an engagement letter is required).

   b. The accountant is required to assess management’s ability to acknowledge their responsibility to establish and maintain controls that are sufficient to provide a reasonable basis for the preparation of reliable interim financial information in accordance with the applicable financial reporting framework.

   • If management does not have the ability to make such an acknowledgement of its responsibility, the accountant should not accept the engagement.

3. Objectives of the engagement:

   a. The objective of a review of interim financial information is to provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to be in conformity with the applicable financial reporting framework.

   b. A review includes obtaining sufficient knowledge of the entity’s business and its internal control as it relates to the preparation of both annual and interim financial information to:

      • Identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence, and

      • Select the inquiries and analytical procedures that will provide the accountant with a basis for communicating whether the accountant is aware of any material modifications that should be made to the interim financial information for it to conform to the applicable financial reporting framework.
4. Limitations of the engagement:
   a. A review does not provide a basis for expressing an opinion about whether the financial information is presented fairly, in all material respects, in conformity with the applicable financial reporting framework.
   b. A review does not provide assurance, that the accountant will become aware of all significant matters that would be identified in an audit.
   c. A review is not designed to provide assurance on internal control or to identify significant deficiencies and material weaknesses in internal controls; however, the accountant is responsible for communicating to management and those charged with governance any significant deficiencies or material weaknesses in internal control that the accountant identified.

5. Other changes:
   a. SAS No. 116 incorporates language requiring the accountant to communicate a significant deficiency or material weakness in internal control as required by SAS No. 115.
   b. The accountant’s report on interim financial information has been changed to reflect reference to “auditing standards generally accepted in the United States.”
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. What automatically exists when either a properly designed control fails to operate as designed or the person who performs the control lacks the appropriate authority or qualifications to do so effectively:
   a) a deficiency in design
   b) a deficiency in operation
   c) a significant deficiency
   d) a material weakness

2. Which of the following might be considered a material weakness:
   a) a deficiency that satisfies both the reasonably possible and material thresholds
   b) a deficiency that satisfies the reasonably possible threshold but not the material threshold
   c) a deficiency that satisfies the material threshold but not the reasonably possible threshold
   d) a deficiency that does not satisfy either threshold but the auditor believes is significant

3. An example of a deficiency that is an indicator of a material weakness is identification of an immaterial fraud committed by:
   a) any party within the organization
   b) employees within the accounting department
   c) senior management
   d) the CEO or CFO only

4. Which of the following is not an example of a circumstance that may be a deficiency, significant deficiency or material weakness:
   a) failure to perform reconciliations of significant accounts on a timely basis
   b) employees who are underpaid, overworked, and resentful
   c) misrepresentation by client personnel to the auditor
   d) management override of controls
5. A written communication of significant deficiencies and material weaknesses must be made no later than:
   a) the report release date
   b) 60 days following the report release date
   c) 30 days from the date on which field work ends
   d) within a “reasonable period of time” after the audit completion date

6. One of the general rules for the communication letter is that an auditor is not permitted to:
   a) add a sentence indicating that one or more significant deficiencies was found
   b) issue a written communication stating that no significant deficiencies were identified
   c) state that there were no material weaknesses identified during the audit
   d) submit the letter to a third party, including a governmental authority

7. An auditor has a client that is incapable of preparing financial statements and related disclosures under GAAP without the assistance of the auditor. Which of the following is correct:
   a) there is a material weakness in internal control
   b) there is a deficiency but not a significant deficiency or material weakness
   c) there is a significant deficiency but not a material weakness
   d) there is neither a deficiency, significant deficiency or material weakness

8. One of the changes made by SAS No. 116 is that the accountant should document his or her understanding of the services to be performed:
   a) in his or her working papers to be retained for a period of 10 years
   b) through a written communication
   c) at a minimum, through an oral communication to senior management
   d) through any means that conveys the scope of the services to be performed
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A deficiency in design exists when a control is missing or an existing control is not properly designed.

   **B: Correct.** A deficiency in operation exists when either a properly designed control fails to operate as designed or the person who performs the control lacks the appropriate authority or qualifications to do so effectively.

   C: Incorrect. Although a deficiency may be elevated to a significant deficiency, it is certainly not automatic and must be evaluated before reaching the conclusion as to whether it is a significant deficiency.

   D: Incorrect. A deficiency must be evaluated first to determine whether it rises to the level of being a material weakness. Thus, a deficiency in operation is not automatically elevated to a material weakness.

   (See page 5 of the course material.)

2. **A: Correct.** In order for a deficiency to be elevated to being a material weakness, it must satisfy both the reasonably possible and material thresholds.

   B: Incorrect. A deficiency that satisfies the reasonably possible threshold but not the material threshold is not a material weakness but could be a significant deficiency.

   C: Incorrect. A deficiency that satisfies the material threshold but not the reasonably possible threshold is not a material weakness but could be a significant deficiency.

   D: Incorrect. A deficiency that does not satisfy either threshold cannot be a material weakness but in limited cases could be considered a significant deficiency.

   (See page 6 of the course material.)

3. A: Incorrect. An immaterial fraud committed by any party within the organization is not, in and of itself, deemed an indicator of a material weakness.

   B: Incorrect. An immaterial fraud committed by employees within the accounting department would not be considered an indicator of a material weakness.

   **C: Correct.** A fraud committed by senior management, whether material or immaterial, is an indicator of a material weakness.

   D: Incorrect. Even though a fraud committed by senior management is an indicator of a material weakness, it is not limited to the CEO or CFO.

   (See page 9 of the course material.)
4. **A: Incorrect.** SAS No. 115 identifies the failure to perform reconciliations of significant accounts on a timely basis as an example of a circumstance that may be a deficiency.

**B: Correct.** The SAS does not list employees who are underpaid, overworked, and resentful as a circumstance of a deficiency, significant deficiency, or a material weakness. It may enhance the risk of fraud but has no impact on whether there is a deficiency, significant deficiency or material weakness.

**C: Incorrect.** Misrepresentation by client personnel to the auditor, may not only be an indicator of fraud but is also identified as an example of a circumstance that may be a deficiency.

**D: Incorrect.** The SAS lists management override of controls as an example of a circumstance of a deficiency.

(See pages 10 to 11 of the course material.)

5. **A: Incorrect.** SAS No. 115 states that the communication is “best made” by the report release date, but does not require that date to be the outside date.

**B: Correct.** The outside date for communication is no later than 60 days following the report release date.

**C: Incorrect.** The SAS does not provide for a date that is 30 days from the date on which field work ends.

**D: Incorrect.** The SAS does not allow for a “reasonable period of time” after the audit completion date as the outside date.

(See page 13 of the course material.)

6. **A: Incorrect.** The auditor may add a sentence indicating that one or more significant deficiencies were found.

**B: Correct.** The auditor is not permitted to issue a written communication stating that no significant deficiencies were identified. The reasoning is that the limited degree of assurance provided by such communication could be misinterpreted.

**C: Incorrect.** The auditor may, but is not required to, state that there were no material weaknesses identified during the audit.

**D: Incorrect.** The auditor may be asked to issue the letter which will be submitted to a third party, possibly a governmental authority.

(See page 14 of the course material.)
7. **A: Correct.** If the client does not have the skill and knowledge to prepare GAAP statements, that fact is a material weakness in internal control.

   B: Incorrect. There is a deficiency but it is a material weakness.

   C: Incorrect. The deficiency is a material weakness and not a significant deficiency because of the magnitude of the deficiency.

   D: Incorrect. Failure to have the ability to prepare financial statements is a deficiency that is elevated to a material weakness.

   (See page 17 of the course material.)

8. **A: Incorrect.** Although it is assumed that the understanding would be documented in the auditor’s working papers, there is no requirement to retain that documentation for a period of 10 years.

   **B: Correct.** SAS No. 116 adds a requirement that the communication must be in writing.

   C: Incorrect. Oral communication is not sufficient as it must be in writing.

   D: Incorrect. SAS No. 116 does not give the auditor latitude to communicate through any means that conveys the scope of the services to be performed.

   (See page 24 of the course material.)
SAS No. 117: Compliance Audits

Issued: December 2009

Effective date:

The provisions of SAS No. 117 are effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.

Objective:

SAS No. 117 supersedes SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.

It is common for governments to establish governmental audit requirements for entities to undergo an audit of their compliance with applicable compliance requirements. SAS No. 117 applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards (GAAS)
- The standards for financial audits under *Government Auditing Standards*
- A governmental audit requirement that requires an auditor to express an opinion on compliance

SAS No. 117 addresses the application of GAAS to a compliance audit. Compliance audits usually are performed in conjunction with a financial statement audit.

The auditor’s objectives in a compliance audit are to:

a. Obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement on whether the entity complied in all material respects with the applicable compliance requirements, and

b. Identify audit and reporting requirements specified in the governmental audit requirement that are supplementary to GAAS and *Government Auditing Standards*, if any, and perform procedures to address those requirements.

Scope of SAS No. 117:

Examples of engagements to which SAS No. 117 applies include:

a. An audit performed in accordance with the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*.

b. An examination of an entity’s compliance with specified requirements in accordance with AT section 601 is the U.S. Department of Education’s audit guide, *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. 

Chapter 8: New Auditing Standards and Other Auditing Developments
SAS No. 117 *does not* apply:

a. To financial statement audit components of such engagements.

b. When the governmental audit requirement calls for an examination, in accordance with Statements on Standards for Attestation Engagements, of an entity’s compliance with specified requirements or an examination of an entity’s internal control over compliance. AT section 601, *Compliance Attestation*, is applicable to these engagements.

**Note:** If the entity is required to undergo a compliance audit and an examination of internal control over compliance, SAS No. 117 applies to performing and reporting on the compliance audit, and AT section 601 is applicable to performing and reporting on the examination of internal control over compliance.

Although certain auditing standards are not applicable to a compliance audit, all auditing standards other than AU section 801, *Compliance Audits* (AICPA, *Professional Standards*), are applicable to the audit of financial statements performed in conjunction with a compliance audit.

AU sections 100-700 and 900 address audits of financial statements, as well as other kinds of engagements. AU sections 100-300 and 500 generally can be adapted to the objectives of a compliance audit. However, with certain exceptions, AU sections 400, 600, 700, and 900 generally cannot be adapted to a compliance audit because they address the auditor’s report on an audit of financial statements and other topics that are not applicable to a compliance audit.

The AU sections that are not applicable to a compliance audit are listed in the appendix of this SAS. All of the other AU sections are applicable to a compliance audit. However, the auditor is not required, in planning and performing a compliance audit, to make a literal translation of each procedure that might be performed in a financial statement audit, but rather to obtain sufficient appropriate audit evidence to support the auditor’s opinion on compliance.

Some AU sections can be adapted and applied to a compliance audit with relative ease, for example, by simply replacing the word *misstatement* with the word *noncompliance*. Other AU sections are more difficult to adapt and apply, and entail additional modification. For that reason, this SAS provides more specific guidance on how to adapt and apply certain AU sections to a compliance audit.

*Government Auditing Standards* and governmental audit requirements contain certain standards and requirements that are supplementary to those in GAAS, as well as guidance on how to apply those standards and requirements.

**Observation:** An example of an engagement to which this SAS is applicable is an audit performed in accordance with the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. SAS No. 117 is applicable because OMB Circular A-133 is a governmental audit requirement that requires the auditor to perform a compliance audit in accordance with both GAAS and *Government Auditing Standards* and to express an opinion on compliance.
Another example is a department specific requirement such as the U.S. Department of Housing and Urban Development Audit Requirements Related to Entities Such As Public Housing Agencies, Nonprofit and For-Profit Housing Projects, and Certain Lenders.

An example of an engagement to which this SAS is not applicable is an engagement performed to satisfy a law or regulation requiring the entity to have an auditor determine whether the entity has spent transportation excise tax monies in accordance with the specific purposes outlined in the law or regulation, but not requiring that the audit be performed in accordance with both GAAS and Government Auditing Standards. Such an engagement could be performed under AT section 601, AT section 101, Attest Engagements, or AT section 201, Agreed-Upon Procedures Engagements (AICPA, Professional Standards, vol. 1), depending on the requirements of the government, law or regulation which will not always indicate which standards to follow. In such cases, auditor judgment will be needed to determine, based on the circumstances, the appropriate standards to follow.

**General requirements of SAS No. 117:**

1. **Management’s Responsibilities:** A compliance audit is based on the premise that management is responsible for the entity’s compliance with compliance requirements. Management’s responsibility for entity’s compliance with compliance requirements includes the following:

   a. Identifying the entity’s government programs and understanding and complying with the compliance requirements
   b. Establishing and maintaining effective controls that provide reasonable assurance that the entity administers government programs in compliance with the compliance requirements
   c. Evaluating and monitoring the entity’s compliance with the compliance requirements
   d. Taking corrective action when instances of noncompliance are identified, including corrective action on audit findings of the compliance audit

2. When performing a compliance audit, the auditor, using professional judgment, should adapt and apply the auditing sections to the objectives of a compliance audit.

   **Note:** The Appendix to the SAS provides those auditing standards sections that are not applicable to compliance audits in accordance with SAS No. 117.

3. The auditor should establish and apply materiality levels for the compliance audit based on the governmental audit requirement.

   a. In a compliance audit, the auditor’s purpose for establishing materiality levels is to:

      • Determine the nature and extent of risk assessment procedures.
      • Identify and assess the risks of material noncompliance.
      • Determine the nature, timing, and extent of further audit procedures.
      • Evaluate whether the entity complied with the applicable compliance requirements.
      • Report findings of noncompliance and other matters required to be reported by the governmental audit requirement.
Note: The SAS states that the auditor’s consideration of materiality is in relation to the government program taken as a whole. However, the governmental audit requirement may specify a different level of materiality for one or more of these purposes. For example, for purposes of reporting findings of noncompliance, OMB Circular A-133 requires that non-compliance that is material in relation to one of the 14 types of compliance requirements identified in the OMB Compliance Supplement (ComplianceSupplement), be reported.

Because the governmental audit requirement usually is established by the grantors and the auditor’s report on compliance is primarily for their use, the auditor’s determination of materiality usually is influenced by the needs of the grantors. However, in a compliance audit, the auditor’s judgment about matters that are material to users of the auditor’s report also is based on consideration of the needs of users as a group, including grantors.

4. Identifying government programs and applicable compliance requirements: The auditor should determine which of those government programs and compliance requirements to test (that is, the applicable compliance requirements) in accordance with the governmental audit requirement.

a. The SAS provides examples of some of the sources an auditor may consult when identifying and obtaining an understanding of the applicable compliance requirements:

- The Compliance Supplement, which is issued by OMB, and used in OMB Circular A-133 audits, contains the compliance requirements that typically are applicable to federal government programs, as well as suggested audit procedures when compliance requirements are applicable and have a direct and material effect on the entity’s compliance. Part 7 of the Compliance Supplement provides guidance for identifying compliance requirements for programs not included therein.

- The applicable program-specific audit guide issued by the grantor agency, which contains the compliance requirements pertaining to the government program and suggested audit procedures, to test for compliance with the applicable compliance requirements.

b. SAS No. 117 offers the following are procedures the auditor may perform to identify and obtain an understanding of the applicable compliance requirements if the Compliance Supplement or a program-specific audit guide is not applicable:

- Reading laws, regulations, rules, and provisions of contracts or grant agreements that pertain to the government program
- Making inquiries of management and other knowledgeable entity personnel (for example, the chief financial officer, internal auditors, legal counsel, compliance officers, or grant or contract administrators)
- Making inquiries of appropriate individuals outside the entity, such as:
  - the office of the federal, state, or local program official or auditor, or other appropriate audit oversight organizations or regulators, about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements
  - a third-party specialist, such as an attorney
• Reading the minutes of meetings of the governing board of the entity being audited
• Reading audit documentation about the applicable compliance requirements prepared during prior years’ audits or other engagements
• Discussing the applicable compliance requirements with auditors who performed prior years’ audits or other engagements

5. Risk assessment procedures: For each of the government programs and applicable compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the applicable compliance requirements and the entity’s internal control over compliance with the applicable compliance requirements.4

a. In performing risk assessment procedures, the auditor should:

• Inquire of management about whether there are findings and recommendations in reports or other written communications resulting from previous audits, attestation engagements, and internal or external monitoring that directly relates to the objectives of the compliance audit.

• Gain an understanding of management’s response to findings and recommendations that could have a material effect on the entity’s compliance with the applicable compliance requirements (for example, taking corrective action).

• Use this information to assess risk and determine the nature, timing, and extent of the audit procedures for the compliance audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives.

b. The SAS states that the nature and extent of the risk assessment procedures the auditor performs may vary from entity to entity and are influenced by factors such as the following:

• The newness and complexity of the applicable compliance requirements
• The auditor’s knowledge of the entity’s internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional engagements
• The nature of the applicable compliance requirements
• The services provided by the entity and how they are affected by external factors
• The level of oversight by the grantor or pass-through entity
• How management addresses findings

6. Assess the risks of material noncompliance: The auditor should assess the risks of material noncompliance whether due to fraud or error for each applicable compliance requirement and should consider whether any of those risks are pervasive to the

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4 See paragraphs .01-08, .10-43, 46-82, and .87-101 of AU section 314, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards, Vol. 1).
entity’s compliance because they may affect the entity’s compliance with many compliance requirements.\textsuperscript{5}

a. Factors the auditor may consider in assessing the risks of material noncompliance are as follows:

- The complexity of the applicable compliance requirements
- The susceptibility of the applicable compliance requirements to noncompliance
- The length of time the entity has been subject to the applicable compliance requirements
- The auditor’s observations about how the entity has complied with the applicable compliance requirements in prior years
- The potential effect on the entity of noncompliance with the applicable compliance requirements
- The degree of judgment involved in adhering to the compliance requirements
- The auditor’s assessment of the risks of material misstatement in the financial statement audit

b. Examples of situations in which there may be a risk of material noncompliance that is pervasive to the entity’s noncompliance are as follows:

- An entity that is experiencing financial difficulty and for which there is an increased risk that grant funds will be diverted for unauthorized purposes
- An entity that has a history of poor recordkeeping for its government programs

7. Perform additional audit procedures in response to assessed risks: If the auditor identifies risks of material noncompliance that are pervasive to the entity’s compliance, the auditor should develop an overall response to such risks.

a. The auditor should design and perform further audit procedures, including tests of details (which may include tests of transactions) to obtain sufficient appropriate audit evidence about the entity’s compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance.

\textbf{Note:} Risk assessment procedures, tests of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance.

b. To test for compliance with applicable laws and regulations, tests of details (including tests of transactions) may be performed in the following areas:

- Grant disbursements or expenditures
- Eligibility files
- Cost allocation plans
- Periodic reports filed with grantor agencies

\textsuperscript{5} See paragraphs .103-.121 of AU section 314.
c. The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance. These procedures should include performing tests of controls over compliance if:

- The auditor’s risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements
- Substantive procedures alone do not provide sufficient appropriate audit evidence, or
- Such tests of controls over compliance are required by the governmental audit requirement.

**Note:** If any of the conditions in this paragraph 9 are met, the auditor should test the operating effectiveness of controls over each applicable compliance audit.

8. **Supplementary audit requirements:** The auditor should determine whether audit requirements are specified in the governmental audit requirement that are supplementary to GAAS and Government Auditing Standards and perform procedures to address those requirements, if any.

a. In instances where audit guidance provided by a governmental agency for the performance of compliance audits has not been updated for, or otherwise conflicts with, current GAAS or Government Auditing Standards, the auditor should comply with the most current applicable GAAS and Government Auditing Standards instead of the outdated or conflicting guidance.

b. Examples of supplementary audit requirements are the requirements in OMB Circular A-133 for the auditor to:

- Perform specified procedures to identify major programs.
- Follow up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings.

9. **Written representations:** The auditor should request from management written representations\(^6\) that are tailored to the entity and the governmental audit requirement, including:

a. Acknowledging management’s responsibility for understanding and complying with the compliance requirements
b. Acknowledging management’s responsibility for establishing and maintaining controls that provide reasonable assurance that the entity administers government programs in accordance with the compliance requirements
c. Stating that management has identified and disclosed to the auditor all of its government programs and related activities subject to the governmental audit requirement
d. Stating that management has made available to the auditor all contracts and grant agreements, including amendments, if any, and any other correspondence relevant to the programs and related activities subject to the governmental audit requirement

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Chapter 8: New Auditing Standards and Other Auditing Developments

e. Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements or stating that there was no such noncompliance

f. Stating whether management believes that the entity has complied with the applicable compliance requirements (except for noncompliance it has disclosed to the auditor)

g. Stating that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements

h. Identifying management’s interpretation of any applicable compliance requirements that are subject to varying interpretations

i. Stating that management has disclosed to the auditor any communications from grantors and pass-through entities concerning possible noncompliance with the applicable compliance requirements, including communications received from the end of the period covered by the compliance audit to the date of the auditor’s report

j. Stating that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken from the end of the period covered by the compliance audit to the date of the auditor’s report

k. Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the auditor’s report or stating that there were no such known instances, and

l. Stating that management is responsible for taking corrective action on audit findings of the compliance audit.

Note: If the auditor determines that it is necessary to obtain additional representations related to the entity’s compliance with the applicable compliance requirements, the auditor should request such additional representations.

10. Subsequent events: The auditor should perform audit procedures up to the date of the auditor’s report to obtain sufficient appropriate audit evidence that all subsequent events related to the entity’s compliance during the period covered by the auditor’s report on compliance have been identified.

a. There are two types of subsequent events that may occur:

First type: consists of events that provide additional evidence with respect to conditions that existed at the end of the reporting period that affect the entity’s compliance during the reporting period.

Second type: consists of events of noncompliance that did not exist at the end of the reporting period but arose subsequent to the reporting period.

b. The auditor should take into account the auditor’s risk assessment in determining the nature and extent of such audit procedures, which should include, but are not limited to, inquiring of management about and considering:
• Relevant internal auditor’s reports issued during the subsequent period.
• Other auditors’ reports identifying noncompliance that were issued during the subsequent period.
• Reports from grantors and pass-through entities on the entity’s noncompliance that were issued during the subsequent period.
• Information about the entity’s noncompliance obtained through other professional engagements performed for that entity.

**Note:** The auditor has no obligation to perform any audit procedures related to the entity’s compliance during the period subsequent to the period covered by the auditor’s report. However, if before the report release date, the auditor becomes aware of non-compliance in the period subsequent to the period covered by the auditor’s report that is of such a nature and significance that its disclosure is needed to prevent report users from being misled, the auditor should discuss the matter with management and, if appropriate, those charged with governance, and should include an explanatory paragraph in his or her report describing the nature of the noncompliance.

An example of a matter of noncompliance that may occur subsequent to the period being audited but before the report release date that may warrant disclosure to prevent report users from being misled is the discovery of noncompliance in the subsequent period of such magnitude that it caused the grantor to stop funding the program.

11. **Evaluating the sufficiency and appropriateness of the audit evidence and forming an opinion:** The auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained.  

   a. The auditor should form an opinion, at the level specified by the governmental audit requirement, on whether the entity complied in all material respects with the applicable compliance requirements, and report appropriately. In forming an opinion, the auditor should evaluate likely questioned costs, not just known questioned costs, as well as other material noncompliance that, by its nature, may not result in questioned costs.

   b. In determining whether an entity has materially complied with the applicable compliance requirements, the auditor may consider the following factors:

   • The frequency of noncompliance with the applicable compliance requirements identified during the compliance audit
   • The nature of the noncompliance with the applicable compliance requirements identified
   • The adequacy of the entity’s system for monitoring compliance with the applicable compliance requirements and the possible effect of any noncompliance on the entity, and
   • Whether any identified noncompliance with the applicable compliance requirements resulted in likely questioned costs that are material to the government program

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7 See paragraphs .70-.76 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, Professional Standards, vol. 1).
Reporting under SAS No. 117:

1. **Report on compliance only**: The auditor’s report on compliance should include the following elements:

   a. A title that includes the word independent
   b. Identification of the one or more government programs
   c. Identification of the applicable compliance requirements or a reference to where they can be found
   d. Identification of the period covered by the report
   e. A statement that compliance with the applicable compliance requirements is the responsibility of the entity’s management
   f. A statement that the auditor’s responsibility is to express an opinion on the entity’s compliance with the applicable compliance requirements based on the compliance audit
   g. A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards, and the governmental audit requirement
   h. A statement that the compliance audit included examining, on a test basis, evidence about the entity’s compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances
   i. A statement that the auditor believes the compliance audit provides a reasonable basis for his or her opinion
   j. A statement that the compliance audit does not provide a legal determination of the entity’s compliance
   k. The auditor’s opinion, at the level specified by the governmental audit requirement, on whether the entity complied, in all material respects, with the applicable compliance requirements
   l. If noncompliance that results in an opinion modification is identified, a description of such noncompliance, or a reference to a description of such noncompliance in an accompanying schedule
   m. If other noncompliance that is required to be reported by the governmental audit requirement is identified (that is noncompliance that does not result in an opinion modification), a description of such noncompliance or a reference to a description of such noncompliance in an accompanying schedule
   n. If the criteria used to evaluate compliance are 1) established or determined by contractual agreement or regulatory provisions or 2) available only to the specified parties, a separate paragraph at the end of the report that includes (a) a statement indicating that the report is intended solely for the information and use of the specified parties (b) an identification of the specified parties to whom use is restricted, and (c) a statement that the report is not intended to be and should not be used by anyone other than the specified parties
   o. The manual or printed signature of the auditor’s firm
   p. The date of the auditor’s report
2. Combined report on compliance and internal control over compliance: If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor combines the auditor’s report on compliance with a report on internal control over compliance, the following should be added to the report elements in connection with a report on compliance only:

   a. A statement that management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs.

   b. A statement that in planning and performing the compliance audit, the auditor considered the entity’s internal control over compliance with the applicable compliance requirements to determine the auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.

   c. A statement that the auditor is not expressing an opinion on internal control over compliance.

   d. A statement that the auditor’s consideration of the entity’s internal control over compliance was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses in internal control over compliance.

   e. The definition of deficiency in internal control over compliance and material weakness in internal control over compliance.

   f. A description of any identified material weaknesses in internal control over compliance or a reference to an accompanying schedule containing such a description.

   g. If significant deficiencies in internal control over compliance were identified, the definition of significant deficiency in internal control over compliance and a description of the deficiencies or a reference to an accompanying schedule containing such a description.

   h. If no material weaknesses in internal control over compliance were identified, a statement to that effect.

   i. The restricted use paragraph described in paragraph 30(n) of SAS No. 117. The restricted use paragraph should be included in all combined reports on the entity’s compliance and internal control over compliance.

Following is an example of a combined report on compliance and internal control over compliance extracted from the Exhibit to SAS No. 117:
Illustrative Combined Report on Compliance with Applicable Requirements and Internal Control Over Compliance – (Unqualified Opinion on Compliance; No Material Weaknesses or Significant Deficiencies in Internal Control Over Compliance Identified) (Source: Exhibit to SAS No. 117)

The following is an illustrative combined report on compliance with applicable requirements and internal control over compliance that contains the elements required.

This illustrative report contains an unqualified opinion on compliance with no material weaknesses or significant deficiencies in internal control over compliance identified. The AICPA Audit Guide Government Auditing Standards and Circular A-133 Audits contains illustrative language for other types of reports, including reports containing qualified or adverse opinions on compliance with either material weaknesses in internal control over compliance, significant deficiencies in internal control over compliance, or both identified.

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**Independent Auditor's Report**

**[Addressee]**

**Compliance**

We have audited Example Entity’s compliance with the [identify the applicable compliance requirements or refer to the document that describes the applicable compliance requirements] applicable to Example Entity's [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] for the year ended June 30, 20X1. Compliance with the requirements referred to above is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards® issued by the Comptroller General of the United States; and [insert the name of the governmental audit requirement or program-specific audit guide], which require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a material effect on [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] for the year ended June 30, 20X1. An audit includes examining, on a test basis, evidence about Example Entity’s compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that are applicable to [identify the government program(s) audited] for the year ended June 30, 20X1.

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8 The standards for financial audits are in chapters 1-55 of Governmental Auditing Standards.
Internal Control Over Compliance

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit, we considered Example Entity’s internal control over compliance to determine the auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity’s internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions to prevent, or detect and correct, noncompliance on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses in internal control over compliance. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, [identify the legislative or regulatory body], and [identify the grantor agency(ies)] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]  
[Date]

3. Separate report on internal control over compliance: If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor chooses to issue a separate report on internal control over compliance, the auditor should include in that separate report the elements for a combined report found in paragraph 2(a) to (i) above and the following additional elements:

- A title that included the word independent
- A statement that the auditor audited the entity’s compliance with applicable compliance requirements pertaining to [identify the government program(s) and the period audited] and a reference to the auditor’s report on compliance
- A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards, and the governmental audit requirement
- The manual or printed signature of the auditor’s firm
- The date of the auditor’s report
a. The auditor should report noncompliance as well as other matters that are required to be reported by the governmental audit requirement in the manner specified by the governmental audit requirement. If the other matters required to be reported by the governmental audit requirement are not appropriate for the auditor to report on, the auditor should follow paragraph 38 of SAS No. 117 related to printed forms, schedules, or reports which states:

“Printed forms, schedules, or reports designed or adopted by government agencies with which they are to be filed sometimes contain prescribed wording. If a printed form, schedule, or report requires the auditor to make a statement that he or she has no basis to make, the auditor should accordingly reword the form, schedule, or report or attach an appropriately worded separate report.”

4. Report modifications:

   a. The auditor should modify his or her opinion on compliance in accordance with SAS No. 58 (AU section 508), Reports on Audited Financial Statements, if any of the following conditions exist:

   • The compliance audit identifies noncompliance with the applicable compliance requirements that the auditor believes has a material effect on the entity’s compliance.
   • A restriction on the scope of the compliance audit.

   b. The auditor should modify the report on compliance only or the separate report on internal control over compliance when the auditor makes reference to the report of another auditor as the basis, in part, for the auditor’s report.

5. Reporting to those charged with governance:

   a. In the absence of a governmental audit requirement to report on internal control over compliance, the auditor should communicate in writing to management and those charged with governance identified significant deficiencies and material weakness in internal control over compliance.9

   Note: When the auditor communicates significant deficiencies or material weaknesses in internal control over compliance to management and those charged with governance, Government Auditing Standards also require the auditor to obtain a response from the responsible officials, preferably in writing, concerning their views on the findings, conclusions, and recommendations included in the auditor’s report on internal control over compliance and include a copy of any written response in the auditor’s report.10

   If such a written response is included in a document containing the auditor’s written communication to management and those charged with governance

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9 See AU section 325, Communicating Internal Control Related Matters Identified in an Audit (AICPA, Professional Standards, Vol. 1).

10 Paragraphs 5.32-5.38 of Government Auditing Standards.
concerning identified significant deficiencies or material weaknesses in internal control over compliance, the auditor may add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph:

“ABC Agency’s written response to the significant deficiencies and material weaknesses in internal control over compliance identified in our compliance audit was not subjected to the auditing procedures applied in the compliance audit of ABC Agency’s compliance and, accordingly, we express no opinion on it.”

b. The auditor also should communicate to those charged with governance of the entity the auditor’s responsibilities under GAAS, Government Auditing Standards, and the governmental audit requirement, an overview of the planned scope and timing of the compliance audit, and significant findings from the compliance audit.\(^{11}\)

6. **Printed forms, schedules, or reports:** Printed forms, schedules, or reports designed or adopted by government agencies with which they are to be filed sometimes contain prescribed wording. If a printed form, schedule, or report requires the auditor to make a statement that he or she has no basis to make, the auditor should accordingly reword the form, schedule, or report or attach an appropriately worded separate report.

7. **Documentation:** The auditor should document the risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance.\(^ {12}\)

   a. The auditor should document the following:

   - His or her responses to the assessed risks of material noncompliance, the procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.\(^ {13}\)

   - Materiality levels and the basis on which they were determined.

   - How he or she complied with the specific governmental audit requirements that are supplementary to GAAS and Government Auditing Standards.

8. **Reissuance of the compliance report:** If an auditor reissues his or her report, the reissued report should include an explanatory paragraph stating that the report is replacing a previously issued report and describing the reasons why the report is being reissued, and any changes from the previously issued report.

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\(^{12}\) See paragraphs .122-.123 of AU section 314.

\(^{13}\) See paragraphs .77 of AU section 318.
a. If additional procedures are performed to obtain sufficient appropriate audit evidence for all of the government programs being reported on, the auditor’s report date should be updated to reflect the date the auditor obtained sufficient appropriate audit evidence regarding the events that caused the auditor to perform the new procedures.

b. If additional procedures are performed to obtain sufficient appropriate audit evidence for only some of the government programs being reported on, the auditor should dual date the report with the updated report date reflecting the date the auditor obtained sufficient appropriate audit evidence regarding the government programs affected by the circumstances and referencing the government programs for which additional audit procedures have been performed.

c. Reissuance of an auditor-prepared document required by the governmental audit requirement that is incorporated by reference into the auditor’s report is considered to be a reissuance of the report.

d. Examples of situations in which the auditor might reissue the compliance report follow:

- A quality control review performed by a governmental agency indicates that the auditor did not test an applicable compliance requirement.
- The discovery subsequent to the date of the compliance report that the entity had another government program that was required to be tested.

**SAS No. 118: Other Information in Documents Containing Audited Financial Statements**

**Issued:** February 2010

**Effective date:**

SAS No. 118 SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

**Objective:**

SAS No. 118 addresses the auditor’s responsibility in relation to other information in documents containing audited financial statements and the auditor’s report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor’s opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated.

The objective of the auditor is to respond appropriately when the auditor becomes aware that documents containing audited financial statements and the auditor’s report thereon include other information that could undermine the credibility of those financial statements and the auditor’s report.
This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

This SAS also addresses other information for which a designated accounting standard setter\(^\text{14}\) has issued standards or guidance regarding the format to be used and content to be included when such information is voluntarily presented in a document containing the audited financial statements and the auditor’s report thereon. The auditor’s responsibility for other information presented in a document containing audited financial statements that is required to be included by a designated accounting standard setter is addressed in SAS No. 120, *Required Supplementary Information*.

**Requirements of SAS No. 118:**

**Scope:**

1. SAS No. 118 applies to other information in documents containing audited financial statements and the auditor’s report thereon.

   a. The term “documents containing audited financial statements” refers to:
      
      - Annual reports (or similar documents) that are issued to owners (or similar stakeholders), and
      - Annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor’s report thereon.

      **Note:** The term *annual reports of governments* includes comprehensive annual reports or other annual financial reports that include the government’s financial statements and the auditor’s report thereon.

   2. SAS No. 118 also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management’s request, devotes attention.

**Reading other information**

1. The auditor should read the *other information* of which the auditor is aware in order to identify material inconsistencies, if any, with the audited financial statements.

   a. *Other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor’s report thereon) that is included in a document containing audited financial statements and the auditor’s report thereon, excluding required supplementary information.\(^\text{15}\)

\(^{14}\) Designated accounting standard setter is defined in paragraph 4 of SAS No. 120.

\(^{15}\) Required supplementary information is defined in paragraph 4 of Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, Professional Standards).
b. Other information may consist of the following:
   - A report by management or those charged with governance on operations
   - Financial summaries or highlights
   - Employment data
   - Planned capital expenditures
   - Financial ratios
   - Names of officers and directors
   - Selected quarterly data

c. Other information does not include the following:
   - A press release or similar memorandum or cover letter accompanying the document containing audited financial statements and the auditor’s report thereon
   - Information contained in analyst briefings
   - Information contained on the entity’s web site

2. The auditor should make appropriate arrangements with management or those charged with governance to obtain the other information prior to the report release date. If it is not possible to obtain all of the other information prior to the report release date, the auditor should read such other information as soon as practicable.

**Note:** Obtaining the other information prior to the report release date enables the auditor to resolve possible material inconsistencies and apparent material misstatements of fact with management on a timely basis. An agreement with management regarding when other information will be available may be helpful. The auditor may delay the release of the auditor’s report until management provides the other information to the auditor.

3. The auditor should communicate with those charged with governance the auditor’s responsibility with respect to the other information, any procedures performed relating to the other information, and the results.

4. The auditor is not required to reference the other information in the auditor’s report on the financial statements. However, the auditor may include an explanatory paragraph disclaiming an opinion on the other information.

Example: An auditor may choose to include a disclaimer on the other information when the auditor believes that the auditor could be associated with the information and the user may infer a level of assurance that is not intended.

Exhibit A to SAS No. 118 provides an example of an explanatory paragraph to disclaim an opinion on other information:

“Our audit was conducted for the purpose of forming an opinion on the basic financial statements as a whole. The [identify the other information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has

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16 See paragraph .23 of AU section 339, Audit Documentation (AICPA, Professional Standards, Vol. 1), for the definition of report release date.
not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.”

5. If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be revised.

**Material inconsistencies identified in other information obtained prior to the report release date**

1. When the auditor identifies a material inconsistency prior to the report release date that requires revision of the audited financial statements and management refuses to make the revision, the auditor should modify the auditor’s opinion in accordance with SAS No. 58 (AU section 508), *Reports on Audited Financial Statements*.

2. When the auditor identifies a material inconsistency prior to the report release date that requires revision of the other information and management refuses to make the revision, the auditor should communicate this matter to those charged with governance and:
   a. Include in the auditor’s report an explanatory paragraph describing the material inconsistency, in accordance with paragraph .11 of SAS No. 58,
   b. Withhold the auditor’s report, or
   c. When withdrawal is possible under applicable law or regulation, withdraw from the engagement.

   **Note:** In audits of governmental entities, withdrawal from the engagement or withholding the auditor’s report may not be options. In such cases, the auditor may issue a report to those charged with governance and the appropriate statutory body, if applicable, giving details of the inconsistency.

**Material inconsistencies identified in other information obtained subsequent to the report release date**

1. When revision of the audited financial statements is necessary as a result of a material inconsistency with other information and the auditor’s report on the financial statements has already been released, the auditor should apply the relevant requirements in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report* (AICPA, *Professional Standards*, Vol. 1).
   a. When revision of the other information is necessary after the report release date and management agrees to make the revision, the auditor should carry out the procedures necessary under the circumstances.

   **Note:** When revision of other information is necessary after the report release date and management agrees to make the revision, the auditor’s procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor’s report thereon, and the other information are informed of the need for revision.
b. When revision of the other information is necessary after the report release date but management refuses to make the revision, the auditor should notify those charged with governance of the auditor’s concerns regarding the other information and take any further appropriate action including obtaining advice from the auditor’s legal counsel.

**Material misstatements of fact**

1. If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor should discuss the matter with management.

   a. When, following such discussions, the auditor still considers that there is an apparent material misstatement of fact, the auditor should request management to consult with a qualified third party, such as the entity’s legal counsel, and the auditor should consider the advice received by the entity in determining whether such matter is a material misstatement of fact.

2. When the auditor concludes that there is a material misstatement of fact in the other information that management refuses to correct, the auditor should notify those charged with governance of the auditor’s concerns regarding the other information and take any further appropriate action.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. In a compliance audit, who is responsible for the entity’s compliance with the compliance requirements:
   
   a) the auditor
   b) party responsible for governance
   c) an entity’s management
   d) the user who defines the scope and subject of the compliance engagement

2. In a compliance audit, if there is a risk of material noncompliance, which one of the following procedures can an auditor perform alone separate from other procedures:
   
   a) tests of controls
   b) risk assessment procedures
   c) analytical procedures
   d) tests of details

3. An audit requirement requires an auditor to report on internal control over compliance. The auditor combines the auditor’s report on compliance with a report on internal control over compliance. Which of the following elements should be added to the existing report on compliance:
   
   a) identification of the applicable compliance requirements or a reference to where they can be found
   b) identification of one or more government programs
   c) a statement that the auditor is not expressing an opinion on internal control over compliance
   d) a statement that compliance with the applicable compliance requirements is the responsibility of the entity’s management
4. For purposes of SAS No. 118, which of the following would meet the definition of "other information":

   a) a press release accompanying a document that contains audited financial statements
   b) a report issued by management on the entity’s operations
   c) information that the entity has on its web site
   d) details and information that are part of an analyst briefing

5. Facts: An auditor concludes that there is a material misstatement of fact in other information, and management refuses to correct it. Which of the following actions should the auditor take under SAS No. 118:

   a) auditor should immediately withdraw from the engagement
   b) auditor should notify those charged with governance of the auditor’s concerns
   c) auditor should call his or her legal counsel
   d) auditor should discuss the matter with management and try to convince it to make the correction
1. A: Incorrect. The auditor is responsible for performing audit procedures but is not responsible for the entity’s compliance.

B: Incorrect. The party responsible for governance, such as a board of directors or audit committee, is not responsible for the entity’s compliance with the compliance requirements. In essence, the party responsible for governance is not responsible for the day-to-day operations of an entity which would include an entity’s compliance with the requirements.

C: Correct. SAS No. 117 states that management is responsible for the entity’s compliance with compliance requirements.

D: Incorrect. The user does not define the scope and subject of the compliance engagement.

(See page 33 of the course material.)

2. A: Incorrect. SAS No. 117 states that tests of controls alone are not sufficient to address a risk of material noncompliance.

B: Incorrect. Risk assessment procedures alone are not sufficient to address a risk of material noncompliance.

C: Incorrect. Performing analytical procedures alone is not sufficient to address a risk of material noncompliance.

D: Correct. In response to the assessed risks of material noncompliance, an auditor should design and perform further audit procedures (including tests of details) to obtain sufficient audit evidence about an entity’s compliance with each of the applicable compliance requirements. There is nothing found in SAS No. 117 that would suggest that tests of details alone are not sufficient.

(See page 36 of the course material.)
3. A: Incorrect. Identification of the applicable compliance requirements or a reference to where they can be found is already an element of the report on compliance and does not have to be added.

B: Incorrect. Identification of one or more government programs is an element found in the report on compliance and does not have to be added.

C: Correct. One of the elements that needs to be added is a statement that the auditor is not expressing an opinion on internal control over compliance.

D: Incorrect. The report on compliance already has a statement that compliance with the applicable compliance requirements is the responsibility of the entity’s management. Thus it does not have to be added.

(See page 41 of the course material.)

4. A: Incorrect. SAS No. 118 states that other information excludes a press release or similar memorandum or cover letter accompanying the document containing audited financial statements and the auditor’s report thereon.

B: Correct. One example of other information noted by SAS No. 118 is a report issued by management or those charged with governance, on the entity’s operations.

C: Incorrect. Information contained on an entity’s website is not “other information” according to SAS No. 118.

D: Incorrect. Details and information that is part of an analyst briefing or report are not considered “other information” as stated in SAS No. 118.

(See page 48 of the course material.)

5. A: Incorrect. Although the auditor might ultimately withdraw, SAS No. 118 does not state that the auditor should immediately withdraw from the engagement.

B: Correct. SAS No. 118 states that there is a presumptively mandatory requirement that the auditor should notify those charged with governance of the auditor’s concerns and take any further appropriate action that is necessary.

C: Incorrect. SAS No. 118 does not require that the auditor should call his or her legal counsel even though the auditor is permitted to do so.

D: Incorrect. Management has already refused to make the change. Discussing the change with management is required prior to management refusing to make the change.

(See page 50 of the course material.)
SAS No. 119: Supplementary Information in Relation to the Financial Statements as a Whole

**Issued:** February 2010

**Effective date:**

SAS No. 118 is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

**Objective:**

Other newly issued SASs address different aspects of other or supplementary information:

SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*, addresses the auditor’s responsibility for financial and nonfinancial information (other than the financial statements and the auditor’s report thereon) that is included in a document containing audited financial statements and the auditor’s report thereon, excluding required supplementary information.

SAS No. 120, *Required Supplementary Information*, deals with the auditor’s responsibility for information that a designated accounting standard setter requires to accompany an entity’s basic financial statements.

SAS No. 119 addresses the auditor’s responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

The objective of the auditor, when engaged to report on supplementary information in relation to the financial statements as a whole, is:

- To evaluate the presentation of the supplementary information in relation to the financial statements as a whole, and
- To report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

The supplementary information does not have to be presented with the audited financial statements in order for the auditor to express an opinion on whether such supplementary information...
information is fairly stated, in all material respects, in relation to the financial statements as a whole. However, in accordance with paragraph 10, if the supplementary information is not presented with the audited financial statements, the auditor’s report on the supplementary information is required to make reference to the auditor's report on the financial statements.

The auditor may be engaged to express an opinion on specified elements, accounts, or items of financial statements for the purpose of a separate presentation, in accordance with AU section 623, Special Reports. In such an engagement, the auditor’s procedures are designed to provide the auditor with reasonable assurance that the supplementary information is not misstated by an amount that would be material to the information itself. An engagement to examine the supplementary information or an assertion related to the supplementary information also may be performed in accordance with AT section 101, Attest Engagements.

Although an auditor has no obligation to apply auditing procedures to supplementary information presented outside the basic financial statements, the auditor may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that the auditor may express an opinion on the supplementary information in relation to the financial statements as a whole.

Management may include non-accounting information and accounting information that is not directly related to the basic financial statements in a document containing the basic financial statements. Ordinarily, such information would not have been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, the auditor would be unable to opine on the information in relation to the financial statements as a whole. In some circumstances, however, such information may have been obtained or derived from accounting records that have been tested by the auditor (for example, number of units produced related to royalties under a license agreement or number of employees related to a given payroll period). Accordingly, the auditor may be in a position to express an opinion on such information in relation to the financial statements as a whole.

Requirements of SAS No. 119:

Definition of supplementary information:

1. Supplementary information is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

   a. Supplementary information may be presented in a document containing the audited financial statements or separate from the financial statements.

   b. Supplementary information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.
2. Supplementary information may be prepared in accordance with an applicable financial reporting framework, by regulatory or contractual requirements, in accordance with management’s criteria, or in accordance with other requirements.

**Procedures to determine whether supplementary information is fairly stated, in all material respects in relation to the financial statements as a whole**

1. In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should determine that all of the following conditions are met:

   a. The supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
   b. The supplementary information relates to the same period as the financial statements.
   c. The financial statements were audited, and the auditor served as the principal auditor in that engagement.
   d. Neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements. (Paragraph 11 addresses reporting while not opining on supplementary information when the report on the financial statements contains an adverse opinion or a disclaimer of opinion.)
   e. The supplementary information will accompany the entity’s audited financial statements, or such audited financial statements will be made readily available by the entity.

2. The auditor should obtain the agreement of management that it acknowledges and understands its responsibility:

   a. For the preparation of the supplementary information in accordance with the applicable criteria.
   b. To provide the auditor with the written representations.
   c. To include the auditor’s report on the supplementary information in any document that contains the supplementary information and that indicates that auditor has reported on such supplementary information.
   d. To present the supplementary information with the audited financial statements or, if the supplementary information will not be presented with the audited financial statements, to make the audited financial statements readily available to the intended users of the supplementary information no later than the date of issuance by the entity of the supplementary information and the auditor’s report thereon.

3. In addition to the procedures performed during the audit of the financial statements, in order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements:
a. Inquire of management about the purpose of the supplementary information and
the criteria used by management to prepare the supplementary information, such
as an applicable financial reporting framework, criteria established by a regulator,
a contractual agreement, or other requirements
b. Determine whether the form and content of the supplementary information
complies with the applicable criteria
c. Obtain an understanding about the methods of preparing the supplementary
information and determine whether the methods of preparing the supplementary
information have changed from those used in the prior period and, if the methods
have changed, the reasons for such changes
d. Compare and reconcile the supplementary information to the underlying
accounting and other records used in preparing the financial statements or to the
financial statements themselves
e. Inquire of management about any significant assumptions or interpretations
underlying the measurement or presentation of the supplementary information
f. Evaluate the appropriateness and completeness of the supplementary
information, considering the results of the procedures performed and other
knowledge obtained during the audit of the financial statements.

Note: In evaluating the appropriateness and completeness of the supplementary
information, the auditor may consider testing accounting or other records through
observation or examination of source documents or other procedures ordinarily
performed in an audit of the financial statements.

g. Obtain written representations from management:

• That it acknowledges its responsibility for the presentation of the
  supplementary information in accordance with the applicable criteria
• That it believes the supplementary information, including its form and content,
  is fairly presented in accordance with the applicable criteria
• That the methods of measurement or presentation have not changed from
  those used in the prior period or, if the methods of measurement or
  presentation have changed, the reasons for such changes
• About any significant assumptions or interpretations underlying the
  measurement or presentation of the supplementary information, and
• That when the supplementary information is not presented with the audited
  financial statements, management will make the audited financial statements
  readily available to the intended users of the supplementary information no
  later than the date of issuance by the entity of the supplementary information
  and the auditor’s report thereon.

Note: Audited financial statements are deemed to be readily available if a
third party user can obtain the audited financial statements without any
further action by the entity. For example, financial statements on an entity’s
website may be considered readily available, but being available upon
request is not considered readily available.

4. When engaged to report on supplementary information in relation to the financial
statements as a whole, the auditor need not apply procedures as extensive as would
be necessary to express an opinion on the information on a stand-alone basis.
5. With respect to the supplementary information, the auditor is not required to obtain a separate understanding of the entity’s internal control or to assess fraud risk.

6. The auditor may consider materiality in determining which information to compare and reconcile to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves.

7. The auditor may consider whether it is appropriate to address the supplementary information in procedures that the auditor performs in auditing the financial statements, including, but not limited to, the following:
   a. Obtaining an updated representation letter
   b. Performing subsequent events procedures
   c. Sending a letter of audit inquiry to the client’s lawyer specifically regarding the information contained in the supplementary information

8. Subsequent events and supplementary information:
   a. The auditor has no responsibility for the consideration of subsequent events with respect to the supplementary information. However, if information comes to the auditor’s attention prior to the release of the auditor’s report on the financial statements regarding subsequent events that affect the financial statements, the auditor should apply the relevant requirements in AU section 560, Subsequent Events.
   b. If information comes to the auditor’s attention subsequent to the release of the auditor’s report on the financial statements regarding facts that may have existed at that date, which might have affected the report had the auditor been aware of such facts, the auditor should apply the relevant requirements in AU section 561, Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report.

Reporting on supplementary information:

1. When the entity presents the supplementary information with the financial statements, the auditor should report on the supplementary information in either:
   - An explanatory paragraph following the opinion paragraph in the auditor’s report on the financial statements, or
   - In a separate report on the supplementary information.

2. The explanatory paragraph or separate report should include the following elements:
   a. A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole.
   b. A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements.
   c. A statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
d. A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America.

e. If the auditor issues an unqualified opinion on the financial statements and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor’s opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

f. If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor’s opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor’s report explaining the qualification), such information is fairly stated, in all material respects, in relation to the financial statements as a whole.

3. When the audited financial statements are not presented with the supplementary information, the auditor should report on the supplementary information in a separate report. When reporting separately on the supplementary information, the report should include, in addition to the elements noted above, a reference to the report on the financial statements, the date of that report, the nature of the opinion expressed on the financial statements, and any report modifications.

a. The date of the auditor’s report on the supplementary information in relation to the financial statements as a whole should not be earlier than the date on which the auditor completed the procedures required in paragraph 3(a) through (g) above.

4. When the auditor’s report on the audited financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information.

a. In such a situation, when permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor’s report on the supplementary information should state that because of the significance of the matter disclosed in the auditor’s report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information.

5. If the auditor concludes, on the basis of the procedures performed, that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the supplementary information. If management does not revise the supplementary information, the auditor should either:
a. Modify the auditor’s opinion on the supplementary information and describe the misstatement in the auditor’s report, or
b. If a separate report is being issued on the supplementary information, withhold the auditor’s report on the supplementary information.

Exhibit A: Illustrative Reporting Examples
[Source: Exhibit A of SAS No. 119]

Example 1: Unqualified opinion on the financial statements and the auditor concludes that the supplementary information is fairly stated:

The following is an example of an explanatory paragraph that the auditor may use when engaged to report on supplementary information in relation to the financial statements as a whole and the auditor is issuing an unqualified opinion on the financial statements and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole:

“Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [identify accompanying supplementary information] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.”

Example 2: Qualified opinion on supplementary information:

The following is an example of an explanatory paragraph that the auditor may use when engaged to report on supplementary information in relation to the financial statements as a whole and the auditor is issuing a qualified opinion on the financial statements and a qualified opinion on the supplementary information:

“Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [identify accompanying supplementary information] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.”
America. In our opinion, except for the effect on the supplementary information of [describe reason for qualification of the auditor’s opinion on the financial statements and reference the explanatory paragraph], the information is fairly stated in all material respects in relation to the financial statements as a whole.”

**Example 3: Auditor disclaims an opinion on the supplementary information:**

The following is an example of an explanatory paragraph that the auditor may use when engaged to report on supplementary information in relation to the financial statements as a whole and the auditor is disclaiming an opinion on the financial statements:

“We were engaged for the purpose of forming an opinion on the basic financial statements as a whole. The [identify accompanying supplementary information] is presented for purposes of additional analysis and is not a required part of the financial statements. Because of the significance of the matter described above [the auditor may describe the basis for the adverse opinion], it is inappropriate to and we do not express an opinion on the supplementary information referred to above.”

**Example 4: Auditor reports separately on supplementary information:**

The following are reporting examples that the auditor may use when reporting separately on supplementary information in relation to the financial statements as a whole.

**Example 4A:**

The following may be used when the auditor has issued an unqualified opinion on the financial statements and an unqualified opinion on the supplementary information:

“We have audited the financial statements of XYZ Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated [date of the auditor’s report on the financial statements] which contained an unqualified opinion on those financial statements. Our audit was performed for the purpose of forming an opinion on the financial statements as a whole. The [identify supplementary information] is presented for the purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.”
**Example 4B:**
The following may be used when the auditor has issued a qualified opinion on the financial statements and a qualified opinion on the supplementary information:

“We have audited the financial statements of XYZ Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated [date of the auditor’s report on the financial statements, the nature of the opinion expressed on the financial statements, and a description of the report modifications]. Our audit was performed for the purpose of forming an opinion on the financial statements as a whole. The [identify supplementary information] is presented for the purpose of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, except for the effect on the accompanying information of the qualified opinion on the financial statements as described above, the information is fairly stated in all material respects in relation to the financial statements as a whole.”

**Example 4C:**
The following may be used when the auditor has disclaimed an opinion on the financial statements:

“We were engaged to audit the financial statements of XYZ Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated [date of the auditor’s report on the financial statements]. However, the scope of our audit of the financial statements was not sufficient to enable us to express an opinion because [describe reasons] and accordingly we did not express an opinion on such financial statements. The [identify the supplementary information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Because of the significance of the matter discussed above, it is inappropriate to and we do not express an opinion on the supplementary information referred to above.”

**Example 4D:**
The following may be used when the auditor has issued an adverse opinion on the financial statements:

“We have audited the financial statements of XYZ Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated [dated of the auditor’s report on the financial statements] which stated that the financial statements are not presented fairly in accordance with [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America [GAAP])] because [describe reasons]. The [identify the supplementary information] is presented for purposes of
additional analysis and is not a required part of the basic financial statements. Because of the significance of the matter discussed above, it is inappropriate to and we do not express an opinion on the supplementary information referred to above."

SAS No. 120: Required Supplementary Information

Issued: February 2010

Effective date:

SAS No. 120 is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Objective:

SAS No. 120 addresses the auditor’s responsibility with respect to information that a designated accounting standard setter requires to accompany an entity’s basic financial statements (hereinafter referred to as required supplementary information). In the absence of any separate requirement in the particular circumstances of the engagement, the auditor’s opinion on the basic financial statements does not cover required supplementary information.

The auditor’s responsibility for financial and nonfinancial information (other than the financial statements and the auditor’s report thereon) that is included in a document containing audited financial statements and the auditor’s report thereon but that is not required by a designated accounting standard setter is addressed in SAS No. 118 Other Information in Documents Containing Audited Financial Statements (AICPA, Professional Standards).

The objectives of the auditor when a designated accounting standard setter requires information to accompany an entity’s basic financial statements are to perform specified procedures in order to:

a. Describe, in the auditor’s report, whether required supplementary information is presented and
b. Communicate when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Requirements of SAS No. 120:

1. Definition:

Required supplementary information: Information that a designated accounting standard setter requires to accompany an entity’s basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.
Designated accounting standard setter: A body designated by the AICPA council to establish GAAP pursuant to Rule 202, Compliance With Standards (AICPA, Professional Standards), and Rule 203, Accounting Principles. The bodies designated by the council to establish professional standards with respect to financial accounting and reporting principles pursuant to Rules 202 and 203 are the following:

- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- Federal Accounting Standards Advisory Board (FASAB)
- International Accounting Standards Board (IASB)

Basic financial statements: Financial statements presented in accordance with an applicable financial reporting framework as established by a designated accounting standard setter, excluding required supplementary information.

Applicable financial reporting framework: The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation 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 regulations.

Prescribed guidelines: The authoritative guidelines established by the designated accounting standard setter for the methods of measurement and presentation of the required supplementary information.

1. Auditor procedures: The auditor should apply the following procedures to required supplementary information:

   a. Inquire of management about the methods of preparing the information, including:

      - Whether it has been measured and presented in accordance with prescribed guidelines
      - Whether methods of measurement of presentation have been changed from those used in the prior period and the reasons for any such changes
      - Whether there were any significant assumptions or interpretations underlying the measurement or presentation of the information

   b. Compare the information for consistency with:

      - Management’s responses to the foregoing inquiries
      - The basic financial statements
      - Other knowledge obtained during the audit of the basic financial statements

   c. Obtain written representations from management:

      - That it acknowledges its responsibility for the required supplementary information
      - About whether the required supplementary information is measured and presented in accordance with prescribed guidelines
• About whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes
• About any significant assumptions or interpretations underlying the measurement or presentation of the required supplementary information

2. If the auditor is unable to complete the procedures in paragraph 1 above, the auditor should consider whether management contributed to the auditor's inability to complete the procedures.

   a. If the auditor concludes that the inability to complete the procedures was due to significant difficulties encountered in dealing with management, the auditor should inform those charged with governance.

   **Note:** Paragraph .39 of AU section 380, *The Auditor's Communication With Those Charged With Governance* provides guidance when the auditor encounters significant difficulties in dealing with management during the audit.

**Reporting**

1. **Explanatory paragraph:** The auditor should include an explanatory paragraph in the auditor’s report on the financial statements to refer to the required supplementary information.

   a. The explanatory paragraph should be included after the opinion paragraph and should include language to explain the following circumstances, as applicable:

   • The required supplementary information is included, and the auditor has applied the audit procedures.
   • The required supplementary information is omitted.
   • Some required supplementary information is missing and some is presented in accordance with the prescribed guidelines.
   • The auditor has identified material departures from the prescribed guidelines.
   • The auditor is unable to complete the auditor procedures.
   • The auditor has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

2. If the entity has presented all or some of the required supplementary information, the explanatory paragraph referred to above should include the following elements:

   a. A statement that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] require that the [identify the required supplementary information] be presented to supplement the basic financial statements

   b. A statement that such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context

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19 See AU section 333, *Management Representations* (AICPA, *Professional Standards*, Vol. 1), for additional requirements and guidance with respect to obtaining written representations from management as part of an audit of financial statements performed in accordance with generally accepted auditing standards.
c. If the auditor is able to complete the audit procedures:

- A statement that the auditor has applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to the auditor’s inquiries, the basic financial statements, and other knowledge the auditor obtained during the audit of the basic financial statements
- A statement that the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide the auditor with sufficient evidence to express an opinion or provide any assurance

d. If the auditor is unable to complete the audit procedures:

- A statement that the auditor was unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States because [state the reasons]
- A statement that the auditor does not express an opinion or provide any assurance on the information

e. If some of the required supplementary information is omitted:

- A statement that management has omitted [description of the missing required supplementary information] that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] require to be presented to supplement the basic financial statements
- A statement that such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- A statement that the auditor’s opinion on the basic financial statements is not affected by the missing information

f. If the measurement or presentation of the required supplementary information departs materially from the prescribed guidelines, a statement that although the auditor’s opinion on the basic financial statements is not affected, material departures from prescribed guidelines exist [describe the material departures from the applicable financial reporting framework]

g. If the auditor has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, a statement that although the auditor’s opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by [identify designated accounting standard setter]
Note: Because the required supplementary information accompanies the basic financial statements, the auditor's report on the financial statements, the auditor's report on the financial statements includes a discussion of the responsibility taken by the auditor on that information. However, because the required supplementary information is not part of the basic financial statements, the auditor's opinion on the fairness of presentation of such financial statements in accordance with the applicable financial reporting framework, is not affected by the presentation by the entity of the required supplementary information or the failure to present some or all of such required supplementary information. Furthermore, if the required supplementary information is omitted by the entity, the auditor does not have a responsibility to present that information.

3. If all of the required supplementary information is omitted, the explanatory paragraph should include the following elements:

a. A statement that management has omitted [description of the missing required supplementary information] that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America) requires to be presented to supplement the basic financial statements.

b. A statement that such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

c. A statement that the auditor’s opinion on the basic financial statements is not affected by the missing information.

Exhibit A: Examples of Explanatory Paragraphs When Reporting on Required Supplementary Information

Following are examples of explanatory paragraphs from Exhibit A of SAS No. 120.

The Required Supplementary Information Is Included, the Auditor Has Applied the Specified Procedures, and No Material Departures from Prescribed Guidelines Have Been Identified

"[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America) require that the [identify the required supplementary information]) on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not
express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.”

All Required Supplementary Information Omitted

“Management has omitted [describe the missing required supplementary information] that [identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] requires to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.”

Some Required Supplementary Information Is Omitted and Some Is Presented in Accordance With the Prescribed Guidelines

“[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America) requires that [identify the included supplementary information] be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with evidence sufficient to express an opinion or provide any assurance.

Management has omitted [describe the missing required supplementary information] that [identify the applicable financial reporting framework] requires to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.”
Material Departures from Prescribed Guidelines Identified

“[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] requires that the [identify the supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America because [state the reasons]. We do not express an opinion or provide any assurance on the information.”

Unresolved Doubts About Whether the Required Supplementary Information Is in Accordance With Prescribed Guidelines

“[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)] requires that the [identify the supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter] who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance. Although our opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by [identify designated accounting standard setter]. [The auditor may consider including in the report the reason(s) he or she was unable to resolve his or her doubts.]”
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Facts: As part of its audit of financial statements, an auditor is required to opine on whether supplementary information is fairly stated. Which of the following procedures is required by the auditor under SAS No. 119:
   a) perform standard auditing procedures as if the supplementary information were the subject matter of the audit
   b) confirm the supplementary information with third parties
   c) ask management to compare and reconcile the information to the underlying accounting records on behalf of the auditor
   d) inquire of management about any significant assumptions or interpretations related to the information

2. Facts: An auditor is issuing an audit report on financial statements. The entity has supplementary information that the auditor needs to report on. Which of the following is an appropriate approach the auditor can take in reporting on the supplementary information:
   a) the auditor must present the supplementary information as a separate engagement and the report thereon cannot be included in the same package as the underlying financial statements
   b) the auditor may report on the supplementary information in an explanatory paragraph in the auditor's report on the financial statements
   c) the auditor may report on the supplementary information but it must be a separate report that immediately follows the report on the financial statements
   d) the auditor must report on the supplementary information as part of the opinion on the underlying financial statements; no separate paragraph is needed

3. Which of the following information does a designated accounting standard setter require to accompany an entity's basic financial statements under SAS No. 120:
   a) other information in documents containing audited financial statements
   b) supplementary information
   c) required supplementary information
   d) notes to financial statements
4. Facts: An auditor is auditing required supplementary information and is unable to complete her procedures. Which of the following statements should she include in an explanatory paragraph in the report on the audited financial statements, as required by SAS No. 120:

a) a statement that the auditor has applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America
b) a statement that the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide the auditor with sufficient evidence to express an opinion or provide any assurance
c) a statement that the auditor does not express an opinion or provide any assurance on the information
d) a statement that management has omitted certain information that the applicable financial reporting framework requires to be presented to supplement the basic financial statements
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. SAS No. 119 does not require that standard auditing procedures be performed on the supplementary information.

   B: Incorrect. There is no requirement to confirm the supplementary information with third parties.

   C: Incorrect. The auditor, not management, is required to compare and reconcile the information to the underlying accounting records.

   **D: Correct.** SAS No. 119 requires the auditor to inquire of management about any significant assumptions or interpretations underlying the measurement and presentation of the supplementary information.

   (See pages 57 to 58 of the course material.)

2. A: Incorrect. SAS No. 119 does not require that the auditor must present the supplementary information as a separate engagement. Further, there is no restriction on the report being included in the same package as the underlying financial statements.

   **B: Correct.** The auditor may report on the supplementary information in an explanatory paragraph following the opinion paragraph in the auditor’s report on the financial statements.

   C: Incorrect. The auditor is permitted to issue a separate report on the supplementary information but it is not required and it does not have to immediately follow the report on the financial statements.

   D: Incorrect. The report on the supplementary information is not part of the opinion on the underlying financial statements. A separate explanatory paragraph is required if the supplementary information is included as part of the report on the financial statements.

   (See page 59 of the course material.)
3. A: Incorrect. Other information is not required to accompany the financial statements. It is optional information.

B: Incorrect. Supplementary information, in general, is not required to accompany the basic financial statements. If a designated accounting standard setter requires that this information accompany the financial statements, it would be called “required supplementary information.”

C: Correct. Required supplementary information is information that a designated accounting standard setter requires to accompany an entity’s basic financial statements.

D: Incorrect. Notes to financial statements are already part of the basic financial statements.

(See page 64 of the course material.)

4. A: Incorrect. This statement is required if the auditor is able to complete her procedures.

B: Incorrect. This statement is required if the auditor is able to complete her procedures.

C: Correct. If the auditor is unable to complete her auditing procedures, she is required to include a statement that the auditor does not express an opinion or provide any assurance on the information.

D: Incorrect. The statement is required only if some of the required supplementary information is omitted, and not because the auditor has been unable to complete her procedures.

(See page 67 of the course material.)
II. Other Auditing Developments

A. CLIENT AND EMPLOYEE FRAUD

1. General

Regardless of whether the U.S. economy is in a growth phase or a recession, there continues to be a record number of frauds being committed either in the form of fraudulent financial reporting cases involving management, or misappropriation of assets (theft) involving employees. As management continues to have pressure to produce earnings to satisfy its shareholders and other third parties, fraudulent financial reporting has flourished. Similarly, employee fraud continues to victimize all industries and companies, regardless of whether in the public or nonpublic sectors. Employees use fraud as a means to solve their personal financial pressures from being strapped with record amounts of personal debt and to reimburse themselves for being overworked in understaffed businesses.

Although the recent cases of fraudulent financial reporting are not as public as Enron, they are just as pervasive. Examples where management has committed fraud include erroneous adjustments made to financial statements, overstated sales and accounts receivable, fabricated inventories, and misapplication of generally accepted accounting principles. There have also been cases of side agreements made in which management modified the terms and conditions of billings as a means to conceal overstated sales. Then, of course, there are the high-profile cases of Enron, WorldCom and others, involving use of off-balance sheet entities and overly aggressive capitalization policies.

The reality is that fraud occurs all of the time, regardless of the economy's cycle, and is committed for many different reasons. For example, because of strong economic times, a company may be more inclined to be overly optimistic in connection with earnings estimates. When those estimates do not materialize, management may attempt to artificially inflate earnings.

What we also know is that there is a direct correlation between the tone that management sets and the degree of fraud that is committed. Consider the conclusion of the Report of the National Commission on Fraudulent Financial Reporting:

"The tone set by top management- the corporate environment or culture within which financial reporting occurs, is the most important factor contributing to the integrity of the financial reporting process......if the tone set by management is lax, fraudulent financial reporting is more likely to occur."

With respect to SEC companies, companies continue to employ several practices to manage earnings:

- Restructuring charges are accelerated or overstated to understate net income.
- Major components of acquisition costs are expensed such as research and development.
• Reserves and allowances are established for a rainy day in years where earnings exceed expectations.

• There are misapplications of accounting principles.

• There is early recognition of revenue.

2. 2009 Fraud Survey:

In August 2009, KPMG issued its annual fraud survey based on responses from corporate executives.

The results suggest that fraud and illegal acts are still rampant through U.S. businesses and that many executives believe such acts are likely to increase in the future.

• 65 percent of respondents perceive fraudulent and illegal acts to be significant risks in their industries.

• 66 percent viewed inadequate internal controls and 47 percent cited management’s override of controls as the highest enablers of fraud to occur.

• 47 percent thought the best way for them to uncover fraud or misconduct was through internal audits and compliance, while 20% thought whistle blowing was effective.

• 32 percent said they expect fraud or misconduct to rise in their organizations in one of three categories:
  - Financial reporting (8% expect a rise)
  - Asset misappropriation (25% expect a rise)
  - Other illegal or unethical acts (20% expect a rise)

• 8 percent stated that fraudulent financial reporting would increase while 66 percent said it would stay at the current level.

• 27 percent stated that their organizations did not know how to conduct fraud investigations.

• 33 percent stated that their firms lacked protocols on how to remedy control breakdowns.

• 71 percent fear the loss of public trust that would occur if a fraud occurred in their organizations.

When asked about the types of improvements needed to deal with fraud and illegal acts:

• 67 percent stated that better communication and training was needed,

• 65 percent stated that better technology-driven techniques were needed, and

• 60 percent stated that better fraud risk assessments were needed.

In addition to the statistics previously noted, the KPMG addresses some of the fraud risks that exist due to the current economic climate.
In particular, the Study notes four areas of concern:

a. **Revenue recognition**: An organization should understand how sales transactions can be manipulated and specific controls and monitoring should be in place to ensure appropriate timing of revenue recognition.

b. **Loan covenants**: Organizations need to pay attention to financial data that affects covenants, and monitor when corporate loans come due for renewal.

c. **Liability accruals**: Organizations need to inquire about rainy-day reserves in accruals and understand significant fluctuations in those accruals.

d. **Subjectivity in the balance sheet**: Directors need to understand subjective balance sheet accounts such as valuation allowances, assumed rates of return, processes to value illiquid assets, contingency accruals, and environmental reserves.

3. **Conditions needed for fraud – the fraud triangle**

*Three conditions* usually are present when a fraud occurs. These three conditions are commonly referred to by fraud examiners as the **fraud triangle**.

1. **Incentive or Pressure**: Management or other employees have an incentive or are under pressure (financial or otherwise), which provides a reason to commit fraud.

2. **Opportunity**: Circumstances exist, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity for a fraud to be perpetrated.

3. **Rationalization or attitude**: Individuals involved in the fraud are able to rationalize committing the fraud. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.
Although the three conditions of the fraud triangle are typically present in a perpetration of a fraud, there are circumstances when only one, or even two of the conditions may be present.

**Examples:**

1. An employee who is *under personal financial pressure* and is *able to rationalize committing a fraud*, is able to perpetrate a fraud even though there is a *strong system of internal control*. The employee uses a narrow breach in the system of internal control.

2. A company that has a *poor system of internal control* is victimized by an employee fraud. The employee, who has *no incentive/pressure* to commit the fraud and appears *not to possess a rationalization/attitude* to commit a fraud, perpetrates a fraud because he or she is tempted by his or her ability to commit the fraud within a poor system of internal control.

3. A manager/owner has *an incentive/pressure* to achieve a certain income level to avoid triggering a loan default, where there is no indication of the presence of the other two conditions.

The three conditions of fraud need to be considered in light of the size, complexity and ownership attributes of the entity.

For example a larger entity might have controls that constrain improper conduct by management including:
- Existence of an audit committee
- Use of an internal audit function
- Existence and enforcement of a formal code of conduct

Conversely, a smaller, usually closely held entity will not have any of the same constraints placed on the management of a larger entity, as noted above. Rarely is an audit committee or internal audit function in use. Moreover, a formal code of conduct is not only non-existent, but also may be discouraged for stifling the entrepreneurial environment. Instead of having formal controls, a smaller entity might have other attributes such as developing a culture that emphasizes integrity and ethical behavior.

In such situations, the auditor should be careful not to be fooled into a sense of security.

**Notes:** An otherwise honest individual can still commit fraud in an environment that imposes sufficient pressure on him or her. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

Although all three conditions of the fraud triangle may help contribute to the perpetration of fraud, the most important condition is *opportunity*. Where there is incentive and rationalization to commit a fraud, such a fraud cannot occur unless the system of internal control allows it to happen. The number one reason why fraud occurs is due to *poor internal controls*, thus creating the opportunity for it to occur.

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20 According to the *Report to the Nation, Occupational Fraud and Abuse* (Association of Certified Fraud Examiners), in 86% of the frauds examined, either poor internal controls or controls that were in place, but were ignored, were cited as the primary reason why the fraud occurred.
The fraud triangle in the 2010 economic climate:

The 2010 economic climate is ripe for fraud in that the three conditions of the fraud triangle exist in many organizations.

Incentive or pressure: Today there is tremendous incentive and pressure to commit fraud. In particular, high layoffs coupled with the pressure for organizations to achieve more output with fewer staff creates pressure on employees. Along with the incentive and pressure on the job, those same employees may feel personal pressure from high levels of personal debt and defaulted mortgages.

Opportunity: With smaller accounting and other staffs, clearly internal business environments may provide the opportunity for employees and management to commit fraud.

Rationalization or attitude: It is easier for an employee to rationalize the perpetration of a fraud when he or she is being squeezed inside, as well as outside, the organization. Pressure to increase earnings means the employee is performing extraordinary efforts for the benefit of the shareholders with little to trickle down to the employees. Moreover, with the elimination of bonuses and contributions to retirement plans within some organizations, employees feel betrayed and can more easily justify committing a fraud.

4. Sentences for fraud are getting longer:

What is the appropriate sentence for fraud: 24 years or death?

With all the frauds that have been prosecuted in the past few years, there is a debate going on as to what is the appropriate punishment for one who commits fraud. The range of sentences worldwide is expansive.

On one end of the spectrum is Michael Resnick, CFO of Royal Ahold NV’s U.S. Foodservice Inc. He pleaded guilty to playing a key role in the huge fraud committed, but was sentenced only to six months of home detention and three years’ probation.

On the other end is Jeffrey Skilling, former Enron CFO, who was sentenced to 24 years in federal prison.

So, what is the “right” sentence?

The Chinese may be taking fraud more seriously than their U.S. counterparts, particularly in the case of a fraud committed at the China Construction bank. In this case, Zhou Limin, the former head of the Bank and its accountant, Lui Yibing stole approximately $30 million from 30 organizations and 400 individuals, of which only $900,000 has been recovered. A Chinese court sentenced both of them to the death penalty. They lost their appeal.

U.S. sentences are getting long:
Although the U.S. courts have yet to elevate fraud cases sentences to death, the tide is certainly turning as courts look at white-collar fraud crime far more seriously than they once did. The days of spending five years in a “country-club” prison for committing fraud are gone.
In the past few years, in some cases, the courts have issued sentences for fraud that exceed those for first degree murder. (On average, murders serve seven years of their sentences.)

We all know that Bernie Madoff got 150 years for his massive $60 billion fraud. But 150 years is certainly not the longest issued in the past few years. In one 2008 case, the federal court handed out a sentence to 72-year old Norman Schmidt for 330 years for an investment scheme. 330 years was the longest sentence issued in a federal white-collar case in Colorado, and most likely anywhere else.

In another case, Virginia authorities sought a 400-year sentence against Edward Hugh Okun in a $126 million fraud case. Okun used more than $40 million of escrow funds held for clients involved in 1031 transactions. Although the authorities wanted 400 years, in the end, the 58-year old Okun received a sentence of 100 years. Why such a long sentence? A key factor that that influenced the long sentence was the fact that Okun stole risk-free escrowed funds as compared with Madoff investors who were fully aware that their funds were invested.

In another high profile case, New York attorney Marc Dreier received only a 20-year sentence for his $400 million Ponzi scheme, even though prosecutors sought 145 years.

Even though the sentencing guidelines for fraud are between 5-15 years, the courts appear willing to punish fraudsters with much longer sentences as a deterrent against future frauds being perpetrated.

**B. THE MOVE TO DUMP THE PCAOB**

Sarbanes-Oxley established the Public Company Accounting Oversight Board (PCAOB) which acts as overseer of public company audits. Since its inception in 2003, much of the criticism of Sarbanes has rested with the PCAOB and the issuance of its strict overreaching auditing standards.

Now, it appears payback is in the works with a court case that could eliminate the PCAOB altogether.

In December 2009, the United States Supreme Court heard a critical case involving an attempt to dissolve the PCAOB on the grounds that it is unconstitutional.

The case started in 2006 when the Free Enterprise Fund and a Nevada CPA firm, Beckstead and Watts, LLP, filed a lawsuit that challenged the legal authority of the PCAOB. Although several legal arguments were made, the crux of the case was that the PCAOB violates Article II of the U.S. Constitution, referred to as the appointments clause. The plaintiff asserted that the PCAOB comes under Article II and, therefore, must be appointed by the President of the United States with the consent of the U.S. Senate, and not the SEC. Under the current system, the PCOAB is a non-governmental body that is appointed by and reports to the SEC, with the President having no direct control over the PCAOB. The only way that the President can assert control over the PCAOB is by threatening to fire the SEC Chairman if he or she does not exert pressure over the PCAOB.
What initiated the litigation was criticism by the PCAOB of a CPA firm’s inspection report. The firm alleged that the PCAOB was not a legal body and had no right to perform any inspections of public company auditors.

A second underlying issue that drove the lawsuit was the claim that the costs for small public companies to operate under Sarbanes and the PCAOB are unreasonably high and force such small companies out of business, delist, or move to a foreign country exchange.

The plaintiffs lost the case as well as the appeal in the U.S. Court of Appeals (in D. C.), leading to the ultimate showdown in the United States Supreme Court.

If the Supreme Court were to invalidate the PCAOB, the effects would be immediate and far reaching. In essence, one key element of Sarbanes (the PCAOB) would be considered unconstitutional. Because Sarbanes does not have a severability clause, the entire Sarbanes-Oxley Act could be deemed unconstitutional and unenforceable. Once Sarbanes is eliminated, some, but certainly not all, of the elements of Sarbanes would have to come back through newly negotiated legislation, which would likely be watered down. If Sarbanes is out, so is Section 404, the Section 304 executive bonus clawback provision, and other controversial sections.

C. NEW PCAOB AUDITING STANDARDS

Auditing Standard (AS) No. 7: Engagement Quality Review and Confirming Amendment to the Board’s Interim Quality Control Standards

In February 2010, the Securities and Exchange Commission (SEC) approved a new standard proposed by the Public Company Accounting Oversight Board (PCAOB), Auditing Standard No. 7, Engagement Quality Review (AS7).

Background:

Section 103 of the Sarbanes-Oxley Act directs the PCAOB to set standards for public company audits, including a requirement for each registered public accounting firm to "provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance . . . ."

A well-performed engagement quality review ("EQR") can serve as an important safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality.

Prior to the adoption of AS7, the PCAOB relied on an interim standard used by the accounting profession, commonly known as "Appendix E" for SECPS member firms.

AS7 provides that accounting firms performing audits and interim reviews of financial information for public companies should plan to commit more resources, including partner time, to engagement quality reviews for fiscal years beginning on or after December 15, 2009.

AS7 will result in partners devoting more hours to a quality review which may also require the work of assistants in larger audits.
Requirements of AS7:

1. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the Public Company Accounting Oversight Board (“PCAOB”).

2. Qualifications of Engagement Quality Reviewer:
   The engagement quality reviewer must have the following attributes:
   a. Be an associated person of a registered public accounting firm. An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.21
   b. Have competence, independence, integrity, and objectivity.
   
   **Note:** The firm’s quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.
   
   c. Possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.
   
   d. Be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review.
   
   **Note:** The reviewer may use assistants in performing the engagement quality review. Personnel who assist the engagement quality reviewer must also be independent, perform the assigned procedures with integrity, and maintain objectivity in performing the review.

To maintain objectivity, the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6)(ii), are exempt from the requirement in this paragraph.

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21 An outside reviewer who is not already associated with a registered public accounting firm would become associated with the firm issuing the report if he or she (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review, or (2) performs the review as agent for the firm issuing the report.
Engagement Quality Review for an Audit Information

1. Engagement Quality Review Process

   a. The engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should:

      1) Hold discussions with the engagement partner and other members of the engagement team, and
      2) Review documentation.

   b. The engagement quality reviewer should:

      1) Evaluate the significant judgments that relate to engagement planning, including:

         • The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
         • The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, and
         • The judgments made about materiality and the effect of those judgments on the engagement strategy.

      2) Evaluate the engagement team's assessment of, and audit responses to:

         • Significant risks identified by the engagement team, including fraud risks, and
         • Other significant risks identified by the engagement quality reviewer through performance of the procedures required by this standard.

      3) Evaluate the significant judgments made about (a) the materiality and disposition of corrected and uncorrected identified misstatements and (b) the severity and disposition of identified control deficiencies.

      4) Review the engagement team's evaluation of the firm's independence in relation to the engagement.

      5) Review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters.

      6) Review the financial statements, management's report on internal control, and the related engagement report.

      7) Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.
8) Evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

9) Evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

2. Evaluation of Engagement Documentation

   a. The engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the required procedures 1) Indicates that the engagement team responded appropriately to significant risks, and 2) Supports the conclusions reached by the engagement team with respect to the matters reviewed.

3. Concurring Approval of Issuance

   a. The engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

   Note: A significant engagement deficiency in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

   b. In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

**Engagement Quality Review for a Review of Interim Financial Information**

1. Engagement Quality Review Process

   a. The engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary, satisfy the requirements in AS7:

   1) Hold discussions with the engagement partner and other members of the engagement team, and
   2) Review documentation.

   b. In a review of interim financial information, the engagement quality reviewer should:
1) Evaluate the significant judgments that relate to engagement planning, including the consideration of:
   - The firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
   - The company's business, recent significant activities, and related financial reporting issues and risks, and
   - The nature of identified risks of material misstatement due to fraud.

2) Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

3) Perform the procedures:
   a) Review the engagement team's evaluation of the firm's independence in relation to the engagement.
   b) Review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters.

4) Review the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be issued.

5) Read other information in documents containing interim financial information to be filed with the SEC and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the interim financial information or material misstatements of fact of which the engagement quality reviewer is aware.

6) Perform the following procedures:
   a) Evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.
   b) Evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

2. **Evaluation of Engagement Documentation**
   
a. In a review of interim financial information, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the required procedures supports the conclusions reached by the engagement team with respect to the matters reviewed.
3. **Concurring Approval of Issuance**

   a. In a review of interim financial information, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care, the review required by this standard, he or she is not aware of a significant engagement deficiency.

   **Note:** A *significant engagement deficiency* in a review of interim financial information exists when: (1) the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

   b. In a review of interim financial information, the firm may grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no report is issued) only after the engagement quality reviewer provides concurring approval of issuance.

**Documentation of an Engagement Quality Review**

1. Documentation of an engagement quality review should contain sufficient information to enable an experienced auditor (having no previous connection with the engagement) to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies:

   a. The engagement quality reviewer, and others who assisted the reviewer,
   
   b. The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer, and
   
   c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

2. Documentation of an engagement quality review should be included in the engagement documentation.

3. The requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, *Audit Documentation*, apply with respect to the documentation of the engagement quality review.

**Qualifications of engagement quality reviewer**

AS7 requires the following:

1. The engagement quality reviewer must be associated with a registered public accounting firm and must be a partner or another individual in an equivalent position.

   a. The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.
b. The reviewer must be independent of the company, conduct the review with integrity, and maintain objectivity.

2. EQR approval is appropriate only if, "after performing with professional due care the review required by this standard, [the EQR professional] is not aware of a significant engagement deficiency." The statement defines significant engagement deficiency.

Changes in language

1. The scope of the changes in engagement quality review procedures is evident in a comparison of the language of the interim statement and AS7.

2. The interim statement says that the concurring partner reviewer's responsibility is fulfilled by performing the following procedures:

   a. Discussing significant accounting, auditing and financial reporting matters with the audit engagement partner.
   b. Discussing the audit engagement team's identification and audit of high-risk transactions and account balances.
   c. Reviewing documentation of the resolution of significant accounting, auditing and financial reporting matters, including documentation of consultation with firm personnel or resources external to the firm's organization (such as standard-setters).
   d. Reviewing a summary of unadjusted audit differences.
   e. Reading the financial statements and auditors' report.
   f. Confirming with the audit engagement partner that there are no significant unresolved matters.

3. The language of AS7 explicitly directs the engagement quality reviewer to evaluate risks to the firm and the company, evaluate the severity of deficiencies in control, and determine if there have been "appropriate" consultations on difficult matters. A final requirement calls upon the reviewer to: "Based on the procedures required by this standard, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies."

4. The nine procedures outlined in AS7 say that the reviewer should:

   a. Evaluate engagement planning, including:
      • The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,
      • The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, and
      • The judgments made about materiality and the effect of those judgments on the engagement strategy.
   b. Evaluate the risk assessments and audit responses, including the identification of significant risks, including fraud risks, and the engagement procedures performed in response to significant risks.
   c. Review the engagement team's evaluation of the firm's independence in relation to the engagement.
d. Evaluate judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) the severity and disposition of identified control deficiencies.

e. Determine if appropriate matters have been communicated, or identified for communication to the audit committee, management, and other parties, such as regulatory bodies.

f. Review the financial statements, management's report on internal control, and the related engagement report.

g. Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission ("SEC") and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.

h. Based on the procedures required by this standard, evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

i. Based on the procedures required by this standard, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

Documentation requirements

1. Documentation of a quality review should provide information that identifies:

   a. The engagement quality reviewer, and others who assisted the reviewer,
   b. The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer, and
   c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

2. Documentation of an engagement quality review should be included in the engagement documentation.

3. The SEC, in its order approving the EQR standard, encouraged the PCAOB to issue guidance on the standard's documentation requirements. The PCAOB plans to publish Staff Questions and Answers on implementation of the standard in the near future.

D. AUDITING STANDARDS BOARD CONVERGENCE PLAN

The Auditing Standards Board (ASB) has started a project aimed at ultimately converging U.S. auditing standards with International Standards on Auditing (ISAs) issued by the International Audit & Assurance Standards Board (IAASB). The project, referred to as the Clarify Project, is similar to the one being done between the FASB and IASB on the GAAP side.

The ASB will redraft all of the auditing sections in its Codification of Statements on Auditing Standards, apply drafting conventions to those standards, and converge the material with the ISAs. The redrafting process will include exposing clarity redrafts, considering comments, making changes, and finalizing the standards.
Although most of the ISA requirements will be requirements of U.S. GAAS, there may be additional GAAS requirements.

Expect many redraft statements of existing GAAS to be issued within the next two years.

In November 2009, the AICPA’s Auditing Standards Board issued a FAQ entitled, Clarify Project: Update and Final Product.

**November 2009 Clarity Project: Update and Final Product**

In response to frequently asked questions regarding the status and ultimate product of the Clarity Project, below are responses to those questions most commonly asked.

**Q. What is the Clarity Project?**

**A.** To aid CPAs’ understanding of generally accepted auditing standards (GAAS) and to improve compliance with their requirements, the Auditing Standards Board (ASB) in 2004 launched a significant effort to make U.S. GAAS easier to read, understand and apply. In 2009, the International Auditing and Assurance Standards Board (IAASB) completed a similar project to clarify its International Standards on Auditing (ISAs). The ASB is converging U.S. GAAS with the ISAs while avoiding unnecessary conflict with Public Company Accounting Oversight Board standards. In 2007, clarity drafting conventions were developed and are being applied to all standards issued by the ASB after January 2008. All Statements on Auditing Standards (SASs) are being clarified over the next three years. More information on the Clarity Project is available on the “Improving the Clarity of ASB Standards” page on the AICPA’s web site.

**Q. When does the ASB expect to complete the Clarity Project?**

**A.** Though it is difficult to say with certainty until the Clarity Project has reached the phase at which the last of the current standards has been clarified and exposed for comment, the ASB is working toward completing the project in the first half of 2011.

**Q. Once all of the ASB’s clarified standards have been finalized, how will they be issued?**

**A.** The ASB will issue all of the clarified standards in one SAS that will be codified in “AU section” format, just as it did in 1972, when SAS No. 1, *Codification of Auditing Standards and Procedures*, was issued. SAS No. 1 was issued as one “book” that contained all of the standards codified in “AU section” format within the SAS. Each AU section was assigned a number and a title.

**Q. Will the SAS number start over as No. 1?**

**A.** No. The SAS number will be the next consecutive number that is available. For purposes of the remainder of these questions, let’s presume the clarified standards will be issued as “SAS No. 11X.”

**Q. What will happen to the SASs currently in effect?**

**A.** When “SAS No. 11X” becomes effective, SASs issued prior to “SAS No. 11X” will be superseded.
Q. Once finalized, when will “SAS No. 11X” become effective?

A. The effective date for all but six clarified AU sections is expected to apply to audits of financial statements for periods beginning on or after December 15, 2010. This date is provisional, but will not be earlier. The ASB believes having a single effective date for all clarified auditing standards will ease the transition to – and implementation of – the clarified standards. The date will be selected to allow enough time for finalization of the standards as well as updating of, and training in, firm methodologies.

The six clarified AU sections whose effective date is expected to be later than the provisional effective date above are:

a. the clarity redraft of AU section 322, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*, whose redraft and revision are being delayed to allow current revisions to ISA 610, *Considering the Work of Internal Audit*, to be incorporated into the proposed SAS.

b. the clarity redraft of AU section 341, *The Auditor’s Consideration of the Entity’s Ability to Continue as a Going Concern*, whose redraft and revision are being delayed in order to enable the proposed SAS to align with expected U.S. accounting standards.

c. the clarity redrafts and revisions of the following AU sections that address engagements other than audits of financial statements:
   - AU section 625, *Reports on the Application of Accounting Principles*,
   - AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*,
   - AU section 711, *Filings Under Federal Securities Statutes*, and

The effective date for the above six AU sections will be determined by Spring 2010.

Q. How will the current AU section numbering and titles change?

A. The ASB is conducting the Clarity Project to clarify all existing AU sections. In some cases, individual AU sections are being clarified “one for one” into individual clarified standards. In other cases, some AU sections are grouped together and clarified into one or more clarified standards. As a result, topics currently associated with certain AU section numbers might be re-titled and assigned different AU section numbers in “SAS No. 11X.” Please refer to a schedule that shows the mapping of existing AU sections and the proposed SASs that would supersede them.

Q. Will early adoption of “SAS No. 11X” be permitted?

A. The ASB has decided that adoption before its effective date of any clarified SAS, unless explicitly permitted, would not be appropriate until all clarified SASs are finalized and can be adopted as a set. It is important that, for legal and practice inspection purposes, it will be very clear which set of standards is in effect. Therefore, auditors should continue to comply with the current standards until the date that “SAS No. 11X” is effective. However, nothing precludes an auditor from implementing aspects of the clarified SASs before their effective date, as long as the auditor continues to comply with the current standards.
Q. Once “SAS No. 11X” is effective, will the ASB continue to issue SASs?

A. Yes. Just as it has up until now, the ASB will continue to issue SASs that will create, amend, or supersede AU sections. In this case, SASs issued subsequent to “SAS No. 11X” will impact the AU sections that “SAS No. 11X” will contain.

Q. How can I access the clarified exposure drafts or final standards that have been issued thus far?

A. As each exposure draft of a clarified auditing standard is issued, it is made available on the “Improving the Clarity of ASB Standards” page on the AICPA’s web site. As each clarified auditing standard is finalized, it is made available on the “Final Clarified Statements on Auditing Standards” page on the AICPA’s website. Please remember, however, that no clarified auditing standard is effective yet.

Q. How can I get more information about the Audit and Attest team’s activities?

A. For more information, visit the “Audit and Attest Standards” page on AICPA’s dedicated website.

E. SEC DELAYS EFFECTIVE DATE OF SECTION 404 FOR SMALLER COMPANIES

In October 2009, the SEC announced what it calls its last extension of Section 404(b) auditor compliance certification for smaller public companies. The six-month extension requires small public companies with a market capitalization of $75 million or less (non-accelerated filers) to start complying with Section 404(b) auditor’s certification report when it files its annual report for the fiscal year ending on or after June 15, 2010. Previously, the implementation date was December 15, 2009.

Small public companies would still have to comply with Section 404(a) which consists of the requirement that management assess the effectiveness of internal controls over financial reporting.

Observation: As of the early part of 2010, there is legislation that has passed the House of Representatives that would exempt public companies with market capitalization of $75 million or less from having to comply with Section 404 of Sarbanes. Currently, the bill is in the Senate.
REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the assignment. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this assignment.

1. Which of the following would not be an effective practice a company might employ to manage earnings:
   a) establish a reserve for bad debts for a rainy day fund
   b) expense major components of an acquisition
   c) early recognition of revenue
   d) capitalize equipment and depreciate it over its GAAP useful life

2. Which of the following would be an example of a subjective balance sheet account:
   a) property, plant and equipment
   b) long-term debt
   c) contingency accrual
   d) cash and cash equivalents

3. Which of the following is an example of an element that is leading to fraud:
   a) employees are earning more money so that they are greedy and may steal from the company
   b) organizations are achieving more output with fewer staff
   c) larger bloated accounting and other staffs provide opportunity for fraud
   d) lower debt levels allow employees to commit fraud

4. In order for an individual to be an engagement quality reviewer under AS7, he or she must have certain attributes. Which of the following is such an attribute:
   a) be a licensed CPA registered with a public accounting firm or public company
   b) must have worked in auditing for not less than ten years previously
   c) be independent of the company being reviewed
   d) must be a partner in the firm that issues the report
SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This is an example of managing earnings. Establish a reserve for bad debts or other reserves for a rainy day fund in the future is one example of how an entity may manage earnings.

   B: Incorrect. This is an example of managing earnings. Expensing major components of an acquisition is a way in which an entity can manage its earnings by shifting future expenses to the current year.

   C: Incorrect. Prematurely recognizing revenue is an example of how an entity does manage earnings.

   D: Correct. Capitalizing equipment properly and depreciating it over its GAAP useful life does not manage earnings. Instead, the element is properly accounted for under GAAP, and does not result in the manipulation of earnings among periods.

   (See pages 75 to 76 of the course material.)

2. A: Incorrect. A subjective balance sheet account is typically one the value of which management can manipulate. In general, property, plant and equipment is not a subjective balance sheet account because its value is not subject to significant manipulation.

   B: Incorrect. Long-term debt is not a subjective balance sheet account. Generally, its balance is not subject to significant manipulation.

   C: Correct. A contingency accrual is a subjective balance sheet account. Because of the uncertainty associated with the underlying accrual, the contingency accrual is subject to management manipulation.

   D: Incorrect. Cash and cash equivalents are generally not subjective accounts because the value is not subject to significant manipulation.

   (See page 77 of the course material.)
3. A: Incorrect. Higher layoffs and lower compensation are putting personal pressure on employees leading to fraud.

   **B: Correct.** More organizations are achieving greater output with fewer staff thereby creating pressure on employees. Such pressure can lead to employees or management committing fraud.

   C: Incorrect. With smaller accounting and other staffs, rather than larger, there may be opportunity for fraud. In particular, with fewer staff, there is a poorer separation of duties.

   D: Incorrect. Employees who carry higher debt levels feel pressure and may commit fraud.

   (See page 79 of the course material.)

4. A: Incorrect. He or she must be an associated person with a registered public accounting firm. There is nothing requiring or permitting the individual to work for a public company.

   B: Incorrect. There is no minimum worked required. However, the reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.

   **C: Correct.** The reviewer must be independent of the company being reviewed and perform the engagement quality review with integrity, and maintain objectivity in performing the review.

   D: Incorrect. The engagement quality reviewer may also be an individual from outside the firm.

   (See page 82 of the course material.)
Glossary

**Accounting records**: Include the records of initial entries and support records, including checks and records of electronic funds transfers, invoices, contracts, general and other ledgers, journal entries, and other adjustments to the financial statements that are not reflected in formal journal entries, and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures.

**Accounting Standards Updates (ASUs)**: Updates subsequent to the effective date of the Codification ASC that: a) are not considered authoritative in their own right, and b) serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification.

**Accuracy**: Amounts and other data relating to recorded transactions and events have been recorded appropriately.

**Acquirer**: The entity that obtains control of the acquire.

**Acquiree**: A business that the acquirer obtains control of in a business combination or a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition.

**Acquisition date**: The date on which the acquirer obtains control of the acquire.

**Amortization method**: Method under which service assets and liabilities are amortized in proportion to and over the period of estimated net servicing income (if servicing revenue exceed costs) or net servicing loss (if servicing costs exceed servicing revenues).

**Applicable compliance requirements**: Compliance requirements that are subject to the compliance audit.

**Applicable financial reporting framework**: The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation 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 regulations.

**Assurance engagement**: An engagement in which an accountant issues a report designed to enhance the degree of confidence of third parties and management about the outcome of an evaluation or measurement of financial statements (subject matter) against an applicable financial reporting framework (criteria).

**Attest engagement**: An engagement that requires independence, as defined in AICPA Professional Standards.
**Audit findings:** The matters that are required to be reported by the auditor in accordance with the governmental audit requirement.

**Audit risk of noncompliance:** The risk that the auditor expresses an inappropriate audit opinion on the entity’s compliance when material noncompliance exists. Audit risk of noncompliance is a function of the risks of material noncompliance and detection risk of noncompliance.

**Available to be issued:** Financial statements are available to be issued when they are a) complete in a form and format that complies with GAAP, and b) all approvals necessary for issuance have been obtained, such as those from management, the board of directors, and/or significant shareholders.

**Basic financial statements:** Financial statements presented in accordance with an applicable financial reporting framework as established by a designated accounting standard setter, excluding required supplementary information.

**Beneficial interests:** Rights to receive all or portions of specified cash inflows by a trust or other entity, including, but not limited to, senior and subordinated shares of interest, principal, or other cash inflows to be “passed-through” or “paid-through,” premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

**Business:** An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors of other owners, members, or participants.

**Carrying amounts:** Amounts at which the assets, liabilities, and non-controlling interests of the VIE would have been carried in the consolidated financial statements if Interpretation 46R had been effective when the entity first met the conditions to be considered a primary beneficiary.

**Classification:** Transactions and events have been recorded in the proper accounts.

**Cleanup call:** An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE entity (or in a series of beneficial interests in transferred financial assets within a qualifying SPE entity), if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

**Collections:** Works of art, historical treasures, or similar assets that are all of the following: a) Held for public exhibition, education, or research to further public service rather than financial gain, b) Protected, kept unencumbered, cared for, and preserved, and c) Subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

**Completeness:** All transactions and events that should have been recorded have been recorded.
Compliance audit: A program specific audit or an organization-wide audit of an entity’s compliance with applicable compliance requirements.

Compliance requirements: Laws, regulations, rules. And provisions of contracts or grant agreements applicable to government programs with which the entity is required to comply.

Conditional promise: A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

Consolidated affiliate of the transferor: An entity whose assets and liabilities are included with those of the transferor in the consolidated, combined, or other financial statements being presented.

Contingent consideration: An obligation of the acquirer to transfer additional assets or equity interests to the former owners or members of an acquire as part of the exchange for control of the acquire if specified future events occur or conditions are met.

Continuing involvement: Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer.

Contractually specified servicing fees: All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer.

Contribution: An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Control of a not-for-profit entity: The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Control risk of noncompliance: The risk that noncompliance with a compliance requirement could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control over compliance.

Cutoff: Transactions and events have been recorded in the correct accounting period.

Deficiency in design: Exists when: a) a control necessary to meet the control objective is missing, or b) an existing control is not properly designed so that even if the control operates as designed, the control objective would not be met.

Deficiency in internal control over compliance: A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis.
**Deficiency in operations:** Exists when: a) a properly designed control does not operate as designed, or b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

**Designated accounting standard setter:** A body designated by the AICPA council to establish GAAP pursuant to Rule 202, Compliance With Standards (AICPA, Professional Standards, vol. 2, ET sec. 202, par. .01), and Rule 203, Accounting Principles (AICPA, Professional Standards, vol. 2, ET sec. 203, par. .01). The bodies designated by the council to establish professional standards with respect to financial accounting and reporting principles pursuant to Rules 202 and 203 are the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Federal Accounting Standards Advisory Board, and the International Accounting Standards Board.

**Detection risk of noncompliance:** The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated with other instances of noncompliance.

**Emerging Issues Task Force (EITF):** Essentially acts to resolve many interpretative issues under existing authoritative GAAP literature that are beyond the scope of the FASB.

**Equity interests:** Ownership interests of investor-owned entities; owner, member, or participant interests of mutual entities; and owner or member interests in the net assets of not-for-profit entities.

**Equity investment:** All equity interests that are required to be reported as equity in that entity’s financial statements.

**Existence:** Assets, liabilities, and equity interests exist.

**Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Fair Value Accounting:** Merely an appraisal of an entity’s net assets from period to period; introduces a degree of volatility to the accounting model.

**Fair value method:** Method by which servicing assets and liabilities are measured at fair value at each reporting date and the changes in fair value are reported in earnings in the period in which the change occurs.

**FASB Accounting Standards Codification (FASB ASC):** New codification of GAAP consisting of five areas, numerous topics, subtopics, sections, and paragraphs.

**Financial asset:** Cash, evidence of an ownership interest in an entity, or a contract that conveys to [one] entity a right : (a) to receive cash or another financial instrument from a [second] entity, or (b) to exchange other financial instruments on potentially favorable terms with the [second] entity.
**Financial liability:** A contract that imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity or to exchange other financial instruments on potentially unfavorable terms with the second entity.

**Financial reporting framework:** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

**Financial statements:** A structured representation of historical financial information, including related notes, intended to communicate an entity’s economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term financial statements ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement or financial statements without notes.

**Goodwill:** An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized.

**Government Auditing Standards:** Standards and guidance issued by the Comptroller General of the United States, Government Accountability Office for financial audits, attestation engagements, and performance audits. Government Auditing Standards also are known as generally accepted government auditing standards (GAGAS) or the Yellow Book.

**Government program:** The means by which governmental entities achieve their objectives. For example, one of the objectives of the U.S. Department of Agriculture is to provide nutrition to individuals in need. Examples of government programs designed to achieve that objective are the Supplemental Nutrition Assistance Program and the National School Lunch Program.

**Governmental audit requirement:** A government requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers.

**Grantor:** A government agency from which funding for the government program originates.

**Identifiable asset:** An asset that either: a) is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

**Inactive market:** A market that does not have adequate activity to provide sufficient observable inputs to determine fair value.
**Inconsistency:** Other information that conflicts with information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor’s opinion on the financial statements.

**Inherent risk of noncompliance:** The susceptibility of a compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.

**Intangible asset:** An asset (not including a financial asset or goodwill) that lacks physical substance.

**Investment-grade financing:** Financing typically obtained from a bank or other lender at rates customarily offered to the lender’s best customers.

**Issued:** Financial statements are issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.

**Known questioned costs:** Questioned costs specifically identified by the auditor. Known questioned costs are a subset of likely questioned costs.

**Likely questioned costs:** The auditor’s best estimate of total questioned costs, not just the known questioned costs. Likely questioned costs are developed by extrapolating from audit evidence obtained, for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn.

**Management:** The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

**Material noncompliance:** In the absence of a definition of material noncompliance in the governmental audit requirement, a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected government program.

**Material weakness:** A deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

**Material weakness in internal control over compliance:** A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.

**Merger date:** The date on which the merger becomes effective.
**Merger of not-for-profit entities:** A transaction or other event in which the governing bodies of two or more not-for-profit entities cede control of those entities to create a new not-for-profit entity.

**Misstatement of fact:** Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

**Non-controlling interest:** The equity in (net assets of) a subsidiary not attributable, directly or indirectly, to a parent.

**Nongovernmental entity:** An entity that is not required to issue financial reports in accordance with guidance promulgated by the Governmental Accounting Standards Board or the Federal Accounting Standards Advisory Board.

**Nonissuuer:** All entities except for those defined in Section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c], the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under Section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

**Nonprofit activity:** An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity’s purpose or mission (for example, goods or services to beneficiaries, customers, or members).

**Nonpublic entity:** Any entity that does not meet any of the following conditions: 1) Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally; 2) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets); 3) It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market; 4) It is required to file or furnish financial statements with the SEC; or 5) It is controlled by an entity covered by any of the criteria in (1) to (4).

**Nonrecourse financing:** A type of debt for which a borrower is not personally liable. If you default on a nonrecourse loan, the lender must recover the amount you owe by foreclosing on the property by which the loan is secured. At-risk rules limit the amount of loss you can take from activities with nonrecourse financing.

**Not-for-profit entity:** An entity that possesses the following characteristics that distinguish it from a for-profit business entity: a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, b) operating purposes other than to provide goods or services at a profit, and c) absence of ownership interests with characteristics that are similar to those of a for-profit business entity.
Occurrence: Transactions and events that have been recorded have occurred and pertain to the entity.

Off-balance sheet entity: A way of raising money that does not appear on the balance sheet. This term came into household use during the Enron bankruptcy. Many of the energy traders’ problems stemmed from setting up inappropriate off-balance sheet entities.

Organization-wide audit: An audit of an entity’s financial statements and an audit of its compliance with the applicable compliance requirements as they relate to one or more government programs that the entity administers.

Other accounting literature: Category of GAAP found in previous GAAP hierarchy consisting of FASB Concepts Statements, AICPA Issues Papers, International Financial Reporting Standards of the International Accounting Standards Board (IASB), Pronouncements of professional associations or regulatory agencies, Technical Practice Aids, and Accounting textbooks, handbooks, and articles.

Other Comprehensive Basis of Accounting (OCBOA): A definite set of criteria, other than accounting principles generally accepted in the United States of America or International Financial Reporting Standards (IFRSs), having substantial support underlying the preparation of financial statements prepared pursuant to that basis. Examples of an OCBOA are as follows:

a) A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the rules of a state insurance commission). b) A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements. c) The cash basis of accounting and modifications of the cash basis having substantial support.

Other information: Financial and nonfinancial information (other than the financial statements and the auditor’s report thereon) that is included in a document containing audited financial statements and the auditor’s report thereon, excluding required supplementary information.

Owners: Holders of equity interests of investor-owned entities; owners, members of, or participants in mutual entities; and owner or member interests in the net assets of not-for-profit entities.

Participating interest: A partial interest in a financial asset that has the following characteristics: a) From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset, b) From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership, c) The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder’s interest is subordinated to the interest of another participating interest holder, and d) No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.
**Pass-through entity:** An entity that receives an award from a grantor or other entity and distributes all or part of it to another entity to administer a government program.

**Prescribed guidelines:** The authoritative guidelines established by the designated accounting standard setter for the methods of measurement and presentation of the required supplementary information.

**Primary beneficiary:** The entity or individual that has a controlling financial interest in a VIE. If the primary beneficiary is an entity, it consolidates the VIE, while if it is an individual, it does not consolidate the VIE.

**Probable:** The future event or events are likely to occur.

**Proceeds:** Cash, beneficial interests, servicing assets, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

**Program-specific audit:** An audit of an entity’s compliance with applicable compliance requirements as they relate to one government program that the entity administers. The compliance audit portion of a program-specific audit is performed in conjunction with either an audit of the entity’s or the program’s financial statements.

**Public Company Accounting Oversight Boards (PCAOB):** The standard-setter for SEC auditors.

**Public entity:** Any entity that meets certain criteria including: a) Its debt or equity securities trade in a public market, b) It is a conduit bond obligor for conduit debt securities that are traded in a public market, c) It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, d) It is required to file or furnish financial statements with the SEC, or e) It is controlled by an entity covered by any of the above criteria.

**Questioned costs:** Costs that are questioned by the auditor because: (1) of a violation or possible violation of the applicable compliance requirements, (2) the costs are not supported by adequate documentation, or (3) the incurred costs appear unreasonable and do not reflect the actions that a prudent person would take in the circumstances.

**Reasonable assurance:** A high level of assurance, about whether the financial statements are free of material misstatements (whether caused by error or fraud).

**Reasonably possible:** The chance of the future event or events occurring is more than remote but less than likely.

**Remote:** The chance of the future event or events occurring is slight.

**Required supplementary information:** Information that a designated accounting standard setter requires to accompany an entity’s basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.
**Review evidence:** Information used by the accountant to provide a reasonable basis for obtaining limited assurance.

**Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

**Risk of material noncompliance:** The risk that material noncompliance exists prior to the audit.

**Sarbanes-Oxley Act:** The Sarbanes-Oxley Act of 2002, was signed into law by U.S. President George W. Bush and became effective on July 30, 2002. The Act contains sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and lawyers. It adopts tough new provisions intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers, and protecting the interests of workers and shareholders.

**Secured borrowing with pledge of collateral:** An approach by which a debtor grants a security interest in certain assets to a lender to serve as collateral under the obligation, with or without recourse to other assets of the debtor.

**Significant deficiency:** A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

**Significant deficiency in internal control over compliance:** A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

**Submission of financial statements:** Presenting to management financial statements that an accountant has prepared.

**Subsequent events:** Events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued.

**Substantive kick-out rights:** The ability of an investor or another party to remove the decision maker.

**Supplementary information:** Information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

**Third party:** All persons, including those charged with governance, except for members of management.
**Those charged with governance**: The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance are specifically excluded from management, unless they perform management functions.

**Transferee**: An entity that receives a financial asset, an interest in a portion of a financial asset, or a group of financial assets from a transferor.

**Transferor**: An entity that transfers a financial asset, an interest in a portion of a financial asset, or a group of financial assets that it controls to another entity.

**Type 1 subsequent events**: Recognized subsequent events based on events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

**Type 2 subsequent events**: Nonrecognized subsequent events based on events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

**Variable Interest Entity**: A variable interest entity has one or both of the following characteristics: (1) its equity at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) as a group, the equity investors lack one or more of the following characteristics: (a) the power through voting rights to direct the entity’s activities that most significantly impact the entity’s economic performance, (b) obligation to absorb expected losses, or (c) right to receive expected residual returns.
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