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Annual Accounting and Auditing Update and Review (Course #5410I/QAS5410I)

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Chapter 1: Subsequent Events (FASB ASC Topic 855) As Amended by ASU No. 2010-09: Subsequent Events Amendments to Certain Recognition and Disclosure Requirements

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Subsequent Events (FASB ASC Topic 855) As Amended by ASU No. 2010-09: Subsequent Events Amendments to Certain Recognition and Disclosure Requirements

Upon completing this chapter, you will be able to:

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

I. Introduction

Issued: May 2009 and amended in February 2010

Effective Date: Interim or annual financial periods ending after June 15, 2009, and shall be applied prospectively. All amendments found in ASU No. 2010-09 are effective upon issuance except for the use of the issued date for conduit debt obligations which is effective for interim or annual periods ending after June 15, 2010.

Objective:

The objective of this Statement is to establish GAAP and requirements for subsequent events. ASC Topic 855 (formerly FASB No. 165) 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 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:

- ASC Topic 450, *Contingencies* (formerly FASB No. 5)
- ASC Topic 740-10, *Accounting for Uncertainty in Income Taxes* (formerly FIN 48)
- ASC Topic 260, *Earnings per Share* (formerly FASB No. 128)

The FASB has undertaken several projects to incorporate accounting guidance that originated as auditing standards into the body of GAAP. In addition to ASC Topic 855, other projects include 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 ASC Topic 855 (formerly FASB No. 165) so that management now is responsible for evaluating subsequent events in connection with a company's financial statements.

In May 2009, the FASB issued a final statement, ASC Topic 855, *Subsequent Events.*

After issuance of ASC Topic 855, the FASB was informed of two implementation issues that result in ASC Topic 855 being in conflict with SEC guidance, thereby requiring further guidance as follows:

1. The SEC has specific requirements related to the identification and disclosure of subsequent events that potentially conflict with certain aspects of the ASC Topic 855 guidance, and

2. An SEC registrant would no longer be permitted to incorporate financial statements by reference because this could be considered a reissuance that would then trigger updating the disclosure required by paragraph ASC 855-10-50-4 for the evaluation of subsequent events.

Consequently, in December 2009, the FASB issued a proposed Accounting Standards Update, *Subsequent Events (ASC Topic 855): Amendments to Certain Recognition and Disclosure Requirements,* which was issued in final form as ASU 2010-09 in February 2010 and makes the following amendments to ASC Topic 855:

1. It clarifies that an entity that either is an SEC filer or 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) is required to evaluate subsequent events through the date that the financial statements are issued. If an entity meets neither of those criteria, then it should evaluate subsequent events through the date the financial statements are available to be issued.

2. The glossary of ASC Topic 855 is amended to remove the definition of *public entity* and replace it with a new definition of *SEC filer*.

3. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between ASC Subtopic 855-10 and the SEC's requirements.

4. The scope of the reissuance disclosure requirements is refined to include revised financial statements only. The term *revised financial statements* is added to the glossary of ASC Topic 855.

Because ASC Topic 855 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, ASC Topic 855 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 ASC Topic 855 and IAS 10 in the areas of refinancing of short-term obligations and curing breaches of borrowing covenants.

III. Requirements of ASC Topic 855

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 address the accounting and disclosures for specific subsequent events include:

   - ASC Topic 450, *Contingencies* (formerly FASB No. 5)
   - ASC Topic 740-10, *Accounting for Uncertainty in Income Taxes* (formerly FIN 48)
   - ASC Topic 260, *Earnings per Share* (formerly FASB No. 128)

2. Definitions used within ASC 855

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)*: consist of events that provide evidence about conditions that *did not exist at the date of the balance sheet* but arose after that date.

c. *SEC filer*: is an entity that is required to file or furnish its financial statements with either: a) the SEC, or b) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

   1) An SEC filer does not include an entity that is not otherwise an SEC filer whose financial statements are included in a submission by another SEC filer.

d. *Revised financial statements*: consist of financial statements revised only for either of the following conditions:

   1) Correction of an error, or
   2) Retrospective application of U.S. GAAP.

3. Rules

a. Subsequent event period:

   1) An entity that meets *either of* the following criteria shall evaluate subsequent events through the date that the financial statements are *issued*.

      - It is an SEC filer, or
      - 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).

   2) All entities other than those in 3(a)(1) above shall evaluate subsequent events through the date that the financial statements are *available to be issued*.

Observation: In the originally issued ASC Topic 855 (formerly FASB No. 165), the document included a concept of "expectation of widely distributing its financial statements to its shareholders and other financial statement users" for determining the appropriate date through which an entity should evaluate subsequent events. In the ASU 2010-09 amendment, the FASB eliminated the "widely distributed" threshold and replaced it with a benchmark, based on whether an entity is either an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market.

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 ASC Topic 855 (FASB No. 165) have their financial statements audited, and others may not widely distribute those financial statements upon completion.

As it relates to non-SEC filers, the concept of an "issuance date" is not meaningful because non-SEC filers 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. SEC filers and conduit obligors should evaluate subsequent events through the date that the financial statements are issued. All other entities (for example, non-SEC filers), should evaluate subsequent events through the date that the financial statements are available to be issued. As a result, most non-SEC filers will not be required to continue to evaluate subsequent events for an extended period of time following the completion of the financial statements which is when those statements are available to be issued.

After the issuance of ASC Topic 855, there was confusion and diversity in practice in determining the appropriate date through which conduit debt obligors should evaluate subsequent events. The FASB clarified that these entities are public entities and, therefore, are subject to evaluation of subsequent events through the date the financial statements are issued.

b. <u>Recognized subsequent events:</u>

1) An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about <u>*conditions that existed at the date of the balance sheet*</u>, 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. ASC Topic 855 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 be issued, 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 receivables 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

a. An entity that is not an SEC filer shall disclose the following:

1) The date through which subsequent events have been evaluated by management.

2) Whether that date is the date the financial statements were issued or the date the financial statements were available to be issued.

Note: An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between ASC Topic 855 and the SEC's requirements.

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.

Example of a disclosure:

Following is a standard disclosure that is required for a non-public entity:

NOTE 4: SUBSEQUENT EVENTS:

Company X has evaluated subsequent events through March 31, 20X3, which is the date through which the financial statements were available to be issued.

Note: The amendments found in ASU 2010-09 remove the requirement for an SEC filer to disclose a date in both issued and revised financial statements.

The SEC's requirements are clear on a registrant's responsibilities for evaluating subsequent events, and the entity is additionally subject to the SEC's continuous disclosure regime. There are certain entities whose financial statements are filed or furnished with the SEC by another entity in accordance with the SEC's requirements. As such, to clarify the requirements, the amendment, ASU 2010-09, removes any potential conflicts with existing SEC literature by no longer requiring disclosure of either the issuance date or the revised issuance date if an entity is an SEC filer. However, the FASB decided to clarify that ASU 2010-09 has no effect on disclosure of the issuance date for an entity that is not an SEC filer.

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. Revised Financial Statements

a. An entity may need to revise (reissue) financial statements, for example, in reports filed with the SEC or other regulatory agencies. ***Revised financial statements*** consist of financial statements revised only for either: 1) correction of an error, or 2) retrospective application of U.S. GAAP. Revised financial statements are considered reissued financial statements.

   1) After the original issuance of the financial statements, events or transactions may have occurred that require disclosure in the revised financial statements to keep them from being misleading.

   2) If an entity revises 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 revised (reissued), unless the adjustment is required by GAAP or regulatory requirements.

   3) 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 revised (reissued), in comparative form along with financial statements of subsequent periods, unless the adjustment meets the criteria stated in this paragraph. Unless the entity is an SEC filer, an entity shall disclose in the revised financial statements the dates through which subsequent events have been evaluated in both a) the issued or available-to-be issued financial statements, and b) the revised financial statements.

   Note: When the FASB issued its subsequent events guidance, it was primarily concerned that the disclosure of the date for the evaluation of subsequent events be updated when an entity revised its financial statements, that is, revised for either correction of an error or retrospective application of U.S. GAAP. Therefore, the FASB decided to clarify which reissuances would be subject to those disclosures by replacing the term *reissuance* with *revised*. Revised financial statements include restatements or retrospective application of U.S. GAAP.

6. Effective Date and Transition

a. ASU 855 is effective for interim or annual financial periods *ending after June 15, 2009*, and shall be applied prospectively. All amendments in ASU 2010-09 are effective upon issuance of the final ASU (February 2010), except for the use of the issued date for conduit debt obligors which is effective for interim or annual periods ending after June 15, 2010.

   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 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. 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 is a non-SEC filer is required to evaluate subsequent events through the date on which the financial statements are:

   a) issued
   b) available to be used
   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 1-4 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 a GAAP format and approvals must have been obtained for issuance. Neither of these factors exist in this example.

   (See page 1-4 of the course material.)

3. A: Incorrect. Only an entity that is either an SEC issuer or a conduit bond obligor should use the “issued” date.

   B: Correct. If an entity is not an SEC filer or conduit bond obligor, the “available to be used” date should be used.

   C: Incorrect. The “ready to be issued” date is not referenced in ASC Topic 855.

   D: Incorrect. ASC Topic 855 does not give the option of using the later of the date issued or available to be issued.

   (See page 1-5 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 1-6 of the course material.)

Chapter 2: Receivables (ASC Topic 310)
ASU No. 2010-20: Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

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Receivables (ASC Topic 310)
ASU No. 2010-20: Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

Upon completing this chapter, you will be able to:

- Identify those instruments to which the new ASU 2010-20 disclosure apply
- Identify the twelve disclosures required by ASU 2010-20
- Define financing receivable and other financial instruments
- Write a disclosure of the accounting policies for loans and trade receivables

I. Introduction

Date issued: July 2010

Effective date:

For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods *ending on or after December 15, 2010*. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010.

For nonpublic entities, the disclosures are effective for annual reporting periods *ending on or after December 15, 2011*.

The amendments in this Accounting Standards Update (ASU) encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption.

Objective:

The objective of the amendments in this ASU is for an entity to provide disclosures that facilitate financial statement users' evaluation of the following:

1. The nature of credit risk inherent in the entity's portfolio of financing receivables.

2. How that risk is analyzed and assessed in arriving at the allowance for credit losses.

3. The changes and reasons for those changes in the allowance for credit losses.

II. Background

The primary objective of ASU No. 2010-20 is to provide financial statement users with greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables. Due to the global economic crisis, effective financial reporting has become the subject of worldwide attention, with a focus on the urgent need for improved accounting standards in a number of areas, including financial instruments.

The ASU provides new disclosures and enhanced current disclosures to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. Currently, a high threshold for recognition of credit impairments impedes timely recognition of losses.

According to the FASB, the ASU addresses three objectives:

1. To expand the credit quality disclosures to provide more transparent financial reporting to investors,
2. To incorporate into U.S. GAAP certain information that is already required to be disclosed to financial statement users by U.S. bank and securities regulators, and
3. To more closely align U.S. GAAP with current IFRS disclosure requirements.

The amendments in this ASU apply to all entities (both public and nonpublic), and affect all entities with financing receivables, generally excluding short-term trade accounts receivable or receivables measured at fair value or lower of cost or fair value.

The extent of the effect depends on the relative significance of financing receivables to an entity's operations and financial position. For example, traditional banking-type institutions that currently measure a large number of financing receivables at amortized cost will be affected to a greater extent than brokers and dealers in securities and investment companies that currently measure most financing receivables at fair value. The effect likely will be less significant for many commercial and industrial entities whose financing receivables are primarily short-term trade accounts receivable.

The ASU requires that an entity should provide disclosures on a disaggregated basis as defined by two levels of disaggregation: One is portfolio segment and the other is class of financing receivable.

Some of the new disclosures include:

- Additional analysis of the allowance for credit losses including its activity
- A description of the policies used to estimate the allowance and charging off accounts
- An aging of past due receivables
- Credit quality indicators
- Modifications of financing receivables.

Further, the ASU amends existing disclosure guidance to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. In addition, the amendments in this ASU are designed to assist financial statement users in assessing credit risk exposures by requiring an entity to disclose credit quality indicators, past due information, and modifications of its financing receivables.

The disclosures required by the amendments in this ASU are similar, but not identical, to those required by IFRS 7, *Financial Instruments: Disclosures*. However, the scope of IFRS 7 includes all financial instruments, not just financing receivables and the allowance for credit losses. The FASB decided to limit the scope of this ASU because it does not want to delay the improved transparency in an entity's financial statements about the allowance for credit losses and the credit quality of financing receivables.

The FASB issued an Exposure Draft of a proposed Statement, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, on June 24, 2009 and issued a final statement as ASU 2010-20 in July 2010.

III. Definitions

Class of Financing Receivable: A group of financing receivables determined on the basis of all of the following:

a. Initial measurement attribute (for example, amortized cost or purchased credit impaired)
b. Risk characteristics of the financing receivable
c. An entity's method for monitoring and assessing credit risk.

Credit Quality Indicator: A statistic about the credit quality of financing receivables. Examples of credit quality indicators include:

- Consumer credit risk scores
- Credit-rating-agency ratings
- An entity's internal credit risk grades
- Loan-to-value ratios
- Collateral
- Collection experience
- Other internal metrics.

Financing Receivable: A financing arrangement that has both of the following characteristics:

a. It represents a contractual right to receive money in either of the following ways:

    - On demand
    - On fixed or determinable dates.

b. It is recognized as an asset in the entity's statement of financial position.

Financing receivables *include* all of the following:

- Loans
- Trade accounts receivable
- Notes receivable
- Credit cards
- Receivables relating to a lessor's right(s) to payment(s) from a lease other than an operating lease that should be recognized as assets in accordance with leveraged leases, direct financing leases, and sales-type leases as defined in ASC 840-30-25-6 through 8, *Leases*.

Financing receivables *exclude* all of the following:

- Debt securities[1]
- Unconditional promises to give such as contributions receivable, that should be recognized as an asset[2]
- Both of the following instruments, covered within ASC Topic 325-40:
  - A transferor's interests in securitization transactions that are accounted for as sales[3]
  - Purchased beneficial interests in securitized financial assets.

Portfolio Segment: The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. Examples of portfolio segments include:

- Type of financing receivable
- Industry sector of the borrower
- Risk rate(s)

Receivables in General: Receivables that may arise from credit sales, loans, or other transactions. Receivables may be in the form of loans, notes, and other types of financial instruments and may be originated by an entity or purchased from another entity.

Standby Commitments to Purchase Loans: Forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is at the option of the seller of the loans and would result in delivery to the entity only if the contract price equals or exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the entity assumes all the market risks of ownership, but shares in none of the rewards. A standby commitment is, in substance, a written put option that will be exercised only if the value of the loans is less than or equal to the strike price.

Factoring Arrangements: Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee.

Rebates: Rebates represent refunds of portions of the precomputed finance charges on installment loans or trade receivables, if applicable, that occur when payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on installment loans or trade receivables because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method.

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[1] As defined by ASC Topic 320-10-15-5, *Investments- Debt and Equity Securities.*
[2] Under ASC Topic 958-605-25-7 to 15, *Not-for-Profit Entities: Revenue Recognition*.
[3] Under ASC Topic 860,*Transfers and Servicing*.

IV. <u>Scope</u>

1. The ASU applies to all entities (public and nonpublic) and to various instruments and transactions that include the following:

    a. Trade accounts receivable
    b. Loans
    c. Loan syndications
    d. Factoring arrangements
    e. Standby letters of credit
    f. Financing receivables.

    Note: Although the ASU applies to all of the above instruments and transactions, several of the disclosures do not apply to trade accounts receivable, and receivables carried at fair value or lower of cost or market.

2. The ASU does not apply to the following transactions and activities:

    a. Mortgage banking activities
    b. A contract that is required to be accounted for as a derivative instrument.

    Example: ASC Topic 815, *Derivatives and Hedging*, states that commitments to purchase or sell mortgage loans or other types of loans at a future date shall be evaluated under the definition of a derivative instrument to determine whether Subtopic 815-10 applies.

V. <u>General Rules</u>

1. Losses from Uncollectible Receivables

a. The inability to make a reasonable estimate of the amount of loss from uncollectible receivables precludes use of the accrual basis and may, if there is significant uncertainty as to collection, suggest that the installment method, the cost recovery method, or some other method of revenue recognition be used.

2. Disclosures

a. List of disclosures: The ASU provides the following disclosure guidance for receivables, off-balance-sheet credit exposures, and foreclosed and repossessed assets. Some of the disclosures have been retained from previous guidance while others are new. The list of disclosures follows:

- Accounting policies for loans and trade receivables
- Assets serving as collateral
- Nonaccrual and past due financing receivables
- Accounting policies for off-balance sheet credit exposures
- Foreclosed and repossessed assets
- Allowance for credit losses
- Impaired loans
- Loss contingencies
- Risks and uncertainties
- Fair value disclosures
- Credit quality information
- Modifications.

The following table summarizes the twelve disclosures and those that have significant changes made by ASU No. 2010-20 and those that are not significant changes:

SUMMARY OF DISCLOSURE CHANGES MADE BY ASU 2010-20				
	Significant Changes?	**Amended, Existing, or New Disclosure**	**Applies to**	**Exempt**
Disclosure 1: Accounting Policies for Loans and Trade Receivables				
The summary of significant accounting policies shall include the following: • The basis for accounting for loans and trade receivables • The method used in determining the lower of cost or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis) • The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment • The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.	No	Amended	Loans and trade receivables	None
If major categories of loans or trade receivables are not presented separately in the balance sheet, they shall be presented in the notes to the financial statements.	No	No change	Loans and trade receivables	None

The allowance for doubtful accounts and, as applicable, any unearned income, any unamortized premiums and discounts, and any net unamortized deferred fees and costs, shall be disclosed in the financial statements.	No	No change	Loans and trade receivables	None
An entity shall disclose its policy for charging off uncollectible trade accounts receivable that have both of the following characteristics: 1. They have a contractual maturity of one year or less 2. They arose from the sale of goods or services.	Yes	New	Loans and trade receivables	Credit card receivables
Disclosure 2: Assets Serving as Collateral				
With respect to required disclosures of the carrying amount of loans, trade receivables, securities and financial instruments that serve as collateral for borrowings, the ASU follows the guidance in ASC Topic 860-30-50-1A, *Transfers and Servicing: Secured Borrowing and Collateral, Disclosures.*	No	No change	All applicable instruments and financing receivables other than exemptions	None
Disclosure 3: Nonaccrual and Past Due Financing Receivables				
The entity's summary of significant accounting policies for financing receivables to which this disclosure applies shall include all of the following, _by class_: 1. The policy for placing financing, if applicable, on nonaccrual status (or discontinuing accrual of interest)	No	Amended	All applicable instruments and financing receivables other than exemptions	The following financing receivables are exempt from having to make the disclosures by class: • Loans acquired with deteriorated credit quality

2. The policy for recording payments received on nonaccrual financing receivables, if applicable 3. The policy for resuming accrual of interest 4. The policy for determining past due or delinquency status.				• Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services.
Both of the following disclosures related to non-accrual and past due financing receivables as of each balance sheet date shall be made, by class: 1. The recorded investment in financing receivables on nonaccrual status, and 2. The recorded investment in financing receivables past due 90 days or more and still accruing	No	Amended	All applicable instruments and financing receivables other than exemptions	<u>Exempt financing receivables</u>: • Loans acquired with deteriorated credit quality • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services.

An entity shall provide an analysis of the age of the recorded investment in financing receivable at the end of the reporting period that are *past due*, as determined by the entity's policy.	Yes	New	All applicable instruments and financing receivables other than exemptions	Exempt financing receivables: • Loans acquired with deteriorated credit quality • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services.
Disclosure 4: Accounting Policies for Off-Balance Sheet Credit Exposures				
An entity is required to disclose a description of the accounting policies and methodology the entity used to estimate its liability for *off-balance-sheet credit exposures* and related charges for those credit exposures. 1. The description shall identify the following: • Factors that influenced management's judgment (such as historical losses and existing economic conditions), and	No	Amended	All applicable instruments and financing receivables with off-balance sheet credit exposure, which consists of credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial	None

• Discussion of risk elements relevant to particular categories of financial instruments.			guarantees, and other similar instruments other than instruments	
Disclosure 5: Foreclosed and Repossessed Assets				
Foreclosed and repossessed assets included in other assets on the balance sheet shall have separate disclosures in the notes to financial statements.	No	No change	All applicable instruments and financing receivables that are foreclosed and repossessed assets	None
Disclosure 6: Allowance for Credit Losses				
An entity shall disclose all of the following by *portfolio segment*: 1. A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses. 2. A description of the policy for charging off uncollectible financing receivables. 3. The activity in the allowance for credit losses for each period, including all of the following: a. The balance in the allowance at the beginning and end of each period b. Current period provision c. Direct write-downs charged against the allowance d. Recoveries of amounts previously charged off.	Yes	New	All applicable instruments and financing receivables other than exemptions	Exempt financing receivables • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services. • Lessor's net

				investments in leveraged leases.
4. The quantitative effect of changes identified. 5. The amount of any significant purchases of financing receivables during each reporting period. 6. The amount of any significant sales of financing receivables or reclassifications of financing receivables to held for sale during each reporting period. 7. The balance in the allowance for credit losses at the end of each period disaggregated on the basis of the entity's impairment method. 8. The recorded investment in financing receivables at the end of each period related to each balance in the allowance for credit losses, disaggregated on the basis of the entity's impairment methodology in the same manner as the disclosure in item (7), above.	Yes	New	All applicable instruments and financing receivables other than exemptions	<u>Exempt financing receivables</u> • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services. • Lessor's net investments in leveraged leases.
Disclosure 7: Impaired Loans				
An entity that has impaired loans is required to make certain disclosures for each class of financing receivable, as follows: • The accounting for impaired loans, and • The amount of impaired loans.	Yes	New	Impaired loans	None
As of the date of each statement of financial position presented:	Yes	New	Impaired loans	None

1. The recorded investment in the impaired loans and both of the following: • The amount of that recorded investment for which there is a related allowance for credit losses and the amount of that allowance, and • The amount of that recorded investment for which there is no related allowance for credit losses. 2. The total unpaid principal balance of the impaired loans.				
The entity's policy for recognizing interest income on impaired loans, including how cash receipts are recorded.	No	No change	Impaired loans	None
For each period for which results of operations are presented: 1. The ***average recorded investment*** in the impaired loans. 2. The related amount of interest income recognized during the time within that period that the loans were impaired. 3. The amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired, if practicable.	No	Amended	Impaired loans	None
1. The entity's policy for determining which loans the entity assesses for impairment. 2. The factors considered in determining that the loan is impaired.	Yes	New	Impaired loans	None

Disclosure 8: Loss Contingencies				
Disclosure is required for circumstances in which no accrual is made for a loss contingency because one or both of the conditions to accrue the loss (probable and reasonably estimated) are not met, or if an exposure to loss exists in excess of the amount accrued.	No	No change	All applicable instruments and financing receivables	None
Disclosure 9: Risks and Uncertainties				
In general, ASC Topic 275-10-50-1, *Risks and Uncertainties*, states that disclosures are required about the risks and uncertainties existing as of the date of those statements in the following areas: 1. Nature of operations 2. Use of estimates in the preparation of financial statements 3. Certain significant estimates 4. Current vulnerability due to certain concentrations.	No	No change	Loans, financial instruments and receivables with concentrations	None
Disclosure 10: Fair Value Disclosures				
ASC Topic 825-10-50, *Financial Instruments*, provides guidance on the required disclosure of fair values of certain assets and liabilities. For trade receivables (and payables), no disclosure is required if the carrying amount of the receivables approximates fair value.	No	No change	All applicable instruments and financing receivables other than exemptions	Trade receivables where the carrying value approximates the fair value.

In most cases, the carrying amount does, in fact, approximate fair value resulting in no fair value disclosures being required.				
Disclosure 11: Credit Quality Information				
An entity shall provide quantitative and qualitative information by class about the credit quality of financing receivables, including all of the following: • A description of the credit quality indicator. • The recorded investment in financing receivables by credit quality indicator (see illustration below). • For each credit quality indicator, the date or range of dates in which the information was ASU for that credit quality indicator. If an entity discloses internal risk ratings, then the entity shall provide qualitative information on how those internal risk ratings relate to the likelihood of loss.	Yes	New	All applicable instruments and financing receivables other than exemptions	<u>Exempt financing receivables</u> • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services.
Disclosure 12: Modifications (Troubled Debt Restructurings)				
For each period for which a statement of income is presented, an entity shall disclose the following about troubled debt restructurings of financing receivables that occurred during the period: 1. By class of financing receivable, qualitative and quantitative	Yes	New	All applicable instruments and financing receivables other than exemptions	<u>Exempt financing receivables</u>: Troubled debt restructurings involving: • Loans acquired with deteriorated credit

information, including both of the following: • How the financing receivables were modified • The financial effects of the modifications. 2. By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for credit losses. For each period for which a statement of income is presented, an entity shall disclose the following for financing receivables modified as troubled debt restructurings within the previous 12 months and for which there was a payment default during the period: 1. By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including both of the following: • The types of financing receivables that defaulted • The amount of financing receivables that defaulted. 2. By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance for credit losses.				quality • Receivables at fair value • Receivables at lower of cost or market • Trade receivables (except for credit card receivables) that have both of the following characteristics: - They have a contractual maturity of one year or less - They arose from the sale of goods or services.

Disclosure 1: Accounting Policies for Loans and Trade Receivables

The ASU provides the following disclosures that are required for financing receivables, consisting of:

- Loans, and
- Trade receivables.

The ASU requires the following information for Disclosure 1:

a. The summary of significant accounting policies shall include the following:

   - The basis for accounting for loans and trade receivables;
   - The method used in determining the lower of cost or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis);
   - The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment; and
   - The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

b. If major categories of loans or trade receivables are not presented separately in the balance sheet, they shall be presented in the notes to the financial statements.

c. The allowance for doubtful accounts and, as applicable, any unearned income, any unamortized premiums and discounts, and any net unamortized deferred fees and costs, shall be disclosed in the financial statements.

d. Exclusive of credit card receivables, an entity shall disclose its policy for charging off uncollectible trade accounts receivable that have both of the following characteristics:

   1) They have a contractual maturity of one year or less, and
   2) They arose from the sale of goods or services.

Disclosure 2: Assets Serving as Collateral

With respect to required disclosures of the carrying amount of loans, trade receivables, securities and financial instruments that serve as collateral for borrowings, the ASU follows the guidance in ASC Topic 860-30-50-1A, *Transfers and Servicing: Secured Borrowing and Collateral, Disclosures:*

a. An entity shall disclose all of the following for collateral.[4]

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

   2) As of the date of the latest statement of financial position presented, both of the following:

      a) The carrying amount and classifications of both:

         - Any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position, and

         - Associated liabilities.

      b) Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

   3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, it shall disclose all the following:

      a) The fair value as of the date of each statement of financial position presented of that collateral
      b) The fair value as of the date of each statement of financial position presented of the portion of that collateral that it has sold or repledged
      c) Information about the sources and uses of that collateral.

<u>Disclosure 3: Nonaccrual and Past Due Financing Receivables</u>

The disclosures in this Disclosure 3 category apply to all financing receivables that have nonaccrual and past due receivables.

Exemption: The disclosures in this Disclosure 3 category *<u>do not apply</u>* to loans acquired with deteriorated credit quality.

In addition, an entity is required to make these disclosures (Disclosure 3) for all financing receivables, *<u>by class of financing receivable</u>*, except the following categories for which disclosure is required but not by class of financing receivable:

- Receivables measured at fair value with changes in fair value reported in earnings
- Receivables measured at lower of cost or fair value

[4] ASC 860-30-40-1A defines collateral as personal or real property in which a security interest has been given.

- Trade accounts receivable (except for credit card receivables) that have both of the following characteristics:
  - They have a contractual maturity of one year or less, and
  - They arose from the sale of goods or services.

Disclosures required:

a. The entity's summary of significant accounting policies for financing receivables to which this disclosure applies shall include all of the following:

   1) The policy for placing financing, if applicable, on nonaccrual status (or discontinuing accrual of interest)

   2) The policy for recording payments received on nonaccrual financing receivables, if applicable

   3) The policy for resuming accrual of interest

   4) The policy for determining past due or delinquency status.

b. Both of the following disclosures related to non-accrual and past due financing receivables as of each balance sheet date shall be made:

   1) The recorded investment in financing receivables on nonaccrual status, and

   2) The recorded investment in financing receivables past due 90 days or more and still accruing.

c. An entity shall provide an analysis of the age of the recorded investment in financing receivables at the end of the reporting period that are past due, as determined by the entity's policy.

   <u>Special exemption from disclosing the aging</u>: The ASU exempts the following types of financing receivables from the disclosure in (c) above related to presenting an analysis of the aging of receivables.

   - Receivables measured at fair value with changes in fair value reported in earnings
   - Receivables measured at lower of cost or fair value
   - Trade accounts receivable (except for credit card receivables) that have both of the following characteristics:
     - They have a contractual maturity of one year or less, and
     - They arose from the sale of goods or services.

   Note: For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due.

The following tables illustrate certain of the disclosures required by the ASU:

Financing Receivables on Nonaccrual Status
As of December 31, 20X1, and 20X0

	20X1	20X0
Commercial	$XX,XXX	$XX,XXX
Commercial real estate:		
Commercial real estate construction	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX
Consumer:		
Consumer – credit card	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX
Consumer – auto	XX,XXX	XX,XXX
Residential:		
Residential – prime	XX,XXX	XX,XXX
Residential – subprime	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX

Age Analysis of Past Due Financing Receivables
As of December 31, 20X1, and 20X0

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
20X1							
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate:							
Commercial real estate construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer – credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential:							
Residential – prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
20X0							
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Commercial real estate:							
Commercial real estate construction	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer:							
Consumer – credit card	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Consumer – auto	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential:							
Residential – prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Finance leases	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Disclosure 4: Accounting Policies for Off-Balance-Sheet Credit Exposures

An entity is required to disclose a description of the accounting policies and methodology the entity used to estimate its liability for *off-balance-sheet credit exposures* and related charges for those credit exposures.

a. The description shall identify the following:

   - Factors that influenced management's judgment (such as historical losses and existing economic conditions), and

   - Discussion of risk elements relevant to particular categories of financial instruments.

b. *Off-balance-sheet exposures* consist of credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments other than instruments within the scope ASC Topic 815, *Derivatives and Hedging.*

Disclosure 5: Foreclosed and Repossessed Assets

ASC Topic 310-10-45-3, *Receivables- Overall- Other Presentations*, states that foreclosed and repossessed assets shall be classified as a separate balance sheet amount or included in other assets on the balance sheet with separate disclosures in the notes to financial statements.

ASU 2010-20 does not change that requirement.

Disclosure 6: Allowance for Credit Losses Related to Financing Receivables

This Disclosure 6 applies to all financing receivables but *does not apply* to the following exempt financing receivables:

a. Special exemption: Disclosure 6 *does not apply* to:

   1) Financing receivables consisting of:

      - Receivables measured at fair value with changes in fair value reported in earnings
      - Receivables measured at lower of cost or fair value
      - Trade accounts receivable (except for credit card receivables) that have both of the following characteristics:
        - They have a contractual maturity of one year or less, and
        - They arose from the sale of goods or services.

2) Lessor's net investments in leveraged leases.

Observation: The FASB excluded certain financing receivables from Disclosure 6. In particular, receivables measured at fair value and lower of cost or fair value are excluded from the scope of Disclosure 6 because the amendments to Disclosure 6 are less relevant to those types of receivables. The FASB reached the conclusion that existing disclosure requirements found in ASC Topics 820, *Fair Value Measurements and Disclosures*, and ASC Topic 825, *Financial Instruments*, provide sufficient information about those types of receivables.

The FASB also excluded trade receivables from Disclosure 6's scope provided those receivables have contractual maturities of one year or less and they arose from the sale of goods or services (except for credit card receivables). The FASB believed that the cost of applying the disclosures to trade receivables exceeded the benefit.

Finally, the FASB concluded that the amended disclosures about the allowance for credit losses were not relevant to leveraged leases and should not apply to lease receivables.

b. An entity shall disclose all of the following by *portfolio segment*:

1) A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses, including all of the following:
   a) A description of the factors that influenced management's judgment, including:
      - Historical losses, and
      - Existing economic conditions.
   b) A discussion of risk characteristics relevant to each portfolio segment.
   c) Identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.
2) A description of the policy for charging off uncollectible financing receivables.
3) The activity in the allowance for credit losses for each period, including all of the following:
   a) The balance in the allowance at the beginning and end of each period
   b) Current period provision
   c) Direct write-downs charged against the allowance
   d) Recoveries of amounts previously charged off.
4) The quantitative effect of changes identified in item (1)(c) and item (3)(b).
5) The amount of any significant purchases of financing receivables during each reporting period.

6) The amount of any significant sales of financing receivables or reclassifications of financing receivables to held for sale during each reporting period.
7) The balance in the allowance for credit losses at the end of each period disaggregated on the basis of the entity's impairment method.
8) The recorded investment in financing receivables at the end of each period related to each balance in the allowance for credit losses, disaggregated on the basis of the entity's impairment methodology in the same manner as the disclosure in item (7), above.

Note: To disaggregate the information required by items (7) and (8) in the preceding paragraph on the basis of the impairment methodology, an entity shall separately disclose the following amounts:

1. Amounts collectively evaluated for impairment.
2. Amounts individually evaluated for impairment.
3. Amounts related to loans acquired with deteriorated credit quality.

c. An entity shall also provide appropriate disclosure of asset valuation allowances.

The following table illustrates certain of the disclosures required and listed in paragraphs (b)(3), (b)(7) and (b)(8) above related to the allowance for credit losses:

Allowance for Credit Losses and Recorded Investment in Financing Receivables
For the years Ended December 31, 20X1 and 20X0

	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Unallocated	Total
20X1							
Allowance for credit losses:							
Beginning balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Charge-offs	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Recoveries	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Provision	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Ending balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending balance: individually evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: collectively evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending balance: loans acquired with deteriorated credit quality	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Financing receivables:							
Ending balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: individually evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: collectively evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: loans acquired with deteriorated credit quality	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX

	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Unallocated	Total
20X0							
Allowance for credit losses:							
Beginning balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Charge-offs	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Recoveries	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Provision	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Ending balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending balance: individually evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: collectively evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Ending balance: loans acquired with deteriorated credit quality	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Financing receivables:							
Ending balance	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: individually evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: collectively evaluated for impairment	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX
Ending balance: loans acquired with deteriorated credit quality	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	-	$XX,XXX

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. Which of the following is not an example of a financing receivable:

   a) loans
   b) credit cards
   c) debt securities
   d) trade accounts receivable

2. Facts: Company X is unable to make a reasonable estimate of the amount of loss from uncollectible receivables. Which of the following is correct:

   a) accrual basis is still permitted under GAAP
   b) use of the installment method is not permitted
   c) use of the cost recovery method is permitted
   d) use of another method of revenue recognition other than accrual basis is not permitted

3. Disclosure 1 requires an entity to disclose its policy for charging off uncollectible trade accounts receivable that have two characteristics. This disclosure applies to which of the following types of receivables:

   a) credit card receivables
   b) loans and trade receivables
   c) troubled debt restructurings
   d) impaired loans

4. Which of the following is exempt from Disclosure 6:

   a) all financing receivables are exempt
   b) receivables measured at net realizable value
   c) credit card receivables
   d) lessor’s net investments in leveraged leases

SUGGESTED SOLUTIONS

1. A: Incorrect. Loans are considered an example of a financing receivable.

   B: Incorrect. Credit cards are considered an example of financing receivables because they represent a contractual right to receive money.

   C: Correct. Debt securities are specifically excluded from the definition of a financing receivable by ASU No. 2010-20.

   D: Incorrect. Trade accounts receivable are included in the list of assets that are considered a financing receivable.

   (See pages 2-4 to 2-5 of the course material.)

2. A: Incorrect. Because of the inability to make a reasonable estimate of the amount of loss, accrual basis is not permitted.

   B: Incorrect. A significant uncertainty as to collection may suggest that use of the installment method be used.

   C: Correct. A significant uncertainty as to collection may suggest that use of the cost recovery method be used.

   D: Incorrect. A significant uncertainty as to collection may suggest that use of some other method of revenue recognition other than accrual basis be used.

   (See page 2-6 of the course material.)

3. A: Incorrect. Credit card receivables are specifically excluded from the disclosure.

   B: Correct. Disclosure 1 applies to loans and trade receivables.

   C: Incorrect. Disclosure 1 does not apply to troubled debt restructurings.

   D: Incorrect. Disclosure 1 does not apply to impaired loans.

   (See page 2-8 of the course material.)

4. A: Incorrect. Only certain financing receivables are exempt making the statement incorrect.

   B: Incorrect. Only receivables measured at fair value, and not net realizable value, are exempt.

   C: Incorrect. Certain trade receivables are exempt but not credit card receivables.

   D: Correct. Lessor's net investments in leveraged leases are exempt from Disclosure 6.

   (See page 2-12 of the course material.)

Disclosure 7: Impaired Loans

ASC Topic 310-10-35-16 and 17 provide a definition of a loan that is impaired. Under the ASC Topic, a loan is impaired when, based on current information and events, it is *probable* that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

Note: This guidance does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor shall apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of this guidance. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.

An entity that has impaired loans is required to make certain disclosures for each class of financing receivable, as follows:

a. *Both* of the following:

    1) The accounting for impaired loans, and
    2) The amount of impaired loans.

b. As of the date of each statement of financial position presented:

    1) The recorded investment in the impaired loans and both of the following:

        - The amount of that recorded investment for which there is a related allowance for credit losses and the amount of that allowance.
        - The amount of that recorded investment for which there is no related allowance for credit losses.

    2) The total unpaid principal balance of the impaired loans.

c. The entity’s policy for recognizing interest income on impaired loans, including how cash receipts are recorded.

d. For each period for which results of operations are presented:

    1) The *average recorded investment* in the impaired loans.
    2) The related amount of interest income recognized during the time within that period that the loans were impaired.
    3) The amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired, if practicable.

Note: The ASU does not specify how a creditor shall calculate the *average recorded investment* in the impaired loans during the reporting period. A creditor shall develop an appropriate method for that calculation. Averages based on month-end balances may be considered an appropriate method.

e. The entity's policy for determining which loans the entity assesses for impairment

f. The factors considered in determining that the loan is impaired.

Note: The disclosures above shall also be made for impaired loans that have been charged off partially, but are not required for loans that have been charged off fully because both the recorded investment and the allowance for credit losses will equal zero.

The following table summarizes the scope of the disclosure requirements for impairment of loans:

	Required Disclosures about the Recorded Investment in Loans That Meet the Definition of an Impaired Loan in Paragraphs 310-10-35-16 through 35-17			
	(A)	(B)	(C)	(D)
Description of Loans	The Total Recorded Investment in the Impaired Loans	Unpaid Principal Balance of the Impaired Loans	The Recorded Investment in (A) for Which There Is A Related Allowance for Credit Losses	The Recorded Investment in (A) for Which There Is No Related Allowance for Credit Losses
Loans that meet the definition of an impaired loan in paragraphs 310-10-35-16 through 35-17 and that have not been charged off fully, separately reported by class	Included. The amount disclosed in (A) must equal the sum of (C) and (D).	Included.	Included if there is a related allowance for credit losses.	Included if there is no related allowance for credit losses.
Loans that meet the definition of an impaired loan in paragraphs 310-10-35-16 through 35-17 and that have been charged off fully	Excluded. The recorded investment and allowance for credit losses are equal to zero.			
Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment and other loans that are excluded from the scope of this Subtopic as defined in paragraph 310-10-35-13	Excluded unless restructured in a troubled debt restructuring (see paragraph 310-40-35-9 for requirements for a restructured loan).			

Following is an illustration of the Disclosure 7: Impaired Loans.

NOTE X: Impaired Loans

The company's policy is to record interest income on impaired loans on a cash basis.

The company's policy is to select an individual loan for impairment when, based on current information and events, it is probable that the company will be unable to collect all amounts due, including interest, according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

Factors considered in determining whether a loan is impaired include internally generated information such as whether the loan is past due, status of other loans due from the same borrower, borrower's financial status and solvency, status of any underlying collateral, and externally obtained information on the borrower, among other factors.

Following is a summary of impaired loans at December 31, 20X1 and 20X0:

Impaired Loans
For the Years Ended December 31, 20X1 and 20X0

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
20X1					
With no related allowance recorded:					
Commercial	$XX,XXX	$XX,XXX	-	$XX,XXX	$XX,XXX
Consumer – credit card	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
Consumer – auto	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
With an allowance recorded:					
Commercial real estate construction	XX,XXX	XX,XXX	$XX,XXX	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total:					
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Consumer	$XX,XXX	$XX,XXX	-	$XX,XXX	$XX,XXX
Residential	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

20X0	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$XX,XXX	$XX,XXX	-	$XX,XXX	$XX,XXX
Consumer – credit card	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
Consumer – other	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
Consumer auto	XX,XXX	XX,XXX	-	XX,XXX	XX,XXX
With an allowance recorded:					
Commercial real estate construction	XX,XXX	XX,XXX	$XX,XXX	XX,XXX	XX,XXX
Commercial real estate – other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – prime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Residential – Subprime	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total:					
Commercial	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Consumer	$XX,XXX	$XX,XXX	-	$XX,XXX	$XX,XXX
Residential	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Disclosure 8: Loss Contingencies

Disclosure is required for circumstances in which no accrual is made for a loss contingency because one or both of the conditions to accrue the loss (probable and reasonably estimated) are not met, or if an exposure to loss exists in excess of the amount accrued.

The disclosures required by this section do not apply to loss contingencies arising from an entity's recurring estimation of its allowance for credit losses.

a. Disclosure of the loss contingency shall be made if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and *either* of the two conditions to record a liability have not been met:

   1) An accrual is not made for a loss contingency because one of the two conditions for the accrual has not been met.

      Example: Either the probable and/or reasonably estimated condition has not been met.

   2) An exposure to loss exists in excess of the amount accrued.

b. The disclosure in the preceding paragraph shall include both of the following:

   1) The nature of the contingency, and
   2) An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

c. Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

1) It is considered probable that a claim will be asserted, and
2) There is a reasonable possibility that the outcome will be unfavorable.

Disclosure 9: Risks and Uncertainties

In general, ASC Topic 275-10-50-1, *Risks and Uncertainties*, states that disclosures are required about the risks and uncertainties existing as of the date of those statements in the following areas:

1. Nature of operations
2. Use of estimates in the preparation of financial statements
3. Certain significant estimates
4. Current vulnerability due to certain concentrations.

Certain loan products and receivables have contractual terms that expose entities to risks and uncertainties that fall into one or more categories.

The ASU does not change the existing GAAP in this area.

Disclosure 10: Fair Value Disclosures

ASC Topic 825-10-50 provides guidance on the required disclosure of fair values of certain assets and liabilities.

For trade receivables (and payables), no disclosure is required if the carrying amount of the receivables approximates fair value. In most cases, the carrying amount does, in fact, approximate fair value resulting in no fair value disclosures being required.

Disclosure 11: Credit Quality Information

The requirements of Disclosure 11 apply to financing receivables.

a. Special exemption: Disclosure 11 *does not apply* to any of the following:

   1) Financing receivables consisting of:

      - Receivables measured at fair value with changes in fair value reported in earnings
      - Receivables measured at lower of cost or fair value
      - Trade accounts receivable (except for credit card receivables) that have both of the following characteristics:
        - They have a contractual maturity of one year or less, and
        - They arose from the sale of goods or services.

b. An entity shall provide information that enables financial statement users to do both of the following:

   1) Understand how and to what extent management monitors the credit quality of its financing receivables in an ongoing manner, and

2) Assess the quantitative and qualitative risks arising from the credit quality of its financing receivables.

To meet the objective of the above disclosure, an entity shall provide quantitative and qualitative information by class about the credit quality of financing receivables, including all of the following:

- A description of the credit quality indicator.
- The recorded investment in financing receivables by credit quality indicator ***(see illustration below).***
- For each credit quality indicator, the date or range of dates in which the information was updated for that credit quality indicator.

Moreover, if an entity discloses internal risk ratings, then the entity shall provide qualitative information on how those internal risk ratings relate to the likelihood of loss.

The following table is from the ASU and illustrates certain disclosures related to credit quality indicators as required by Disclosure 11. This particular disclosure illustrates the recorded investment in financing receivables by credit quality indicator identified in the second bullet down as noted above.

Credit Quality Indicators
As of December 31, 20X1, and 20X0

Corporate Credit Exposure
Credit Risk Profile by Creditworthiness Category

	Commercial		Commercial Real Estate Construction		Commercial Real Estate – Other	
	20X1	20X0	20X1	20X0	20X1	20X0
AAA – AA	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
A	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
BBB – BB	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
B	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
CCC – C	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
D	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Corporate Credit Exposure
Credit Risk Profile by Internally Assigned Grade

	Residential – Prime		Residential – Subprime	
	20X1	20X0	20X1	20X0
Grade:				
Pass	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Special mention	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Substandard	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Corporate Credit Exposure
Credit Risk Profile Based on Payment Activity

	Consumer – Credit Card		Consumer – Other		Finance Leases		Consumer – Auto	
	20X1	20X0	20X1	20X0	20X1	20X0	20X1	20X0
Performing	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX
Nonperforming	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX	$XX,XXX

Disclosure 12: Modifications

Disclosure 12 applies only to a creditor's troubled debt restructurings of financing receivables. For purposes of this disclosure guidance, a creditor's modification of a lease receivable that meets the definition of a troubled debt restructuring is subject to this disclosure guidance.

a. Scope exception: Disclosure 12 does not apply to troubled debt restructurings of either of the following:

    1) Financing receivables consisting of:

        - Receivables measured at fair value with changes in fair value reported in earnings
        - Receivables measured at lower of cost or fair value
        - Trade accounts receivable (except for credit card receivables) that have both of the following characteristics:
            - They have a contractual maturity of one year or less, and
            - They arose from the sale of goods or services.

    2) Loans acquired with deteriorated credit quality that are accounted for within a pool.

b. For each period for which a statement of income is presented, an entity shall disclose the following about troubled debt restructurings of financing receivables that occurred during the period:

    1) By class of financing receivable, qualitative and quantitative information, including both of the following:
        a) How the financing receivables were modified, and
        b) The financial effects of the modifications.

    2) By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for credit losses.

c. For each period for which a statement of income is presented, an entity shall disclose the following for financing receivables, modified as troubled debt restructurings within the previous 12 months, and for which there was a payment default during the period:

1) By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including both of the following:
   a) The types of financing receivables that defaulted, and
   b) The amount of financing receivables that defaulted.

2) By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance for credit losses.

The following table illustrates certain of the disclosures required by Disclosure 12 related to loan modification:

Modifications
As of December 31, 20X1, and 20X0

	20X1			**20X0**		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Residential – prime	XXX	$XX,XXX	$XX,XXX	XXX	$XX,XXX	$XX,XXX
Residential – subprime	XXX	XX,XXX	XX,XXX	XXX	XX,XXX	XX,XXX
Consumer – other	XXX	XX,XXX	XX,XXX	XXX	XX,XXX	XX,XXX
Finance leases	XXX	XX,XXX	XX,XXX	XXX	XX,XXX	XX,XXX

	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted				
Troubled Debt Restructurings:				
Residential – prime	XXX	$XX,XXX	XXX	$XX,XXX
Residential – subprime	XXX	XX,XXX	XXX	XX,XXX
Consumer – other	XXX	XX,XXX	XXX	XX,XXX
Finance leases	XXX	XX,XXX	XXX	XX,XXX

2. **Level of disaggregation used for disclosures:**

Many of the required disclosures must be presented by <u>class or portfolio segment of financing receivables</u>.

<u>Portfolio segment</u>**:** A portfolio segment is the level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. Examples of portfolio segments include:

- Type of financing receivable
- Industry sector of the borrower
- Risk rate(s).

Class of financing receivable: A class is a group of financing receivables determined on the basis of all of the following:

- Initial measurement attribute (for example, amortized cost or purchased credit impaired)
- Risk characteristics of the financing receivable
- An entity's method for monitoring and assessing credit risk.

Note: A class of financing receivables is typically a further breakdown (disaggregation) of a portfolio segment. In determining the appropriate classes of financing receivables related to a portfolio segment, the portfolio segment is the starting point with further disaggregation in accordance with the following guidance:

a. An entity should base its principal determination of class of financing receivables on both of the following:

    1) Initial measurement attribute: Classes should first segregate financing receivables on the basis of the model under which they were initially recorded, such as any of the following:

        - Amortized cost
        - Loans acquired with deteriorated credit quality which are accounted for under ASC Subtopic 310-30, *Loan and Debt Securities Acquired With Deteriorated Credit Quality.*

    2) Entity assessment: Classes should secondarily be disaggregated to the level that an entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables.

b. In determining the appropriate level of its internal reporting to use as a basis for disclosure, an entity should consider the level of detail needed by a user to understand the risks inherent in the entity's financing receivables. An entity could further disaggregate its financing receivables portfolio by considering numerous factors. Examples of factors that the entity should consider include any of the following:

    1) Categorization of borrowers, such as:

        - Commercial loan borrowers
        - Consumer loan borrowers
        - Related party borrowers

2) Type of financing receivable, such as:

- Mortgage loans
- Credit card loans
- Interest-only loans
- Finance leases

3) Industry sector, such as:

- Real estate
- Mining

4) Type of collateral, such as:

- Residential property
- Commercial property
- Government-guaranteed collateral
- Uncollateralized (unsecured) financing receivables

5) Geographic distribution, including both of the following:

- Domestic
- International

6) Factors related to concentrations of credit risk

Note: A creditor should determine, in light of the facts and circumstances, both of the following: 1) How much detail it must provide to satisfy the disclosure requirements of this ASU, and 2) How it disaggregates information into classes for assets with different risk characteristics.

The ASU indicates that a creditor must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the entity's financing receivables and allowance for credit losses. For example, a creditor should not obscure important information by including it with a large amount of insignificant detail. Similarly, a creditor should not disclose information that is so aggregated that it obscures important differences between the different types of financing receivables and associated risks.

Observation: Prior to the issuance of the ASU, the FASB noted that the allowance for credit loss disclosure under U.S. GAAP was required on an aggregate basis only. The FASB concluded that such disclosures should be further disaggregated to the level at which the allowance for credit losses is calculated and monitored, which is defined as the *portfolio segment*, a new term introduced by ASU No. 2010-10.

Further, the amendments in this ASU require disaggregation by *class* for certain credit risk disclosures: credit quality indicators, age analysis of past due financing receivables, impaired financing receivables, and financing receivables on nonaccrual status. According to the FASB, having a consistent approach to disaggregation by class across those credit risk disclosures will provide financial statement users with the most useful and transparent level of comparison because the information will be reported at the same level of detail in which the financing receivables are monitored and assessed within the entity.

3. Effective Date and Transition: ASU No. 2010-20:

The following represents the transition and effective date information related to Accounting Standards ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses:*

a. For public entities:

   1) The amendments to disclosures as of the end of a reporting period shall be effective for the first interim or annual reporting period *<u>ending on or after December 15, 2010</u>*.

   2) The amendments to disclosures about activity that occurs during a reporting period is effective for the first interim or annual reporting period *<u>beginning on or after December 15, 2010</u>*.

b. For nonpublic entities, the amendments to disclosures shall be effective for the first annual reporting period *<u>ending on or after December 15, 2011</u>*.

c. An entity shall provide comparative disclosures for each reporting period ending after initial adoption.

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. With respect to impaired loans, which of the following must be disclosed for such loans:

   a) the average recorded investment
   b) the total recorded investment
   c) the range of high and low investment values
   d) the amount of interest income received on an accrual basis

2. Which of the following situations would not require a disclosure of a loss contingency:

   a) an accrual has been made for the loss contingency and there is no excess loss exposure
   b) no accrual has been made because one or both of the conditions to accrue a loss (probable and reasonably estimated) are not met
   c) an accrual has been made and loss exposure exceeds the amount accrued
   d) the probable criterion has been met but the reasonably estimated one has not been met for recording a loss contingency

3. With respect to disclosures of fair values of certain assets and liabilities, which of the following is correct with respect to the trade receivables and payables:

   a) no disclosure is required for trade receivables and payables
   b) disclosure is required for trade receivables and payables in all cases
   c) no disclosure is required if the carrying amount of the receivables is less than the fair value
   d) disclosure is not required if the carrying amount of the receivables approximates fair value

4. Which of the following is <u>not</u> a factor in determining a class of financing receivables:

   a) initial measurement attribute (for example, amortized cost or purchased credit impaired
   b) risk characteristics of the financing receivable
   c) an entity's method for monitoring and assessing credit risk
   d) industry sector of the borrower

SUGGESTED SOLUTIONS

1. **A: Correct.** The average recorded investment in the impaired loans is required to be disclosed.

   B: Incorrect. The average, and not the total recorded investment, must be disclosed.

   C: Incorrect. GAAP does not require a range of high and low investment values be disclosed.

   D: Incorrect. GAAP requires disclosure of the amount of interest income recognized on a cash basis, not accrual basis.

   (See page 2-29 of the course material.)

2. **A: Correct.** If there is no excess loss exposure, a disclosure would not be required.

   B: Incorrect. If no accrual has been made because one or both of the conditions to accrue a loss (probable and reasonably estimated) are not met, a disclosure is required.

   C: Incorrect. If the exposure exceeds the amount accrued, a disclosure is required.

   D: Incorrect. If the probable criterion has been met but the reasonably estimated one has not been met, no accrual would have been made for the loss contingency. Consequently, disclosure of the potential loss would be required.

   (See page 2-32 of the course material.)

3. A: Incorrect. Disclosure is required for trade receivables and payables in certain cases making the statement incorrect.

   B: Incorrect. There are situations in which disclosure for trade receivables and payables is not required making the statement incorrect.

   C: Incorrect. There is no rule that no disclosure is required if the carrying amount of the receivables is less than the fair value.

   D: Correct. The ASU states that disclosure of receivables is not required if the carrying amount of the receivables approximates fair value.

   (See page 2-32 of the course material.)

4. A: Incorrect. Initial measurement attribute, such as amortized cost or purchased credit impaired, is a factor in determining a class of financing receivables.

   B: Incorrect. Risk characteristics of the financing receivable is a factor in determining a class.

   C: Incorrect. An entity's method for monitoring and assessing credit risk is a factor to determine a class of financing receivables.

   D: Correct. Industry sector of the borrower is an example of a portfolio segment, and not a class of financing receivables.

   (See page 2-36 of the course material.)

Chapter 3: Plan Accounting – Defined Contribution Pension Plans (Topic 962)
ASU No. 2010-25: Reporting Loans to Participants by Defined Contribution Pension Plans: A Consensus of the FASB Emerging Issues Task Force

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Plan Accounting—Defined Contribution Pension Plans (ASC Topic 962)
ASU No. 2010-25: Reporting Loans to Participants by Defined Contribution Pension Plans: A Consensus of the FASB Emerging Issues Task Force

Upon completing this chapter, you will be able to:

- Explain how loans to participants should be classified and measured by defined contribution pension benefit plans

I. Introduction

Date issued: September 2010

Effective date: The amendments in this update are effective for fiscal years ending after December 15, 2010. The amendments should be applied retrospectively to all prior periods presented, effective for fiscal years ending after December 15, 2010.

Objective:

The objective of the amendments in this ASU is to clarify how loans to participants should be classified and measured by defined contribution pension benefit plans.

II. Background

Participants in a defined contribution plan can direct the investment of their plan account balance into an investment in a loan to themselves if the plan allows for participant loans. Although participant loans are by their nature receivables, for reporting purposes, participant loans are considered a plan investment.

Participant loans are currently classified as investments in accordance with the defined contribution pension plan guidance.

ASC Subtopic 962-325, *Planning Accounting-Defined Contribution Pension Plans-Investments-Other*, requires most investments held by a plan, including participant loans, to be presented at fair value. ASC Topic 820, *Fair Value Measurements and Disclosures*, provides specific guidance on how fair value should be measured.

According to ASC Topic 820, fair value of a plan investment 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. Under ASC Topic 820, plans can no longer assume that the outstanding principal balance of a loan approximates its fair value and, so, the valuation principles of ASC Topic 820 should be applied.

In practice, most participant loans are carried at their unpaid principal balance, plus any accrued but unpaid interest, which was considered a good faith approximation of fair value. However, some stakeholders questioned whether that measurement conforms to ASC Topic 820, which requires the use of observable and unobservable inputs such as market interest rates, borrower’s credit risk, and historical default rates to estimate the fair value of participant loans. Other parties have questioned whether the use of those assumptions would result in information that is decision useful.

The EITF concluded in this ASU that participant loans are unique plan assets that should be *classified as notes receivable* from participants, and not as investments. Further, the EITF concluded that classification of participant loans as receivables acknowledges that participant loans are essentially a participant borrowing against their own individual account. Furthermore, EITF members noted that this classification best reflects the legal nature of the asset, which is a loan from the plan to the participant.

Because the participant loans are to be considered notes receivable, such loans should be reported at their unpaid principal balance plus any accrued but unpaid interest, instead of being recorded at fair value.

III. Scope

1. The ASU amendments apply to any defined contribution pension plan that allows participant loans.

IV. Rules

1. The amendments in this ASU follow:

   a. For reporting purposes, participant loans shall be classified as notes receivable from participants, and not as investments.

      1) The notes receivable should be segregated from plan investments.

   b. The participant loans shall be measured at their unpaid principal balance plus any accrued and unpaid interest.

   c. The fair value disclosures required for investments under ASC Topic 825-10-50-10 through 50-16, *Financial Instruments*, are not required for participant loans.

Note: The EITF discussed that the Department of Labor requires participant loans to be included as an investment on the supplemental schedule of assets held (measured as the unpaid principal balance plus any accrued but unpaid interest) to be included with the audited financial statements. The EITF noted that although for purposes of the supplemental schedule participant loans will still be reported as investments, the current value included on the supplemental schedule for the participant loans will now be consistent with the measurement requirements in GAAP.

Participant loans are not as commonly observed outside the United States and IAS 26, *Accounting and Reporting by Retirement Benefit Plans,* does not specifically provide accounting guidance for participant loans. However, IAS 26 acknowledges that there may be some situations in which fair value may not be the most meaningful measurement attribute for plan investments, such as when securities that have a fixed redemption value are acquired to match the obligations of the plan or specific parts of the plan. It also states that estimates of fair value may not be possible in certain situations. IAS 26 does not explicitly require a specific classification of the loans to participants as investments or receivables separately from investments. However, participant loans are generally carried at amortized cost by a plan applying international standards.

Example:

The following are illustrative financial statements and disclosures (Source: ASU 2010-25, as modified by the Author):

	20X1	20X0
Assets:		
Investments (Note X)	$xx	$xx
Receivables:		
Employer contribution	xx	xx
Participant contributions	xx	xx
Notes receivable from participants	***xx***	***xx***
Total receivables	xx	xx
Total assets	xx	xx
Liabilities:		
Accounts payable	xx	xx
Accrued expenses	xx	xx
Total liabilities	xx	xx
Net assets available for benefits	$xx	$xx

V. Effective Date and Transition

1. The amendments to ASU shall be effective for fiscal years ending after December 15, 2010, with early application permitted.

2. An entity shall apply retrospectively the amendments in the ASU to prior years presented comparatively.

3. Any disclosures required by ASC Topic 250-10-50-1 through 50-3, *Accounting Changes and Error Corrections*, shall be provided in the period an entity adopts the amendments.

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. Under current practice, how are participant loans classified under existing defined contribution pension plan guidance:

   a) as an investment
   b) as a deferred asset
   c) as a note receivable
   d) as an intangible asset

2. How should participant loans be measured under ASU 2010-25:

   a) fair value plus interest
   b) unpaid principal balance plus accrued and unpaid interest
   c) net realizable value
   d) lower of cost or market value

3. Which of the following is correct as it relates to the EITF's response to the Department of Labor's handling of participant loans on the supplemental schedule of assets held:

   a) participant loans are included on the schedule as a note receivable at fair value
   b) participant loans are included on the schedule as an investment at fair value
   c) participant loans are included on the schedule at fair value
   d) participant loans are included on the schedule as an investment at the unpaid principal balance plus any accrued but unpaid interest

SUGGESTED SOLUTIONS

1. **A: Correct.** Current practice classifies participant loans as investments.

   B: Incorrect. There is no evidence that participant loans are classified as a deferred asset.

   C: Incorrect. Although the ASU seeks to classify participant loans as a note receivable, under current practice such loans are not presented as notes receivable.

   D: Incorrect. There is no evidence that participant loans are classified as an intangible asset.

   (See page 3-2 of the course material.)

2. A: Incorrect. The fair value model does not apply to participant loans under ASU 2010-25.

   B: Correct. The ASU requires that participant loans be measured at the unpaid principal balance plus accrued and unpaid interest.

   C: Incorrect. The ASU does not provide for use of net realizable value.

   D: Incorrect. The ASU does not provide for use of lower of cost or market value.

   (See page 3-3 of the course material.)

3. A: Incorrect. Participant loans are included on the schedule as an investment at the unpaid principal balance plus any accrued and unpaid interest.

   B: Incorrect. Participant loans are included on the schedule as an investment, but not at fair value.

   C: Incorrect. Participant loans are not included on the schedule at fair value.

   D: Correct. The ASU states that participant loans are included on the schedule as an investment at the unpaid principal balance plus any accrued and unpaid interest.

   (See page 3-3 of the course material.)

Chapter 4: ASU 2010-28 and the Impairment of Long-Lived Assets, Goodwill, and Other Intangible Assets During the Economic Downturn

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ASU 2010-28 and the Impairment of Long-Lived Assets, Goodwill and Other Intangible Assets During the Economic Downturn

Upon completing this chapter, you will be able to:

- Recall the impairment rules for four categories of assets including goodwill
- Review the changes to goodwill and tests for impairment of goodwill
- Review the types of assets which apply to impairments
- Identify the steps that are applied in testing and measuring an impairment of long-lived assets to be held and used
- Apply the rules of accounting for impairment of long-lived assets held for sale
- Review the disclosure and financial statement presentation of impaired assets and related losses

I. Background

With the current state of affairs in the United States economy, there are many public and non-public companies that have significant impairments of live-lived assets (equipment and real estate), goodwill, and intangible assets with indefinite lives. GAAP requires that companies test their goodwill and long-lived assets with indefinite lives annually for impairment, while long-lived assets (equipment and real estate) and intangibles with finite lives must test for impairment only if there is a reason to do so.

A typical acquisition includes the recording at fair value of long-lived tangible assets (equipment and real estate), long-lived intangibles with indefinite lives (such as licenses, tradenames and trademarks), intangibles with finite lives (such as patents), and finally goodwill.

ASC 805, *Business Combinations* (formerly FASB No. 141 (revised 2007)), requires that in a business combination, an acquirer must record at fair value all assets, liabilities and any noncontrolling interests in the acquiree. ASC 805 requires that intangible assets other than goodwill, be recognized apart from goodwill if they meet certain criteria. ASC 805 further requires that goodwill be initially recognized as an asset in the financial statements, as the excess of the cost of an acquired entity, over the net of the amounts assigned to assets and liabilities assumed.

Once the underlying assets of an acquisition are recorded at their fair value, the rules as to whether or not to depreciate or amortize those assets, and how and when to test for impairment writedown, come into play.

The authority for testing impairment of long-lived assets, intangibles and goodwill is found in a series of FASB statements that were issued in the early 2000s, and that drastically changed the way in which such assets were tested for impairment.

The following two tables summarize the authority for accounting for impairment of various assets:

Intangibles: Goodwill and Other (ASC 350), as amended by ASU 2010-28 (formerly FASB No. 142)	• Goodwill • Intangible assets with indefinite lives
Impairments (ASC 360) (formerly FASB No. 144)	• Long-lived assets (equipment, real estate, etc.) • Intangible assets with finite lives

Accounting for Impairments of Assets			
Type of Asset	**Authority for Impairment**	**Accounting Treatment**	**Impairment Test Approval**
Goodwill	ASC 350 (formerly FASB No. 142)	Not amortized	Tested annually for impairment
Intangibles with indefinite lives (trade names, etc.)	ASC 350 (formerly FASB No. 142)	Not amortized	Tested annually for impairment
Long-lived tangible assets (equipment and real estate)	ASC 360 (formerly FASB No. 144)	Depreciated	Tested for impairment only if there is an indication that an impairment might exist
Intangibles with finite lives (patents, etc.)	ASC 360 (formerly FASB No. 144)	Amortized	Tested for impairment only if there is an indication that an impairment might exist

Because fair value is the basis for measuring impairment, ASC 820, *Fair Value Measurements and Disclosures* (formerly FASB No. 157), provides guidance by defining fair value and requiring an entity to follow ASC 820 anytime fair value is measured, such as in the case of ASC 350 (formerly FASB No. 142) and ASC 360 (formerly FASB No. 144).

In December 2010, the FASB Emerging Issues Task Force (EITF) issued ASU No 2010-28, *Intangibles – Goodwill and Other (Topic 350) When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts: A Consensus of the FASB Emerging Issues Task Force*, to deal with testing goodwill when an entity has zero or negative carrying amounts. ASU No. 2010-28 is later in this chapter.

II. <u>Four Categories of Assets</u>

In this chapter, the author discusses the accounting for impairment for the following *four categories* of assets:

- Goodwill
- Intangible assets with indefinite lives
- Long-lived tangible assets such as equipment and real estate
- Intangible assets with finite lives

Category 1: Goodwill:

ASC 805*, Business Combinations* (formerly FASB No. 141R), defines goodwill as:

> *"An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."*

ASC 350 provides the rules for accounting for goodwill after a portion of the acquisition price is allocated to goodwill by ASC 805 (formerly FASB No. 141R).

The rules for testing goodwill for impairment follow:

1. **Goodwill *<u>should not be amortized</u>* but should be tested for impairment *<u>at least annually.</u>***

    a. The test shall be performed at the *reporting unit level*.

    Note: For most non-public entities, the entity has one reporting unit so that goodwill is tested at the entity level.

    b. The annual impairment test may be performed any time during the fiscal year provided the test is performed at the same time each year. Different reporting units may be tested for impairment at different times.

    Note: Goodwill should be tested for impairment on an interim basis (between annual tests) if an event occurs or circumstances change (a triggering event) that would *<u>more-likely-than-not</u>* (more than 50% chance) reduce the fair value of the reporting unit below the carrying value. Examples of events or circumstances that may warrant performing an interim test include:

    - Significant adverse change in the business climate or legal factors
    - Adverse legal issue or action against the reporting unit
    - Action or assessment by a regulator
    - Unanticipated competition
    - Loss of key employee
    - More-likely-than-not (more than 50% likelihood) expectation that all or a significant part of a reporting unit will be sold or disposed of

- There is a test for recoverability under ASC 360 (formerly FASB No. 144) of a significant asset group within the reporting unit
- There is a recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

c. Because goodwill is tested for impairment under ASC 350 (formerly FASB No. 142), it should not be tested for impairment under ASC 360 (formerly FASB No. 144).

d. <u>Ordering of tests for impairment</u>: If an asset group is tested for impairment under ASC 350, the ASC 360 impairment test of those assets shall be performed before the goodwill impairment test. Any impairment loss incurred on the test of the assets under ASC 360 should be recognized before the goodwill test is performed.

Example: Reporting Unit X consists of various tangible and intangible assets, including goodwill. X is performing an impairment test of all of its assets under ASC 360. X also must perform its annual test for impairment of goodwill.

Conclusion: X should first perform its test for impairment of all of its tangible and intangible assets under ASC 360. If there is an impairment of those assets, they should be written down and an impairment loss recorded prior to including those assets in the test for impairment of goodwill under ASC 350. The written down assets would be used to test for goodwill impairment.

2. Special Goodwill Impairment Test Carryforward Rule

As a means to make the impairment rules of ASC 350 less burdensome, ASC 350 offers a special relief provision under which an entity may be able to test for impairment in the first year, and carryforward the test to each successive year, without updating it. The rule works like this:

a. A detailed determination of the fair value of a reporting unit may be carried forward from one year to the next if all of the following criteria have been met:

- The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination.

- The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.

- Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

Example: In 20X2, Company X performs its first impairment test of goodwill assigned to Reporting Unit B. Based on the test, the fair value of the reporting unit exceeds its carrying value by a substantial margin.

In 20X3, Company X is ready to perform its annual impairment test of goodwill. The assets and liabilities of Reporting Unit B have not changed significantly. Further, there has been little change in the operations and profitability of Reporting Unit B. X believes that if a current 20X3 test were to be done, the likelihood that the fair value would be less than the carrying value is remote.

Conclusion: Company X is not required to perform a test for 20X3 and, instead, may follow the special rule by carrying forward the 20X2 test and use it for 20X3. X qualifies to use this special exception for several reasons. First, the assets and liabilities assigned to Unit B have not changed significantly from 20X2 (the most recent fair value determination) to 20X3. Second, the most recent fair value determination (20X2) resulted in the fair value exceeding the carrying value by a substantial margin. Third, as of 20X3, the likelihood of the fair value being less than the carrying value is remote. In years 20X4 and beyond, X may be able to continue to carry forward the results of the 20X2 test, thus avoiding the arduous annual impairment test.

Observation: Although the author believes there are many flaws with ASC 350, this provision is one of the Statement's bright spots in that it provides administrative relief to an otherwise burdensome calculation. The way this provision is written, a company could conceivably conduct one test of impairment and carry forward that test indefinitely to several subsequent years. The test would have to be updated only when there was a significant change in assets and liabilities assigned to the unit or a triggering event that might lead to a potential impairment loss.

3. General Steps to Test Goodwill for Impairment

In order to perform the annual test for impairment of goodwill, the following steps must be applied:

Step 1. Identify the reporting units
Step 2. Assets and liabilities, including goodwill, must be assigned to reporting units
Step 3. Goodwill assigned to each reporting unit must be tested for impairment

Each of these steps will be discussed in detail.

STEP 1: Identifying the Reporting Units:

a. Goodwill should be tested at the *reporting unit level*.

A reporting unit is the same as an *operating segment as defined by ASC 280, Segment Reporting* (formerly FASB No. 131), or one level below an operating segment level.

Note: Even if an entity is nonpublic and not required to report segment information, it must follow the guidance of ASC 280 to determine its operating segments and reporting units and must test goodwill for impairment at the reporting unit level.

The following box summarizes the operating segment rules found in ASC 280.

Definition of an Operating Segment

ASC 280 defines an ***operating segment*** as a component of an enterprise:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),

- Whose operating results are regularly reviewed by the enterprise's chief operating decision maker[1] to make decisions about resources to be allocated to the segment and assess its performance, and

- For which discrete financial information is available.

A component of an operating segment is a reporting unit if the component *constitutes a business*[2] for which discrete financial information is available and *segment management* regularly reviews the operating results of that component.

Two or more components of an operating segment shall be aggregated and considered one single reporting unit if the components have *similar economic characteristics*.

ASC 280 provides guidance as to whether components have *similar economic characteristics* in each of the following areas:

- The nature of the products and services
- The nature of the production processes
- The type or class of customer for their products and services
- The methods used to distribute their products or provide their services
- The nature of the regulatory environment such as in the case with banking, insurance, or public utilities
- The manner in which an entity operates its business and the nature of those operations
- Whether the components are economically interdependent: Example: Whether goodwill is recoverable from the separate operations of each component or from two or more components working in concert
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects.

Components that share similar economic characteristics but relate to different operating segments may not be combined into a single reporting unit.

[1] ASC 280 states that the term "chief operating decision maker" identifies a function, and not necessarily a manager with a specific title. Usually, a chief operating decision maker is its CEO or COO, but it may be a group of officers consisting of, for example, the president and vice presidents, among others.
[2] EITF 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, provides guidance on determining whether an asset group constitutes a business.

Example: There are three operating segments: Americas, Europe and Asia. Each has two components (A and B) that are dissimilar to each other but similar to the corresponding components in the other segments. The entity would not be permitted to combine component A from each of the segments to make Reporting Unit A.

An operating segment is considered a reporting unit if:

- All of its components are similar,
- None of its components are individually a reporting unit, or
- The operating segment consists of only a single component.

Note: FASB Staff Announcement D-101 clarified some of the confusion surrounding the reporting unit concept. Specifically, the Announcement states the following:

1. How an entity manages its operations and how an acquired entity is integrated with the acquiring entity are key to determining the reporting units of the entity.

2. An operating segment must satisfy several requirements in order for it to constitute a reporting unit:

   a. It must meet the definition of a <u>*business*</u> under EITF No. 98-3 in which:

      The assets transferred must contain <u>all of the inputs and processes necessary for it to continue to conduct normal operations</u> after the transferred set is separated from the transferor.

   b. <u>*Discrete financial information*</u> is available and <u>*segment management*</u> must regularly review the operating results of that component (segment.)

      - Discrete information can constitute as little as operating information. (A balance sheet does not have to be produced for that segment).

      - A segment manager is directly accountable to and maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts, or plans for the segment.

      - Reporting units should reflect the way an entity manages its operations.

Example: Joe is the founder of Joe Pizza's Inc. which owns eight pizza stores. All eight stores sell essentially the same products consisting of pizzas and sandwiches. Store number 1 was started from scratch, while Stores 2 through 8 were purchased. The stores are located throughout New England. On the general ledger of Joe's Pizza's Inc., goodwill is separated as follows:

Store	Amount of Goodwill
Store #2	$100,000
Store #3	200,000
Store #4	150,000
Store #5	250,000
Store #6	300,000
Store #7	125,000
Store #8	175,000
Total goodwill	$1,300,000

Stores #2 and #4 are losing money and may have an impairment of goodwill. For purposes of testing for goodwill impairment, Joe wishes to combine all goodwill and test for impairment in the aggregate for all stores, rather than for goodwill for individual stores.

Should goodwill be tested for impairment individually for each store, or in the aggregate?

Conclusion: Goodwill should be tested in the aggregate for all stores.

Goodwill shall be tested at the reporting unit level. A reporting unit is defined using the operating segment definition in ASC 280. Further, components within an operating segment shall be aggregated and considered *one single reporting unit* if the components have similar economic characteristics. Factors to consider in determining if there are similar economic characteristics include:

- The nature of the products and services
- The nature of the production processes
- The type or class of customer for their products and services
- The methods used to distribute their products or provide their services
- If applicable, the nature of the regulatory environment such as in the case with banking, insurance, or public utilities
- Whether the components are economically interdependent
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects

In this example, it appears that all of the components (pizza stores) satisfy several of the criteria for having similar economic characteristics. First, there are similar products offered in each of the stores. Second, the production process (making pizzas and sandwiches) is the same. Third, the type of customer, a retail customer, is the same, at each store. Fourth, the method used to distribute the products is the same at all stores. Fifth, there is probably economic interdependence among the stores in that there are volume purchases of ingredients, common management, etc. And, sixth, there are probably some shared assets and resources among the stores such as common accounting and bookkeeping, management, and administrative costs.

Observation: The above example illustrates the potential manipulation that can occur in terms of how an entity establishes its reporting units. By establishing broader-based reporting units, any potential impairment of goodwill from an ailing unit can be offset by the positive aspects of other units or components. In the above example, by testing for impairment of goodwill in the aggregate for all stores, any potential impairment writedown of goodwill applicable to individual stores (Stores #2 and #4) may be avoided. Any gains in the six profitable stores may offset the losses applicable to Stores #2 and #4.

How should reporting units be determined for nonpublic entities?

A nonpublic entity must establish reporting units using the definition of an operating segment found in ASC 280, even though the entity is exempt from the application of ASC 280's segment reporting. For most nonpublic entities, there is one single reporting unit for the entire legal entity, thus eliminating the arduous task of separating the legal entity into multiple reporting units. Nonpublic entities are likely to establish separate legal and reporting entities for each reporting unit, thereby eliminating the use of consolidation. The following example illustrates the author's point.

Example: Tony Tamali personally owns 100% of the common stock of various businesses as follows:

Description of business	**Legal ownership**	**Shares Owned By**
Five pizza shops	Tremendous Tony's Pizza, Inc.	Tony Tamali
Lumber yard	Tremendous Tony's Lumber, Inc.	Tony Tamali
Transportation Company	Tremendous Tony's Transportation Co.	Tony Tamali

Financial statements are issued separately for each of the three entities.

Conclusion: In a publicly held setting, the above ownership would be structured so that one legal entity (a parent company) would own the common stock of each of the above entities. The result would be three reporting units within one consolidated legal entity (the parent).

Because the above businesses are nonpublic, the common stock of each entity is owned personally by Tony, rather than by a parent company, thus eliminating the need to consolidate the businesses. This means that each legal entity has one reporting entity. Impairment of goodwill should be tested separately for each of the three legal entities.

STEP 2: Assets and Liabilities, Including Goodwill Must Be Assigned to Reporting Units

After reporting units have been identified, the next step is to assign assets and liabilities (including goodwill) to reporting units. The general rules for assignment are as follows:

1. Assets and assumed liabilities (including corporate assets and liabilities) should be assigned to one or more reporting units if *both* of the following two criteria are met:

   a. The asset will be employed in or the liability relates to operations of that reporting unit, and

   b. The asset or liability will be considered in determining the fair value of the reporting unit.

2. Assets and liabilities assigned to a reporting unit may also include assets and liabilities typically considered "*corporate items*" as long as those assets and liabilities relate to operations of the reporting unit and will be considered in determining the fair value of the reporting unit.

   a. Examples of corporate assets and liabilities that may be assigned to a reporting unit include environmental liabilities related to an operating facility and pension assets and liabilities.

      Example: A company has an environmental liability related to an oil spill created by Reporting Unit A.

      Conclusion: Although the liability is a corporate item, it should be assigned to Unit A for purposes of performing any impairment tests.

   b. Some assets and liabilities may be used in or related to the operations of several reporting units. In such cases, the assets and liabilities should be assigned to the various units using reasonable and supportable methodology, applied in a consistent manner.

      Example: Assets and liabilities not directly related to a specific reporting unit but from which several reporting units benefit, could be allocated according to the relative benefits received by the different reporting units, or based on the relative fair value of the reporting units. For example, a pension liability applicable to employees of several reporting units might be allocated to the units based on payroll tax expense.

3. <u>Goodwill is allocated to the reporting units</u>:

   a. All goodwill acquired in a business combination must be assigned to one or more reporting units as of the acquisition date.

      1) Goodwill is assigned to reporting units of the acquiring entity that are expected to benefit from the synergies of the combination even though other assets or liabilities may not be assigned to that unit.

      2) Goodwill from one acquisition may be assigned to several reporting units.

      3) The methodology for assigning goodwill must be reasonable, supportable and applied in a consistent manner.

      4) The amount of goodwill assigned to a unit is determined in a manner similar to how the amount of goodwill recognized in a business combination would be determined.

4. Formula for applying goodwill to a unit:

At date of acquisition, a "*purchase price*" is determined for the assets and liabilities to be assigned to a reporting unit, with the excess allocated to goodwill for that unit:

Total purchase price assigned to a reporting unit
Less: Purchase price allocated to assets and liabilities

Equals: Goodwill assigned to that reporting unit

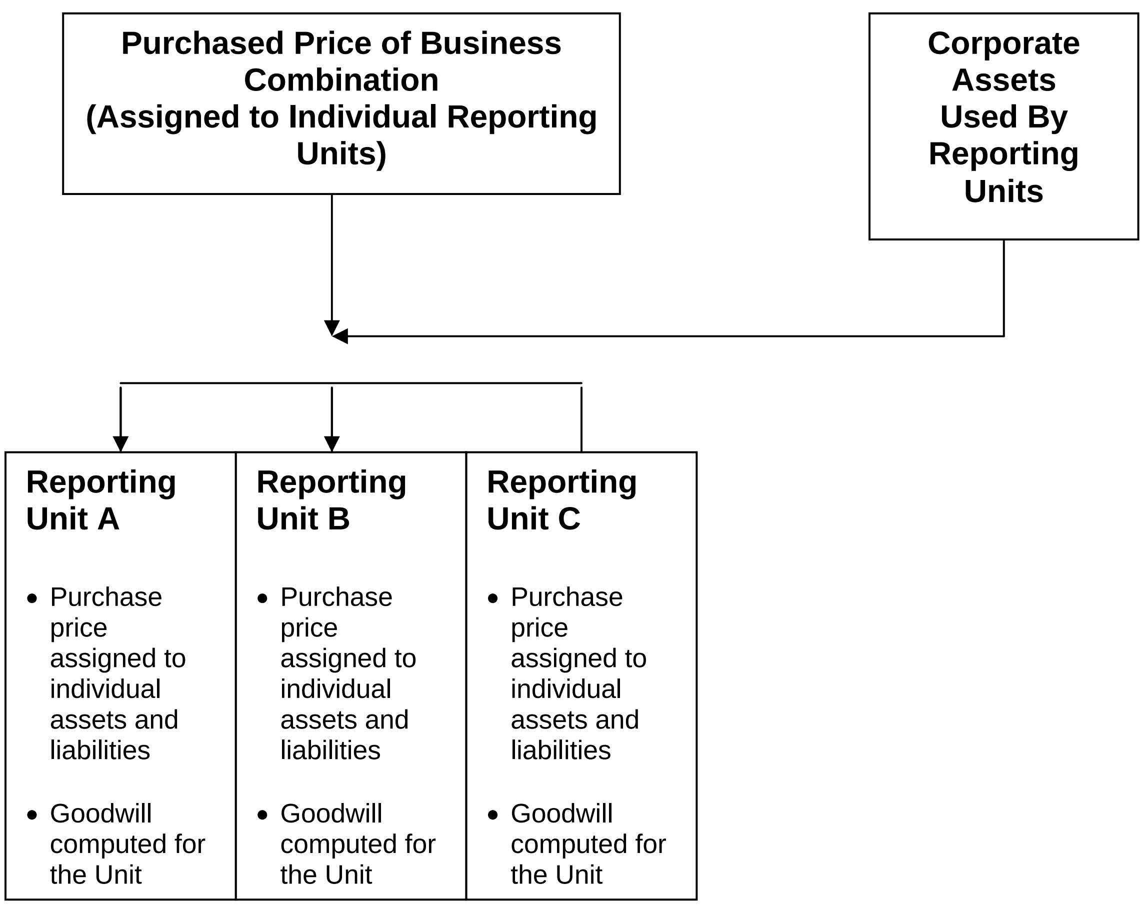
If goodwill is assigned to a reporting unit that has not been assigned any of the assets of liabilities related to the acquisition, the amount of goodwill to be assigned to the unit should be computed using the following "with and without" formula:

Fair value of the reporting unit before the acquisition
Less: Fair value after the acquisition

Equals: Goodwill assigned to that reporting unit

The following chart illustrates the general approach to assigning assets and liabilities (including goodwill) to reporting units.

Illustration of Assignment of Purchase Price to Reporting Units



In the previous illustration, at each acquisition, a purchase price is determined for the acquisition, resulting in assets, liabilities and goodwill being assigned to reporting units. As a result, each reporting unit has its own goodwill assigned to that unit, which must be tested annually for impairment and potential writedown.

The application of the Statement results in several interesting questions.

Must all the assets (including goodwill) of an entity be assigned to a reporting unit?

Response: No. The Statement requires that only those assets that *relate to the operations* of a unit should be assigned to that unit. Thus, some corporate assets and liabilities remain unallocated such as general and administrative tangible assets.

However, the Statement does require that all goodwill acquired in a business combination be assigned to one or more reporting units as of the acquisition date. Although the FASB considered not requiring "enterprise" or "corporate" goodwill to be allocated to reporting units, in the final statement, the FASB concluded that all goodwill must be allocated to reporting units.

What if there is a reorganization of the reporting structure?

ASC 350 does provide guidance when an entity reorganizes its reporting structure. If such a structure changes the composition of one or more of its reporting units, the assets and liabilities must be reassigned to the units affected using the same guidance applied to the initial allocation of those assets, liabilities, and goodwill to the units. Further, goodwill must be reassigned to the units using a relative fair value allocation approach.

Example: Company X reorganizes its reporting structure under which Reporting Unit A is integrated with Units B, C and D. Goodwill in Unit A would be assigned to units B, C and D based on the relative fair values of those three units immediately before Unit A is integrated into the Units.

Can assets be moved to another reporting unit once they are assigned?

Certain assets of an entity may be generic in use so that they can be used within several reporting units. Those assets may be initially assigned to a particular unit and, subsequently, reassigned to another unit for use. The Statement does not address the movement of assets among reporting units in situations in which there is not a reorganization of the reporting structure. Therefore, there is no formal restriction in transferring assets among units provided there is a good business reason for doing so.

Take a look at this example:

Example: Assets are acquired in a business combination and assigned to Reporting Unit A. Although the equipment assigned is used by Unit A, it could also be used in several other units including Units B and C.

Two years after the acquisition, Unit B is having financial difficulties that may result in a writedown of goodwill assigned to Unit B. Management decides to move certain assets that are high unrealized gains from Unit A to Unit B to mitigate the effect of a writedown of goodwill in Unit B. Can they do it?

Conclusion: Provided there is a sound economic reason, it appears that the transfer of assets between units is acceptable even if the result is that the recording of a goodwill impairment loss is avoided. This example is a clear illustration of the potential abuse that can result from companies shifting assets between reporting units.

Observation: Intangible assets represents an area that companies use to manipulate earnings from year to year. In particular, goodwill lends itself to the most abuse. Initially, companies attempt to over allocate an acquisition price to goodwill and indefinite-lived intangible assets because those assets are not amortized. Then, after the allocation is made, a company can manipulate profits from year to year by using the very subjective impairment loss rules. In years in which a company has excess profits, it may choose to manipulate earnings by creating a larger writedown and corresponding impairment loss. Then, in years in which the company has a loss, it may attempt to avoid recording an impairment loss.

Here are a few ways to manipulate earnings using goodwill:

> <u>Minimize or maximize the number of reporting units to which goodwill is assigned</u>: If a company wants to minimize the amount of goodwill impairment loss, it simply reduces the number of reporting units to which goodwill is assigned. By doing so, any reporting units with losses that have goodwill impairments can be offset by other profitable units. Conversely, if a company wants to accelerate goodwill writedowns from impairments, it can expand the number of units so that those loss units will incur goodwill impairment losses.
>
> <u>Manipulate the allocation of goodwill to reporting units</u>: A company may attempt to allocate a larger portion of goodwill to those reporting units that are profitable and a smaller amount to those units that have operating losses. In doing so, that portion of goodwill allocated to profitable units will not be written down for impairment as the assigned reporting units are profitable.

Special Rules for Impairment Testing by a Subsidiary

A subsidiary's goodwill shall be tested for impairment at the subsidiary level using the subsidiary's reporting units. If a goodwill impairment loss is recognized at the subsidiary level, goodwill of the reporting unit or units at the higher consolidated level in which the subsidiary's reporting unit where the goodwill resides must also be tested for impairment if the event that gave rise to the loss at the subsidiary level would more likely than not reduce the fair value of the reporting unit at the higher consolidated level.

A goodwill impairment loss is recognized at the consolidated level only if goodwill of the higher-level reporting level is impaired.

Example: Subsidiary S has an impairment loss in its Reporting Unit SU. At the Parent company level, Unit SU is part of a larger consolidated Reporting Unit PU.

Conclusion: Because the subsidiary's Reporting Unit SU has an impairment loss, the parent's Unit PU must also be tested for impairment. At the parent consolidated level, an impairment loss is recognized only if there is an impairment loss from testing SU. Assuming that the parent's test of Unit PU results in no impairment of the goodwill assigned to PU, no impairment should be recorded on a consolidated basis. That is, the subsidiary's recorded impairment loss would be eliminated because there is no loss on a consolidated basis.

STEP 3: Goodwill Assigned to Each Reporting Unit Must Be Tested Annually for Impairment

Once reporting units are established and assets (including goodwill) and liabilities are assigned to each reporting unit, the entity is required to make an annual test of goodwill assigned to each reporting unit. The test is done separately for each reporting unit and may result in goodwill assigned to one unit being written down, while goodwill for another unit not being written down for impairment. The rules for testing goodwill outlined by ASC 350 were augmented by the issuance of ASU No. 2010-28 in December 2010.

The test consists of applying two formulas as follows:

> *<u>First Step</u>: Identify a Potential Goodwill Impairment*
> *<u>Second Step</u>: Measure the Impairment*

First Step: Identify a Potential Goodwill Impairment

A potential goodwill impairment exists in either of the following <u>two scenarios</u>:

Scenario 1: potential impairment: If the fair value of the reporting unit is less than the carrying value of the reporting unit:

> Fair value of the reporting unit
> <u>Less: Carrying value of reporting unit</u>
> ***Equals: Negative amount- there is a potential impairment- go to Second Step and measure the impairment***

If fair value is greater than the carrying value (e.g., there is a positive amount), there is no potential impairment and the Second Step is not performed.

Scenario 2: potential impairment: If the carrying amount of the reporting unit is zero or negative and it is more likely than not that a goodwill impairment exists:

If the carrying amount of a reporting unit is zero or negative and it is more likely than not (more than 50 percent probability) that a goodwill impairment exists, there is a potential impairment and the Second Step of the impairment test shall be performed.

In considering whether it is more likely than not that a goodwill impairment exists, an entity shall evaluate whether there are adverse qualitative factors, such as:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- The testing for recoverability under the *Impairment or Disposal of Long-Lived Assets* rules of a significant asset group within a reporting unit
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

Second Step: Measure the Impairment Loss

If the first step is satisfied, a goodwill impairment should be measured in the Second Step using the following formula:

Fair value of the reporting unit
Less: Fair value of assigned assets and liabilities (excluding goodwill)
Equals: Implied goodwill value- reporting unit

Implied goodwill value- reporting unit
Less: Carrying value of goodwill- reporting unit
Equals: Impairment loss

Goodwill Test for Impairment

Is the fair value of reporting unit less than the carrying value of reporting unit

YES

Potential Impairment of Goodwill

Go to Step 2

NO

Is the carrying amount of the reporting unit zero or negative and

Is it more likely than not that a goodwill impairment exists taking into account adverse qualitative factors, such as:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel

YES

NO

NO IMPAIRMENT

Step 2: Measure Impairment

FMV Unit
<u>- FMV-A/L of Unit</u>
= Implied GW

Implied GW
<u>- Carrying value of GW</u>
= *Loss*

Entry:
Loss
Goodwill

Notes:

a. If the second step is not complete before the financial statements are issued and a goodwill impairment loss is probable and can be reasonably estimated, the best estimate of that loss should be recognized in those financial statements. Any adjustment to that estimated loss upon the completion of the loss measurement shall be recognized in the subsequent reporting period.

b. The aggregate amount of goodwill impairment losses must be presented as a *separate line item in the income statement before the subtotal income from continued operations* (or a similar caption), unless a goodwill impairment loss is associated with a discontinued operation. A goodwill impairment loss associated with a discontinued operation must be included on a net of tax basis within the results of discontinued operations.

c. After the impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new cost basis.

d. Restoration of previously recognized impairment losses is prohibited (e.g., once goodwill is written down, it cannot be written back up).

Observation: Notice that the second step is applied only if the first step is satisfied in that there is a potential impairment. Step 1 merely answers the question as to whether or not there may be a potential impairment, but does not attempt to measure any impairment. If there is a potential impairment in the first step (based on scenario 1 or 2), the second step measures the amount of the impairment. The second step compares the fair value of the reporting unit to the fair value of the individual assets and liabilities assigned to that unit, exclusive of goodwill. The difference between the fair value of the entire unit, and the fair value of all of its assets and liabilities, exclusive of goodwill, is considered implied goodwill value. The implied goodwill value is compared with the carrying value (book value) of goodwill and written down to the implied goodwill value.

In determining whether a potential impairment exists in Step 1, you will notice that there are two scenarios either of which if satisfied means there is a potential impairment and Step 2 is performed to measure impairment. In the first scenario, if the fair value of the reporting unit is less than the carrying value of the assets and liabilities assigned to that unit by any amount, there is a potential impairment and the second step is performed. Conversely, if the fair value exceeds the carrying value, there is no potential impairment and Step 2 is not performed.

Scenario 2 is a recent amendment to ASC 350 made by ASU 2010-28, issued in December 2010. Scenario 2 states that if the carrying amount of a reporting unit is zero or negative, there is deemed to be a potential impairment and Step 2 shall be performed, when it is more likely than not (more than 50 percent probability) that a goodwill impairment exists. ASU 2010-28 includes a list of adverse qualitative factors that would lead to a conclusion that it is more likely than not that a goodwill impairment exists.

Once goodwill is written down, the writedown may not be restored. This fact emphasizes the importance of the timing of the impairment testing. For example, an entity may incur a goodwill writedown and loss due solely to the fact that the test is performed during a weak economic cycle when the entity's fair value is in decline. Subsequently, when the entity's fair value recovers, it is not able to restore the previously written down goodwill.

EXAMPLES ILLUSTRATING APPLICATION OF GOODWILL IMPAIRMENT RULES

Example 1: Company X is performing its annual test of goodwill impairment for Reporting Unit C at December 31, 20XX.

Facts:

Fair value of Reporting Unit C	$1,000,000
Carrying value of all assets and liabilities assigned to Reporting Unit C	850,000
Fair value of individual assets and liabilities of Reporting Unit C (exclusive of goodwill)	800,000
Carrying value (book value) of goodwill	500,000

First Step: Identify a Potential Impairment

Fair value of the reporting unit	$1,000,000
Less: Carrying value of reporting unit	850,000
Equals: Positive amount- no impairment	***$150,000***

Conclusion: Because the fair value of the reporting unit exceeds the carrying value of the unit, there is no impairment and the Second Step does not have to be performed.

Example 2: Same facts as Example 1 except that the amounts have changed to the following:

• Fair value of Reporting Unit C	$1,000,000
• Carrying value of all assets and liabilities assigned to Reporting Unit C	1,100,000
• Fair value of individual assets and liabilities of Reporting Unit C (exclusive of goodwill)	800,000
• Carrying value (book value) of goodwill	500,000

1. First Step: Identify a Potential Impairment:

Fair value of the reporting unit	$1,000,000
Less: Carrying value of the reporting unit	1,100,000
Equals: Negative amount- go to second step	**$(100,000)**

2. Second Step: Measure the Impairment Loss:

Fair value of the reporting unit	$1,000,000
Less: Fair value of individual assets and liabilities (exclusive of goodwill) assigned to the reporting unit	800,000
Implied goodwill value	$200,000
Implied goodwill value	$200,000
Less: Carrying value of goodwill	500,000
Equals: Impairment loss	***$(300,000)***

Entry:

Goodwill impairment loss	300,000	
Goodwill		300,000

The impairment loss is presented on the statement of income in the following manner:

Company X Statement of Income For the Year Ended December 31, 20XX	
Net sales	$xx
Cost of sales	xx
Gross profit	xx
Operating expenses	xx
Impairment loss on goodwill	***(300,000)***
Net income before income taxes	xx
Income taxes	xx
Net income	$xx

Example 3: Company X is performing its annual test of goodwill impairment for Reporting Unit C at December 31, 20XX.

Facts:

Fair value of Reporting Unit C	$1,200,000
Carrying value of all assets and liabilities assigned to Reporting Unit C	(700,000)
Fair value of individual assets and liabilities of Reporting Unit C (exclusive of goodwill)	900,000
Carrying value (book value) of goodwill	300,000

During the year, Company X incurred several adverse qualitative factors as follows:

- X was sued by a competitor for patent infringement involving X's key product.
- X lost its top sales person resulting in a significant reduction in sales.
- A new competitor has entered the market with sizeable resources.

First Step: Identify a Potential Impairment

There are two scenarios under which there is a potential impairment.

Scenario 1: Is the value of the reporting unit less than the carrying value of the reporting unit?

Fair value of the reporting unit	$1,000,000
Less: Carrying value of reporting unit (negative)	(700,000)
Equals: Positive amount- no impairment	***POSITIVE AMOUNT***

Conclusion: Because the fair value of the reporting unit exceeds the carrying value of the unit, Scenario 1 results in *no potential impairment* and the Second Step does not have to be performed.

Scenario 2: Is the carrying value zero or negative and is it more likely than not that a goodwill impairment exists?

Conclusion: Yes. The carrying value is less than zero ($700,000). Further, there are several adverse qualitative factors that support the fact that it is more likely than not that a goodwill impairment exists.

- X is being sued by a competitor for patent infringement involving X's key product, which suggests there is a significant adverse change in legal factors.
- X lost key personnel with the loss of its top sales person resulting in a significant reduction in sales.
- There is an unanticipated new competitor that entered the market with sizeable resources.

Therefore, based on Scenario 2, there is a potential impairment and the Second Step should be performed to measure a goodwill impairment.

Second Step: Measure the Impairment Loss:	
Fair value of the reporting unit	$1,000,000
Less: Fair value of individual assets and liabilities (exclusive of goodwill) assigned to the reporting unit	900,000
Implied goodwill value	$100,000
Implied goodwill value	$100,000
Less: Carrying value of goodwill	300,000
Equals: Impairment loss	***$(200,000)***

Entry:

Goodwill impairment loss	200,000	
Goodwill		200,000

The impairment loss is presented on the statement of income in the following manner:

Company X
Statement of Income
For the Year Ended December 31, 20XX

Net sales	$xx
Cost of sales	xx
Gross profit	xx
Operating expenses	xx
Impairment loss on goodwill	***(200,000)***
Net income before income taxes	xx
Income taxes	xx
Net income	$xx

Observation: The issuance of ASU 2010-28 in December 2010 made a significant difference in the testing and measurement of goodwill impairments. ASU 2010-28 added a second scenario under which there would be deemed to be a potential impairment of goodwill. That scenario is where the carrying value of the reporting unit (assets and liabilities) is zero or negative and it is more likely than not (based on factors) that a goodwill impairment exists.

This second scenario means that an entity with goodwill that has negative carrying value (assets less liabilities) and some adverse qualitative factors is going to have to measure goodwill for an impairment loss. This result was not applicable prior to ASU 2010-28 under the originally issued ASC 350.

Is it possible to have an impairment in the first step yet have no writedown of goodwill in the second step?

Yes. A company could have a negative amount in the first step. When the second step is performed, the implied goodwill value may be lower than the carrying value of the goodwill. This result could be due to the fact that the company has goodwill with a low carrying value.

Example 4: Company X is performing its annual test of goodwill impairment for Reporting Unit C at December 31, 20XX.

Facts:

Fair value of Reporting Unit C	$1,000,000
Carrying value of all assets and liabilities assigned to Reporting Unit C	(700,000)
Fair value of individual assets and liabilities of Reporting Unit C (exclusive of goodwill)	600,000
Carrying value (book value) of goodwill	300,000

During the year, Company X incurred several adverse qualitative factors as follows:

- X was sued by a competitor for patent infringement involving X's key product.
- X lost its top sales person resulting in a significant reduction in sales.
- A new competitor has entered the market with sizeable resources.

First Step: Identify a Potential Impairment

There are two scenarios under which there is a potential impairment:

Scenario 1: Is the value of the reporting unit less than the carrying value of the reporting unit?

Fair value of the reporting unit	$1,000,000
Less: Carrying value of reporting unit	700,000
Equals: Positive amount- no impairment	***POSITIVE AMOUNT***

Conclusion: Because the fair value of the reporting unit exceeds the carrying value of the unit, Scenario 1 results in no potential impairment and the Second Step does not have to be performed.

Scenario 2: Is the carrying value zero or negative and is it more likely than not that a goodwill impairment exists?

Conclusion: Yes. The carrying value is less than zero ($700,000). Further, there are several adverse qualitative factors that support the fact that it is more likely than not that a goodwill impairment exists.

- X is being sued by a competitor for patent infringement involving X's key product, which suggests there is a significant adverse change in legal factors.
- X lost key personnel with the loss of its top sales person resulting in a significant reduction in sales.
- There is an unanticipated new competitor that entered the market with sizeable resources.

Therefore, based on Scenario 2, there is a potential impairment and the Second Step should be performed to measure a goodwill impairment.

Second Step: Measure the Impairment Loss:	
Fair value of the reporting unit	$1,000,000
Less: Fair value of individual assets and liabilities (exclusive of goodwill) assigned to the reporting unit	600,000
Implied goodwill value	$400,000
Implied goodwill value	$400,000
Less: Carrying value of goodwill	300,000
Equals: Impairment loss	***$ 0***

Conclusion: Even though there was a potential impairment in the first step, there is no impairment loss in the second step. The implied goodwill of $400,000 is greater than the carrying value of goodwill ($300,000) resulting in no writedown for impairment.

4. Determining Fair Value

a. **In determining fair value under ASC 350 or ASC 360, a company is required to follow the guidance found in ASC 820, *Fair Value Measurements and Disclosures,* which was actually issued after the effective date of both ASC 350 and ASC 360.**

General fair value rules found in ASC 820 are provided in the following box.

Fair Value Rules- ASC 820 (formerly FASB No. 157)

ASC 820 defines fair value as:

> *"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."*

In determining fair value, there are a few rules in ASC 820 as follows:

a. There is the assumption of exchange: 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.

    1) An orderly transaction is one 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 such as a forced liquidation or distress sale.

    Note: The transaction to sell an asset or transfer a liability is a hypothetical one at the measurement date, considered from the perspective of the market participant that holds the asset or owes the liability. The objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (the exit price).

b. Assumption of market: A fair value measurement assumes that the transaction to sell the asset or transfer a liability occurs in the *principal market for the asset or liability* or, in the absence of a principal market, *the most advantageous market for the asset or liability.*

    - *Principal market*: is the market in which the reporting entity would sell the asset or transfer the liability with the *greatest volume and level of activity* for the asset or liability.

    - *Most advantageous market:* is the one in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability, considering transaction costs in the respective market(s).

    1) Regardless of whether the market is a principal or most advantageous market, it should be considered from the perspective of the reporting entity thereby allowing for differences between and among entities with different activities.

    2) The principal market prevails over the most advantageous market: If there is a principal market for the asset or liability, the fair value measurement represents the price in that principal market even if there is a price in a different market that is potentially more advantageous (e.g., higher price) at the measurement date.

Example 1: A company is trying to determine the fair value of a certain asset. The principal market in which A can sell the asset (e.g., the one in which there is likely to be the greatest volume and level of activity) is Market X which will yield a price of $80. The company is aware of a Market Y in which the company believes it could possibly get $100 for the asset. However, Y is not as active a market as X in terms of volume and level of activity. Thus, Y may be the most advantageous market (e.g., can get the highest price) but is not the principal market.

Conclusion: Even though the company may be able to obtain $100 for the asset in the most advantageous market (Market Y), because there is a principal market (Market X), the value in Market X prevails. Thus, the fair value used is $80, not $100.

Example 2: Change the facts. Neither Market X nor Y is the principal market. That is, the volume and level of activity in both X and Y is about the same.

Conclusion: Because there is no principal market (e.g., a market with the greatest volume and level of activity), fair value should be determined based on the most advantageous market – that is, the market in which price is maximized.

In this example, the fair value used is $100, the price in Market Y, the most advantageous market in which price is maximized.

3) The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability <u>*shall not be adjusted for transaction costs, but shall be adjusted for transport costs if such costs are an attribute of the asset or liability.*</u>

Note: Transaction costs represent incremental direct costs[3] to sell the asset or transfer the liability in the principal (or most advantageous) market for the asset or liability. The Statement suggests that transaction costs are not an attribute of an asset or liability and, instead, are specific to the transaction and differ depending on how the reporting entity transacts business.

Transport costs are costs to transport an asset or liability to or from its principal (or most advantageous) market. If location is an attribute of an asset or liability (such as in the case of a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall be adjusted to include the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

[3] Incremental direct costs to sell are those costs that result directly from and are essential to that transaction and that would not have been incurred by the reporting entity had the decision to sell the asset (or transfer the liability) not been made.

4) A fair value measurement is for a particular asset or liability and should consider attributes specific to the asset or liability, such as a condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date.

   - The asset or liability might be a standalone or a group of assets and/or liabilities (e.g., an asset group, reporting unit, or a business). The determination of whether it is a standalone or group depends on its unit of account.

   - The *unit of account* determines what is being measured by reference to the level at which the asset or liability is aggregated.

c. Market participants: Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:
   1) Independent of the reporting entity (e.g., not related parties as defined by ASC 850, *Related Party Disclosures* (formerly FASB No. 57)),
   2) 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,
   3) Able to transact for the asset or liability, and
   4) Willing to transact for the asset or liability in that they are motivated but not forced or otherwise compelled to do so.

   Note: The fair value of the asset or liability is determined based on the assumptions that market participants would use in pricing the asset or liability. The reporting entity is not required to identify specific market participants. Rather, the entity should identify characteristics that distinguish market participants generally, considering factors specific to the asset or liability, the principal (or most advantageous) market, and the market participants with whom the reporting entity would transact in that market.

d. Application of fair value to assets: Fair value measurement assumes the *highest and best use* of the asset *by market participants* considering a use at the measurement date that is:

   - Physically possible
   - Legally permissible
   - Financially feasible

   1) Highest and best use refers to the use of an asset that would maximize the value of the asset or group of assets, and is based on the use of the asset by market participants even if the intended use by the reporting entity is different.

   Note: Because the highest and best use is determined based on the asset's use by market participants, regardless of whether an in-use or in-exchange premise is used, the fair value measurement considers assumptions that market participants would use in pricing the asset.

e. Application of fair value to liabilities: Fair value measurement assumes that the liability is transferred to a market participant at the measurement date assuming:
   - The liability to the counterparty continues,
   - It is not settled, and
   - The performance risk relating to that liability is the same before and after its transfer.

   1) Nonperformance risk is included in the fair value of a liability and refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred.

Valuation techniques:

a. Valuation techniques that should be used in determining fair value shall be those that are consistent with any one of the following ***three approaches***:

   - Market approach
   - Income approach
   - Cost approach

The following chart compares the ***three approaches***:

Valuation approach	**Description**	**Examples of methods used**
Market approach	Uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business)	• Market multiples derived from a set of comparables • Matrix pricing
Income approach	Uses valuation techniques to convert future amounts such as cash flows or earnings to a single present amount (discounted)	• Present value techniques • Option-pricing models such as Black-Scholes-Merton or binomial model formulas • Multiperiod excess earnings method
Cost approach	Is based on the amount that currently would be required to replace the service capacity of an asset (e.g., the current replacement cost)	• Based on the cost to a buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence
(1): Multiples must lie within a range with a different multiple for each comparable. The selection of where within the range the appropriate multiple falls requires judgment, considering factors specific to the measurement, both qualitative and quantitative.		

Note: Valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value. In some situations, using a single valuation technique will be sufficient. For example, using a market approach (e.g., quoted market prices in an active market for identical assets or liabilities), may be appropriate to determine fair value without considering use of a second technique.

If multiple valuation techniques are used to measure fair value, the results shall be evaluated and weighed, as appropriate, considering the reasonableness of the range indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

Although valuation techniques shall be consistently applied, there are circumstances in which a change in techniques is appropriate if the change results in a measurement that is equally or more representative of fair value. Such an example is where new markets develop, new information becomes available, information previously used is no longer available, or techniques improve. Revisions due to a change in the valuation technique or its application shall be accounted for as a change in accounting estimate under ASC 250, *Accounting Changes and Error Corrections* (formerly FASB No. 154). The disclosure requirements of ASC 250 are not required.

Example 1: Company Y is determining the fair value of equipment. Because the equipment is relatively new, Y can easily obtain quoted market prices for identical or comparable equipment. Y obtains four quoted prices for similar equipment of $900, $1,200, 1,250 and $1,300.

Conclusion: Y may be able to determine fair value using only a market approach, based on quoted prices for identical equipment. Thus, using a cost or income approach in addition to a market approach is probably not necessary.

Because Y has obtained a range of values ($900 to $1,300), Y would select a particular value within the range that is most representative of fair value in the circumstances. Three of the four values are clustered in the range of $1,200 to $1,300. Thus, Y would most likely select as its fair value one of the upper prices, $1,200, $1,250, or $1,300.

Example 2: Change the facts. There are no quoted prices for identical or comparable equipment because the equipment is old and is no longer offered within the market place.

Conclusion: Y may wish to use several approaches to determine fair value, such as both a cost and market approach. In using the market approach, Y may be able to obtain quoted market prices for similar (but not identical) equipment.

b. <u>Inputs used in valuation techniques:</u> Inputs are assumptions that market participants would use in pricing an asset or liability, including assumptions about risk.[4]

[4] Risk can consist of risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or risk inherent in the inputs used in the technique.

1) Inputs can be *observable* or *unobservable*:

- Observable inputs: Inputs reflective of assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Example: Quoted market prices on an exchange.

- Unobservable inputs: Inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Note: Observable inputs are certainly more credible than unobservable inputs to the extent that valuation techniques should maximize the use of observable inputs and minimize the use of unobservable inputs.

Fair value hierarchy:

The Statement establishes a fair-value hierarchy that prioritizes inputs to valuation techniques used to measure fair value as follows:

Level 1 inputs (highest priority) (Observable): Quoted market prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 inputs (Observable): Inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly. Examples include:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active (markets in which there are few transactions, the prices are not current, or price quotes vary substantially either over time or among market makers (some brokered markets) in which little information is released publicly (e.g., principal to principal market)
- Inputs other than quoted prices that are observable such as interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)

Level 3 inputs (Unobservable): Unobservable inputs that should be used only to the extent that observable inputs are not available.

Note: Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity is not required to undertake all possible efforts to obtain information about market participant assumptions. However, the entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. The entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

Note: The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest to unobservable inputs (Level 3). In some cases, the inputs used might fall into two different levels of the hierarchy. The level within which the fair value measurement in its entirety shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

If an input used to measure fair value is based on bid and ask prices, such as in the case of a dealer market, the price within the bid-ask spread that is most representative of fair value shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2 and 3). The Statement does not preclude use of conventions that may expedite the measurements within a bid-ask spread, such as mid-market or other pricing conventions.

What if there is not an active market?

FASB Staff Position (FSP): FAS 157-3: *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, was issued to clarify the application of ASC 820, *Fair Value Measurements and Disclosures,* when there is a market that is not active.

Key principles noted within the FSP include the following:

a. A fair value measurement consists of the price at which a transaction would occur between market participants at the measurement date.

b. The objective is to determine the price that would be received by the holder of the financial asset in an orderly transaction (the exit price notion) that is not a forced liquidation or distressed sale at the measurement date.

   - When markets are dislodged, an entity is required to use judgment to evaluate whether individual transactions are forced liquidations or distressed sales.

   - An entity cannot conclude that all market activity within a dislodged market represents forced liquidations or distressed sales. Further, it is also not appropriate to conclude that any transaction price is determinative of fair value, particularly with a non-active market.

c. When relevant observable inputs are not available (e.g., Level 1 and 2 inputs are not available), the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates to determine fair value is acceptable (a Level 3 input).

   - ASC 820 addresses a range of valuation techniques that an entity can use to estimate fair value when relevant observable inputs (such as Level 2) require significant adjustments based on unobservable data, and therefore would be considered a Level 3 fair value measurement.

Example: An observable input may be irrelevant and require significant adjustment if the volume and level of trading activity in the asset have declined significantly over time or among market participants, or the prices are no longer current.

- Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make, including adjustments for nonperformance and liquidity risks.

d. Use of broker quotes to determine fair value is relevant when based on an active market. With respect to assets in non-active markets, an entity should place less reliance on broker or pricing services quotes because such quotes may be based on broker models based on unobservable inputs and information only available to the broker.

- Even less weight should be placed on a broker quote if it is a nonbinding offer instead of a binding offer.

Examples of applications of ASC 820

The following examples illustrate the application of the Statement and have been extracted from ASC 820 as modified by the author.

Example 1: Asset group

Facts: Company X, a strategic buyer, acquires a group of assets (Assets A, B and C) in a business combination. Asset C is billing software developed by the acquired entity for its own use in conjunction with Assets A and B (related assets). The reporting entity measures the fair value of each of the assets individually, consistent with the specified unit of account for the assets. X determines that each asset would provide maximum value to market participants principally through its use in combination with other assets as a group (the highest and best use is in-use).

The market in which X would sell the assets is the market in which it initially acquired the assets (e.g., the entry and exit markets from the perspective of the reporting entity are the same). Market participant buyers with whom the reporting entity would transact in that market have characteristics that are generally representative of both financial buyers and strategic buyers and include those buyers that initially bid for the assets.

There are differences in the values of the assets within the two groups as follows:

Strategic buyer asset group: These buyers have related assets that would enhance the value of the group within which the assets would be used (market participant synergies). Those assets include a substitute asset for Asset C (the billing software), which would be used for only a limited transition period and could not be sold standalone at the end of that period.

Because strategic buyers have substitute assets, Asset C would not be used for its full remaining economic life. The indicated fair values of Assets A, B and C within the strategic buyer asset group (reflecting the synergies from the use of the assets within the group) are:

Asset	Fair value
A	$360
B	260
C	30
As a group	$650

Financial buyer asset group: The reporting entity determines that financial buyers do not have related or substitute assets that would enhance the value of the group within which the assets would be used. Asset C (the billing software) would be used for its full remaining economic life.

The indicated fair values of Assets A, B and C within the financial buyer asset group (reflecting the synergies from the use of the assets within the group) are:

Asset	Fair value
A	$300
B	200
C	100
As a group	$600

Conclusion: The fair values of Assets A, B and C would be determined based on the use of the assets as a group within the *strategic buyer group* ($360, $260, and $30). Although the use of the assets within the strategic buyer group does not maximize the fair value of each of the assets individually, it does maximize the fair value of the assets as a group ($650).

Note: Because there are two markets and neither appears to be a principal market, the market used to determine fair value is the most advantageous market. That market is the one in which the company can maximize its price. Price is maximized by looking at the total price on a group basis, not individual asset basis.

Example 2: Land

Facts: Company X acquires land in a business combination. The land is currently developed for industrial use as a manufacturing facility site. The current use is not necessarily its highest and best use. Nearby sites have recently been developed for residential use as sites for high-rise condominiums. Based on current zoning, X determines that the land currently used as a site for manufacturing could be developed as a site for residential housing (for high-rise condominiums).

Conclusion: The highest and best use of the land would be determined by comparing the fair value of the land used in the manufacturing operation (in-use) and the value of the land as a vacant site for residential use, reflective of the costs necessary to convert the land to a vacant site (in-exchange). The highest and best use of the land would be determined based on the higher of those values.

Example 3: Machine Held and Used

Facts: Company X has concluded that an asset group may be impaired under ASC 360. Inside the group is a machine that must be measured for fair value for purposes of allocating the impairment to the entire group of assets.

The machine was initially purchased and subsequently customized by the entity for use in its operations. The customization was not extensive.

In determining the fair value, X has determined that the asset would provide maximum value to market participants through its use in combination with other assets as a group (as installed or otherwise configured for use). Therefore, the highest and best use of the machine is in-use.

X determines that sufficient data are available to apply the cost approach and, because the customization was not extensive, the market approach. The income approach is not used because the machine does not have a separately identifiable income stream from which to develop reliable estimates of future cash flows. Further, information about short-term and intermediate-term lease rates for similarly used machinery that otherwise could be used to project an income stream (e.g., lease payments over remaining service lives) is not available.

X applies the ***market and cost approaches***.

Market approach: The market approach is applied as follows:

- X uses quoted market prices for similar (but not identical) machines adjusted for differences between the machine (as customized) and the similar machines.
- The measurement reflects the price that would be received for the machine in its current condition (used) and location (installed and configured for use), thereby including installation and transportation costs.
- X concludes that the fair value indicated by the market approach ranges from $40,000 to $48,000.

Cost approach: The cost approach is applied as follows:

- X estimates the amount that currently would be required to construct a substitute (customized) machine of comparable utility.
- The estimate considers the condition of the machine (for example, the physical deterioration, functional obsolescence, and economic obsolescence), and includes installation costs.
- X concludes that the fair value indicated by the cost approach ranges from $40,000 to $52,000.

Conclusion: X determines that the fair value indicated by the market approach is more representative of the fair value than the value indicated by the cost approach. Thus, more weight is given to the results of the market approach. That conclusion is based on the relative reliability of the inputs, considering the degree of comparability between the machine and the similar machines. Key factors considered include:

- The inputs used in the market approach (quoted prices for similar machines) require relatively fewer and less subjective adjustments than the inputs used in the cost approach.

- The range indicated by the market approach overlaps with, but is narrower than, the range indicated by the cost approach.

- There are no known unexplained differences (between the machine and the similar machines) within that range.

X further determines that the higher end of the range indicated by the market approach is most representative of fair value, largely because the majority of relevant data points in the market approach fall at or near the higher end of the range.

Accordingly, X determines the fair value of the machine at $48,000, the highest value within the range of values using the market approach.

Example 4: Software Asset

Facts: X acquires a group of assets. The asset group includes an income-producing software asset internally developed for license to customers and its complementary assets (including a related database with which the software asset is used).

In allocating the cost of the group to the individual assets acquired, X measures the fair value of the software asset. X determines that the software asset would provide maximum value to market participants through its use in combination with other assets (its complementary assets) as a group. Therefore, the highest and best use of the software asset is in-use.

X determines that in addition to the income approach, sufficient data might be available to apply the cost approach but not the market approach. Information about market transactions for comparable software assets is not available.

The income and cost approaches are applied as follows.

Income approach: The income approach is applied as follows:

- X uses a present value technique.

- The cash flows used in the present value technique reflect the income stream expected to result from the software asset (license fees from customers) over its economic life.

- X computes the fair value using the present value technique at $15 million.

Cost approach: The cost approach is applied as follows:

- X applies the cost approach by estimating the amount that currently would be required to construct a substitute software asset of comparable utility.
- In determining the amount to construct a substitute asset, X considers the functional, technological, and economic obsolescence.
- X computes the fair value using a cost approach at $10 million.

Conclusion: Because X has obtained a fair value using both the income and cost approach, X must now evaluate the results and select a fair value.

X believes the results of the cost approach would not be representative of fair value because market participants would not be able to replicate a substitute software asset of comparable utility. Certain attributes of the software are unique, having been developed using proprietary information, and cannot be readily replicated.

The result is that X determines that use of the income approach is the more appropriate measure of fair value. Thus, X computes fair value of the software asset at $15 million.

Example 5: Level 1 Principal for Most Advantageous Market

Facts: X has a financial asset that is traded on two different exchanges with different prices. X transacts in both markets and has the ability to access the price in those markets for the asset at the measurement date.

Details on prices and related transactions costs that would be received follow:

	Market A	**Market B**
Price	$26	$25
Transaction costs	(3)	(1)
Net price	$23	$24

Market A is the market in which X would sell the asset with the greatest volume and level of activity for the asset. Market B is the most advantageous market in that it will yield the highest net price ($24 versus $23).

Conclusion: The fair value is $26, the price for the principal market (Market A). The principal market is that market in which the entity would sell the asset with the greatest volume and level of activity. ASC 820 (formerly FASB No. 157) states that the principal market is the one used to determine fair value even if there is another most advantageous market in which a higher net price can be obtained.

Change the facts: Neither Market A or B is the principal market.

Conclusion: If neither market is the principal market for the asset, the fair value would be measured using the price in the most advantageous market, which is Market B. The most advantageous market is the one in which the reporting entity would sell the asset with the price that maximizes the amount that would be received for the asset, considering transaction costs (e.g., the net amount that would be received).

Because the price in Market B, adjusted for transaction costs, would maximize the net amount at $24 (versus $23 for Market A), the fair value would be measured at Market B's market price of $25.

Note further that transaction costs are used solely to determine the most advantageous market. The price used to measure fair value is the gross price and is not adjusted for those transaction costs.

b. Applying fair value to ASC 350 (formerly FASB No. 142) and ASC 360 (formerly FASB No. 144)

In applying the fair value rules under ASC 350 and ASC 360, fair value is required as follows:

- Fair value of a reporting unit (or entity), and
- Fair value of individual assets and liabilities

c. Fair value of a reporting unit

ASC 350 requires that the fair value of a reporting unit be measured in performing a test of impairment of goodwill.

The fair value of a reporting unit is the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties.

ASC 820 (formerly FASB No. 157) defines fair value as:

> *"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."*

In determining fair value for a reporting unit, generally, the following rules apply:

1) A market approach using quoted market prices (Level I inputs) in active markets is the best evidence of fair value and should be used as the basis for the measurement, if available.

2) The fair value of the unit is not likely to be equal to the fair value of the underlying assets and liabilities of the unit.

3) The market price of an individual equity security and the market capitalization of a reporting unit with publicly traded stock may not be representative of the fair value of the reporting unit as a whole. Therefore, the quoted market price of an individual share of stock need not be the sole measurement basis of the fair value of a reporting unit.

4) If quoted market prices are not available, the estimate of fair value of the reporting unit shall be based on alternative approaches based on the best information available that may include:

   - Market approach: Quoted prices of similar assets, or
   - Income approach such as a multiple of earnings or capitalization rate or present value technique.

Note: If a present value technique is used, estimates of future cash flows shall be consistent with the object of measuring fair value. Those techniques should incorporate assumptions that marketplace participants would use in their estimates of fair value. If such information is not available without undue cost and effort, an entity may use its own assumptions. Present value techniques should follow the guidance of FASB Concept Statement No. 7 which include:

- An estimate of the future cash flows, or in more complex cases, series of future cash flows at different times.
- Expectations about possible variations in the amount or timing of those cash flows.
- The time value of money, represented by the risk-free rate of interest.
- The price of bearing the uncertainty inherent in the asset or liability.
- Other, sometimes unidentifiable, factors including illiquidity and market imperfections.

A valuation technique based on multiples of earnings, revenue, or a similar performance measure may be used to estimate the fair value of a reporting unit if that technique is consistent with the objective of measuring fair value. Use of a multiple of earnings or revenue to determine the fair value of a reporting unit may be appropriate in certain situations.

d. Fair value of individual assets or liabilities

1) To repeat, the <u>definition of fair value</u> 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."*

2) 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.

3) The tax basis of an asset or liability should not be considered a factor in determining its fair value.

Observation: ASC 350 and ASC 820 do not give any specific guidance as to how the fair value of individual assets and liabilities should be determined. Yet, ASC 805 (formerly FASB 141R) provides specific assistance as to how to determine fair value of selected asset categories for purposes of allocating the purchase price to the fair value of assets. Although ASC 805's guidance is not applicable to ASC 350, fair value is fair value. Therefore, it would appear that the same guidance used for ASC 805 would be appropriate to use for ASC 350. Next, the author has presented ASC 805's chart with slight modifications. This chart gives some guidance as to how the fair value of individual assets and liabilities can be measured for use in the second step formula in the goodwill impairment test.

Description of asset acquired or liability assumed	**Method for determining fair value**
Marketable securities	Fair value
Receivables	Present value of amounts to be received based on current interest rates, less allowance for uncollectibility and collection costs, if needed.
Inventories	<u>Finished goods</u>: Estimated selling prices less costs of disposal (commissions, selling costs) and a reasonable profit allowance. <u>Work in process</u>: Estimated selling prices of finished goods less a) costs to complete and disposal of the inventory, and b) a reasonable profit allowance based on similar finished goods. <u>Raw materials</u>: Current replacement costs.
Plant and equipment	Current replacement cost based on similar capacity use, unless the expected future use will result in a lower value to the acquiring entity.
Intangible assets that are separate from goodwill	Estimated fair values.
Other assets including land, natural resources, and nonmarketable securities	Appraised values.
Defined Benefit Pension Obligation: Projected benefit obligation in excess of plan assets- defined benefit plan (or vice versa)	Based on measurement under ASC 715, *Compensation-Retirement Benefits* (a portion formerly FASB No. 87).
Post-Retirement Benefit Obligation	Based on measurement under ASC 715, *Compensation-Retirement Benefits* (a portion formerly FASB No. 106).
Liabilities and accruals, including warranties, vacation pay, and deferred compensation	Present value of amounts to be paid at appropriate current interest rates.
Other liabilities and commitments, including unfavorable leases, contracts, commitments, and costs of plant closings	Present value of amounts to be paid at appropriate current interest rates.
Preacquisition contingencies	Present value of amounts to be paid at appropriate current interest rates.

e. Using a "short-cut" method to determine fair value

ASC 350 (formerly FASB No. 142) gives the acquiring entity latitude in determining the fair value of the reporting entity as a whole and the individual assets and liabilities of that unit. Fair value can be obtained using quoted market prices if the entity is publicly held or by using any other reasonable method. Absent quoted market prices, the FASB suggests that fair value using present value may be the best approach to determine fair value. Alternatively, ASC 350 states that a formula based on a multiple of earnings or revenue is appropriate if the entity knows the multiples used to value another entity with comparable operations and economic characteristics.

For larger publicly held entities, fair value may be obtained with relative ease. Such companies may be able to use quoted market prices of its equities to determine the fair value of the reporting unit. Further, information may be already available as to the fair value of individual assets and liabilities obtained for other purposes such as insurance coverage. Thus, for a publicly held entity, the administrative burden to determine fair value of both the reporting unit and the individual assets and liabilities may be minimal.

With respect to nonpublic entities, ASC 350 may be burdensome and costly to implement. First, the entity has no quoted market price for its equity to use for fair value. Even if the entity has obtained a valuation of its stock for purposes of estate planning and gifting those shares, that fair value is likely to be deeply discounted for lack of marketability. Second, the entity is not likely to have fair value information on its individual assets and liabilities. In such a case, how should a nonpublic entity implement ASC 350?

In this section, the author would like to suggest that nonpublic entities apply a short-cut method in situations in which all that is needed is documentation that there is no impairment of goodwill.

Here is what we know ASC 350 requires:

1. On at least an annual basis, goodwill (and intangibles with indefinite lives) must be tested for impairment.

2. Once the impairment test for goodwill is performed for the first year, the entity may be able to carryforward that test to future years on an indefinite basis provided:

    - The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination;

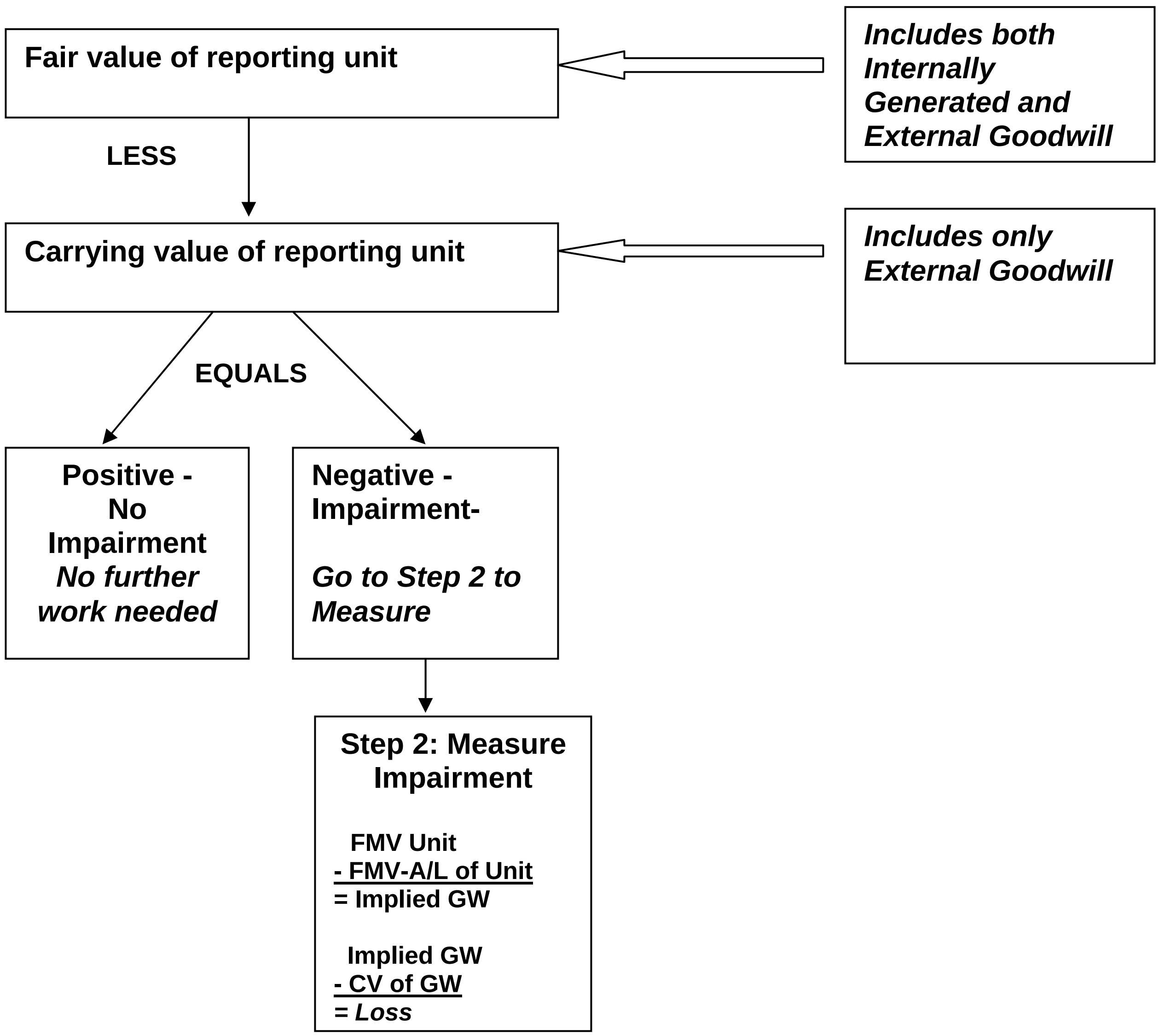
    - The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin; and

    - Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

In most cases, a profitable entity will not have a writedown of goodwill for an impairment even in years during which there has been a loss. The reason is because under GAAP, companies only recognize external (purchased) goodwill. Internally generated goodwill, the goodwill generated by the entity over time, is not recorded on an entity's balance sheet.

The writedown of goodwill under ASC 350 only encompasses external goodwill. Yet, internal goodwill is reflected in the fair value of the net assets of a reporting unit, but not in the carrying value, and may offset any potential writedown in external goodwill. The following chart depicts this important point:

The Impairment Formula- Internally Generated and External Goodwill



The above chart illustrates the fact that the fair value of a reporting unit *includes both internally and externally generated goodwill*, while the *carrying value includes only external (purchased) goodwill*.

The result is a simple conclusion based on mathematics. In most cases, a relatively stable and profitable entity will be required to perform the annual test for goodwill impairment, but will not incur an impairment loss. Any internally generated goodwill located as part of the fair value of the unit will offset any potential impairment loss writedown of external (purchased goodwill). That is, Step 1 will be a positive amount, thereby not requiring the entity to move to Step 2 to measure an impairment.

Although an entity may not have a goodwill impairment loss, that entity must still perform an annual test for impairment under ASC 350 (formerly FASB No. 142). Unless the entity wants to hire an outside valuation specialist, a method to determine the fair value of the entity must be obtained.

At a minimum, an entity must perform Step 1 to confirm that there is no impairment. If the accountant is conducting an audit, review or even a compilation, the burden to make this calculation may fall on the accountant.

Fair value of the reporting unit
<u>Less: Carrying value of the reporting unit</u>
If Positive- no impairment

The above formula is what the accountant or his/her client must focus on. How does one determine the fair value of the reporting unit without conducting a formal valuation?

The author recommends that a short-cut (rule-of-thumb) approach be used in certain situations.

Examples might be the following:

Type of entity	**Rule-of-Thumb Method**
Manufacturer, retailer or wholesaler	Earnings multiple: Example: *EBITDA x 5*
Professional practice	Revenue multiple: Example: *Gross revenue x 1*

These are rule-of-thumb approaches that should work in most situations involving nonpublic entities.

Let's look at a simple example:

Facts: In 20X1, Company X is a manufacturer of widgets and has $300,000 of goodwill on its balance sheet. X has one reporting unit, which is the legal entity.

The company is required to perform an annual test of goodwill impairment. Joe, the owner of X said he is not willing to pay "one nickel" to obtain an outside valuation. X's auditor, Mary has been asked to perform the test.

Other data includes:

Earnings before interest, taxes, depreciation and amortization (EBITDA)	$1,000,000
Carrying value of X's net assets, including goodwill	3,000,000

Conclusion: Assume Mary uses the capitalization of earnings (earning multiple) approach (EBITDA x 5) to measure the fair value of the reporting unit, which is the legal entity.

Formula:

Fair value of entity: $1,000,000 x 5 =	$5,000,000
Carrying value of entity	3,000,000
Positive	***$2,000,000***

The result is that the fair value exceeds the carrying value by a significant amount. No potential impairment exists and Mary does not have to go to the second step and measure an impairment.

Further, because the carrying value of X's net assets, including goodwill is not zero or negative, there is no potential impairment under the second scenario test of ASC 350.

What happens in 20X3 and beyond?

In 20X3, Mary is required to perform another impairment test on goodwill. She has two choices.

Option 1: Perform the same or similar test again, with likely the same result, or
Option 2: Use the Special Carryforward Exception.

To recollect, ASC 350 permits an entity to carryforward the test results from one year to another without having to perform another test if the following factors occur:

- The assets and liabilities that make up the reporting unit (legal entity) have not changed significantly since the most recent fair value determination;
- The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin; and
- Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote.

It appears that X qualifies for use of the special carryforward exception. First, let's assume that in 20X3, there has been minimal change in the assets and liabilities of X. Second, the most recent valuation (20X2) resulted in the fair value exceeding the carrying value by a substantial amount ($2,000,000 excess). And third, the likelihood that the fair value of the entity will be less than the carrying value is remote. Assuming X satisfies these three conditions, the valuation and the related conclusion used for the 20X2 test can be carried forward and used for the 20X3 without requiring an update. The 20X3 test can be carried forward and used for 20X4 and beyond, as well, until there is either a material change in the asset and liabilities of the entity or there is the likelihood that an impairment might exist due to a series of operating losses.

The reason why the rule of thumb approach works is because the goal is not to arrive at a true fair value. Instead, the goal is only to obtain a comfort level in knowing that the fair value exceeds the carrying value. The amount by which fair value exceeds carrying value is irrelevant.

If one is concerned about the appropriateness of the capitalization rate (5 times), this method can be used based on a high and low approach as follows:

Change the facts: Let's assume Mary believes that the range of capitalization rates is somewhere between 4 and 7 times for similar companies. Mary can calculate the estimated fair value based on a high-low range as follows:

	High range	Low range
Fair value:		
$1,000,000 x 7	$7,000,000	
1,000,000 x 4		$4,000,000
Carrying value	-3,000,000	-3,000,000
Positive	$4,000,000	$1,000,000

By using a high-low range, the company (or its accountant) can feel comfortable that the fair value exceeds the carrying value even in the worst-case scenario (based on a 4-times multiple).

There are flaws to the rule-of-thumb approach. The most important one is that it may be difficult to obtain EBITDA in a nonpublic entity because of unusual items that may flow through the business. In a business valuation, such items are adjusted to arrive at normalized earnings. Examples include excess (or understated) salaries, personal items, excess fringe benefits, etc. For example, in a C corporation, it is not unusual to "bonus out" the profit to the officers and shareholders. This result is that the company has an understated profit with overstated salaries and wages. In extreme cases, the accountant may wish to add back the larger items to arrive at a truer EBITDA.

Example: C Corporation had an EBITDA before bonus of $300,000. At year-end, Harry paid himself a bonus of $250,000, bringing EBITDA down to $50,000. Harry's total compensation for the year was $400,000. Harry's position is "golfer" and he could be replaced for about $75,000. Assume the excess compensation is $325,000 and that a reasonable capitalization rate used for companies in similar industries is 5 times EBITDA.

In obtaining EBITDA, the excess compensation should be added back as follows:

Reported EBITDA	$50,000
Add back estimate of excess compensation	325,000
Revised EBITDA	375,000
Capitalization rate	5
Estimated fair value	$1,875,000

5. Triggering Events Affecting Goodwill Impairment Charges

Due to the downturn in the United States economy, many companies have recorded significant goodwill impairment losses under ASC 350.

Although goodwill must be tested annually for impairment, ASC 350 requires it to be tested more frequently if there is a triggering event that creates the impairment. The FASB gives examples of triggering events to include:

- Significant adverse change in the business climate or legal factors
- Adverse legal issue or action against the reporting unit
- Action or assessment by a regulator
- Unanticipated competition
- Loss of key employee
- More-likely-than-not (more than 50% likelihood) expectation that all or a significant part of a reporting unit will be sold or disposed of
- There is a test for recoverability under ASC 360 (formerly FASB No. 144) of a significant asset group within the reporting unit
- There is a recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

The previous list is not all-inclusive.

A reduction in stock price could also be considered a triggering event, although there are many cases in which a decline in stock price did not result in an impairment.

The real drivers for impairment are fair value and carrying value of the reporting unit's net assets. Fair value is affected by a triggering event.

What are some of the triggering events that have created goodwill impairment charges?

In October 2010, the Georgia Tech College of Management issued a report entitled *Triggering Events and Goodwill Impairment Charges* (Report). This Report, based on a study of 40 public companies, looks at how these companies handled goodwill impairment for 2008 and the triggering events that created the impairment. 2008 was a year where there was a significant number of goodwill impairment losses recorded. The Report also addresses those companies that had triggering events but did not record goodwill impairment losses.

Conclusions reached based on the Report follow:

1. On average, out of the companies sampled that recorded impairment charges, the amount of the impairment loss was sizeable, at 67 percent of the goodwill balance.

2. There is some overlap between those triggering events related to companies that recorded goodwill impairment losses and those that did not record the losses. Those triggering events that were the most correlated with impairment losses were those that lessened profitability, and therefore affected the fair value of a reporting unit.

3. A decline in a company's stock price and/or market capitalization (equity market prices) was not necessarily correlated with those companies recording impairment losses. Instead, many companies that had declines in stock price argued that the decline was a function of an "irrational market" and nothing to do with the company's fundamental problems affecting impairment.

Following is a chart that compares the key triggering events as outlined in the Report:

Companies that recorded goodwill impairment losses	Companies that did not record goodwill impairment losses
COMMON TRIGGERING EVENTS- ALL COMPANIES	
• Change in strategic direction	• Change in strategic direction
• Decline in equity market prices	• Decline in equity market prices
• Increase in competition	• Increase in competition
• Increased operating losses	• Increased operating losses
• Macro economic conditions	• Macro economic conditions
• Tightening of credit markets	• Tightening of credit markets
TRIGGERING EVENTS THAT DIFFER BETWEEN THOSE COMPANIES THAT RECORDED IMPAIRMENTS AND THOSE THAT DID NOT	
• Downsizing of personnel and operations	• Lower revenue
• Lower gross margin	• Technological changes
• Lower sales prices	• Uncertainty of future cash flows
• Loss of key customer	• Decline in revenues and earnings
• Negative industry trends	
• Recurring losses	
• Restructuring action	
• Lack of market acceptance of company products	
• Violation of non-compete agreement	
• Change in customer mix	
• Higher costs	
Source: *Triggering Events and Goodwill Impairment Charges,* Georgia Institute of Technology, College of Management (October 2010)	

Observation: The table lists triggering events that are common among companies that recorded goodwill impairment losses and those that did not. Although there is commonality among some triggering events such as change in strategic direction, increase in competition, and increased operating losses, in general there is little linkage between the triggering events and whether the companies record an impairment loss. Again, a triggering event is only relevant if it results in the fair value of a reporting unit declining below its carrying value.

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. Which of the following is correct as it relates to goodwill:

   a) goodwill should be amortized over 15 years with no test for impairment required
   b) goodwill should not be amortized and should be tested for impairment only if there is a reason to do so
   c) goodwill should be amortized over its useful life and tested for impairment at least annually
   d) goodwill should not be amortized and should be tested for impairment at least annually

2. Facts: X is performing an impairment test of all of its assets including goodwill. Which of the following is the correct order in which X should test the impairment of its tangible and intangible assets other than goodwill, and its test of goodwill impairment:

   a) goodwill should be tested for impairment first and adjusted; then the test for impairment of all other tangible and intangible assets should be done
   b) goodwill and all other tangible and intangible assets should be combined and tested for impairment simultaneously under ASC 360 (formerly FASB No. 144)
   c) all tangible and intangible assets other than goodwill should be tested and adjusted before the goodwill impairment test is performed
   d) goodwill and all intangible assets should be tested together separate from the test of tangible assets

3. Facts: For the year ended December 31, 20X2, Company X performs an impairment test of goodwill in Reporting Unit Z. Based on the test, X concludes that the fair value of Z exceeds its carrying value by a significant amount and that there is no 20X2 impairment. In 20X3, the overall assets and liabilities and profitability of Z have not changed since 20X2 and X believes that if a test were to be done in 20X3, the likelihood that the fair value would be less than the carrying value is remote. Which of the following is correct:

   a) X should perform the test for impairment in 20X3 as required by GAAP
   b) X is not required to perform a test for impairment in 20X3
   c) X qualifies to use the special exception for 20X4, but must perform a test in 20X3
   d) X has a one-time waiver of the test which it can use in 20X3 but not for 20X4 and beyond

4. The author notes that there are a few ways to manipulate earnings using goodwill. One way to minimize the amount of goodwill impairment loss is to:

   a) allocate a larger portion of goodwill to those reporting units that are profitable
   b) decrease the number of reporting units to which goodwill is assigned
   c) change the goodwill formula
   d) expand the number of reporting units

5. Facts: Company X is testing its goodwill for impairment. The fair value is greater than the carrying value of the reporting unit. The carrying value is greater than zero. How should X proceed:

   a) there is a potential impairment, and X should go to the second step and measure the impairment
   b) there is no potential impairment, but X should go to the second step and measure the impairment
   c) there is a potential impairment, and X should not go to the second step and measure the impairment
   d) there is no potential impairment, and X should not go to the second step and measure the impairment

6. If there is an impairment loss from goodwill, the loss should be presented:

   a) in the income statement before the subtotal income from continued operations
   b) in the statement of comprehensive income as an element of other comprehensive income, net of the tax effect
   c) in the income statement as a separate line item, net of the tax effect
   d) in the income statement, in the other income section

7. What valuation approach compares prices produced by transactions of identical or similar assets or liabilities:

   a) cost approach
   b) in-exchange approach
   c) income approach
   d) market approach

8. What inputs are placed into Level 3 inputs in the fair-value hierarchy:

   a) inputs that are derived principally from or corroborated by observable market data by correlation
   b) observable inputs other than quoted prices included in Level 1 that are observable
   c) observable, unadjusted, quoted market prices in active markets for identical assets or liabilities that are accessible
   d) unobservable inputs that should be used when observable inputs are unavailable

9. Which of the following is correct as it relates to goodwill:

   a) fair value of a reporting unit includes both internally and externally generated goodwill
   b) fair value of a reporting unit includes only external (purchased) goodwill
   c) carrying value of a reporting unit includes both internally and externally generated goodwill
   d) carrying value of a reporting unit includes only internally generated goodwill

10. Facts: Company X is a manufacturer that has $100,000 of goodwill and one reporting unit, which is its legal entity. X wishes to perform a short-cut approach to testing goodwill for impairment using 5 times EBITDA.

X's EBITDA is	$500,000
Carrying value of X's net assets, including goodwill	1,000,000

What does the first step to test for potential impairment look like:

a)

Fair value of entity	$2,500,000
Carrying value of entity	1,000,000
Positive (no potential impairment)	$1,500,000

b)

Fair value of entity	$1,200,000
Carrying value of entity	1,000,000
Positive (no potential impairment)	$200,000

c)

Fair value of entity	$1,000,000
Carrying value of entity	1,500,000
Negative (potential impairment)	$(500,000)

d)

Fair value of entity	$2,000,000
Carrying value of entity	1,000,000
Positive (potential impairment)	$1,000,000

SUGGESTED SOLUTIONS

1. A: Incorrect. Goodwill is not amortized over 15 years and a test for impairment is required under GAAP.

   B: Incorrect. Although goodwill should not be amortized, it must be tested at least annually and not only if there is a reason to do so.

   C: Incorrect. Goodwill should not be amortized over its useful life, although it is correct that it should be tested for impairment at least annually.

   D: Correct. GAAP requires that goodwill should not be amortized and should be tested for impairment at least annually.

   (See page 4-4 of the course material.)

2. A: Incorrect. The test of goodwill impairment is done last, not first, making the statement incorrect.

   B: Incorrect. ASC 350 (formerly FASB No. 142) and ASC 360 (formerly FASB No. 144) do not allow for goodwill and all other tangible and intangible assets to be combined and tested for impairment simultaneously.

   C: Correct. GAAP requires that all tangible and intangible assets other than goodwill be tested and adjusted first. Then, the adjusted numbers are included in the test for goodwill impairment.

   D: Incorrect. GAAP does not provide for goodwill and all intangible assets being tested together separate from the test of tangible assets.

   (See page 4-5 of the course material.)

3. Incorrect. X qualifies for the special carryforward exception and does not have to perform the test in 20X3.

   B: Correct. X qualifies to use the special carryforward exception and does not have to perform a test in 20X3. Key factors qualifying for the exception include 1) assets and liabilities have not changed significantly from 20X2, 2) the 20X2 test resulted in fair value exceeding carrying value by a substantial margin, and 3) the likelihood of fair value being less than carrying value is remote.

   C: Incorrect. The exception applies to 20X3 and may or may not apply to 20X4 and beyond.

   D: Incorrect. There is no one-time waiver of the test.

   (See page 4-5 of the course material.)

4. A: Incorrect. Allocating a larger portion of goodwill to those reporting units that are profitable does not result in minimizing the amount of goodwill impairment loss.

   B: Correct. By decreasing the number of reporting units to which goodwill is assigned, those units that have losses can be offset by profitable units.

   C: Incorrect. Changing the goodwill formula would violate the formula authorized by GAAP and is not an option.

   D: Incorrect. By expanding the number of reporting units, certain loss units cannot be offset by profitable units, resulting in greater losses, not a minimization of losses.

   (See page 4-14 of the course material.)

5. A: Incorrect. Because the fair value exceeds the carrying value, there is no potential impairment, and X should not go to the second step and measure the impairment. Further, because the carrying value is greater than zero, there is no potential impairment under scenario 2.

   B: Incorrect. Because there is no potential impairment, X should not go to the second step and measure the impairment.

   C: Incorrect. There is no potential impairment, and therefore, X should not go to the second step and measure the impairment.

   D: Correct. With the fair value exceeding carrying value, there is no potential impairment and X should not go to the second step and measure the impairment.

   (See page 4-15 of the course material.)

6. **A: Correct.** The aggregate amount of goodwill impairment losses must be presented as a separate line item in the income statement before the subtotal income from continued operations.

   B: Incorrect. Goodwill impairment losses are not part of other comprehensive income.

   C: Incorrect. Impairment losses are not presented as a separate line item, net of the tax effect.

   D: Incorrect. There is no requirement that the impairment losses be included in the other income section in the income statement.

   (See page 4-18 of the course material.)

7. A: Incorrect. In determining fair value, the cost approach uses as its basis the amount that an entity would have to spend to replace the asset's service capacity.

   B: Incorrect. The in-exchange approach is not a valuation approach. Rather, it is an approach used to determine the highest and best use of an asset.

   C: Incorrect. In determining fair value, the income approach uses techniques to convert future amounts to a single present amount.

   D: Correct. In determining fair value, the market approach compares prices produced by transactions of identical or similar assets or liabilities.

   (See page 4-27 of the course material.)

8. A: Incorrect. Inputs used to measure fair value that result principally from or are substantiated with observable market data by correlation are an example of Level 2 inputs.

   B: Incorrect. Observable inputs used to measure fair value that are other than quoted prices included in Level 1 are classified as Level 2 inputs.

   C: Incorrect. Observable, unadjusted, quoted market prices in active markets for identical assets or liabilities that are accessible are classified as Level 1 inputs.

   D: Correct. Unobservable inputs used to measure fair value that should be used when observable inputs are unavailable are classified as Level 3 inputs.

   (See page 4-29 of the course material.)

9. **A: Correct.** Fair value of a reporting unit includes both internally and externally generated goodwill, while carrying value includes only external goodwill.

   B: Incorrect. Fair value of a reporting unit includes both internal and external (purchased) goodwill in that internal goodwill grows with the profits of the entity.

   C: Incorrect. Carrying value of a reporting unit includes only externally generated goodwill, that is goodwill that is purchased.

   D: Incorrect. Carrying value of a reporting unit includes only external (purchased) and not internally generated goodwill.

   (See page 4-40 of the course material.)

10. **A: Correct.** The fair value is $500,000 EBIDTA times 5 or $2,500,000. Because fair value exceeds carrying value, there is no potential impairment of goodwill.

    B: Incorrect. Fair value is $2,500,000 and not $1,200,000 making the answer incorrect.

    C: Incorrect. Fair value is $2,500,000 and not $1,000,000, making the answer incorrect.

    D: Incorrect. The fair value is $2,500,000 and not $2,000,000. Further, if the result is positive, there is no potential impairment.

    (See pages 4-41 to 4-42 of the course material.)

Category 2: Intangible Assets with Indefinite Useful Lives:

An intangible asset with an indefinite life *should not be amortized* until its life is determined to be no longer indefinite.

An intangible asset is deemed to have an indefinite life if there is no legal, regulatory, contractual, competitive, economic, or other factors that limit the useful life of an intangible asset. That is, there is no limit placed on the end of the assets useful life to the reporting entity.

Examples of intangible assets that might have indefinite lives include:

- Certain trademarks and trade names
- Certain licenses such as liquor and broadcast licenses
- Taxi medallions
- Franchises
- Airport routes

A company is required to follow certain rules in ASC 350 (formerly FASB No. 142) in testing an intangible asset with an indefinite life for impairment.

a. An intangible asset (other than goodwill) with an indefinite life should be tested for impairment *annually,* or more frequently on an interim basis if an event or circumstance occurs between annual tests indicating that the asset might be impaired.

b. Unlike goodwill, the impairment test for an intangible asset with an indefinite life consists of a single step as follows:

   Formula for Annual Impairment Test:

   Fair value of intangible asset
   Less: Carrying value of intangible asset
   Equals: Impairment loss

   1) If an impairment loss is recognized, the written-down carrying amount of the intangible shall be the asset's new basis for subsequent impairment tests.

   2) The reversal of previously recognized impairment losses is prohibited.

Example: In 20X1, Joe's Manhattan Taxi Service purchases a competitor's business that includes 30 taxi licenses (medallions). Out of the total purchase price of $10 million, $7 million is assigned to the 30 taxi licenses based on the fair value in the market place. The licenses have an indefinite life and are renewed annually by paying a small renewal fee.

Conclusion: The $7 million of cost allocated to the intangible asset (licenses) should not be amortized until the useful economic life becomes finite. However, each year the Company should test the licenses for impairment by comparing the $7 million carrying value to the fair value in the market.

Assume that on December 31, 20X1, the fair value of the licenses is $5 million. The licenses should be written down to fair value as follows:

Formula for impairment:

Fair value of licenses	$5,000,000
Less: Carrying value of licenses	7,000,000
Equals: Impairment loss	***$(2,000,000)***

Entry: December 31, 20X1:

Loss	2,000,000	
Licenses		2,000,000

Change the facts: Assume on January 1 of 20X2, the local government changes the law and states that all licenses will become null and void at the end of 20X8.

Conclusion: At this point, the useful economic life is now finite, with 7 years remaining. The revised carrying value of $5 million should be amortized over the 7-year period (20X2 through 20X8) on a straight-line basis, unless another systematic and rational method is used.

Category 3: Long-lived Tangible Assets- Equipment and Real Estate

In down economic climates, long-lived tangible assets, such as equipment and real estate, may have an impairment. The rules for impairment of long-lived tangible assets are found in ASC 360 (formerly FASB No. 144) and related to those assets to be held and used. ASC 360 has separate rules for those long-lived assets that are to be disposed of by sale of other means, the subject of which is not covered in this chapter.

Under ASC 360, an impairment loss exists when the carrying amount of a long-lived tangible asset (asset group) exceeds its fair value. An impairment loss is recognized only if *two conditions occur*:

Condition 1: The carrying amount of the asset is not recoverable based on future undiscounted cash flows expected to result from the use and ultimate disposition of the asset or asset group, *and*

Condition 2: The carrying amount exceeds the fair value.

The impairment assessment is based on the carrying amount of the asset or asset group at the date it is tested for recoverability, regardless of whether it is in use or under development.

1. Steps to Apply the Impairment Test- Long-Lived Tangible Assets

a. There are essentially three steps to applying the impairment test:

Step 1: Perform a Review of Events and Changes in Circumstances
Step 2: Test for Impairment
Step 3: Measure the Impairment Loss

Step 1: Perform a Review of Events and Changes in Circumstances

An impairment test is only performed if there is an indication that an impairment might exist. A long-lived asset is tested whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. In Step 1, *the entity reviews all of the events and changes in circumstances to determine if a potential impairment exists*- that is, the carrying amount of the asset(s) may not be recoverable.

Examples of events and changes in circumstances that might warrant a test include:

- A significant decrease in the market price of a long-lived asset (asset group)
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- A current expectation that, more likely than not (more than a 50 percent change) a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

Note: If a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and the method used, or the amortization period for certain intangible assets under ASC 350, *Intangibles-Goodwill and Other* (formerly FASB No. 142).

Any revision to the remaining useful life of a long-lived asset should be used in developing estimated future cash flows used to test the asset for recoverability. Any change in the accounting method for the asset resulting from that review shall be made only after applying ASC 360 (formerly FASB No. 144).

Step 2: Test for Impairment- Long-Lived Tangible Assets

If a review of the events and changes in circumstances in Step 1 indicates that there might be an impairment (e.g., carrying value may not be recoverable), Step 2 should be performed.

The formula for testing for impairment is as follows:

> ***The carrying amount of the asset (asset group) is compared with the estimated future undiscounted cash flows to be generated from use or ultimate disposition of the asset (asset group).***

Estimated future cash flows	**>**	**Carrying amount of the asset**	**=**	**NO IMPAIRMENT (Stop- no further action required)**
Estimated future cash flows	**<**	**Carrying amount of the asset**	**=**	**IMPAIRMENT (Go to Step 3)**

Step 3: Measure the Impairment

If, based on Step 2, estimated future cash flows are less than the carrying amount of the asset, the asset (or asset group) carrying amount is not recoverable (e.g., there is an impairment). Therefore, an asset impairment must be measured in Step 3.

Formula for measuring an impairment:

Carrying amount of the asset
<u>Less: Fair value of asset</u>
Equals: Impairment loss

If the carrying amount is less than the fair value of the asset, an impairment loss is recorded as follows:

Impairment loss	xx	
Asset		xx

After an impairment loss is recognized, <u>*the reduced carrying amount shall become the new cost*</u>. For depreciable assets, the new cost shall be depreciated over the asset's remaining useful life.

Restoration of previously recognized impairment losses is <u>*prohibited.*</u>

Example: In 20X1, Company X has certain machinery and equipment within its widget division that may be impaired. Based on a review of this equipment, the company believes that the carrying amount of the equipment may not be recoverable.

The remaining estimated useful life (based on the depreciation schedules) is 4 years.

Additional information:

Remaining useful life of the assets	4 years
Carrying amount of the equipment	$500,000
Estimated (undiscounted) future cash flows*	400,000
Fair value of the equipment**	480,000

* Estimated net cash flows for the remaining useful life of the asset including estimated salvage value.

** Based on the fair value of similar machinery and equipment within the marketplace.

Conclusion: Company X has already performed Step 1 in that through its review, it has concluded that there are events and circumstances that suggest that the carrying amount of the equipment may not be recoverable.

Next, Company X should perform test for impairment (Step 2) as follows:

Step 2: Test for impairment

Estimated Future Cash Flows		Carrying Amount		
	<		=	ASSET IS IMPAIRED [Go to Step 3)
$400,000		$500,000		

In Step 2, the estimated future cash flows of $400,000 are compared with the carrying amount of the asset, $500,000. Because the estimated future cash flows are less than the carrying amount, the carrying amount will not be recovered over the remaining useful life. As a result, Step 3 should be performed to measure the amount of the impairment.

Step 3: Measure the impairment- Long-Lived Tangible Assets

Carrying amount	$500,000
- Fair value	480,000
= Impairment loss	**(20,000)**

Entry:

Impairment loss	20,000	
Equipment		20,000

Once the impairment loss is recorded, the $480,000 becomes the equipment's new basis for computing depreciation in future years. Because there has been an impairment, the company should review the remaining useful life of the asset and, if needed, adjust it.

Change the facts: Same facts as the previous example. Assume that in 20X2, the fair value of the equipment increases to $510,000. Can the Company restore the impairment loss recorded in 20X1?

Conclusion: The Company is prohibited from writing up the asset to recover the previously recorded impairment loss.

2. Grouping Long-Lived Tangible Assets for the Test

For purposes of performing the impairment test, a long-lived asset(s) shall be grouped with other assets and liabilities at the *lowest level* for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities (referred to as an asset group).

Example: They are used together to *generate joint cash flows.*

a. Examples where joint cash flows may be evident include:

- Operations joined by one contract,
- One product line that acts as a loss leader for another more profitable product line, and
- Networking equipment used throughout several operations.

b. The entity level may be considered the asset group level if there are no identifiable cash flows generated at a level below the entity level.

Note: Most smaller entities will test for impairment under this Statement at the entity level since that is the lowest level at which identifiable cash flows are generated.

c. Goodwill shall be included in an asset group to be tested for impairment only if the asset group is or includes a "reporting unit."[5] Goodwill shall not be included in a lower-level asset group that includes only part of a reporting unit. Estimated cash flows used to test a lower-level group shall not be adjusted to reflect the effect of excluding goodwill from the group.

d. If an impairment loss is recognized for the asset group, the loss shall reduce only the carrying amount of a long-lived asset(s) of the group.

1) The loss shall be allocated to long-lived assets within the group on a pro rata basis using the relative carrying amounts of those assets.

2) The loss allocated to an individual asset shall not reduce that asset's carrying amount below its fair value, provided the fair value can be determined without undue cost and effort.

e. Any writedowns or adjustments of assets and liabilities within an asset group shall be made in the following order:

1) The carrying amounts of assets and liabilities (exclusive of goodwill) ***not covered*** by ASC 360 (formerly FASB No. 144) that are included in the asset group, shall be adjusted in accordance with GAAP prior to being included in the asset group for the impairment test.

2) Impairment losses made under ASC 360 shall be made next.

3) Lastly, any impairment losses for goodwill and intangible assets covered by ASC 350 shall be made.

Note: If the company has intangible assets with indefinite lives (e.g., trademarks, franchises), those assets would be tested for impairment and adjusted (if needed), prior to the test and adjustment of long-lived assets under this Statement. That is, the second step above would be the test for the impairment of the intangibles with indefinite lives.

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[5] FASB No. 142 (ASC 350) defines a reporting unit as the same level or one level below an operating segment as defined in FASB No. 131 (ASC 280), *Disclosures about Segments of an Enterprise and Related Information.* Under FASB No. 142 (ASC 350), goodwill is tested at the reporting unit level.

Example: Company X has various assets including equipment, inventory, current assets, goodwill, and liabilities. X has had several years of losses and is concerned that its long-term assets may be impaired.

X must perform a test of its equipment (long-lived assets) under ASC 360 (formerly FASB No. 144).

X must also perform its annual test of impairment of goodwill under ASC 350 (formerly FASB No. 142).

The test of long-lived assets and the test for impairment of goodwill will both be performed at the legal entity level since that level represents the lowest cash flow level for ASC 360 and the reporting unit for testing goodwill under ASC 350.

Conclusion: The long-lived asset test must be performed before the test for goodwill. Before the long-lived asset (equipment) test is performed, all other assets and liabilities (exclusive of goodwill) should be adjusted in accordance with GAAP. For example, inventories should be adjusted to lower of cost or market value and receivables to net realizable value as required by GAAP. Once those assets and liabilities are adjusted, the test for long-lived assets (equipment) is performed. If the impairment test results in a writedown of long-lived assets, that writedown is done before those assets are included in the carrying value of X for purposes of testing goodwill for impairment.

f. Assigning liabilities to an asset group

1) ASC 360 (formerly FASB No. 144) requires that the impairment test be performed at the lowest level at which an asset or asset group generates cash flows and independent of other cash flows. That means that all assets and liabilities associated with a cash-flow-generating group should be included in the test for impairment. Further, the cash flow related to each asset and liability should be included.

2) With respect to liabilities of an asset group, those liabilities that are an integral part of the asset group are included in the group for purposes of the test. Moreover, the cash flows associated with those liabilities are included in the net cash flows.

Example: Company X has a division that manufactures widgets. The division is considered the lowest level at which cash flows are generated independent of other cash flows. The division has the following assets and liabilities:

Cash	xx
Accounts receivable	xx
Equipment	xx
Intangibles	xx
Accounts payable and accrued expenses	(xx)
Notes payable- banks	(xx)
Net assets	*xx*

Conclusion: In performing the impairment test under ASC 360, the asset group includes all of the above net assets, including the accounts payable, accrued expenses and notes payable, since all of these liabilities are an integral part of generating cash flows for the division. Further, the cash flows associated with those liabilities should be reflected in the cash flows used for the impairment test. That means that the principal payments, if any, on the notes payable would be reflected as a cash outflow in the test.

Observation: There may be instances in which liabilities may be part of a division, but should not be reflected in the asset group. The reason is because those liabilities do not directly help in the generation of cash flows for that asset group. Examples may be a corporate house account or intercompany account that does not directly affect the generation of cash flows.

According to one FASB Task Force member interviewed by the author, the FASB has received many questions regarding the mechanics of how to assign liabilities to a particular asset group. The FASB's unofficial response is that one factor to consider in whether a liability should be assigned to an asset group is *whether that liability could be settled separately from the remaining net assets* of the group. For example, obligations that are secured by long-lived assets of an asset group such as a mortgage on real estate, should be included in the asset group since that mortgage cannot be settled without liquidation of the underlying asset. The "settled" criterion is not really clear and is full of ambiguities. The FASB plans to issue further guidance on this and other matters in the near future.

Examples illustrating the application of grouping under ASC 360 (formerly FASB No. 144):

Following are three examples that illustrate how the asset grouping rules work. The author has extracted Example 3 from ASC 360 and modified it to make it more user friendly.

Example 1: A hotel chain shares advertising programs and reservation systems, yet each hotel carries its own reservations equipment asset.

Conclusion: The equipment of each hotel may be aggregated for purposes of testing and measuring impairment because the operations were interdependent.

Example 2: A bus company operates five (5) routes for a municipality under a contract that requires the Company to provide *all five routes* regardless of whether all five are profitable. In total, ten buses are used to operate all five routes at two buses per route. One of the five routes (route X) operates at a severe loss while the other four routes operate profitably. Information on the five routes follows:

	Route X	Other 4 routes	Total
# buses in route(s)	2	8	10
Carrying amount of the buses (A)	$500,000	$2,200,000	$2,700,000
Estimated future cash flows-operations Estimated salvage value of assets Estimated total future cash flows (B)	$(200,000) 50,000 $(150,000)	$3,080,000 220,000 $3,300,000	 $3,150,000
Test for Impairment Carrying amount (A) vs. future cash flows (B)	***IMPAIRMENT***	***NO IMPAIRMENT***	***NO IMPAIRMENT***
Measurement of Impairment Loss Fair value Carrying value ***Impairment loss***	 $100,000 500,000 ***$(400,000)***	 $5,000,000 2,200,000 ***NONE***	 $5,100,000 2,700,000 ***NONE***

Should the buses allocated to each route be tested and measured for impairment separately, or combined for one test and measurement for all five routes?

Conclusion: Because the Company does not have the option of operating less than five routes, *all five routes (and the buses related thereto) are used together to generate joint cash flows*. Thus, impairment should be *tested and measured in the aggregate* for all five routes. In the aggregate, the test for impairment looks like this:

Estimated Future Cash Flows		Carrying Amount		
	>		=	**NO IMPAIRMENT**
$3,150,000		$2,700,000		

Because the estimated future cash flows exceed the carrying amount, the asset is expected to be recovered, resulting in no impairment, and no reason to go to Step 3 to measure an impairment loss.

Observation: Notice the impact of aggregating routes for the impairment test as compared with testing each route separately. Had the impairment test been performed separately for each individual route, Route X would have incurred an impairment loss of $400,000. By aggregating, the five routes for the test, Route X's impairment loss is offset by the gains from the other four routes. Thus, no impairment loss is computed.

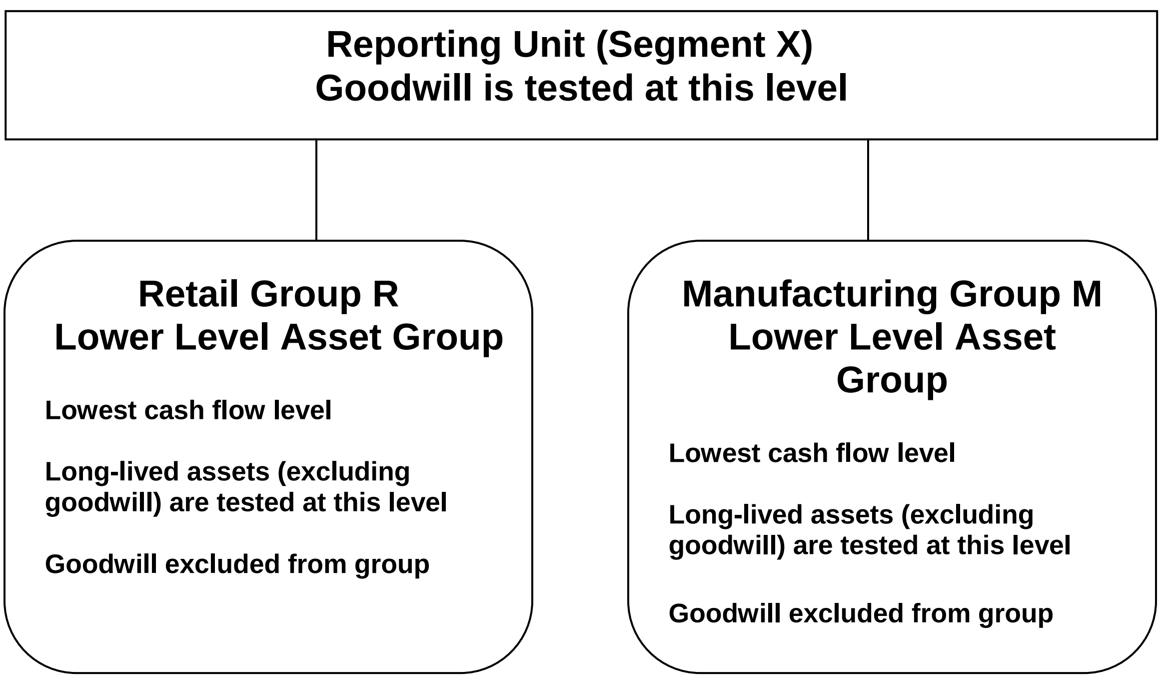
Further, this example brings to light the fact that the physical condition of the underlying asset is irrelevant to whether it is impaired. For example, assume in the above example that the bus routes were tested independently resulting in a loss writedown of the two buses used in Route X. Assume further, that all ten buses were purchased at the same time and are in relatively similar condition. Yet, despite the similar condition of all buses, only the buses in Route X are written down solely based on the fact that they are not properly used to generate cash flows.

The above example leaves many issues open as to whether operations may be combined to perform the impairment test. Remember, if one can demonstrate that two operations are interrelated due to the generation of joint cash flows, the impairment test may be performed by aggregating both operations. This could result in one positive operation mitigating the effect of a loss in the other operation.

Example: A company has Segment X. The segment includes goodwill. For purposes of testing goodwill for impairment, Segment X is considered a reporting unit. Within X are two separate divisions: the retail division (R) and the manufacturing division (M), each of which generate cash flows independent of each other and represent the lowest level for which identifiable cash flows are generated. The retail division has encountered recurring losses and events and changes in circumstances suggest that the carrying amount of its assets may not be recoverable.

Conclusion: For performing an impairment test, assets must be grouped at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. In this example, the retail division represents one asset group, while the manufacturing division represents another asset group.

Both of these groups (R and M) are lower-level groups that are subsets of the reporting unit (Segment X).



Because events and circumstances suggest that the carrying amount of R's assets may not be recoverable, an impairment test on R must be performed. In performing that test, the goodwill of Segment X shall not be included in the asset group of R since R is a lower-level group that does not include a reporting unit (X).

Example 3: Company X owns a manufacturing division (M) that together with other assets is tested for impairment as a group. M is the lowest level at which cash flows are generated that are independent of other cash flows. Events and circumstances suggest that there may be an impairment of the long-lived assets of M.

Details follow:

Carrying amount of all assets and liabilities of M	$2,750,000
Estimated future cash flows of M	2,000,000
Fair value of M	2,150,000

At the date of the test, M's balance sheet looks like this:

Asset Group- M	**Carrying amount**
Current assets- various	$400
Liabilities	(150)
Long-lived assets:	
Asset A	590
Asset B	780
Asset C	950
Asset D	180
Total long-lived assets	2,500
Total net assets	$2,750

Conclusion: M should be tested following these procedures.

Step 1: Review for impairment- already performed

Step 2: Test for Impairment

Estimated Future Cash Flows		Carrying Amount		
	<		=	IMPAIRMENT
$2,000,000		$2,750,000		

Because the estimated future cash flows are less than the carrying amount, the assets are not recoverable. As a result, Step 3 is performed to measure the impairment loss.

Step 3: Measure the impairment loss

Fair value of M	$2,150,000
Carrying value of M's net assets	2,750,000
Impairment loss	***$(600,000)***

The $(600,000) impairment loss must be recorded. ASC 360 states that the impairment loss should be allocated to long-lived assets on a pro-rata basis based on their relative carrying values. Other assets and liabilities that are part of the asset group receive no allocation of the impairment loss.

The allocation of long-lived assets is made as follows:

Asset Group- M	**Carrying amount**	**%**	**Allocation of impairment loss**	**Adjusted carrying amount**
Current assets- various	$400			$400
Liabilities	(150)			(150)
Long-lived assets:				
Asset A	590	**24%**	**$(144)**	446
Asset B	780	**31%**	**(186)**	594
Asset C	950	**38%**	**(228)**	722
Asset D	180	**7%**	**(42)**	138
Total long-lived assets	2,500	**100%**	**(600)**	1,900
Total net assets	$2,750		**$(600)**	$2,150

Entry for impairment loss

Impairment loss	600	
Asset A		144
Asset B		186
Asset C		228
Asset D		42

If goodwill had been included as part of the asset group, no allocation would have been made to goodwill.

Change the facts: Assume the same facts as Example 3, except that Asset C's fair value is $822,000.

Conclusion: After the allocation of the impairment loss in Example 3, Asset C's adjusted carrying value is $722,000, which is below its fair value of $822,000. ASC 360 states that as a result of an allocation to an individual long-lived asset, that asset's adjusted carrying value after the allocation should never be lower than its fair value. If it is, a reallocation must be done to allocate the $100,000 excess from Asset C to the remaining long-lived assets within the group.

Using the same schedule from Example 3 above, a reallocation must be done.

Asset Group- M	Adjusted carrying amount	%	Allocation of impairment loss	Adjusted carrying amount
Current assets- various	$400			$400
Liabilities	(150)			(150)
Long-lived assets:				
Asset A	446	**38%**	**$(38)**	408
Asset B	594	**50%**	**(50)**	544
Asset D	138	**12%**	**(12)**	126
Subtotal	1,428	**100%**	**(100)**	1328
Asset C	722		**100**	822
Total net assets	$2,150		**$0**	$2,150

Additional entry for impairment loss

Asset C	100	
Asset A		38
Asset B		50
Asset D		12

3. Applying the Impairment Rules to Individual Long-Lived Tangible Assets

ASC 360 requires that for purposes of performing the impairment test, assets are grouped at the lowest level at which identifiable cash flows are independent of other cash flows. That is, at a level where assets work together to generate cash flows for the entity. However, it is common for companies to have individual assets that do not, by themselves, generate cash flows.

Examples include:

- One single piece of manufacturing equipment
- Corporate headquarters facility
- Computer equipment
- Corporate furniture and equipment

Can an entity write down individual assets that do not generate cash flows by themselves?

It appears not. ASC 360 is designed to measure an impairment for a segment of a business. Individual assets that are impaired because the fair value is less than the carrying value, should not be written down unless those assets individually generate cash flows.

ASC 360 states in circumstances in which a long-lived asset does not have identifiable cash flows, the asset group for that asset shall include all assets and liabilities of the entity. What this means is that the individual assets will be tested for impairment as part of an overall test of all assets and liabilities of the entity.

There are instances where individual assets may generate independent cash flows and thus, be tested individually for impairment. A common example is an apartment building that generates its own cash flows that are independent of other cash flows. The building could be tested for impairment independently.

4. Estimating Cash Flows for the Impairment Test- Long-Lived Tangible Assets

ASC 360 does not provide detail as to how an entity should compute cash flows for purposes to performing the impairment test. What the Statement does say is that the *cash flows are net* (cash inflows less associated cash outflows), and that they are the cash flows that *are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset or asset group*. What does this mean? It means that whatever cash flows are expected to be generated by an asset or asset group should be reflected in the net cash flows used for the test.

The formula for estimated cash flows is as follows:

	FUTURE CASH FLOWS					
	20X1	**20X2**	**20X3**	**20X4**	**20X5**	**Total**
Net income generated from the asset group	XX	XX	XX	XX	XX	XX
Add back non-cash items:						
Depreciation and amortization	XX	XX	XX	XX	XX	XX
Deferred income taxes	XX	XX	XX	XX	XX	XX
Gain/loss on sale of asset	XX	XX	XX	XX	XX	XX
Other non-cash adjustments	XX	XX	XX	XX	XX	XX
Cash from operations	XX	XX	XX	XX	XX	XX
Add back: Interest expense	XX	XX	XX	XX	XX	XX
Deduct: Principal payments on liabilities/debt assigned to the asset group	(XX)	(XX)	(XX)	(XX)	(XX)	(XX)
Net cash flow	**XX**	**XX**	**XX**	**XX**	**XX**	**XX**
Add: Salvage value on sale of asset/asset group at the end of the asset lives					XX	XX
Less: Capital expenditures required to maintain existing service potential of asset group	(XX)	(XX)	(XX)	(XX)	(XX)	(XX)
NET CASH FLOWS	**XX**	**XX**	**XX**	**XX**	**XX**	**XX**

The above chart is not authoritative, but follows the limited guidance offered by ASC 360:

a. Estimated future cash flows used in the test for impairment of a long-lived asset group shall include only the future net cash flows (cash inflows less cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset group.

b. The estimated cash flows are undiscounted.

c. Interest charges that will be recognized as an expense are excluded from cash flows.

d. Principal payments on mortgages or notes assigned to the asset group should be included as a net cash outflow.

e. The estimated cash flows should include a salvage value based on the assumption that the long-lived asset (asset group) is sold at the end of their useful lives. The salvage value should be net of costs to sell.

f. The estimated cash flows shall be based on the entity's own assumptions about its use of the asset group and shall include all evidence.

    1) Assumptions used must be reasonable in relation to assumptions used to develop other information used by the entity for comparable periods such as internal budgets and projections, accruals for incentive compensation plans, or information communicated to others.

    2) If alternative courses of action to recover the carrying amount of a long-lived asset group are under consideration or if a range is estimated for the amount of possible future cash flows associated with the action, the likelihood of those possible outcomes should be considered.

        a) Financial Accounting Concept Statement (FACS) No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, offers *two methods* for cash flow estimation:

            - *Traditional (best-estimate) approach:* based on a single most-likely amount in a range of possible estimated amounts.

            - *Expected (probability-weighted) approach:* based on the sum of probability-weighted amounts in a range of possible estimated amounts.

The following example illustrates the application of the probability-weighted approach.

Example: A company is conducting its test for impairment. In determining future cash flows, the company has several options for using the asset group. In computing future cash flows, a probability-weighted cash flow calculation can be made as follows:

Future cash flows	Probability of outcome	Weighted expected cash flows
$1,000,000	60%	$600,000
600,000	30%	180,000
400,000	10%	40,000
Probability-weighted future cash flows		$820,000

The $820,000 estimated future cash flow would be compared to the carrying value of the asset(s) to determine if there is an impairment.

g. Cash flows used shall be made for the remaining useful life of the asset or asset group to the entity.

1) If an asset group is being tested, the remaining useful life of *the primary asset* of the group shall be used.

2) The *primary asset* is the principal long-lived tangible asset being depreciated or intangible asset being amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity.

3) The primary asset cannot be land or an intangible asset not being amortized.

4) Factors to be considered in determining whether a long-lived asset is a primary asset of an asset group include:

- Whether other assets of the group would have been acquired without the asset.
- The level of investment that would be required to replace the asset.
- The remaining useful life of the asset relative to other assets of the group.

5) If the primary asset is not the asset of the group with the longest remaining useful life, estimates of future cash flows for the group should assume the sale of the asset group at the end of the primary asset's useful life.

h. Estimates of future cash flows shall be based on the *existing service potential* of the asset or asset group at the date it is tested.

1) The service potential of a long-lived asset (asset group) encompasses several factors including:

- Remaining useful life

- Cash-flow-generating capacity
- Physical output capacity

2) Estimates of future cash flows include cash outflows associated with future expenditures necessary to *maintain the existing service potential including those expenditures* needed to replace the service potential of component parts of long-lived assets and component assets other than the primary asset in the asset group.

3) Cash flows exclude the cost of future capital expenditures that would increase the service potential of a long-lived asset (asset group).

Example: In testing the impairment of an apartment building, future cash flows should include capital expenditures needed to maintain the building in its existing position as a rental property. Examples would include a roof replacement and apartment renovations that maintain the property.

Capital expenditures that increase the service potential of the building (such as an addition or health club) would not be included in the future cash flows calculation.

i. Future cash flows for a long-lived asset group that is under development shall be based on the expected service potential when development is substantially complete.

   1) Those estimates shall include cash flows associated with all future expenditures necessary to develop a long-lived asset including interest payments that will be capitalized as part of the cost of the asset.

   2) If an asset that is under development is part of an asset group that is in use, the estimated future cash flows shall include the cash flows associated with future expenditures needed to maintain the existing service potential of the asset group as well as the cash flows associated with all future expenditures needed to substantially complete the asset that is under construction.

Example: A company engaged in mining and selling phosphate estimates future cash flows from its commercially minable phosphate deposits in order to test the recoverability of the asset group that includes the mine and related long-lived asset (plant and equipment). Deposits from the mined rock must be processed in order to extract the phosphate. As the active mining area expands along the geological structure of the mine, a new processing plant is constructed near the production area. Continuing to extract minable deposits over the life of the mine may require building numerous plants.

Conclusion: ASC 360 states that when a long-lived asset is under development and may be part of an asset group that is in use, the estimated future cash flows used shall include the cash flows associated with not only maintaining the existing service potential of the asset group, but also the cash flows associated with future expenditures needed to substantially complete an asset under construction.

In this example, in testing for impairment of the mine and related long-lived assets, the estimated future cash flows from its commercially minable phosphate deposits should include cash flows associated with future expenditures needed to build all of the required processing plants.

Example: A Company's fish processing division (F) is located in New Bedford, Massachusetts. At that division, there is various equipment used to process and can fish for shipment and sale to various wholesalers.

The Company believes that events and changes in circumstances suggest that there may be an impairment within the division. The most important event is the fact that the division's sales and profitability continues to decline due to heightened foreign competition.

For purposes of testing for impairment, the division is considered the lowest level at which cash flows are generated independent of other cash flows. Facts surrounding this scenario follow:

At the date of the test, F's balance sheet looks like this:

Asset Group- F	**Carrying amount**	**Remaining useful life**
Current assets- various	$3,000,000	
Liabilities, including bank term loan	(2,000,000)	
Long-lived assets:		
Asset A	2,000,000	4 years
Asset B- primary asset	**8,000,000**	**6 years**
Asset C	2,500,000	5 years
Asset D	4,500,000	5 years
Various other tangible assets	1,000,000	4.5 years
Total long-lived assets	18,000,000	
Total carrying value of net assets	$19,000,000	

The Company has selected Asset B as its primary asset because it is a major piece of manufacturing equipment. Without it, the remainder of the operation would not be possible. Cash flows are calculated over the next 6 years (the remaining useful life of the primary Asset B).

Year	Net cash flows*	Capital expenditures**	Salvage value of assets***	Total undiscounted cash flows
1	$2,500,000	$(400,000)	$0	$2,100,000
2	2,200,000	(500,000)	0	1,700,000
3	2,000,000	(500,000)	0	1,500,000
4	1,800,000	(500,000)	0	1,300,000
5	1,600,000	(1,300,000)	0	300,000
6	1,400,000	(200,000)	8,000,000	9,200,000
	$11,500,000	$(3,400,000)	$8,000,000	$16,100,000

* Consists of net income before depreciation, amortization, and other non-cash items less principal payments. (Example for year 1).
** Capital expenditures to maintain the existing operations. The expenditures replace certain long-lived assets within the group as their lives expire.
*** Estimated selling price of the entire asset group and the end of the life, net of estimated selling costs.

The computation of net cash flows would look like this, using, for example, Year 1:

Formula for Year 1 Estimated Future Net Cash Flows

Net income generated from the asset group	$XX
Add back non-cash items:	
Depreciation and amortization	XX
Deferred income taxes	XX
Gain/loss on sale of asset	XX
Other non-cash adjustments	XX
Cash from operations	**XX**
Add back: Interest expense	XX
Deduct: Principal payments on liabilities/debt assigned to the asset group	(XX)
Net cash flow	**$2,500,000**

Carrying amount of all assets and liabilities of F	$19,000,000
Estimated future cash flows of F	16,100,000
Fair value of F (given)	17,000,000

Step 2: Test for Impairment:

Estimated Future Cash Flows		Carrying Amount		
	<		=	IMPAIRMENT
$16,100,000		$19,000,000		

Step 3: Measure the impairment:

Carrying amount of all assets and liabilities of F	$19,000,000
Fair value of F	17,000,000
Impairment loss	$(2,000,000)

The $2,000,000 impairment loss is allocated to long-lived assets on a pro rata basis based on relative carrying value.

Asset Group- F	**Carrying amount**	**%**	**Allocation of impairment loss**	**Adjusted carrying amount**
Current assets- various	$3,000,000			$3,000,000
Liabilities	(2,000,000)			(2,000,000
Long-lived assets: equipment				
Asset A	2,000,000	**11%**	**$(220,000)**	1,780,000
Asset B- primary asset	8,000,000	**44%**	**(880,000)**	7,120,000
Asset C	2,500,000	**14%**	**(280,000)**	2,220,000
Asset D	4,500,000	**25%**	**(500,000)**	4,000,000
Various other	1,000,000	**6%**	**(120,000)**	880,000
Total long-lived assets	18,000,000	**100%**	**(2,000,000)**	16,000,000
Total net assets	$19,000,000		**$(2,000,000)**	$17,000,000

Entry for impairment loss

Impairment loss	2,000,000	
Asset A		220,000
Asset B		880,000
Asset C		280,000
Asset D		500,000
Other long-lived assets		120,000

Observations: The number of years to be included in the useful life has been an issue of controversy in developing ASC 360. Prior to the issuance of ASC 360, some respondents believed that the selection of one particular primary asset is subject to manipulation since the choice of a primary asset is subjective. The FASB considered several other options including using a weighted-average or composite asset life for all long-lived assets. The FASB decided not to use this approach as it considered its use to be unusually burdensome. Additionally, the FASB considered capping the number of years at 10, which was rejected in the final issued ASC 360.

The Statement requires that the estimated salvage value at the end of the asset group's life be reflected in the net cash flows for that asset group. The salvage value should be based on the assumption that the entire asset group as a whole is sold at the end of the life of the primary asset of the group. The salvage value is based on the assumption that at the sale, all liabilities of the asset group are paid off or settled, including notes payable. Although the Statement does not mention costs to sell, the author believes that the costs to sell should be deducted from the estimated selling price of the net assets to arrive at a net salvage value. In accounting terminology, salvage value is typically considered the "net" amount that an entity will receive from the sale of an asset or assets. Therefore, it is appropriate to deduct estimated selling costs in computing salvage value.

ASC 360 gives poor guidance on the computation of cash flows. The result is that without such guidance, the rules are rampant with abuse. In the above example, notice that the net cash flows of the asset group include a deduction for the principal payments on the term note. If those payments give rise to a negative cash flow, a company could eliminate that negative cash flow by merely transferring the note outside the asset group to another more profitable asset group. The payment terms do not have any impact on the cash flow calculation since any remaining note balance is deducted in arriving at a net salvage value at the end of the life of the group's primary asset.

Notice in the above example, that net working capital changes are not reflected in the cash flows amount- that is, the change in receivables, inventories and accounts payable/accrued expenses. One could argue that a true net cash flow amount should reflect those changes consistent with the formula used in the statement of cash flows. ASC 360 is silent on this matter. The author believes that the changes should not be reflected in the net cash flows amount. To do so could result in a profitable entity writing down long-lived assets solely because of its working capital management function. For example, assume that to take advantage of favorable ingredient pricing, a manufacturer stocks up on the inventories of selected raw materials, and depleted its cash. If the net cash flows formula were to include the change in working capital components such as inventory, this company might have a negative cash flow solely because of the increase in inventories. This could result in an otherwise profitable entity writing down its plant, equipment and intangibles. This is not the intent of ASC 360.

5. Computing fair value for the long-lived assets impairment test

If there is an impairment in Step 2 whereby estimated future cash flows are less than the carrying value of the assets or asset group, Step 3 is performed to measure the impairment:

Carrying amount of all assets and liabilities of the asset group	$XX
Fair value of the assets and liabilities of the asset group	- XX
Impairment loss	$XX

For an asset group, the fair value is based on the fair value of the group as a whole- that is, the value of the group if it were sold in an arms-length transaction. One way to arrive at the fair value of the asset group is to value each individual asset and liability within the group. However, the value of the group may be different from the sum of the values of the individual assets and liabilities due to the value of goodwill. That goodwill can be factored into the value of the group separately. For example, the fair value of Asset

Group X is merely the sum of the fair value of individual assets and liabilities of the group, plus the fair value of goodwill.

A company is required to follow the guidelines of ASC 820 (formerly FASB No. 157) in determining fair value for an asset or asset group. Following are some of those guidelines:

a. ASC 820 defines fair value as:

   "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."

b. Valuation techniques that should be used in determining fair value shall be those that are consistent with any one of the following *three approaches*:

   - Market approach- quoted market prices
   - Income approach- present value techniques (traditional or weighted) or multiples of earnings
   - Cost approach - cost to purchase or construct asset

   Note: Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for measurement, if available. In its absence, one of the other techniques should be used that includes present value of cash flows generated from the asset or asset group based on FASB Concepts Statement No. 7*, Using Cash Flow Information and Present Value in Accounting Measurement*. FACS No. 7 offers two methods to cash flow estimation:

   Traditional (best-estimate) present value approach: based on a single set of the most likely cash flows and a single interest rate, commensurate with the risk.

   Expected (probability-weighted) present value approach: based on the sum of probability-weighted amounts in a range of possible estimated amounts and a risk-free rate.

   If there are uncertainties about the timing and amount of cash flows, an expected present value approach may be more appropriate to use.

Example: Events and circumstances suggest that the long-lived assets in Company X's division might be impaired. The Company performs Step 2 to test for impairment as follows:

Step 2: Test for Impairment:

Carrying amount of all assets and liabilities	$19,000,000
Estimated future cash flows	16,100,000

Estimated future cash flows < Carrying amount of assets
$16,100,000 $19,000,000

Because the estimated future cash flows are less than the carrying amount of the assets and liabilities, there is an impairment and the impairment loss must be measured by comparing the fair value of the assets and liabilities to the carrying value as follows:

Step 3: Measure the impairment:

Carrying amount of all assets and liabilities of the asset group	$XX
Fair value of the asset group	- XX
Impairment loss	$XX

Options to determine fair value:

In determining fair value, we will look at three options as follows:

Option 1: Based on the quoted value of individual assets and liabilities.
Option 2: Using present value based on the traditional present value approach.
Option 3: Using present value based on the expected present value approach.

Option 1: Determine fair value based on the quoted value of the individual assets and liabilities:

Asset Group	**Carrying amount**	**Fair value of individual assets/liabilities**
Current assets- various	$3,000,000	***$3,000,000***
Liabilities	(2,000,000)	***(2,000,000)***
Long-lived assets:		
Asset A	2,000,000	***1,500,000***
Asset B- primary asset	8,000,000	***7,600,000***
Asset C	2,500,000	***2,300,000***
Asset D	4,500,000	***3,800,000***
Various other tangible assets	1,000,000	***1,000,000***
Goodwill	***0***	***200,000***
Total long-lived assets	18,000,000	***16,400,000***
Total carrying value of net assets	***$19,000,000***	***$17,400,000***

The fair value of the individual assets and liabilities in the asset group is based on quoted prices of those assets or similar assets, and amounted to $17,400,000 total. It includes an estimate of the fair value of goodwill, which in this case is $200,000. The impairment loss is computed as follows:

Carrying amount of all assets and liabilities	$19,000,000
Fair value (calculated above)	***- 17,400,000***
Impairment loss	$(1,600,000)

The $1,600,000 impairment loss should be allocated to long-lived assets on a pro rata basis based on relative carrying value. An example of that allocation is not given here but was covered in previous examples.

Entry for impairment loss

Impairment loss	1,600,000	
Long-lived assets*		1,600,000

* The loss should be allocated to the long-lived assets within the group (exclusive of goodwill) on a pro rata basis based on relative carrying values.

Option 2: Determine fair value using traditional present value technique:

Using the traditional present value approach, the estimated cash flows to be generated by the asset group over the remaining useful life of the primary asset is used, including cash flows from salvage value.

Assume the primary asset in the group is Asset B and its remaining useful life is 5 years and the discount rate commensurate with the risk for a similar transaction is 8%. Using the traditional present value approach, fair value would be computed as follows (estimated cash flows are given):

Year	Estimated net cash flows from the asset group	Interest rate	Present value of cash flows
1	$2,600,000	8%	$2,392,000
2	2,400,000	8%	2,031,000
3	2,200,000	8%	1,713,000
4	2,000,000	8%	1,432,000
5	* 9,000,000	8%	5,932,000
Present value of future cash flows (fair value of asset group)			***$13,500,000***

* Includes salvage value (net of costs to sell) from the estimated sale of the asset group at the end of the five year period.

Using the traditional present value approach, one set of estimated future cash flows is discounted using one interest rate that is commensurate with the risk.

Step 3: Measure the impairment loss would be applied as follows:

Carrying amount of all assets and liabilities	$19,000,000
Fair value (above)	13,500,000
Impairment loss	***$(5,500,000)***

Entry for impairment loss

Impairment loss	5,500,000	
Long-lived assets*		5,500,000

* The $5,500,000 impairment loss should be allocated to long-lived assets on a pro rata basis based on relative carrying value. An example of that allocation is not given here but was covered in previous examples.

Option 3: Determine fair value using the expected present value technique:

Using the expected present value approach, multiple cash flow scenarios are probability-weighted to obtain an expected cash flow for each year. The annual weighted expected cash flow is discounted using a risk-free rate.

Year	Estimated net cash flows	Probability weighted	Expected net cash flows
1	$1,800,000	20%	$360,000
	2,000,000	30%	600,000
	2,400,000	50%	1,200,000
	Year 1 expected net cash flows		***2,160,000***
2	1,600,000	10%	160,000
	1,900,000	40%	760,000
	2,300,000	50%	1,150,000
	Year 2 expected net cash flows		***2,070,000***
3	1,500,000	30%	450,000
	1,700,000	30%	510,000
	2,200,000	40%	880,000
	Year 3 expected net cash flows		***1,840,000***
4	1,400,000	35%	490,000
	1,700,000	25%	425,000
	2,300,000	40%	920,000
	Year 4 expected net cash flows		***1,835,000***
5	* 8,300,000	10%	830,000
	* 8,600,000	40%	344,000
	* 9,100,000	50%	4,550,000
	Year 5 expected net cash flows		***5,724,000***

* Includes salvage value (net of costs to sell) from estimated sale of the asset group at the end of the five-year period.

The weighted expected annual cash flows are then discounted using the risk-free rate, which would be the rate earned on a five-year treasury instrument. Assume that rate is 5%.

Year	Expected net cash flows from the asset group	Risk-free rate	Present value of cash flows
1	$2,160,000	5%	$2,052,000
2	2,070,000	5%	1,868,000
3	1,840,000	5%	1,578,000
4	1,835,000	5%	1,573,000
5	5,724,000	5%	4,429,000
Present value of future cash flows (fair value of asset group)			***$11,500,000***

Step 3: Measure the impairment loss would be applied as follows:

Carrying amount of all assets and liabilities	$19,000,000
Fair value (above)	***11,500,000***
Impairment loss	$(7,500,000)

Entry for impairment loss

Impairment loss	7,500,000	
Long-lived assets *		7,500,000

* The $7,500,000 impairment loss should be allocated to long-lived assets (exclusive of goodwill) on a pro rata basis based on relative carrying value. An example of that allocation is not given here but was covered in previous examples.

Observation: The above example illustrates the three primary methods that can be used to calculate fair value of assets within a group. The first method (quoted market prices method), a value for the asset group is obtained by valuing the individual assets and liabilities (including goodwill) using the quoted prices; that is, the prices available in the market. Unfortunately, many long-lived assets, such as equipment and machinery, do not have quoted market prices. Thus, the present value method (traditional or expected present value method) might have to be used.

In using either the traditional or expected present value method, FACS No. 7 requires that assumptions that marketplace participants would use in determining their estimated fair value be incorporated into the calculation provided such information can be obtained without undue cost and effort. Otherwise, the entity may use its own assumptions.

FACS No. 7 permits either present method (traditional or expected) to be used. However, it notes that in circumstances where there are uncertainties about the timing and amount of cash flows, the expected present value method is more appropriate. Although the expected method may have the advantage of weighting several cash flow scenarios, it does have a fundamental flaw in estimating the probability weighting factor.

For example, how does one determine whether an estimated cash flow should be weighted at 20% or 30%? Because of the subjective nature of the weighting, the expected present value method may not be any more accurate than the simpler traditional method.

6. Dealing with the Impairment of Real Estate Held for Use

The impairment rules for real estate are no different than those involving other long-lived assets. However, the application of the rules is actually easier to implement for real estate versus other assets for several reasons:

a. Future cash flows are more definable and less volatile since most costs are fixed.

b. The impairment is usually computed on a property-by-property basis since that is the lowest level at which net cash flows are generated that are independent of other cash flows.

c. Fair value is more discernable and available.

Like other impairment calculations, the process of determining whether there is an impairment of real estate requires the three steps:

Step 1: Review of events and changes in circumstances
Step 2: Test for impairment
Step 3: Measurement of the impairment loss

Although real estate values can be volatile in soft economies, the mechanism of testing for impairment under ASC 360 results in real estate that has declined in value not necessarily being written down to the lower of fair value or carrying value.

The primary reason is due to the fact that in order to measure and record an impairment loss in Step 3 (carrying value less fair value), there must be an impairment determined in Step 2 (future cash flows are less than the carrying amount). Because most real estate has an extended useful life which may exceed 30 years, it is very difficult to fail the cash flow test.

Consider the following example:

Harry owns a commercial office building in downtown Boston. He purchased the property in the height of the real estate market. Presently, there is a glut of vacant commercial space and events and circumstances suggest that the building might be impaired.

Assume:

Carrying amount of all assets and liabilities of the asset group	$2,000,000
Estimated net cash flow per year	$110,000
Remaining useful life of the building	30 years
Fair value of the building	$1,100,000

Step 2: Test for impairment:

Estimated annual future cash flows $110,000 x 30 years = $3,300,000

Estimated future cash flows	>	Carrying amount	***= NO IMPAIRMENT***
$3,300,000		$2,000,000	

Step 3: Measure the impairment loss:

Not applicable since Step 2 did not result in an impairment.

If Step 3 had been done, the impairment loss would have looked like this:

Carrying amount of all assets and liabilities	$2,000,000
Fair value (above)	***1,100,000***
Impairment loss	$(900,000)

Conclusion: The real estate has declined to the extent that the fair value of $1,100,000 is less than the carrying amount of $2,000,000. However, that decline in value is not recorded as an impairment loss. The reason is because Step 2 did not result in an impairment. The estimated future cash flows of $3,300,000 exceed the carrying amount of $2,000,000. Because the remaining useful life of the real estate is 30 years, cash flows for the impairment test are accumulated over a 30-year period, resulting in ample cash flow to exceed the carrying amount and, thus, avoid having to measure an impairment in Step 3. This example is in contrast to a test for impairment of machinery or equipment, where cash flows must be accumulated using a much shorter remaining life of perhaps five years.

Let's consider the steps to testing and measuring an impairment of real estate.

Step 1: Review of the Events and Change in Circumstances:

Events and changes in circumstances that suggest that real estate might be impaired include:

- Significant decline in the market price of the real estate or similar real estate
- Continued decline in rental rates and vacancies
- Failure to meet debt service on a regular basis
- Change in the use of the property
- Known environmental contamination
- Legal changes such as rent control or use restrictions

If any of the above factors are known, a test for impairment should be performed.

Step 2: Test for Impairment

In testing for impairment, there are a few issues that are indigenous to real estate:

1. The asset grouping is likely to be on an individual property basis since that is the lowest level at which cash flows are generated independent of other cash flows.

2. Annual net cash flows should include:

   - Net operating income (rental income less operating expenses) before interest, depreciation and amortization, but *after principal payments*.

     - The cash flows should reflect estimated increases or decreases in rental income and operating expenses over the remaining useful life of the property.

   - Estimated capital expenditures needed to maintain the property over the remaining useful life.

     Examples:
     - Roof replacement every 8 years
     - Apartment renovation during turnovers
     - Painting and porch replacement

     Note: Capital expenditures that would increase the future service potential of the asset (e.g., qualify the property for an alternative use), are not included in the future cash flows.

   - Salvage (residual) value at the end of the life of the real estate assuming the real estate is sold. The residual value should be *net of selling costs such as commissions,* and should reflect the payoff of any remaining mortgages on the property at the expected time of sale.

     Salvage value formula:

Estimated selling price at the end of the asset's useful life	$xx
Less: estimated costs to sell the property, including commissions, advertising, etc.	(xx)
Less: Mortgage payoff at estimated time of sale	(xx)
Salvage value (net)	$xx

The cash flow formula is summarized like this.

	Annual net cash flow
Net operating income before interest, depreciation and amortization*	$xx
- Principal payments on mortgages secured by real estate	(xx)
- Estimated reserves for capital expenditures and replacements needed to maintain the property	(xx)
+ Salvage value at the end of the asset's life, assuming the real estate is sold (net of costs to sell)	xx
NET CASH FLOW	**$xx**

* Rental income less cash operating expenses, accrual basis.

3. The remaining useful life should be the remaining life in the hands of the entity.

   a. The remaining useful depreciable life is a strong indicator of the remaining life for purposes of computing cash flows.

   b. If an entity plans to sell the property within a certain period of time (e.g., next five years), the remaining useful life should not exceed the estimated remaining time that the entity plans to hold the property.

   c. The ability to obtain renewed or replacement financing should be a factor in determining the remaining useful life of the asset.

Step 3: Measure the Impairment

If there is an impairment determined in Step 2, the real estate impairment loss must be measured. If the real estate is rental property, the best way to determine fair value is to use a capitalization rate.

Example: Net operating income / Capitalization rate =Fair value of real estate

If the property is land, fair value should be determined based on the quoted market price or price for similar land.

Example: The following example illustrates the application of ASC 360 to real estate.

Facts: Company X is a real estate company that has 100 commercial and residential rental properties.

Property C is a residential rental property that was purchased 12 years ago at the height of the real estate market. Management believes that C might be impaired. The neighborhood in which the property is located has deteriorated significantly since the date of purchase, resulting in declining rents and higher-than-usual vacancies. Management believes that in the future, the property may be located in a valuable location where a downtown redevelopment may occur. As a result, management has decided to hold onto the property indefinitely.

When the property was purchased, X obtained a 20-year commercial mortgage. For GAAP purposes, management has selected 39 years as the useful life, which is consistent with management's intent to use the property and, coincidentally, the same life as the tax life. Specific details follow:

Asset Group:	
Carrying amount: Land Building Fixtures and appliances Total	 $500,000 7,200,000 100,000 $7,800,000
Mortgage on property	(1,000,000)
Net carrying amount of asset group	$6,800,000
Remaining useful life (based on depreciation schedule)	27 years*
Fair value of asset group	2,500,000**

* Original life 39 years less 12 years depreciation = 27 years remaining.
** NOI $350,000/ 10% capitalization rate = $3,500,000 less mortgage balance $(1,000,000) = $2,500,000.

ESTIMATED FUTURE CASH FLOWS						
Year	Operating cash flows*	Capital expenditures**	NOI	Principal payments	Salvage value of assets***	Total undiscounted cash flows
1	$400,000	($50,000)	$350,000	(50,000)	$0	$300,000
2	250,000	(50,000)	200,000	(50,000)	0	150,000
3	250,000	(50,000)	200,000	(50,000)	0	150,000
4	250,000	(50,000)	200,000	(50,000)	0	150,000
5	250,000	(50,000)	200,000	(50,000)	0	150,000
6	250,000	(50,000)	200,000	(50,000)	0	150,000
7	250,000	(50,000)	200,000	(50,000)	0	150,000
8	250,000	(50,000)	200,000	(50,000)	0	150,000
9	250,000	(50,000)	200,000	(50,000)	0	150,000
10	250,000	(50,000)	200,000	(50,000)	0	150,000
11-15	1,250,000	(250,000)	1,000,000	(250,000)	0	750,000
16-20	1,250,000	(250,000)	1,000,000	(250,000)	0	750,000
21-25	1,000,000	(250,000)	750,000	0	0	750,000
26	200,000	(50,000)	150,000	0	0	150,000
27	200,000	(50,000)	150,000	0	1,500,000	1,650,000
	$6,550,000	**$(1,350,000)**	**$5,200,000**	**(1,000,000)**	**$1,500,000**	**$5,700,000**

Calculations:

* Rental income less operating expenses (real estate taxes, insurance, maintenance, utilities, management). Excludes depreciation, amortization and interest.

** Estimated capital expenditures to maintain the existing property such as roof replacement, windows, apartment renovation.

*** Estimated salvage at the end of the property's life: Year 27 NOI $150,000/10% capitalization rate = $1,500,000 estimated value in year 27.

Step 2: Test for impairment:

Estimated future cash flows	<	Carrying amount	***= IMPAIRMENT***
$5,700,000		$6,800,000	

Because the estimated future cash flows is less than the carrying amount of the property, there is an impairment, and Step 3 must be performed to measure the impairment loss.

Step 3: Measure the Impairment Loss

Carrying amount of the property	$6,800,000
Fair value (above)	-2,500,000
Impairment loss	$(4,300,000)

The loss should be allocated to the components of the long-lived assets (building, land and equipment) based on each asset's relative carrying amount as follows:

Carrying amount:	Carrying amount	% of total CV	Allocation of loss	Revised carrying amount
Land	$500,000	6.4	$(275,200)	$224,800
Building	7,200,000	92.3	(3,968,900)	3,231,100
Fixtures and appliances	100,000	1.3	(55,900)	44,100
Total	$7,800,000	100%	$(4,300,000)	$3,500,000

Entry for impairment loss

Impairment loss	4,300,000	
Land		275,200
Building		3,968,900
Fixtures and appliances		55,900

After the assets are written down, the revised carrying amount of the building and fixtures and appliances should be depreciated over the remaining useful life of the assets.

Observation: In computing net cash flows from real estate, the amount of principal payments is deducted in arriving at the net cash flow amount. At first glance, one might think that an accelerated mortgage amortization schedule could result in negative cash flows and, thus, an impairment of real estate. However, this is not the case. Although it is true that an accelerated amortization schedule reduces net cash flows per year, the offset occurs in the year in which the asset is assumed sold. The net salvage value of the real estate is computed after deducting the mortgage balance and costs to sell. Therefore, an accelerated principal schedule results in reductions in cash flows in earlier years, but a smaller or no reduction in the salvage value in later years when the mortgage balance is lower.

Dealing with the impairment of land

An impairment loss is more likely to be incurred for land as compared with rental property. The reason is primarily due to the fact that land's only cash flow may be from the ultimate disposition of the property, resulting in the carrying amount not being recovered.

Example: Assume Company X holds land for investment. The only cash flows related to the property are carrying costs (real estate taxes and insurance) and proceeds from the ultimate sale of the property. The Company's plan is to hold the property for another five years and then sell it.

Management is concerned that the asset might be impaired given the deterioration of the surrounding area coupled with the economic downturn. The property was originally purchased for $5,000,000 and presently has a fair value of $3,000,000 as indicated in the table below:

Carrying amount	$5,000,000
Fair value	3,000,000*

* Based on quoted market value per acre for similar properties in the area.

Management tentatively plans to hold the property for another five years. It believes that, at worst, the fair value of the property will not deteriorate any further and could be sold for $3,000,000 at the end of five years.

Estimated future cash flows over the next five years are as follows:

ESTIMATED FUTURE CASH FLOWS					
Year	Operating cash flows*	Capital expenditures	NOI	Salvage value of assets	Total undiscounted cash flows
1	$(50,000)	$0	$(50,000)	$0	$(50,000)
2	(55,000)	0	(55,000)	0	(55,000)
3	(60,000)	0	(60,000)	0	(60,000)
4	(65,000)	0	(65,000)	0	(65,000)
5	(75,000)	0	(70,000)	3,000,000	2,930,000)
	$(300,000)	**0**	**$(300,000)**	**$ 0**	**$2,700,000**

* Costs to maintain the property including real estate taxes insurance and maintenance.

Step 2: Test for impairment:

Estimated future cash flows	<	Carrying amount	***= IMPAIRMENT***
$2,700,000		$5,000,000	

Step 3: Measure the Impairment Loss:

Carrying amount	$5,000,000
Fair value (above)	-3,000,000
Impairment loss	$(2,000,000)

Entry for impairment loss

Impairment loss	2,000,000	
Land		2,000,000

Observation: The above example illustrates how easy it is to record an impairment loss on land versus rental property. Because rental property generates net cash flow and may have an extended useful life of twenty to thirty years, rarely will a rental property fail the impairment test. That is, future estimated cash flows will most likely exceed the carrying amount, notwithstanding unusual facts and circumstances. The result is that Step 2 does not result in an impairment and, therefore, Step 3 is not performed to measure an impairment.

With respect to non-leased land, the result may be different. It is more likely that land that has declined in value may be written down to recognize an impairment loss. Because non-leased land does not generate annual cash flows exclusive of the net proceeds from the ultimate sale of the land, it is possible that the future cash flows from ultimate use of the land will be less than the carrying amount, resulting in an impairment in Step 2 of the test. Then, Step 3 is performed to measure the impairment in which the carrying amount is written down to the fair value of the land.

7. Interrelation of Impairment Test for Long-Lived Assets with Goodwill Test

If there is a test performed for impairment of long-lived assets (other than goodwill), a similar test must be performed for the impairment of goodwill under the requirements of ASC 350 (formerly FASB No. 142).

The interrelation of impairment tests of long-lived assets under ASC 360 (formerly FASB No. 144) and those under ASC 350 for goodwill, and intangible assets with indefinite lives can be rather difficult to understand and apply for several reasons.

a. The test for impairment of long-lived assets under ASC 360 may be done for a different asset grouping as compared with the grouping for testing goodwill under ASC 350.

    - ASC 360 tests long-lived assets (other than goodwill) for impairment based on the grouping of assets at the <u>*lowest level at which they generate cash flows*</u> independent of other cash flows.

    - ASC 350 tests goodwill for impairment at the <u>*reporting unit level*</u>.

b. There is an ordering for testing long-lived assets (other than goodwill) and goodwill that must be followed. Essentially, long-lived assets (other than goodwill) are tested first for impairment, followed by the goodwill test.

In performing a test of impairment of long-lived assets and goodwill of an entity, ASC 350 and ASC 360 indicate an ordering that must be followed:

1. Assets and liabilities are segregated into two groups:

    <u>Asset Group</u>- used to test impairment of long-lived assets
    <u>Reporting Unit</u>- used to test goodwill for impairment

2. First, the carrying amounts of any assets or liabilities that are part of the asset group or reporting unit that are not long-lived assets tested for impairment should be adjusted to their carrying amounts in accordance with appropriate GAAP.

Examples:

- Inventories should be adjusted to lower of cost or market value
- Accounts receivable should be adjusted to net realizable value (net of allowance)
- Liabilities such as accounts payable, long-term debt and retirement obligations should be adjusted to their carrying amounts required by GAAP.

3. Intangible assets with indefinite lives located within the asset group or reporting unit are adjusted to the *lower of fair value or carrying amount*.

4. Long-lived assets within the asset group are tested for impairment. Any loss, if applicable, reduces the carrying amount of those long-lived assets within the asset group on a pro rata basis.

5. Goodwill is tested for impairment at the reporting unit level, which is likely to be a higher level than the asset group.

Example:

Joe's Golf Ball Manufacturing Corp. has three manufacturing plants, each of which generates income and cash flow independent of the other. All three plants manufacture golf balls that are sold to various retailers and wholesalers.

The golf ball business has been declining in the past few years due to increased foreign and domestic competition. Joe (the sole shareholder) is concerned that there is an impairment of assets and goodwill.

Specific data related to this business follows as of December 31, 20X1:

	Plant 1	Plant 2	Plant 3	Consolidated
Cash	$100	$500	$50	$650
Accounts receivable (adjusted to NRV)	200	100	300	600
Inventories (adjusted to LCM)	300	400	500	1,200
Total current assets	600	1,000	850	2,450
Plant, equipment and fixtures	2,000	3,000	4,000	9,000
Intangible assets with finite lives	500	700	600	1,800
Intangibles with indefinite lives	1,000	1,200	1,400	3,600
Liabilities	(400)	(900)	(1,000)	(2,300)
NET ASSETS- ASSET GROUP	***$3,700***	***$5,000***	***$5,850***	***14,550***
Goodwill				8,000
NET ASSETS- REPORTING UNIT				**$22,550**

Long-lived assets (other than goodwill) will be tested for impairment on a per-plant basis since that is the lowest level at which cash flows are generated independent of other cash flows.

For purposes of testing goodwill, the reporting unit is deemed to be the consolidated entity, which includes all three plants.

Conclusion: In conducting the tests and measurements of impairment of both long-lived assets and goodwill under ASC 350 and ASC 360, an ordering must be followed.

Step 1: All assets and liabilities other than long-lived assets and goodwill that are included in the asset group should be adjusted to their related values based on other GAAP requirements. In this case, accounts receivable should be adjusted to net realizable value (carrying value less allowance), inventories should be adjusted to the lower of cost or market value, and liabilities should be adjusted to the settlement amounts. In the above table, these items have already been properly adjusted in accordance with GAAP.

Step 2: Adjust intangibles with indefinite lives:

ASC 350 requires that intangible assets with indefinite lives be tested annually for impairment. The test is a one-step test that bypasses the undiscounted cash flows test required by ASC 360.

Formula- Impairment of Intangible with an Indefinite Life:	
Fair value of the intangible asset	$xx
Carrying amount of the intangible asset	xx
If negative = impairment	***($x)***

Assume the following data related to the intangible asset with an indefinite life:

	Plant 1	Plant 2	Plant 3
Fair value of the intangible asset	$800	$1,500	$1,100
Carrying amount of the intangible asset	1,000	1,200	1,400
Lower of fair value or carrying amount	800	1,200	1,100
Impairment loss	***$(200)***	***$0***	***$(300)***

Entries- To Write Down Intangible Assets with Indefinite Lives

Plant 1:		
Impairment loss- intangible asset- indefinite lives	200	
Intangible asset- indefinite life		200
Plant 2:		
No entry		
Plant 3:		
Impairment loss- intangible asset- indefinite lives	300	
Intangible asset- indefinite life		300

Once the intangible assets with indefinite lives have been adjusted, the revised carrying amounts are included in the asset group for purposes of performing the test of impairment of long-lived assets (other than goodwill).

Step 3: Test of Impairment of Long-lived assets (other than goodwill)

After the intangible assets with indefinite lives are adjusted, the next step is to test the impairment of the remainder long-lived assets within the asset groups.

The table presented above is replicated below. However, notice that the intangible assets with indefinite lives are now adjusted to reflect the writedowns of those assets to the lower of fair value and carrying amount.

	Plant 1	Plant 2	Plant 3	Consolidated
Cash	$100	$500	$50	$650
Accounts receivable (adjusted to NRV)	200	100	300	600
Inventories (adjusted to LCM)	300	400	500	1,200
Total current assets	600	1,000	850	2,450
Plant, equipment and fixtures	2,000	3,000	4,000	9,000
Intangible assets with finite lives	500	700	600	1,800
Intangibles with indefinite lives- adjusted	***800***	***1,200***	***1,100***	***2,100***
Liabilities	(400)	(900)	(1,000)	(2,300)
CARRYING AMOUNT OF ASSET GROUP	***$3,500***	***$5,000***	***$5,550***	***14,050***
Goodwill				8,000
CARRYING AMOUNT OF REPORTING UNIT				**22,050**

The next step is to test and measure the impairment of the other long-lived assets in the asset groups, consisting of plant, equipment and fixtures, and intangible assets with finite lives.

Assume the following additional data:

ASSET GROUP	Plant 1	Plant 2	Plant 3
TEST FOR IMPAIRMENT:			
Estimated future cash flows (given)	3,400	5,500	3,700
Carrying amount (from table above)	3,500	5,000	5,550
Test result	Future cash flows are less than the carrying amount ***IMPAIRMENT***	Future cash flows exceed the carrying amount ***NO IMPAIRMENT***	Future cash flows are less than the carrying amount ***IMPAIRMENT***
MEASURE THE IMPAIRMENT:			
Fair value of the asset group (given)	2,500	Not applicable	5,100
Carrying amount (from table above)	3,500	Not applicable	5,550
Impairment loss	***$(1,000)***	***Not applicable***	***$(450)***

The loss is allocated to long-lived assets in the group based on relative carrying amount immediately before the impairment loss is recorded. Intangible assets with indefinite lives are excluded from the allocation since those assets have already been adjusted to fair value in the previous test.

Plant 1:	Carrying amount	%	***Allocation of loss***	Revised carrying amount
Plant, equipment and fixtures	$2,000	80%	***$(800)***	$1,200
Intangibles with finite lives	500	20%	***(200)***	300
	2,500	100%	***(1,000)***	1,500
Plant 3:				
Plant, equipment and fixtures	4,000	87%	***(390)***	3,610
Intangibles with finite lives	600	13%	***(60)***	540
	4,600	100%	***(450)***	4,150

Entries- To write down intangible assets (other than goodwill) in the asset group:

Plant 1:

Impairment loss- intangible asset- indefinite life	1,000	
Plant, equipment and equipment- Plant 1		800
Intangible asset- indefinite life- Plant 1		200

Plant 2:

No entry- no impairment

Plant 3:

Impairment loss- intangible asset- indefinite life	450	
Plant, equipment and fixtures- Plant 3		390
Intangible asset- indefinite life- Plant 3		60

Step 4: Test and Measurement of Goodwill

The final step in the impairment process is to test and measure a goodwill impairment loss, if applicable. Unlike the test of long-lived assets other than goodwill which was tested at the asset group, the test and measurement of goodwill for impairment is done at the reporting unit level, which is usually a level that is higher than the asset group level.

Prior to conducting the test, the long-lived assets are adjusted to the new carrying amounts based on Step 3 above. The revised table now looks like this. Items adjusted are reflected in bold italic.

	Plant 1	Plant 2	Plant 3	Consol. (Reporting Unit)	Fair value of individual assets/ liabilities
Cash	$100	$500	50	$650	$650
Accounts receivable (adjusted to NRV)	200	100	300	600	600
Inventories (adjusted to LCM)	300	400	500	1,200	1,200
Total current assets	600	1,000	850	2,450	2,450
Plant, equipment and fixtures- adjusted	***1,200***	***3,000***	***3,610***	***7,810***	7,810
Intangible assets with finite lives- adjusted	***300***	***700***	***540***	***1,540***	1,540
Intangibles with indefinite lives- adjusted	***800***	***1,200***	***1,100***	***3,100***	3,400
Liabilities	(400)	(900)	(1,000)	(2,300)	(2,300)
CARRYING AMOUNT OF ASSET GROUP	***2,500***	***5,000***	***5,100***	***12,600***	
Fair value of individual assets/liabilities- exclusive of goodwill					**12,900**
Goodwill				8,000	
CARRYING AMOUNT OF REPORTING UNIT				**20,600**	

The steps for testing and measuring goodwill are as follows:

TEST FOR IMPAIRMENT:	
Fair value of the reporting unit (given)	$18,000
Carrying amount of the reporting unit (previous table)	20,600
Fair value is less than carrying amount	***IMPAIRMENT***
MEASURE THE IMPAIRMENT:	
Fair value of reporting unit (given)	$18,000
Fair value of the individual assets and liabilities of the reporting unit (excluding goodwill) (previous table)	12,900
Implied goodwill value	$5,100
Implied goodwill value	$5,100
Goodwill carrying amount	8,000
Impairment loss-goodwill	***$(2,900)***

Entries- To write down goodwill at the reporting unit (consolidated) level:

Impairment loss- goodwill	2,900	
Goodwill		2,900

The first step in testing goodwill for impairment is to compare the fair value of the reporting unit as a whole to the carrying amount of the assets and liabilities of the reporting unit. In this example, the fair value of the reporting unit (given) of $18,000 is compared with the carrying amount of the unit which is $20,600. Because the fair value is less than the carrying amount, there is a deemed impairment which must be measured. In measuring the impairment, the fair value of the reporting unit as a whole is compared with the total of the fair value of the individual assets and liabilities (exclusive of goodwill) of the reporting unit. The difference of $5,100 is deemed to be the implied goodwill value. The goodwill carrying amount of $8,000 is written down to the $5,100 implied value, resulting in an impairment loss of $(2,900).

After all entries have been made, the consolidated statement of income would look like this:

	Consolidated (Reporting Unit)
Cash	$650
Accounts receivable (adjusted to NRV)	600
Inventories (adjusted to LCM)	1,200
Total current assets	2,450
Plant, equipment and fixtures- adjusted	7,810
Intangible assets with finite lives- adjusted	1,540
Intangibles with indefinite lives- adjusted	3,100
Liabilities	(2,300)
Fair value of individual assets/liabilities Exclusive of goodwill	12,600
Goodwill	5,100
CARRYING AMOUNT OF REPORTING UNIT	**$17,700**

A summary of the activity for the impairment losses looks like this:

Reporting unit (consolidated entities)	
Beginning carrying amount	$22,550
Writedown of intangibles with indefinite lives	(500)
Writedown of long-lived assets	(1,450)
Writedown of goodwill	(2,900)
Ending carrying amount	$17,700

Joe's Golf Ball Manufacturing Corp. Consolidated Statement of Income For the Year Ended December 31, 20X1	
Net sales	$xx
Cost of sales	xx
Gross profit on sales	xx
Selling, general and administrative expenses	xx
Loss on impairment of long-lived assets	***(a)(1,950)***
Loss on impairment of goodwill	***(2,900)***
Income from operations	xx
Other income (expense)	xx
Income from continuing operations before income	xx
Income tax expense	xx
Income before discontinued operations	xx
Discontinued operations (net of $xx tax benefit)	xx
Extraordinary items (net of $xx tax benefit)	xx
Cumulative effect of an accounting change (net of $xx tax benefit)	xx
Net income	$xx

(a) Calculated as follows:	
Loss on writedown of intangibles plant 1: $(200); plant 3: $(300) =	$(500)
Loss on writedown of intangible assets: plant 1: $(1,000) plant 3: $(450) =	(1,450)
Total	$(1,950)

ASC 350 and ASC 360 require that the impairment losses on long-lived assets and intangibles with indefinite lives be presented as part of income from continuing operations. However, there is no requirement to show the loss on the face of the statement of income. Conversely, ASC 350 specifically requires that an impairment loss on goodwill must be presented on the face of the statement of income as a separate item in income from continuing operations.

Example 2: Interrelation of Impairment Rules Tested at the Legal Entity Level

Example 1 illustrates a scenario where a company's asset group for testing impairment of long-lived assets differs from the reporting unit used for testing goodwill impairment.

For many or most non-public entities, the *entity level* is likely to be both the asset group and reporting unit for testing all impairments. The result is that the tests are simplified by performing all tests at the same entity level. In such a case, the rules for goodwill change.

ASC 360 states that goodwill shall *be included in an asset group* to be tested for impairment if the asset group is or includes a reporting unit. A legal entity is certainly a reporting unit and must include goodwill when the test for impairment of long-lived assets is made.

Assume same facts as Example 1 except that the tests for impairment of long-lived assets and goodwill are tested at the same time (assume December 31) at the entity level, which is deemed to be both the asset grouping for ASC 360 and the reporting unit level for ASC 350.

Assume further that intangible assets with indefinite lives have already been adjusted to fair value.

	Entity-level carrying amount	%	Allocation of loss	Revised carrying amount
Cash	$650			$650
Accounts receivable (adjusted to NRV)	600			600
Inventories (adjusted to LCM)	1,200			1,200
Total current assets	2,450			2,450
Plant, equipment and fixtures-adjusted	9,000	83%	$(3,350)	5,650
Intangible assets with finite lives-adjusted	1,800	17%	(700)	1,100
Intangibles with indefinite lives-adjusted	3,100			3,100
Liabilities	(2,300)			(2,300)
Subtotal	14,050			10,000
Goodwill	***8,000***			***8,000***
CARRYING AMOUNT OF ASSET GROUP	***$22,050***	***100%***	***$(4,050)***	***$18,000***

TEST FOR IMPAIRMENT:	
Estimated future cash flows (given)	$16,000
Carrying amount (from table above)	22,050
Test result- Future cash flows are less than the carrying amount	***IMPAIRMENT***
MEASURE THE IMPAIRMENT:	
Fair value of assets/liabilities (given)	$18,000
Carrying amount (from table above)	22,050
Impairment loss	***$(4,050)***

The test for impairment of long-lived assets (other than goodwill) is being done at the entity level, which qualifies as a reporting unit. ASC 360 states that where the asset group is a reporting unit in testing for an impairment of long-lived assets, goodwill should be included as part of the asset group tested. In the above example, the $8,000 goodwill is included in the carrying amount of the assets tested. The resulting impairment loss of $(4,050) is allocated to the long-lived assets (plant, equipment and fixtures, and intangibles with finite lives). There is no allocation made to intangible assets with indefinite lives since they have already been adjusted to fair value previously. There is also no allocation to goodwill since it is tested separately in the next step.

Final step: Test of goodwill for impairment

Once the long-lived assets have been tested and measured for impairment, the final step is to test and measure a goodwill impairment, if any. The carrying amount of the net assets of the entity have been adjusted to reflect the impairment loss on long-lived assets, as noted in the following schedule in bold italic.

	Revised carrying amount	Fair value of individual assets/liabilities
Cash	$650	$650
Accounts receivable (adjusted to NRV)	600	600
Inventories (adjusted to LCM)	1,200	1,200
Total current assets	2,450	2,450
Plant, equipment and fixtures- adjusted	5,650	5,650
Intangible assets with finite lives- adjusted	1,100	1,100
Intangibles with indefinite lives- adjusted	3,100	3,100
Liabilities	(2,300)	(2,300)
Subtotal	***10,000***	***10,000***
Goodwill	***8,000***	
CARRYING AMOUNT OF ENTITY	***$18,000***	

TEST FOR IMPAIRMENT:	
Fair value of the reporting unit (given)	$18,000
Carrying amount of the reporting unit (table above)	18,000
Test result- Fair value is less than carrying amount	***NO IMPAIRMENT***
MEASURE THE IMPAIRMENT:	
No measurement required	

Because the fair value of the reporting unit is the same as the carrying amount of the unit, $18,000, there is no impairment of goodwill.

The above example illustrates a key point within ASC 360. If a test for impairment of long-lived assets and goodwill is done at the same entity level and at the same date, there is generally no writedown of goodwill. The reason is due to the fact that all assets (exclusive of goodwill) are adjusted to fair value in the earlier stages, resulting in the fair value of the entity being the same as the carrying amount. In the final step when the test for impairment of goodwill is performed, the fair value and carrying amount of the entity are the same. Thus, there is no impairment of goodwill and no measurement of an impairment loss.

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. Intangible assets (other than goodwill) with indefinite lives should be tested for impairment:

   a) annually
   b) only when events or circumstances indicate there may be an impairment
   c) if cash flows exceed fair value
   d) quarterly within an annual period

2. Company X is testing equipment for impairment. The estimated future cash flows are less than the carrying amount of the asset. Which of the following is correct:

   a) there is no impairment and no further action is required
   b) there is an impairment and further action is required
   c) there is no impairment but further action is still required
   d) there is an impairment but no measurement is required

3. In performing an impairment test of a long-lived tangible asset, how should assets be grouped:

   a) at the lowest level for which joint cash flows are generated
   b) at the highest level at which joint cash flows are generated
   c) with all cash flows of similar assets and liabilities
   d) not grouped but tested for each individual asset only

4. Under GAAP, goodwill is included in an asset group that is tested for impairment if the asset group:

   a) includes a reporting unit
   b) includes part of a reporting unit
   c) excludes part of a reporting unit
   d) excludes a reporting unit

5. In performing an impairment computation of tangible assets, writedowns or adjustments of assets and liabilities within an asset group are made in a particular order. Which of the following is the *first adjustment* made for writedowns or adjustments to assets and liabilities within an asset group:

   a) impairment losses made to tangible assets and intangible assets with finite lives covered by ASC 360
   b) impairment losses for goodwill and intangible assets with indefinite lives covered by ASC 350
   c) assets and liabilities, exclusive of goodwill, that are not covered by ASC 360 that are included in the asset group
   d) tangible assets only

6. In estimating cash flows for the impairment test of long-lived tangible assets, which of the following statements is correct:

   a) estimated cash flows are discounted at the prevailing interest rate
   b) interest charges are included in the cash flows computation
   c) estimated cash flows include a salvage value
   d) estimated cash flows are based on the industry assumptions

7. In estimating cash flows for the impairment test of long-lived tangible assets, which of the following statements is correct. Cash flows used are made for the remaining useful life of the asset or asset group to the entity. The remaining useful life is based on:

   a) the average life of the assets in the group
   b) the shortest remaining life of any asset within the group
   c) the longest remaining life of any asset within the group
   d) the primary asset

8. Which of the following is an example of an event and change in circumstances that suggests that real estate might be impaired:

   a) significant appreciation in the market price of real estate
   b) stable rental rates and vacancies
   c) steady cash flow
   d) known environmental contamination

9. In testing impairment of real estate, salvage value should:

   a) exclude the impact of selling costs
   b) not reflect the payoff of any remaining mortgages on the property
   c) be based on the assumption that the real estate is not sold
   d) be net of selling costs

10. In performing an impairment test for long-lived assets and goodwill, which of the following adjustments would be done to assets and liabilities that are part of the asset group or reporting unit that are not long-lived assets:

   a) inventories are adjusted to cost
   b) accounts receivable are adjusted to lower of cost or market value
   c) liabilities are adjusted to carrying fair value
   d) patents are adjusted to lower of cost or market value

SUGGESTED SOLUTIONS

1. **A: Correct.** Indefinite lived intangible assets are tested annually.

   B: Incorrect. Intangible assets with finite lives are tested only when events or circumstances indicate there may be an impairment.

   C: Incorrect. Cash flows are not a factor in the initial assessment as to whether a test is required.

   D: Incorrect. There is no requirement that such assets be tested for impairment quarterly.

   (See page 4-53 of the course material.)

2. A: Incorrect. If the estimated future cash flows are less than the carrying amount of the asset, there is no impairment.

   B: Correct. Because the cash flow is less than the carrying amount, there is an impairment. Therefore, the impairment must be measured.

   C: Incorrect. There is an impairment.

   D: Incorrect. There is an impairment and, therefore, measurement is required.

   (See page 4-54 of the course material.)

3. **A: Correct.** Assets are grouped at the lowest level for which joint cash flows are generated that are largely independent of other cash flows.

   B: Incorrect. They are grouped at the lowest, not the highest, level at which joint cash flows are generated.

   C: Incorrect. Assets are not grouped based on similar assets and liabilities.

   D: Incorrect. In general, testing by individual asset is not the approach used by GAAP.

   (See page 4-57 of the course material.)

4. **A: Correct.** Goodwill is included if the asset group is or includes a reporting unit.

   B: Incorrect. It must include all of the reporting unit and not part of it.

   C: Incorrect. It must include, not exclude, a reporting unit and it cannot be part of a unit.

   D: Incorrect. It must include, and not exclude a reporting unit.

   (See page 4-58 of the course material.)

5. A: Incorrect. Impairment losses made to tangible assets and intangible assets with finite lives under ASC 360 is the second adjustment in the order, not the first.

   B: Incorrect. Impairment losses for goodwill and intangible assets with indefinite lives under ASC 350 is the last adjustment, not the first.

   C: Correct. The first adjustment is to the carrying amounts of assets and liabilities (exclusive of goodwill) not covered by ASC 360.

   D: Incorrect. An adjustment to tangible assets, by itself, is not the first adjustment. Impairment losses made by ASC 360, which includes tangible assets and intangible assets with finite lives, are the first adjustment.

   (See page 4-58 of the course material.)

6. A: Incorrect. Estimated cash flows are undiscounted.

   B: Incorrect. Interest charges are excluded from cash flows.

   C: Correct. Estimated cash flows include a salvage value based on the assumption that the long-lived asset (asset group) is sold at the end of their useful lives.

   D: Incorrect. Estimated cash flows are based on the entity's assumptions and not those of the industry.

   (See page 4-67 of the course material.)

7. A: Incorrect. The average life of the assets in the group is not used.

   B: Incorrect. The shortest remaining life of any asset within the group is not used.

   C: Incorrect. The longest remaining life of any asset within the group is not used.

   D: Correct. The remaining useful life of the primary asset is used to compute cash flows.

   (See page 4-68 of the course material.)

8. A: Incorrect. One example is a significant decline in the market price, and not significant appreciation in the market price of real estate.

   B: Incorrect. A continued decline in rental rates and vacancies, and not stable rental rates and vacancies, is an example.

   C: Incorrect. A deficiency in cash flow illustrated by a failure to meet debt service on a regular basis is an example that real estate might be impaired. Having steady cash flow is not an example.

   D: Correct. A known environmental contamination is one example of an event and change in circumstances that suggests that real estate might be impaired.

   (See page 4-80 of the course material.)

9. A: Incorrect. Salvage value should be net of selling costs making the statement incorrect.

   B: Incorrect. Salvage value should reflect the payoff of any remaining mortgages on the property.

   C: Incorrect. Salvage value should be based on the assumption that the real estate is sold at the end of the real estate life.

   D: Correct. Salvage value should be net of selling costs such as commissions.

   (See page 4-81 of the course material.)

10. A: Incorrect. Inventories are adjusted to lower of cost or market value, and not to cost.

    B: Incorrect. Accounts receivable are adjusted to net realizable value, and not to lower of cost or market value.

    C: Correct. Liabilities are adjusted to carrying value under GAAP.

    D: Incorrect. A patent is a long-lived asset. The question deals with assets that are not part of long-lived assets.

    (See pages 4-87 to 4-88 of the course material.)

Category 4: Intangible Assets with Finite Useful Lives:

An intangible asset with a ***finite useful life*** should be amortized over its useful life unless that life is determined to be indefinite.

An intangible asset with a *finite useful life* is defined as one that *does not* have an "indefinite life."

Examples of intangible assets with finite useful lives follow:

- Customer list
- Patent
- Copyright
- Licenses with defined term

Intangible assets with finite lives that are held for use (and not intended for sale or disposal) should be tested for impairment under FASB No. 144 (ASC 360) as follows:

1. Steps to Apply the Impairment Test- Intangible Assets with Finite Useful Lives

a. Like long-lived tangible assets (equipment and real estate), there are essentially *three steps* to apply the impairment test to intangible assets with finite lives.

Step 1: Perform a Review of Events and Changes in Circumstances
Step 2: Test for Impairment
Step 3: Measure the Impairment Loss

Step 1: Perform a Review of Events and Changes in Circumstances:

An impairment test is only performed on intangible assets with finite lives if there is an indication that an impairment might exist. An intangible asset with a finite life is tested whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. In Step 1, the entity reviews all of the events and changes in circumstances to determine if a potential impairment exists- that is, the carrying amount of the asset(s) may not be recoverable.

Examples of events and changes in circumstances that might warrant a test include:

- A significant decrease in the market price of a long-lived asset (asset group)

- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

- A current expectation that, more likely than not (more than a 50 percent chance) a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

a. The test for impairment under ASC 360 (formerly FASB No. 144) consists of two steps:

Step 2: Test for Impairment:

The carrying amount of the intangible asset is compared with the estimated future (undiscounted and without interest charges) net cash flows to be generated from use of this asset (including its ultimate disposition). If the net cash flows over the remaining useful life are less than the carrying value of the intangible asset, there is an impairment, and Step 2 is performed.

Step 3: Measure the Impairment:

If an asset is impaired under Step 2, the loss is measured:

Fair value of the intangible asset
<u>Less: Carrying value of the intangible asset</u>
Equals: Impairment loss

Note: The FASB decided to apply the three-step ASC 360 test only to intangible assets *<u>with finite lives</u>*, and *<u>not to those with indefinite lives</u>*. Intangibles with finite lives can compute estimated future cash flows over their remaining finite useful lives. The same is not true for intangibles with indefinite lives. Because their lives are indefinite, any cash flows computed in Step 2 would also be indefinite. The result is that there would never be an impairment calculated under Step 2 because under Step 2, future cash flows would always exceed the carrying value of the intangible asset.

Once an impairment loss is recorded, can it be reversed back into income in future years?

No. Once an asset (tangible or intangible) is written down and an impairment loss is recorded, a company is not permitted to write the asset back up and reverse to loss. Instead, when the asset is written down, the lower amount becomes that asset's new cost basis that cannot be written back up.

III. Deferred Income Taxes

When there is an impairment of goodwill, intangible asset other than goodwill, or a long-lived tangible asset, the result is that the asset is written down for book purposes, but not for tax purposes. The impairment loss represents a temporary difference that leads to the recording of a deferred income tax asset.

Assume that on December 31, 20X1, there is an impairment writedown of goodwill in the amount of $100,000 for book purposes.

The deferred tax asset would be computed as follows:

At December 31, 20X1:

Goodwill book basis	$450,000
20X1 impairment writedown	(100,000)
Revised book basis	350,000
Tax basis	150,000
Revised temporary difference	(200,000)
Temporary difference before writedown	(300,000)
Reversal of temporary difference	100,000
Tax rate	40%
DIT provision adjustment- 20X1	$40,000

Entry: 20X1

Impairment loss	100,000	
Goodwill		100,000
Deferred income tax asset	40,000	
Income tax expense- deferred		40,000

The deferred tax asset reverses through future depreciation or through the ultimate sale of the asset.

Are deferred tax assets and liabilities included as recognized assets or liabilities in testing for goodwill of a reporting unit?

Yes. All assets and liabilities assigned to a unit are included for purposes of the test. Assume that a test for impairment is being done for a reporting unit. The deferred tax assets are included in the value of the recognized assets of the unit such as in the case of the example below.

Fair value of recognized assets:

	Reporting Unit A
Assets excluding goodwill	$400
Total assets	900
Liabilities:	
Accounts payable	(100)
Accrued expenses	(150)
Deferred income taxes	***(200)***
Net assets	$850

Assume that the fair value of Unit A is $1,000, the implied value of goodwill would be as follows:

Fair value of Unit A	$1,000
Fair value of recognized assets and liabilities (excluding goodwill)*	850
Implied goodwill	150
Carrying value of goodwill	80
Impairment loss	70

* Includes deferred tax liability.

In the above example, the deferred tax liability of $200 is included in the net assets of Unit A in computing the impairment loss on goodwill.

IV. Financial Statement Display

ASC 350 and ASC 360 provide the following rules for the financial statement display of all impairment losses.

a. All impairment losses should be presented as part of *income from continuing operations* or a similar caption:

- Goodwill impairment losses should be aggregated and presented as a separate line item.
- Goodwill impairment losses associated with a discontinued operation should be included (on a net-of-tax basis) within the results of discontinued operations.
- Impairment losses related to intangible assets with an indefinite life should be presented on the income statement where deemed appropriate.
- The impairment loss recognized for a long-lived asset (equipment, real estate and intangible assets with finite lives) included in income from continuing operations also includes those assets to be held or used.

Note: There is no requirement to present the impairment loss related to a long-lived asset as a separate line item on the income statement. The loss can be included as part of an income statement caption. Example: An impairment loss is included as part of "Other income (loss)" on the income statement.

For a not-for-profit organization, the loss is presented in income from continuing operations in the statement of activities.

Illustration of Financial Statement Presentation:

Net sales	$xx
Cost of sales	xx
Gross profit on sales	xx
Selling, general and administrative expenses	xx
Impairment losses on long-lived assets	***xx***
Goodwill impairment losses	***xx***
Income from operations	xx
Other income (expense)	xx
Income before income taxes	xx
Income tax expense	xx
Net income	$xx

How should impairment losses be presented in the statement of cash flows?

Response: An impairment loss related to goodwill or intangible assets with indefinite lives is a non-cash item that should be shown as an adjustment (add back) in the operating section of the statement of cash flows.

Example: Assume an impairment loss of $100,000 on goodwill and $50,000 impairment loss on equipment writedowns.

Net income	$xx
Adjustments to reconcile net income to cash from operating activities:	
Depreciation and amortization	xx
Deferred income taxes	xx
Goodwill impairment loss	***100,000***
Impairment losses on long-lived assets	***50,000***
Increase in accounts receivable	xx
Decrease in inventories	xx
Increase in accounts payable	xx
Increase in accrued expenses	xx
Net cash from operating activities	$xx

V. Disclosures

ASC 350 and ASC 360 require the following disclosures.

a. Disclosures for impairment losses involving goodwill and intangible assets with indefinite lives:

1) Goodwill: The aggregate amount of impairment losses recognized.

2) Intangible assets (other than goodwill) with indefinite lives: For each impairment loss recognized related to an intangible asset, the following information shall be disclosed in the notes that include the period in which the loss is recognized:

- A description of the impairment intangible asset and the facts and circumstances leading to the impairment.

- The amount of the impairment loss and the method for determining the fair value.

- The caption in the income statement or the statement of activities in which the impairment loss is aggregated.

- If applicable, the segment in which the impaired intangible asset is reported.

3) Goodwill impairment losses: For each goodwill impairment loss recognized, the following shall be disclosed in the notes that include the period in which the impairment loss is recognized:

   - A description of the facts and circumstances leading to the impairment.

   - The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof).

   - If a recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons thereof and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

b. Disclosures for impairment losses involving long-lived tangible assets (equipment and real estate) and intangible assets with finite lives:

1) The following disclosures shall be made in the notes to the financial statements for the period in which an impairment loss is recognized:

   - A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment.

   - If not separately stated on the face of the income statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss.

   - The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique).

   - For publicly held companies, the segment in which the impaired asset (asset group) is reported under the segment reporting rules found in ASC 280 (formerly FASB No. 131).

Example 1: Footnote and Presentation:

Facts: At December 31, 20X2, Company A's financial statements look like this:

Company A
Balance Sheet
December 31, 20X2 ($000s)

Current assets:		Current liabilities	
Cash	$xx	Accounts payable	$xx
Accounts receivable	xx	Accrued expenses	xx
Inventory	xx	Current portion of debt	xx
Other current assets	xx	Other current liabilities	xx
Total current assets	xx	Total current liabilities	xx
Property, plant and equipment, net	xx	Long-term debt	xx
Goodwill	xx	Stockholder's equity	xx
Other intangibles assets, net	xx		
Total assets	$xx	Total liabilities and equity	$xx

Company A
Statement of Income
For the Year Ended December 31, 20X2

Sales	$xx
Cost of sales	xx
Gross profit on sales	xx
Selling, general and administrative expenses	xx
Goodwill impairment losses	***(2,000)***
Impairment losses on long-lived assets	***(1,000)***
Income from operations	xx
Income tax expense	xx
Income before discontinued operations	xx
Discontinued operations (net of $xx tax benefit)	xx
Extraordinary items (net of $xx tax benefit)	xx
Cumulative effect of an accounting change (net of $xx tax benefit)	xx
Net income	$xx

The following disclosures are required by ASC 350 and ASC 360.

Disclosures in 20X2:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Impairment losses:

Impairment losses related to goodwill, intangible assets other than goodwill, and plant and equipment, if any, are recorded in the statement of income as part of income from operations.

NOTE X: IMPAIRMENT LOSSES:

In 20X2, the Company recorded an impairment loss in the amount of $2,000 related to the writedown of goodwill associated with its web broadcasting unit. The unit's primary revenue is derived from offering video and audio streaming services to businesses throughout the United States and European markets. The broadcasting unit has incurred three consecutive years of operating losses as a result of increased competition and a lag in anticipated cost efficiencies from new technologies. The fair value of the web broadcasting unit was estimated using the expected present value of future cash flows. ***The $2,000 impairment loss is presented as a separate line item in the statement of income as part of income from operations***.

In 20X2, the Company also recorded an impairment loss in the amount of $1,000 related to the writedown of certain manufacturing equipment, patents and other intangible assets used within its widget manufacturing segment**.** The impairment reflects the decline in the fair value below the carrying value of these assets as a result of continued operating losses within the segment. In calculating the loss, fair value was computed based on the present value of the net cash flows (using a 4 percent discount rate) estimated to be generated by the segment during the remaining useful lives of the impaired assets, with the loss allocated to the related assets on a pro-rata basis. ***The $1,000 impairment loss is presented as a separate line item in the statement of income as part of income from operations***.

<u>(Publicly held companies only)</u>
The impairment loss is included in the Widget Manufacturing segment which is more fully disclosed in Note 10.

VI. <u>Avoiding Impairment Losses under GAAP</u>

There are three ways to avoid having to record impairment losses under GAAP:

- Use OCBOA- income tax basis accrual financial statements
- Ignore ASC 350 (formerly FASB No. 142) based on the argument that its effect is not material
- Ignore ASC 350 and reference a GAAP departure exception in the report.

One way to avoid having to deal with ASC 350 issues is to use OCBOA- income tax basis financial statements. By doing so, goodwill and intangibles are amortized over 15 years under Section 197 of the Internal Revenue Code, thereby avoiding the test of impairment altogether. If OCBOA financial statements are used, those GAAP disclosures that are applicable to OCBOA financial statements must still be made. Interpretation 14 of SAS No. 62 requires that if OCBOA financial statements are issued, all relevant disclosure that are similar to those required by GAAP must be made.

A second way to avoid ASC 350 is not to implement it at all based on the argument that avoidance has an immaterial impact on the financial statements. There are numerous small businesses that have an immaterial, even de minimis amount of goodwill and intangible assets on their balance sheets. Are such companies required to implement ASC 350 when the result would not be material? The author believes that if a company has an immaterial amount of goodwill or intangible assets with indefinite lives on its balance sheet that it has been amortizing, the company could continue to amortize these assets despite the fact that it violates ASC 350. This argument is supported by the fact that if the company continues to amortize goodwill and intangibles with indefinite lives, the result is not material. That is, the small amount of amortization and the understated goodwill and intangible assets are not material as a percentage of net income and total assets, respectively. The author does recommend that the accountant's or auditor's working papers include an explanation that he or she is aware of the fact that ASC 350 should be adopted, but that the effect of its adoption and continued application, would be immaterial to the financial statements.

A third option is for the company to simply violate GAAP by ignoring ASC 350. If the impact of continuing to amortize goodwill and certain intangibles is material, there is a GAAP departure which requires an exception in the accountant’s or auditor’s report.

Examples:

Compilation Report

Accountant's Compilation Report

Board of Directors
XYZ Company

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. 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 is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

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, we did become aware of a departure from accounting principles generally accepted in the United States of America that is (are) described in the following paragraph.*

Accounting principles generally accepted in the United States of America require that goodwill and certain intangible assets with indefinite lives not be amortized and be tested annually for impairment. Management has informed us that the Company continues to amortize goodwill and has not conducted the annual impairment test. The effects of these departures from accounting principles generally accepted in the United States of America have not been determined. [or, The effects of these departures would have been to increase goodwill and trademarks by $xx and xx, respectively, retained earnings by $xx, and net income by $xx.]

James J. Fox & Company

Review Report

Independent Accountant's Review Report

Board of Directors
XYZ Company

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 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. Accordingly, we do not express such an opinion.

Management is 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.

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 us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, ***with the exception of the matter described in the following paragraph***, 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 goodwill and certain intangible assets with indefinite lives not be amortized and be tested annually for impairment. Management has informed us that the Company continues to amortize goodwill and have not conducted the annual impairment test. The effects of these departures from accounting principles generally accepted in the United States of America have not been determined. [or, The effects of these departures would have been to increase goodwill and trademarks by $xx and xx, respectively, retained earnings by $xx, and net income by $xx.]

James J. Fox & Company

Audit Report

<u>Independent Auditor's Report</u>

To the Board of Directors
XYZ Company

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

As disclosed in Note 2, in connection with goodwill and certain intangible assets with indefinite lives, the company has recorded amortization expense and has not tested these assets for impairment. In our opinion, goodwill and intangible assets with indefinite lives should not be amortized and, should be tested annually for impairment in accordance with accounting principles generally accepted in the United States of America. The effects on the financial statements of the preceding practice are not reasonably determinable. or [If the financial statements were corrected for that departure from accounting principles generally accepted in the United States of America, goodwill and certain intangible assets would have increased by $100,000 and net income and stockholders' equity would have increased by $60,000, net of the tax effect.]

In our opinion, <u>***except for the effects of amortizing goodwill and certain intangible assets with indefinite lives, and not testing those assets for impairment***</u>, as discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company

Note: If the effect of the GAAP departure is known, it should be noted in the report and related disclosure. With respect to not amortizing goodwill and trademarks, the effect may not be known if a test of impairment has not been done.

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. How should intangible assets with finite lives be tested for impairment:

   a) tested under ASC 360 (formerly FASB No. 144)
   b) tested under ASC 350 (formerly FASB No. 142)
   c) not tested under the special finite lives exception
   d) recorded at lower of cost or market value thereby negating the need for an impairment test

2. Facts: Company X has an impairment writedown of goodwill in the amount of $200,000. X's federal and state tax rate is 40%. Which of the following is the correct deferred income tax result:

   a) X should record a deferred income tax liability in the amount of $80,000
   b) X should record a deferred income tax asset in the amount of $80,000
   c) X should not record any deferred income tax related to this transaction because the writedown will also be recorded on the tax return
   d) X should record both a deferred income tax asset and liability in the amount of $80,000 each

SUGGESTED SOLUTIONS

1. **A: Correct.** Intangible assets with finite lives are tested under ASC 360 (formerly FASB No. 144).

   B: Incorrect. Only intangible assets with indefinite lives are tested under ASC 350 (formerly FASB No. 142), and not those with finite lives.

   C: Incorrect. There is no special finite lives exception.

   D: Incorrect. Such intangibles are not recorded at the lower of cost or market value and there is a requirement that intangible assets with finite lives be tested for impairment if certain conditions are met.

   (See page 4-103 of the course material.)

2. Incorrect. The $200,000 represents a future tax deduction which creates a deferred income tax asset of $80,000 and not a deferred income tax liability.

   B: Correct. The $200,000 writedown creates a $80,000 deferred income tax asset to reflect the future tax benefit for the tax deduction.

   C: Incorrect. The $200,000 represents a temporary difference that creates a deferred income tax asset.

   D: Incorrect. The $200,000 creates a deferred income tax asset but not a deferred income tax liability.

   (See page 4-105 of the course material.)

CHAPTER 5: Business Combinations (ASC Topic 805)
ASU No. 2010-29: Disclosure of Supplementary Pro Forma Information for Business Combinations

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Business Combinations (ASC Topic 805) – ASU No. 2010-29: Disclosure of Supplementary Pro Forma Information for Business Combinations

Upon completing this chapter, you will be able to:

- Explain about the diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations
- Describe the changes made by ASU 2010-29 with respect to the presentation of pro forma revenue and earnings in a business combination
- Apply the expanded supplemental pro forma disclosures required by ASU 2010-29

I. Introduction

Date issued: December 2010

Effective date:

The amendments in this Update are effective prospectively 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, 2010*. Early adoption is permitted.

Objective:

The objective of this Update is to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations.

ASU 2010-29 amends ASC Topic 805, *Business Combinations* (FASB No. 141R), to do the following:

1. Require that a public company present the pro forma revenue and earnings as if the business combination occurred at the beginning of the comparable prior annual reporting period, and

2. Expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination(s).

II. Background

ASC Topic 805 (formerly FASB No. 141R) requires a public entity to disclose pro forma information for business combinations that occurred in the current reporting period. The disclosures include pro forma revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period.

In practice, some preparers have presented the pro forma information in their comparative financial statements as if the business combination that occurred in the current reporting period had occurred as of the beginning of each of the current and prior annual reporting periods. Other preparers have disclosed the pro forma information as if the business combination occurred at the beginning of the prior annual reporting period only, and carried forward the related adjustments, if applicable, through the current reporting period.

The ASU brings clarity to the application of pro forma information by defining the acquisition date that should be used for reporting the pro forma financial information disclosures in Topic 805 when comparative financial statements are presented. The ASU also requires a description of the nature and amount of material, nonrecurring pro forma adjustments that are directly attributable to the business combination(s).

Although U.S. GAAP is converging with international standards, there is a slight difference in the U.S. GAAP under this ASU as compared with IASB standards. More specifically, under IASB standards, IFRS 3, *Business Combinations,* permits, but does not require, pro forma disclosures for the comparative period. IFRS does not require a description of the nature and amount of material, nonrecurring pro forma adjustments.

III. <u>Definitions</u>

The following definitions, used in this ASU, are extracted from ASC Topic 805 (formerly FASB No. 141R).

> **Acquiree:** the business or businesses that the acquirer obtains control of in a business combination.
>
> **Acquirer**: the entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity is always the acquirer.
>
> **Acquisition date:** the date on which the acquirer obtains control of the acquiree.
>
> **Business combination:** a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as “true mergers” or “mergers of equals” also are business combinations as that term is used in this Statement.
>
> **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.

IV. <u>Rules</u>

1. The amendments in this Update affect any <u>*public entity*</u> as defined by ASC Topic 805 (FASB No. 141R) that enters into business combinations that are material on an individual or aggregate basis.

2. The ASU amends ASC Topic 805 (FASB No. 141R) as follows with respect to *public* entities that have a business combination(s) within a period.

   a. Non-public entities are exempt from the ASU.

   b. If a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only.

   c. Supplemental pro forma disclosures are expanded to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings.

3. Business Combinations – Overall Disclosure

   a. Following is a listing of the revised disclosures required after the amendment of ASU 2010-29. Changes made by the ASU are noted in **bold**. The acquirer in a business combination shall disclose the following information for each business combination that occurs during the reporting period:

      1) The name and a description of the acquiree

      2) The *acquisition date*

      3) The percentage of voting equity interests acquired

      4) The primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree

      5) For transactions that are recognized separately from the acquisition of assets and assumptions of liabilities in the business combination all of the following:

         a) A description of each transaction
         b) How the acquirer accounted for each transaction
         c) The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized
         d) If the transaction is the effective settlement of a preexisting relationship, the method used to determine the settlement amount.

      6) The disclosure of separately recognized transactions required in (5) above shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.

7) In a business combination achieved in stages, all of the following:

   a) The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date

   b) 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 immediately before the business combination and the line item in the income statement in which that gain or loss is recognized

   c) The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination

   d) Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

8) If the acquirer is a ***public entity***, all of the following:

   a) The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.

   b) If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).

   c) If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information).

   Example: For a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

   d) The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

Note: If disclosure of any of the information required by (8) above is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable.

9) Disclosures: Business combinations disclosure by a ***not-for-profit entity*** that is a ***public entity***:

Instead of disclosing the information in 2(a)(8) above for a public entity, a not-for-profit (NFP) acquirer that is a public entity shall disclose all of the following information for each acquisition that occurs during the reporting period:

a) Revenues attributable to the acquiree since the **acquisition date** that are included in the statement of activities for the reporting period

b) Changes in **unrestricted net assets**, changes in **temporarily restricted net assets**, and changes in **permanently restricted net assets** attributable to the **acquiree** since the acquisition date that are included in the statement of activities for the reporting period

c) The revenues of the combined entity as though the acquisition date for all acquisitions that occurred during the current year had been at the beginning of the annual reporting period (supplemental pro forma information)

d) Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets as though the acquisition date for all acquisitions that occurred during the current year had been at the beginning of the annual reporting period (supplemental pro forma information).

e) The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the acquisition(s) included in the reported pro forma revenues and changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets (supplemental pro forma information).

Note: If it presents comparative financial information, an NFP acquirer that is a public entity shall disclose the supplemental pro forma information required by the preceding paragraph for the comparable prior reporting period as though the acquisition(s) date for all acquisitions that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period.

For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

If the disclosure of any of the information is impracticable, the NFP acquirer shall disclose that fact and explain why the disclosure is impracticable.

Example: Illustration of Disclosure Requirements – Public Entity

Facts: Acquirer is a public entity and that Target is a private entity.

Conclusion: The following illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual footnote might present many of the disclosures illustrated in a simple narrative format.

NOTE X

The amounts of Target's revenue and earnings included in Acquirer's consolidated income statement for the year ended December 31, 20X2, and the revenue and earnings of the combined entity had the acquisition date been January 1, 20X2 [if comparative financial statements are not presented], and January 1, 20X1 [if comparative financial statements are presented], are as follows.

	Revenue	Earnings
Actual revenue and earnings from the acquisition date:		
Actual from June 30, 20X2 to December 31, 20X2	$5,000	$1,700
If comparative statements are not presented:		
20X2 supplemental pro forma from January 1, 20X2 to December 31, 20X2	28,000	13,000*
If comparative statements are presented:		
20X2 supplemental pro forma from January 1, 20X2 to December 31, 20X2	28,000	15,000*
20X1 supplemental pro forma from January 1, 20X1 to December 31, 20X1	27,000	12,000

Supplemental pro forma earnings were adjusted to exclude $1,800 of acquisition-related costs incurred in 20X2 and $200 of nonrecurring expense related to the fair value adjustment to acquisition-date inventory. 20X1 supplemental pro forma earnings were adjusted to include these charges.

* Difference of $2,000 is the adjustment for acquisition-related costs ($1,800) and nonrecurring expense ($200).

V. Implementation Guidance and Illustrations

1. The amendments are applied prospectively 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, 2010*. Earlier application is permitted.

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. Which of the following must a public entity disclose in connection with a business combination:

   a) revenue and earnings of the combined entity in a business combination on a pro forma basis
   b) total assets, total liabilities and combined equity on a pro forma basis
   c) consolidated balance sheets on a pro forma basis
   d) a detailed pro forma balance sheet and income statement on a line-by-line basis

2. Company X, a public company, issues comparative financial statements for 20X2 and 20X1, and has a business combination on June 1, 20X2. As of which date should X disclose pro forma revenue and earnings:

   a) January 1, 20X2
   b) June 1, 20X2
   c) January 1, 20X1
   d) December 31, 20X2

3. One of the key changes made by ASU 2010-29 is a disclosure of the nature and amount of any material _________________ included in the reported pro forma revenue and earnings.

   a) recurring eliminating adjustments in the consolidation
   b) prior period adjustments
   c) restatement adjustments
   d) nonrecurring pro forma adjustments

SUGGESTED SOLUTIONS

1. **A: Correct.** ASU 2010-29, requires that a public entity disclose revenue and earnings of the combined entity in a business combination on a pro forma basis.

   B: Incorrect. GAAP does not require that pro forma information be disclosed about an entity's total assets, total liabilities and combined equity.

   C: Incorrect. Although the combined entities might issue consolidated balance sheets, there is no requirement that they be disclosed and certainly no requirement to present them on a pro forma basis.

   D: Incorrect. There is no requirement to disclose a detailed pro forma balance sheet and income statement on a line-by-line basis.

   (See page 5-2 of the course material.)

2. A: Incorrect. When there are comparative financial statements, the pro forma information is presented as of the beginning of the prior year, which is January 1, 20X1, and not January 1, 20X2.

   B: Incorrect. June 1, 20X2 is the acquisition date and is not used for pro forma disclosure purposes.

   C: Correct. Pro forma revenue and earnings should be presented as of the beginning of the prior year, which is January 1, 20X1.

   D: Incorrect. December 31, 20X2 is an irrelevant date for purposes of pro forma disclosure.

   (See page 5-5 of the course material.)

3. A: Incorrect. ASU 2010-29 does not require that recurring eliminating adjustments in the consolidation be disclosed.

   B: Incorrect. Disclosure of prior period adjustments has nothing to do with pro forma information under ASU 2010-29.

   C: Incorrect. Restatement adjustments are not covered by ASU 2010-29 and do not affect pro forma information.

   D: Correct. ASU 2010-29 requires a disclosure of nonrecurring pro forma adjustments directly attributable to the business combination(s).

   (See page 5-5 of the course material.)

Chapter 6: Accounting and Tax Update on Uncertain Tax Positions: FIN 48: Accounting for Uncertainty in Income Tax (ASC 740), ASU 2009-06 and IRS Audits of Uncertain Tax Positions (Announcement 2010-75)

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Accounting and Tax Update on Uncertain Tax Positions: FIN 48: Accounting for Uncertainty in Income Taxes (ASC 740), ASU 2009-06 and IRS Audits of Uncertain Tax Positions (Announcement 2010-75)

Upon completing this chapter, you will be able to:

- Review the rules for uncertain tax positions found in FIN 48 (ASC 740)
- Identify the disclosures related to uncertain tax positions that ASU 2009-06 eliminates for non-public companies
- Describe how FIN 48 (ASC 740), related to uncertain tax positions, applies to pass-through entities
- Compare ways that entities previously accounted for tax positions
- Provide examples of various tax positions
- Apply the two-step approach to evaluating and recognizing a tax position
- Appropriately present an unrecognized tax benefit liability
- Compute the amount of interest expense recognized

I. Introduction

This chapter addresses key issues involving the issuance of FASB Interpretation No. 48 (FIN 48 or the Interpretation) (FASB ASC 740-10). FIN 48 was issued in 2006 and was effective in 2007 for public companies and in 2009 for nonpublic companies. In September 2009, FIN 48 was further clarified by the issuance of Accounting Standards Update (ASU) 2009-06: *Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 450).*

Since the issuance of FIN 48, numerous practice issues have arisen that need further clarification.

There is another twist to the FIN 48 saga. The IRS is using certain disclosures required by FIN 48 as a roadmap to audit a company's uncertain tax positions. In fact, recently issued IRS Announcement 2010-76 uses the same benchmark as GAAP (the more-likely-than-not threshold) to evaluate whether uncertain tax positions must be disclosed on federal income tax returns.

In this chapter, the author revisits FIN 48 and addresses some of the open issues that practitioners want resolved. The author also discusses some of the IRS-related matters and how companies can deal with the IRS's use of FIN 48 information to facilitate its audits.

Although the accounting for uncertain tax positions is found under the FASB's codification, ASC 740-10, *Accounting for Uncertainty in Income Taxes,* in this chapter, the author uses the term FIN 48 to reference this topic.

II. Background

ASC 740, *Income Taxes* (formerly FASB No. 109), addresses the accounting treatment for income taxes including the computation of deferred income taxes. However, prior to the issuance of FIN 48, FASB No. 109 did not deal with how to account for uncertain tax positions. For example, should a current provision (accrued tax liability) reflect the tax benefit from a deduction that the company is not sure it will receive if it is audited by the IRS, a state or other tax jurisdiction?

Prior to the issuance of FIN 48, there had been diversity in practice as to how to account for tax positions. Some entities had recorded the full tax liability or benefit related to a tax position at the time the tax position was taken or expected to be taken on the tax return and had ignored the probability of whether the position would be sustainable in audit. If an adjustment was made during an IRS or state audit conducted several years after the provision was recorded, the adjustment was made to the current provision and flown through income tax expense in the year of the IRS or state audit.

Other companies recorded the tax effect of a tax position on a best-estimate basis using a threshold as to whether the positions would be sustained upon examination. Where there was a question of sustainability in audit, some companies adjusted the liability using an allowance or valuation account.

In June 2006, the FASB issued FIN 48 which was effective for public companies for fiscal years beginning after *December 15, 2006*. Subsequently, with its issuance of FSP FIN 48-3, the FASB deferred the effective date of FIN 48 for nonpublic enterprises to the annual financial statements for fiscal years *beginning after December 15, 2008* (e.g., 2009 calendar year ends).

FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements under FASB No. 109, *Accounting for Income Taxes (ASC 740).*

More specifically, it:

- Addresses the recognition and measurement of a tax position taken or expected to be taken in a tax return, and

- Provides guidance on the treatment of derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition, as they relate to tax positions.

The Interpretation applies a *two-step approach* to evaluating and recognizing a tax position:

1. If it is *more likely than not (more than 50% probability)* that a tax position will be sustained upon IRS or state tax examination (including any appeals or litigation process), the amount of the tax effect of a tax position is retained on the financial statements.

2. If it is not more likely than not that the tax position (50% or less probability) will be sustained upon an IRS or state tax examination, all of the tax effect of the tax position is eliminated in the financial statements.

In some cases, the current provision for income taxes recorded on an entity's financial statements will differ from the actual tax liability on the tax return.

Since the issuance of FIN 48, the FASB has issued additional guidance with FASB Staff Position (FSP) FIN 48-1, and ASU 2009-06: *Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 740).*

ASU 2009-06 amends FIN 48 to eliminate certain disclosures for non-public companies and to clarify the scope to which FIN 48 applies.

To further complicate matters, in IRS Announcements 2010-9 and 2010-17, the IRS announced plans to change the reporting requirements regarding certain business uncertain tax positions. Under the proposed IRS changes, certain businesses would be required to disclose uncertain tax positions on their tax returns using a new Schedule UTP. Moreover, the IRS plans to use the financial statement disclosures required by FIN 48 to assist it in auditing any uncertain tax positions.

In this chapter, the author addresses not only the GAAP issues related to FIN 48, but also how the FIN 48 information is impacting the IRS's audits of uncertain tax positions.

III. Scope of Interpretation

1. The Interpretation applies to all entities including:

    - For-profit
    - Not-for-profit
    - Pass-through entities, and
    - Entities taxed in a manner similar to pass-through entities such as REITs and registered investment companies.[1]

Note: ASU 2009-06 confirms that not-for-profit and pass-through entities, and tax-exempt organizations are subject to the Interpretation because they can pay taxes. For example, an S corporation can be subject to a built-in gain tax under IRC section 1374. Similarly, a not-for-profit entity can be subject to a tax on unrelated business income.

2. Types of taxes:

    a. The Interpretation *applies to*:

        - Federal income taxes
        - State and local income taxes
        - Foreign income taxes.

[1] Entities whose liability is subject to 100 percent credit for dividends paid (REITs and registered investment companies).

b. The Interpretation *does not apply to*:

- Sales and use taxes
- Franchise taxes
- Real estate and personal property taxes
- Fees that are not taxes.

3. The Interpretation applies to *all tax positions* accounted for under FASB No. 109 (ASC 740).

   a. A *tax position* is defined as a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.

   b. A tax position results in either:

   - A permanent reduction in income taxes payable,
   - A deferral of income taxes otherwise currently payable to future years, or
   - A change in the expected realizability of deferred tax assets.

   Note: ASU 2010-06 states that 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.

   c. Examples of tax positions include:

Tax position	Example
• A decision not to file a tax return such as in the case of a state tax return	• Company does not file a state tax return even though it does business in that state
• An allocation or shift of income between jurisdictions, such as an apportionment between various states	• Company takes a position to compute apportionment among states that shifts taxable income to the lower tax rate state
• The characterization of income or expense or a decision to exclude reporting taxable income in a tax return	• Company treats certain income as capital gain instead of ordinary income
• A decision to classify a transaction, entity, or other position in a tax return as tax exempt (or deferred)	• Company treats certain income as tax exempt • Company deducts certain personal expenses of a shareholder
• A decision that shifts a tax deduction or income from one tax period to another	• Company expenses certain equipment repairs and small purchases (e.g., less than $1,000 each) instead of capitalizing them
• An entity's tax status including its status as a pass-through entity or a tax-exempt not-for-profit entity	• Company takes the position that it has made a proper election to be taxed as an S corporation and that the current S corporation status is valid and in force. • Company takes the position that its LLC is taxed as a partnership and not as a corporation

Observation: The Interpretation applies to all tax positions. In theory, each tax deduction and income item taken on a tax return represents a tax position. For example, if any entity takes a tax deduction for compensation expense, the entity is taking a position that in accordance with the Internal Revenue Code (IRC), that item is fully tax deductible in that tax period. Therefore, many tax return items represent tax positions for which the entity believes there is a 100 percent probability of being sustainable if audited. Conversely, there are tax positions that have a much higher risk of being unsustainable if audited. One example might be where an entity deducts a large equipment repair in the current tax period when, under the IRC, such items should most likely be capitalized and depreciated over several years.

ASU 2009-06 amended FIN 48 to include under the definition of a tax position an entity's tax status such as an entity's status as a pass-through entity (S corporation) or a tax-exempt not-for-profit entity. For example, one such tax position is the company's position that it is properly in compliance with the IRC to be taxed as an S corporation, or it is an LLC that is taxed as a partnership instead of a corporation.

Application of FIN 48 to pass-through and tax exempt entities:

S corporations and FIN 48:

For the most part, pass-through entities do not have a federal tax liability and, therefore, FIN 48's recognition provisions do not apply.

There are generally three instances in which an S corporation could have a federal tax liability as follows:

- Built-in gains tax under IRC Section 1374
- LIFO recapture tax under IRC Section 1363
- Excess passive income tax under IRC Section 1375.

Other than these three situations, all federal income taxes are paid at the shareholder level and not the S-corporation entity level.

Under present law, if an entity converts from C to S status and has a built-in gain (unrealized gain) in its assets, and those assets are sold within five years of the conversion date, the entity pays an S corporation level "built-in gain" tax under IRC Section 1374.[2]

The LIFO recapture tax applies if a C corporation that has a LIFO reserve (difference between LIFO and FIFO inventory) converts to an S corporation. In such a circumstance, the entity must recapture the LIFO reserve and pay the tax on the LIFO reserve over a four-year period; the last year as a C corporation and the first three years as an S corporation. Consequently, the S corporation does, in fact, pay three-fourths of the tax on the LIFO recapture, making it subject to the guidance of FIN 48.

Finally, an S corporation can have an entity-level tax if it has excess passive income under IRC Section 1375. The Section 1375 tax applies if the entity has two elements: 1) it has net passive income (dividends, interest, capital gains, rental income, etc.) in excess of 25 percent of its gross receipts, and 2) it has earnings and profits from when it was a C corporation.

Absent the three exceptions, an S corporation does not pay an entity level federal income tax.

However, an S corporation may pay a state income tax which would make it subject to the requirements of FIN 48. Although the author does not have the statistics, there are many states that tax an S corporation at the entity level even though it is taxed at the shareholder level for federal income tax purposes.

Example 1: S Corporation

Facts: Entity X converted to an S Corporation from a C Corporation effective January 1, 20X0. In 20X3, Entity S disposed of assets subject to built-in gains and reported a tax liability on its 20X3 tax returns. X pays no state-level income taxes.

[2] The American Recovery and Reinvestment Act of 2009 reduced the 10-year recognition period to 7 years The Small Business Jobs Act of 2010 further reduced the recognition period to 5 years.

Conclusion: X has tax positions to consider related to the built-in gains tax including, but not limited to:

Tax position: Built-in gain:

- Whether other assets were sold subject to the built-in gains tax
- Whether the income associated with the calculation of the taxable amount of the built-in gains is correct
- Whether the basis associated with the built-in gains calculation is correct
- Whether or not Entity S is subject to the built-in gains tax.

Tax position: S corporation status:

- Whether X has properly complied with the requirements to be taxed as an S corporation and pay no federal and state income taxes.

Example 2: S Corporation

Facts: Entity X is an S Corporation with no entity-level federal income taxes. X does pay an entity level state income tax of 8%.

Conclusion: Although X pays no federal income tax, it does have several tax positions to consider that are subject to the requirements of FIN 48.

Tax positions: State income tax:

- Whether the income subject to the state income tax is correct.

Tax position: S corporation status:

- Whether X has properly complied with the requirements to be taxed as an S corporation and pay no federal income taxes.

LLCs- partnerships and FIN 48:

At the federal level, partnerships do not pay a federal income tax. There are no exceptions within the Internal Revenue Code.

An LLC is a different situation. Although at the federal level, an LLC defaults to being taxed as a partnership with all income being taxed to its members, the LLC may elect to be taxed as a corporation under the so-called "check-the-box" rules. If the LLC is taxed as a partnership, the recognition provisions of FIN 48 would not apply because there is no entity-level income tax expense. Conversely, if the LLC elects to be taxed as a C corporation, there would be an entity-level tax that would be subject to the requirements of FIN 48.

What about state taxes related to pass-through entities?

Although there are limited instances in which an S corporation or LLC will pay an entity-level tax, there are far greater instances in which state income taxes are imposed at the entity level for an S corporation, partnership or LLC. In such circumstances, the state taxes are subject to the requirements of FIN 48. Some states assess an income tax on the entity, while others assess a tax at the shareholder or member level but permit the entity to pay the tax on behalf of the shareholder or member.

Example 3: Attribution of Income Taxes to the Entity or Its Owners

Facts: Entity A, a partnership with two partners (Partner 1 and Partner 2), has a nexus in Jurisdiction J (a state). 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 (loan or owner's distribution) and is not part of J's income tax expense. Consequently, any tax positions related to these taxes are not subject to the requirements of FIN 48.

Example 3A: Agreement Between Entity A and Its Partners

Same facts as Example 3 except that there is an agreement between Entity A and its two partners under which Entity A is required to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J.

Conclusion: The conclusions in Example 3 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 4: Attribution of Income Taxes to the Entity or Its Owners

Facts: Assume the fact pattern in Example 3 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 as part of the entity's income tax expense and subject to the guidance in FIN 48. Tax positions related to these income taxes must be considered under FIN 48.

Example 5: Attribution of Income Taxes to the Entity or Its Owners

Facts: Entity S, an S Corporation, files a tax return in Jurisdiction J (a state). 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 (a loan or distribution) and not considered income tax expense. Because the transaction is not part of the entity's income tax expense, tax positions related to these income taxes are not subject to FIN 48.

Tax-exempt entities and FIN 48:

Although most tax-exempt entities do not pay an entity-level tax, there can be a tax imposed on unrelated business income (UBI). Consequently, a tax position found in a tax-exempt entity would be how the entity accounts for UBI.

Example 1: Tax-Exempt Entity

Facts: Entity Y, a tax-exempt not-for-profit entity, enters into transactions that may be subject to income tax on unrelated business income.

Conclusion: Y has tax positions to consider including, but not limited to:

- Entity Y's characterization of its activities as related or unrelated to its exempt purpose
- Entity Y's allocation of revenue between activities that relate to its exempt purpose and those that are allocated to unrelated business income
- The allocation of Entity Y's expenses between activities that relate to its exempt purpose and those that are allocated to unrelated business activities
- Whether Y qualifies as a tax-exempt not-for-profit entity.

If a pass-through or tax-exempt entity pays no federal or state income taxes, does it have any tax positions that would be subject to the requirements of FIN 48?

Yes. ASU 2009-06 amends FIN 48 by changing the definition of a tax position to include an entity's status as a pass-through entity or as a tax-exempt not-for-profit entity.

Example 1: Company X is an S corporation that pays no federal or state income taxes at the entity level.

Conclusion: Even though X pays no income taxes, X still has a tax position that is subject to the requirements of FIN 48. That tax position is the fact that X has elected S corporation status and that the S status is in full effect. If the tax position of having S status were incorrect, X would have an additional liability for federal and state income taxes.

Example 2: Company Y is a two-member LLC that is taxed as a partnership and pays no federal and state income taxes at the entity level.

Conclusion: Y has a tax position which is that it is taxed as a partnership and complies with the requirements to be taxed as a partnership. If the tax position of having partnership taxation treatment were not correct, Y could be taxed as a C corporation (under the check-the-box rules) and Y would incur entity-level federal and state taxes.

Group of related entities: FIN 48

ASU 2009-06 addresses how a reporting entity should account for the tax positions of all entities within a related party group. The ASU states that a reporting entity must account for the tax positions of all entities within the related party group, regardless of the tax status of the reporting entity.

Example 3: Financial Statements of a Group of Related Entities

Facts: Entity A, a partnership with two partners, owns a 100 percent interest in Entity B and is required to issue consolidated financial statements.

Entity B is a C corporation 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.

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. What does FIN 48 address:

   a) abnormal cost accounting
   b) computation of deferred income taxes
   c) measurement of fair value
   d) recognition and measurement of tax positions

2. Tax positions can result in:

   a) a change in the amount of deferred tax assets that are expected to be realized
   b) a reduction of income taxes that are not currently payable
   c) a temporary reduction in income taxes payable
   d) not filing tax returns

3. Expensing certain equipment repairs and small purchases rather than capitalizing them is an example of what tax position:

   a) characterizing income in a tax return
   b) classifying a transaction entity as tax exempt
   c) shifting a tax deduction or income from one tax period to another
   d) shifting income between jurisdictions

4. 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:

   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

SUGGESTED SOLUTIONS

1. A: Incorrect. ASC 330, *Inventory*, addresses abnormal costs accounting, not FIN 48.

   B: Incorrect. FIN 48 does not address the computation of deferred income taxes.

   C: Incorrect. ASC 820, *Fair Value Measurements and Disclosures*, addresses how to measure fair value, which is not addressed by FIN 48.

   D: Correct. FIN 48 addresses recognition and measurement of tax positions.

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

2. **A: Correct.** Tax positions can result in a change in the amount of deferred tax assets that are expected to be realized.

   B: Incorrect. Tax positions can result in a deferral of income taxes that are not currently payable to future years.

   C: Incorrect. Tax positions can result in a permanent reduction in income taxes payable.

   D: Incorrect. Deciding not to file a tax return is not a result of a tax position. Rather, it is a tax position.

   (See page 6-5 of the course material.)

3. A: Incorrect. An example of characterizing income or deciding to exclude reported taxable income in a tax return is when a company treats certain income as capital gain instead of ordinary income.

   B: Incorrect. An example of classifying a transaction entity as tax exempt is when a company treats certain income as tax exempt.

   C: Correct. An example of shifting a tax deduction or income from one tax period to another is when a company expenses certain equipment repairs and small purchases rather than capitalizing them.

   D: Incorrect. An example of shifting income between jurisdictions is when a company shifts taxable income to a lower tax rate state by computing apportionment.

   (See page 6-6 of the course material.)

4. 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 non public entities even though there are certain disclosures that apply to public entities only.

   (See page 6-9 of the course material.)

IV. <u>Requirements of FIN 48</u>

1. General rule:

a. An entity shall initially recognize the financial statement effects of a tax position using a *<u>two-step approach</u>*:

Step 1: <u>Satisfy the more-likely-than-not threshold</u>: It must be *<u>more likely than not</u>* (more than 50 percent likelihood), based on the technical merits, that the position will be sustained upon examination, and

Step 2: <u>Measure the tax benefit of the tax position:</u> If Step 1 is satisfied, the tax position is initially measured at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon effective settlement with a taxing authority that has full knowledge of all relevant information.

b. If Step 1 is not satisfied (e.g., the more-likely-than-not threshold is not met), 100% of the tax benefit of the tax position is not recognized.

Example:

Company X takes a tax deduction on its tax return in the amount of $100,000 which saves the Company $40,000 in federal and state income taxes.

Company X believes that if X is audited, it is more likely than not (more than 50% probability) that the entire deduction will be sustained based on the merits.

Conclusion:

Because X believes it is more likely than not (more than 50% probability) that if X is audited, the deduction will be sustained, no entry is required under FIN 48. Instead, the deduction is included in X's current tax provision.

Change the facts:

X believes that if audited, it is only a 25% probability that the deduction will be sustained. That is, X believes it will lose the entire deduction if audited.

Conclusion:

The more-likely-than-not threshold has not been satisfied. Consequently, the tax benefit of the deduction should be adjusted as follows:

Income tax expense	40,000	
Liability for unrecognized tax benefit		40,000

c. <u>Step 1: Defining the more-likely-than-not criterion</u>:

1) More likely than not means the likelihood is more than 50 percent and is a positive assertion that an entity believes it is entitled to the economic benefits associated with the tax position.

2) The determination of whether the more-likely-than-not threshold is met is based on all facts, circumstances, and information available at the reporting date.

3) Presumption of an examination:

   a) In assessing the more-likely-than-not criterion, it is presumed that the tax position will be examined (including resolution of the related appeals or litigation process) by the relevant taxing authority that has full knowledge of all relevant information.

   b) The technical merits from taking a particular tax position can be derived from various sources including:
      - Legislation and statutes and intent
      - Regulations, rulings and case law
      - Past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities.

   c) Each tax position must be evaluated without regard to the possibility of offset or aggregation with other positions.

   d) The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not threshold is met, is a matter of judgment based on the individual facts and circumstances. Factors to consider in determining the unit of account to be used include:

      - Manner in which the entity prepares and supports its income tax return, and
      - The approach it anticipates the taxing authority will take during the examination.

Note: The unit of account aspect of the Interpretation essentially deals with the issue of whether one should combine tax positions in applying the Interpretation. For example, assume a tax position is that an entity expenses certain repairs and maintenance instead of capitalizing them. How would this tax position be tested by each individual asset, or by combining similar assets? The answer lies in considering two factors. First is the manner in which the entity prepares and supports its income tax return. Second is the approach the entity anticipates the taxing authority will take if examined. Because there is no hard and fast answer, an entity can essentially justify either approach; that is, combine all fixed assets and apply one individual tax position for expensing repairs related to all of those assets. Alternatively, the expensing policy can be applied to each individual fixed asset. By combining the assets and applying one tax policy to all assets, the entity has the advantage that the policy on certain assets that may not satisfy the more-likely-than-not threshold may be offset with those that do.

Observation: In issuing the Interpretation, the FASB considered whether uncertainty about examination of a tax position (examination risk) should be a factor in the decision to recognize the effect of the tax position. After all, an entity could have an unsustainable tax position that would never be challenged unless audited. With audit rates extremely low, the risk of losing the tax benefit was relatively low. In reaching its conclusions, the FASB noted that income tax systems are founded on the principles of compliance, self-assessment, and self-reporting, and that enforcement powers are secondary to the self-assessment and reporting requirements. Considering examination risk in tax positions is analogous to reporting accounts payable based not on the amount owed but, rather, on the amount that would be ultimately paid if the creditor filed suit to collect the debt.

Does the Interpretation apply to fees other than taxes?

Technically, no. The Interpretation applies to taxes and not fees or other assessments made by authorities. The result is that with respect to such fees or assessments, entities should follow the contingency rules found in FASB No. 5 (ASC 450) which provide that such amounts are recorded when they meet the probable threshold.

d. Step 2: Measure the tax benefit of the tax position:

1) If a tax position satisfies Step 1 (it meets the more-likely-than-not criterion), Step 2 applies to measure the tax benefit of the tax position.

2) The tax position is measured at the *largest amount of tax benefit that is greater than 50 percent likely of being realized* upon effective settlement with a taxing authority that has full knowledge of all relevant information.

   a) The measurement shall consider the amounts and probabilities of the outcomes that could be realized upon effective settlement using facts, circumstances and information available at the reporting date (the date of the most recent financial statements).

   b) The amount is based on management's best estimate of what it would accept in a settlement with the taxing authority.

   Note: In satisfying the Step 1 criterion (more-likely-than-not that the position will be sustained upon audit), it is presumed that not only will the position be examined by the taxing authority (e.g., IRS), but that if necessary, the entity will go through both the appeals and litigation process to justify the tax position. Yet, in measuring the tax benefit of the tax position, the amount recorded is based on the assumption that the case will be negotiated and settled with the taxing authority to avoid the costs of litigation. Thus, the amount recorded reflects what the entity would ultimately accept from the taxing authority to resolve a dispute and avoid court.

   A tax opinion can be external evidence supporting a more-likely-than-not threshold, but such an opinion is not required.

e. The unrecognized tax benefit liability:

1) There may be an unrecognized tax benefit, which is the amount of benefit recognized in the balance sheet that may differ from the amount taken or expected to be taken in the tax return in the current year.

2) A liability is created for the unrecognized tax benefit which presents the entity's potential future obligation to the taxing authority for a tax position that was not recognized under the Interpretation.

3) The liability is presented as a current liability on the balance sheet (or as a reduction in the refundable receivable) to the extent the entity anticipates payment (or receipt) of cash within one year or the operating cycle, whichever is longer.

4) The liability shall not be combined with deferred tax liabilities or assets.

5) Use of a valuation account, like the one found in FASB No. 109 (ASC 740) related to deferred income tax asset realization, is not a substitute for recording a liability.

The following table depicts the relationship between book income, taxable income reported on the tax return and taxable income that is based on tax positions more likely than not to be sustained in an audit.

Interrelation: Book Income and Taxable Income			
Taxable income			**Book income**
Taxable income based on tax positions more likely than not to be sustained in audit	Taxable income reported on tax return		
Tax to be paid if audited	***Tax paid based on tax return***		***Tax computed on book income***

-----Unrecognized tax----- benefit liability

--------Deferred income-------- Taxes

Observation: The unrecognized tax benefit liability represents the difference between the tax benefit reported on the tax return for a particular item and the amount of benefit the entity believes it will receive if it is audited and has to settle with the taxing authority. Consider the liability as a contingency "cushion" for the tax adjustment that might be made if audited.

f. <u>Subsequent recognition, derecognition, and measurement</u>:

1) If the more-likely-than-not threshold is not met in the period for which a tax position is taken or expected to be taken, the entity shall recognize the benefit in the first interim period that meets any <u>*one of the following three conditions*</u>:

- The more-likely-than-not recognition threshold is met by the reporting date of the subsequent period.
- The tax position is *effectively settled* through examination, negotiation or litigation.
- The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

2) An entity shall derecognize a previously recognized tax position in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination.

   a) Using a valuation allowance, as defined by FASB No. 109 (ASC 740), is not permitted as a substitute for derecognition of the tax benefit.

3) Subsequent recognition, derecognition, and measurement shall be based on management's best judgment given the facts, circumstances, and information available at the reporting date.

   a) A tax position need not be legally extinguished and its resolution need not be certain to subsequently recognize, derecognize or measure the position.

4) Subsequent changes in judgment that lead to changes in recognition, derecognition, and measurement should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

   a) A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period (including any related interest and penalties) shall be recognized as a discrete item in the period in which the change occurs.

   b) A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior interim period within the same fiscal year is an integral part of an annual period and, consequently, shall be reflected pursuant to the provisions of paragraph 19 of APB No. 28, *Interim Financial Reporting*, and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*.

What is the definition of effective settlement?

FASB Staff Position (FSP) FIN 48-1 provides the following guidance in determining effective settlement.

a. An entity shall evaluate all of the following conditions when determining effective settlement:

   - The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.

- The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination.
- It is remote that the taxing authority would examine or reexamine any aspect of the tax position. Management shall consider the taxing authority's policy on reopening closed examinations and the specific facts and circumstances of the tax position. Management shall presume the taxing authority has full knowledge of all relevant information in making the assessment on whether the taxing authority would reopen a previously closed examination.

b. An entity shall recognize the benefit of a tax position when it is effectively settled.

c. In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination.

d. Effective settlement of a tax position subject to an examination does not result in effective settlement of similar or identical tax positions in periods that have not been examined.

e. If an entity that had previously considered a tax position effectively settled becomes aware that the taxing authority may examine or reexamine the tax position or intends to appeal or litigate any aspect of the tax position, the tax position is no longer considered effectively settled and the entity shall reevaluate the tax position.

Note: An entity may obtain information during the examination process that enables that entity to change its assessment of the technical merits of a tax position or of similar tax positions taken in other periods. However, the effectively settled conditions do not provide any basis for the entity to change its assessment of the technical merits of any tax position in other periods.

Note: FIN 48 used the terms "ultimately settled" and "ultimate settlement" as the benchmark for recognizing the benefit of a tax position. The FASB staff received inquiries seeking clarification of the meaning of "ultimately settled" and "ultimate settlement", among other terms. In resolving some of the questions related to FIN 48, FSP FIN 48-1 substitutes the term "ultimately settled" with the term "effectively settled."

Example 1: Tax Deduction:

Company X computes its 20X7 tax provision as follows:

	Taxable Income	Tax rate	Tax (Federal/state)
Net sales	$1,000,000		
Operating expenses:			
Travel	***(2,500)***		
All other	(597,500)		
Total operating expenses	(600,000)		
NIBT	400,000	40%	160,000
M-1: Depreciation	(50,000)	40%	(20,000)
Taxable income	$350,000	40%	$140,000

Entry:		
Income tax expense	160,000	
Deferred income tax asset		20,000
Accrued tax liability		140,000

Company X takes a $2,500 tax deduction for certain items that may be nondeductible travel related to a shareholder's spouse. The tax benefit of the item embedded within the tax provision is $1,000 ($2,500 x 40%).

X believes that if it were audited by the IRS and Massachusetts Department of Revenue, it is more likely than not that the deduction is sustainable even if X has to go to appeals or even tax court.

However, if X were audited, there is a possibility that it may be required to settle with the IRS for a portion of the deduction based on the following probabilities:

Possible estimated outcome (tax benefit)	Individual probability of occurring (%)	Cumulative probability of occurring (%)
$1,000	5%	5%
800	30%	35%
600	**20%**	**55%**
400	25%	80%
200	15%	95%
0	5%	100%

Conclusion:

Step 1 is satisfied because X believes it is more likely than not that the deduction would be sustained in the event of audit, including any required appeal or tax court decision.

Therefore, X goes to Step 2 and measures the amount of benefit to be recorded. Because $600 is the largest amount of tax benefit that is greater than 50 percent likelihood of being realized upon ultimate settlement, the entity should recognize a tax benefit of $600 in the financial statements.

Given that X has reflected the entire $2,500 tax deduction and related $1,000 tax benefit in its tax provision, the entry needs to be adjusted as follows:

Tax benefit reflected in provision	$(1,000)
Probable tax benefit	(600)
Liability adjustment required- current provision (credit)	$ 400

Revised Entry:		
Income tax expense	160,400	
Deferred income tax asset		20,000
Accrued tax liability		140,000
Liability for unrecognized tax benefit		**400**

Observation: In the above example, notice that a probability weighting must be assigned to various outcomes. The outcome that is selected ($600, in this example) is the one that has a cumulative probability of outcome that exceeds 50 percent.

The $400 additional liability represents the unrecognized tax benefit, which is the difference between a tax position taken on the tax return and the benefit recognized and measured under the Interpretation. It represents the entity's potential future obligation to the taxing authority for the tax position that is not recognized. That is, upon audit and ultimate settlement with the taxing authority, the entity expects that it may have a tax adjustment due to the taxing authority in the amount of $400 for the disallowed portion of the tax deduction.

The $400 liability is classified as current to the extent the entity anticipates payment within one year or the operating cycle, if longer. In this case, the liability would likely be presented long-term as it will probably be several years before the entity is audited and an ultimate settlement reached with the taxing authority.

In the above example, there are actually several potential taxing authorities that could examine the tax returns, the IRS and various state authorities.

Change the facts:

What if the more-likely-than-not threshold is not met for sustaining the deductibility of the $2,500?

If Step 1 is not satisfied in that it is not more likely than not that the $2,500 deduction will be sustained upon audit, the entire tax benefit of $1,000 is not recognized.

The revised entry looks like this:

Revised Entry:		
Income tax expense	161,000*	
Deferred income tax asset		20,000
Accrued tax liability		140,000
Liability for unrecognized tax benefit		**1,000**

* Book income ($400,000) plus unrecognized deduction ($2,500) = $402,500 x 40% = $161,000.

Example 2: Timing of a deduction:

In 20X7, Company X purchases equipment for $70,000.

For tax purposes, X deducts the entire cost under Section 179 of the Internal Revenue Code. For GAAP, it depreciates the equipment on a straight-line basis over 7 years. The first-year half-year convention is ignored in this example. X is concerned that the equipment may not qualify for expensing under Section 179 and the deduction could be challenged.

X is certain that the equipment is fully deductible so that the more-likely-than-not threshold has been met. However, in ultimate settlement with the IRS and state department of revenue, X believes that the largest benefit that is greater than 50% likely of being realized upon ultimate settlement is depreciation over 5 years.

Assume the federal and state tax rate is 40% and that book income before income taxes is $500,000.

Conclusion:

The initial entry to set up the tax effect of the transaction is as follows:

Book income before depreciation income taxes	$500,000
Depreciation 70,000/7 years	(10,000)
Book income before income taxes	490,000
M-1 item- depreciation	*(60,000)
Taxable income	$430,000

* $70,000 per tax return - $10,000 for books

20X7 Entry:

Income tax expense (1)	196,000	
Accrued income taxes (2)		172,000
Deferred income tax liability (3)		24,000

(1): $490,000 x 40% = $196,000
(2): $430,000 x 40% = 172,000
(3): $60,000 basis difference x 40% = $24,000

Once the initial entry is made, an additional entry must be recorded to reflect the unrecognized tax benefit on the equipment deduction as follows:

Tax benefit reflected in tax return (1)	$(28,000)
Probable tax benefit upon settlement (2)	(5,600)
Liability adjustment	$ 22,400

(1): $70,000 deduction x 40% = $28,000 benefit on tax return
(2): $70,000/ 5 years = $14,000 x 40% = $5,600 benefit upon settlement if audited.

20X7 additional entry:

Deferred income tax liability	22,400	
Liability on unrecognized tax benefit		22,400

The liability adjustment is offset by a reduction in the deferred income tax liability. Because the adjustment is based on the timing of a deduction (expense versus 5-year depreciation) and not the ultimate loss of the deduction altogether, the entry is made to defer income taxes.

Observation: The previous example illustrates a common situation in practice when an entity chooses to accelerate the deduction of an item on its tax return beyond what the Code allows. Examples include:

- Expensing small capital expenditures below a certain threshold amount (e.g., expense all items under $1,500, individually).
- Expensing certain larger repair expenditures based on the argument that they provide no future benefit to the underlying asset.

In audit, the entity could be required to capitalize some of those items in an ultimate settlement with a taxing authority. The issue is whether the entity should record a liability for the potential unrecognized tax benefit related to these items being capitalized. Because these items are ultimately tax deductible and the dispute in audit would be one of the timing of deductibility, it would appear that most entities will ignore the recording of a liability. After all, the offset would merely be to a deferred tax liability thereby making the entry one that affects the balance sheet only.

State taxes and FIN 48

Perhaps one of the most challenging issues related to FIN 48 is the state income tax exposure that exists for companies regardless of whether they have filed state returns. It is quite common for private companies to file a state income tax return in one state and avoid filing in neighboring states until those states contact the company for audit. Most states consider that a company is conducting business in their state (e.g., there is a nexus) if that company has sales, assets (a sales office), or payroll in that state.

If the company has not filed a payroll tax or sales tax return in a particular state, that company's nexus to the state could go undetected for years, maybe decades, while the company continues to limit its state filing to its home state. Then, one day, a neighboring state notifies the company that it has not filed state tax returns for numerous years and seeks a retroactive tax assessment, along with interest and penalties.

This is an example of a situation to which FIN 48 applies. If a company does not record a tax provision for a particular state, that company must demonstrate that, upon audit by that state, it is more likely than not (more than 50 percent probability) that the company's tax position (there is no nexus to the state and no tax liability due to that state) will be sustained. If not sustainable in audit, the company should record a tax liability to reflect the additional tax (including interest and penalties) based on the assumption that the company will be audited by that state and will have to pay the additional tax, interest and penalties.

Wouldn't the additional state tax be offset by a refund of the state taxes in the home state?

Some practitioners take the position that if the company does not file a state tax return in a particular state, there is no risk of additional tax liability because an additional tax in one state would be offset by a reduction in taxes in the home state, except for a slight impact of different tax rates. That is, in theory, the total state tax apportionment should not exceed 100 percent.

Although, in theory, this assumption is correct, there are holes in the logic. First, the tax rate differential among states will impact the net adjustment in taxes. Second, and more significantly, there is the risk that the statute of limitations restricts the company's ability to file amended state returns to receive state tax refunds. If a company is audited by a state with which the company has never filed state returns, that company may have to file five, six or more state tax returns and pay past due taxes, interest and penalties. When filing corresponding amended state returns in the home state to obtain refunds, some of the refund years may be closed under the statute of limitations. Therefore, it is clearly not a zero-sum effect.

Example 3: State Tax Nexus:

Company X has been incorporated in Massachusetts since 1929 and has filed a Massachusetts corporate excise (income) tax return for each year since inception.

Since 1990, X has done some business in Rhode Island and has not filed a tax return in that state based on its position that it does not have any nexus in Rhode Island. In particular, it has no payroll, no tangible assets and its sales office resides in Massachusetts.

Nevertheless, X is concerned that "one of these days" a nasty Rhode Island state tax collector is going to come knocking on X's door to assess back taxes. Because no returns have been filed, there is no statute of limitations.

X's accountant, Joe, is quite familiar with Rhode Island's administrative practices and policies. In general, as a matter of policy, Rhode Island goes back only 6 years in determining whether there is a tax return due and a deficiency is owed. The problem is that if Rhode Island were to assert that there was an assessment due, it would be too late to file an amended return in Massachusetts to adjust the apportionment and receive a refund in back years 4-6 (beyond the three-year statute of limitations). Thus, X's real exposure for a Rhode Island tax liability is for years 20X1, 20X2 and 20X3. For years 20X4-20X6 and the current year 20X7, X would be able to file an amended return in Massachusetts and come close to offsetting the additional tax with a refund of the tax in Massachusetts. Interest and penalties would still be incurred.

Scenario 1:

X believes that upon audit by Rhode Island, it is more likely than not that its tax position (e.g., not filing a Rhode Island state tax return) would be sustained and that it does not have a nexus in Rhode Island. Thus, X believes it is 100% likely it would retain its tax benefit (e.g., not recording a liability for Rhode Island income taxes).

Conclusion:

X is not required to record a liability for the unrecognized tax benefit. First, it has satisfied the more-likely-than-not threshold. Second, the possible outcome that yields more than a 50 percent cumulative probability is that there is zero tax due. In this case, the tax benefit represents the Rhode Island taxes not accrued or paid.

Scenario 2:

Same facts as Scenario 1 except that X has had a sales office in Rhode Island since 1990. X believes that upon audit by Rhode Island, it is *not* more likely than not that its tax position (e.g., not filing a Rhode Island state tax return) would be sustained because of the nexus created by the sales office.

Assume the tax liabilities that would be incurred if X were to be audited by the state of Rhode Island are as follows:

Rhode Island taxes- 20X1 to 20X7, including interest and penalties	$100,000
Massachusetts taxes refundable with amended returns 20X4-20X7	(30,000)
Net increase in tax upon audit	$70,000

Conclusion:

Because X fails the more-likely-than-not threshold, none of the tax benefit should be recognized. In this case, the tax benefit consists of not recording a Rhode Island tax liability in the financial statements.

Thus, X should record a Rhode Island tax liability for the years 20X1 through 20X7. The liability should be based on the possible outcome that X believes it is more than 50% likely to occur upon an ultimate settlement with the state of Rhode Island. Presumably, in making the entry for the Rhode Island tax liability (including interest and penalties), X should also record a Massachusetts income tax receivable for all years open by statute (20X4-20X7), reflective of the amended returns that would be filed to adjust the income apportionment between the two states.

In this case, a liability would be recorded for Rhode Island taxes (including interest and penalties) with a corresponding debit for the refund that would be received from filing an amended Massachusetts state tax returns as follows:

Entry:		
Income tax expense	70,000	
Liability for unrecognized tax benefit		***100,000***
Liability for unrecognized tax benefit	***30,000***	

How long would the liability for the Rhode Island tax be recorded on the balance sheet?

The liability for the Rhode Island tax is based on the assumption that the Rhode Island Department of Revenue audits the company and assesses the tax (including interest and penalties) retroactively to 20X1. However, the likelihood of the company being audited is remote and the statute of limitations will not expire because tax returns have yet to be filed. Consequently, the liability will remain on the balance sheet indefinitely until the company is audited and assessed for the back taxes.

Why isn't X recording a liability going back to 1990, its first year doing business in the state of Rhode Island?

The Interpretation states that in evaluating the technical merits from taking a particular tax position, one can use various sources including:

- Legislation and statutes and intent
- Regulations, rulings and case law
- Past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities

It is known that Rhode Island, as a matter of practice and policy, looks back only six years in assessing back taxes. This past administrative practice can be used by X in reaching a conclusion as to how far back X should go in accruing Rhode Island taxes.

Example 4: Highly Certain Tax Position:

Company X has finalized its tax calculation for the 20X7 financial statements. Based on the computation, X has reviewed all tax deductions and revenue recorded and believes there are no tax positions that are even remotely at risk of being denied in an ultimate audit. All are based on clear and unambiguous tax law.

For example, X recorded and paid compensation expense for its salaries. Other operating expenses, such as insurance, utilities, supplies, etc. all were appropriately recorded. All trade payables, receivables, and accruals were properly recorded and subsequently paid within the statutorily required time frame. All revenue is appropriately recorded in the correct period.

Conclusion:

All tax positions used to compute the tax return liability clearly satisfy the more-likely-than-not criterion (all are at 100% likely of being sustained in audit) based on clear and unambiguous tax law. Accordingly, each tax position (e.g., each position to deduct each expense) clearly meets the recognition criterion (Step 1) and should be evaluated for measurement (Step 2). In determining the amount to measure, management is highly confident that the full amount of each deduction will be allowed so that it is clear that it is greater than 50 percent likely that the full amount of each tax position (each tax deduction) will ultimately be realized upon settlement with the taxing authorities. Thus, the entity would recognize the full tax benefit of each tax position. That is, the benefit of each tax deduction is recorded and no unrecognized tax benefit liability is needed.

Observation: Example 4 above illustrates a typical situation for most companies in applying FIN 48. The Interpretation applies to all tax positions. This means that every tax deduction taken on a tax return represents a tax position; that is, a position justifying the deduction on the tax return. On its face, it is quite clear that most tax positions easily satisfy the more-likely-than-not threshold and that 100 percent of the deduction will be allowed in an ultimate settlement. As a result, an entity can simply ignore most tax positions as being fully deductible and not requiring any liability for unrecognized tax benefits. It is within one or two tax positions that an entity must really apply the Interpretation guidance and possibly record an unrecognized tax benefit liability.

For example, a company, may have many tax positions related to the deductibility of various expenses. However, the only one that may result in a liability for unrecognized tax benefits may be the fact that the company expensed certain repairs related to equipment. All other policies, such as those related to the deduction of typical recurring operating expenses, easily satisfied the more-likely-than-not criterion and will result in 100 percent of the tax benefit being realized if there is a settlement in audit.

Example 5: Determining the Unit of Account:

Company X determines that it has $1 million of research and experimentation (R&E) credit on its 20X7 tax return. The credit consists of R&E on 4 separate projects ($250,000 per project).

X has sufficient 20X7 taxable income to use the entire credit.

In assessing whether X will ultimately sustain the credit for each project, X reaches the following conclusions.

Project	Credit taken	More-likely-than-not threshold satisfied	Go to Step 2?	Anticipated benefit in settlement if audited
1	$250,000	Yes	Yes	$200,000
2	250,000	Yes	Yes	200,000
3	250,000	Yes	Yes	200,000
4	250,000	No	No	50,000
Total	$1,000,000			$650,000

Scenario 1:

Management concludes that the appropriate unit of account is to treat each individual research project as a separate tax position. In reaching this conclusion, X considers two criteria required by the Interpretation:

1. The level at which X accumulates information to support the tax return, and
2. The level at which X anticipates the taxing authorities will address the R&E credit.

Because X accumulates information separately for each project and believes the taxing authorities will audit each project individually, X concludes that there are four units of account, each with a separate tax policy.

Conclusion:

In Step 1, Projects 1, 2 and 3 satisfy the more-likely-than-not threshold. Project 4 does not. Thus, the R&E credit related to Projects 1, 2 and 3 it measured in Step 2. In Step 2, the benefit that X anticipates it will receive from each project upon settlement with the taxing authorities is $200,000 per project, or $600,000 total. The result is that X should recognize the $600,000 tax benefit related to Projects 1, 2 and 3, but not Project 4.

Because X has recorded a current tax provision credit of $1,000,000, a $400,000 liability for unrecognized tax benefits should be recorded.

<u>20X7 additional entry:</u>		
Income tax expense	400,000	
Liability on unrecognized tax benefit		400,000

Scenario 2:

Same facts as Scenario 1 except that X believes that all four projects should be treated as one unit of account with one tax policy.

Conclusion:

By treating all four as one unit of account, Steps 1 and 2 are tested in the aggregate for all four projects, rather than testing them individually.

In Step 1, the projects satisfy the more-likely-than-not threshold in the aggregate (including Project 4).

In Step 2, it is anticipated that it is more than 50 percent likely that $650,000 of the credit will be realized upon settlement with the taxing authority. Because X has already recorded a current tax provision that reflects the entire $1,000,000 credit, X must make an entry to record a $350,000 liability for unrecognized tax benefits.

<u>20X7 additional entry:</u>		
Income tax expense	350,000	
Liability on unrecognized tax benefit		350,000

Observation: Example 5 illustrates the benefits of combining several tax positions together and treating them as one unit of account. By doing so, those tax positions that may not satisfy the more-likely-than-not threshold individually are combined with other positions that do satisfy the threshold. As such, weaker individual tax positions satisfy Step 1 and proceed to the measurement test in Step 2.

In the above example, Project 4's tax benefit was realized by combining it with the others in Scenario 2, resulting in a total tax benefit recognized of $650,000 instead of only $600,000 in Scenario 1.

Example 6:

Company X takes a deduction in the amount of $10,000 on its 20X7 federal and state income tax returns which results in a tax benefit of $4,000. The deduction relates to several personal expenses of X's sole shareholder, Tony.

In evaluating the tax position taken, X believes it is <u>*not more-likely-than-not*</u> that the tax position will be sustained in audit. That is, X believes they will lose the deduction in audit. Therefore, X does not satisfy Step 1 of FIN 48 and cannot record the tax benefit related to the $4,000 and makes the following entry in 20X7.

<u>20X7 Entry:</u>

Income tax expense	xx	
Deferred income tax asset	xx	
Accrued tax liability		xx
Liability for unrecognized tax benefit		**4,000**

Continuing with this example, assume X does not get audited and the 3-year statute of limitations for audit expires in 20X11. X does not believe that the IRS and state can keep the statute of limitations open beyond three years.

Conclusion:

The Interpretation states that if the more-likely-than-not threshold is not met and the tax benefit is not recognized, an entity shall recognize the benefit when any one of the following three scenarios occurs:

- The more-likely-than-not recognition threshold is met by the reporting date of the subsequent period.
- The tax matter is ultimately settled through negotiation or litigation.
- The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

In this example, in 20X11, the statute of limitations expires. Therefore, X should reverse off the liability and recognize the tax benefit related to the deduction as follows:

<u>20X11 Entry:</u>

Liability for unrecognized tax benefit	4,000	
Income tax expense		4,000

Should interest and penalties be accrued to reflect the risk that an adjustment may be made to a tax position upon IRS or state audit?

Yes. The Interpretation states that when the tax law requires interest to be paid on an underpayment of income taxes, an entity should start recognizing interest expense in the first period the interest would begin accruing according to the relevant tax law.

The amount of interest expense recognized is computed by applying the applicable statutory rate of interest to the difference between the tax position recognized under the Interpretation and the amount previously taken or expected to be taken in the tax return.

Tax penalties are accrued only if the tax position meets the minimum statutory threshold for incurring such penalties on the tax position upon audit. The entity starts accruing penalties as an expense in the period in which it claims or expects to claim the position on the tax return.

If tax penalties are not expected to be incurred because the tax position does not meet a statutory threshold for such penalties, no penalties are accrued.

Moreover, if tax penalties were not recognized when a tax position was initially taken, the expense shall be recognized in the period in which the entity's judgment about meeting the statutory threshold changes.

How long should interest and applicable penalties be accrued?

Interest and penalties associated with tax positions should continue to be accrued and recorded as expense until one of three conditions occur:

1. The more-likely-than-not recognition threshold is met and the tax benefit of the tax position is recognized.
2. The tax matter is effectively settled through negotiation or litigation with the taxing authority.
3. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

In any of the three cases noted above, accrued interest and related penalties, if any, should be reversed off and credited to expense.

How should you classify interest and penalties- as part of taxes or as interest and penalties?

FIN 48 states that interest and penalties expense recognized may be classified as either income taxes or separated into interest expense and penalties expense, depending on the accounting policy of the entity. Under either scenario, the classification must be consistently applied.

Example:

For 20X7, Company X takes a tax position in deducting an expense that may not be deductible on its federal and state income tax returns.

The result is as follows:

	Tax deduction	Tax rate	Tax benefit
Tax benefit taken on tax returns	($2,500)	40%	$(1,000)
Probable tax benefit in audit	(1,500)	40%	(600)
Likely adjustment in audit			$ 400

Entry:		
Income tax expense (given)	140,400	
Deferred income tax asset (given)	20,000	
Accrued tax liability (given)		160,000
Liability for unrecognized tax benefit		**400**

X believes that if audited by both the IRS and Commonwealth of Massachusetts Department of Revenue, X will be able to settle on a tax adjustment in the amount of $400 plus interest charged on that assessment. X believes penalties will not be charged as it has substantial support for its tax position taken.

X files its federal and state tax returns on September 15, 20X8.

Conclusion:

X should start accruing interest on the $400 unrecognized tax benefit starting on March 15, 20X8 (the due date of the tax returns) until the case is either settled or the statute of limitations expires on September 15, 20X11 (3 years from the date the returns are filed).

Assuming the statutory interest rate is 10%, the entries would look like the following:

Period	Unrecognized tax benefit/accrued interest*	Interest rate	Accrued interest
March 15, 20X8 to December 31, 20X8	$400	10%	$32
20X9	432	10%	43
20X10	475	10%	48
January 1, 20X11 to September 15, 20X11	523	10%	37
Total accrued interest			$160
* Based on simple annual compounding. Interest would typically be computed on continuous compounding.			

Each year, 20X8 through 20X11, X would accrue interest in the amounts noted in the table above.

At September 15, 20X11, X would have an accrual for the unrecognized tax benefit as follows:

Unrecognized liability	$400
Accrued interest	160
Total liability	$560

Assume that as of September 15, 20X11, X has not been audited by the IRS or the Massachusetts Department of Revenue.

Conclusion:

Because there has been no audit, X should derecognize (reverse off) the liability for both the tax benefit ($400) and accrued interest ($160) as follows:

Entry:

Liability for unrecognized tax benefit	400	
Accrued interest	160	
Income tax expense		400
Interest expense		160

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. What is the second step in FIN 48's approach to evaluating and recognizing a tax position:

   a) determine the unit of account to be used
   b) examine the tax position by a taxing authority
   c) fulfill the more-likely-than-not limit
   d) measure the tax position's tax benefit

2. If the first step in the FIN 48's approach to evaluating and recognizing a tax position is not satisfied:

   a) the amount recorded is based on the assumption that the case will be negotiated
   b) the tax benefit of the tax position must be measured
   c) the tax position's tax benefit is not recognized
   d) there is a more than 50% likelihood that the tax position will be sustained

3. What does "more likely than not" mean:

   a) each unit of account will probably be tested individually
   b) the entity believes there are no economic benefits of the tax position
   c) the entity is more than 50% certain it is entitled to economic benefits
   d) the taxing authority will not examine the tax position

4. The unrecognized tax benefit is the amount:

   a) of benefit recognized in the balance sheet
   b) that is the same as that taken in the tax return in the current year
   c) that the entity may be obligated to pay to the taxing authority in the future
   d) that the entity would accept from the taxing authority to resolve a dispute

5. The unrecognized tax benefit liability:

   a) does not have to be recorded if a valuation account is used
   b) is presented as a current liability on the balance sheet
   c) is the benefit amount the entity believes it will receive if audited
   d) must be combined with deferred tax liabilities

6. An entity shall derecognize a tax position in the first period when:

   a) it is no longer more likely than not that the tax position would be sustained
   b) the more than 50% recognition threshold is met by the reporting date of the subsequent period
   c) the statute of limitations for examining and challenging the tax position has expired
   d) the tax matter is ultimately negotiated or litigated

SUGGESTED SOLUTIONS

1. A: Incorrect. Determining the unit of account is part of fulfilling the first step of FIN 48, and not Step 2.

   B: Incorrect. The first step and not the second step of fulfilling the more-likely-than-not limit involves the examination of the tax position by a taxing authority that has complete knowledge of all relevant information.

   C: Incorrect. The first step and not the second step in FIN 48's approach to evaluating and recognizing a tax position is to fulfill the more-likely-than-not limit.

   D: Correct. The second step in the FIN 48's approach to evaluating and recognizing a tax position is to measure the tax position's tax benefit.

   (See page 6-15 of the course material.)

2. A: Incorrect. If the first step is satisfied and the tax benefit of the tax position is measured, the amount recorded is based on the assumption that the case will be negotiated and reflects what the company would accept from the taxing authority to resolve a dispute or to settle.

   B: Incorrect. If the first step in the FIN 48's approach to evaluating and recognizing a tax position is satisfied, the tax benefit of the tax position must be measured, which is the second step in the Interpretation's approach.

   C: Correct. If the first step in the FIN 48's approach to evaluating and recognizing a tax position is not satisfied, the tax position's tax benefit is not recognized.

   D: Incorrect. If the first step in the FIN 48's approach to evaluating and recognizing a tax position is satisfied, it means that there is a more than 50% likelihood that the tax position will be sustained.

   (See page 6-15 of the course material.)

3. A: Incorrect. Under FIN 48, determining how to treat units of account involves deciding to combine tax positions or keep each tax position separate. Either way can be justified.

   B: Incorrect. More-likely-than-not means that there is a positive assertion that the entity is entitled to the economic benefits (i.e., the entity believes that they qualify to receive the available economic benefits of the tax position).

   C: Correct. More-likely-than-not means that the entity is more than 50% certain it is entitled to economic benefits of the tax position.

   D: Incorrect. In determining whether the tax position meets the more-likely-than-not threshold, it is presumed that a taxing authority will examine the tax position.

   (See page 6-15 of the course material.)

4. **A: Correct.** The unrecognized tax benefit is the amount of benefit recognized in the balance sheet.

   B: Incorrect. The unrecognized tax benefit may differ from the amount taken or expected to be taken in the tax return in the current year.

   C: Incorrect. The unrecognized tax benefit liability is a liability that is created for the unrecognized tax benefit. The liability presents the amount that the entity may be obligated to pay to the taxing authority in the future for a tax position that FIN 48 did not recognize.

   D: Incorrect. The measurement of the tax benefit is the amount that the entity would accept from the taxing authority to resolve a dispute or avoid court.

   (See page 6-17 of the course material.)

5. A: Incorrect. According to FIN 48, recording an unrecognized tax benefit liability cannot be substituted with the use of a valuation account.

   B: Correct. On the balance sheet, the unrecognized tax benefit liability is presented as a current liability, or as a reduction in the refundable receivable, to the extent that the entity anticipates payment, or receipt, of cash within a year or the operating cycle, whichever is longer.

   C: Incorrect. The unrecognized tax benefit liability is the difference between the tax benefit reported on the tax return for an item and the benefit amount that the entity believes it will receive if it is audited and must settle.

   D: Incorrect. According to FIN 48, deferred tax liabilities cannot be combined with the unrecognized tax benefit liability.

   (See page 6-18 of the course material.)

6. **A: Correct.** An entity shall derecognize a tax position in the first period when it is no longer more likely than not that the tax position would be sustained.

   B: Incorrect. If Step 1 is not satisfied in the period a tax position is taken or expected to be taken, but the more than 50% recognition threshold is met by the reporting date of the subsequent period, the entity shall recognize the benefit in the first interim period.

   C: Incorrect. If Step 1 is not satisfied in the period a tax position is taken or expected to be taken, but the statute of limitations for examining and challenging the tax position has expired, the entity shall recognize the benefit in the first interim period.

   D: Incorrect. If Step 1 is not satisfied in the period a tax position is taken or expected to be taken, but the tax matter is ultimately negotiated or litigated, the entity shall recognize the benefit in the first interim period.

   (See page 6-19 of the course material.)

V. Disclosures

1. All entities shall disclose the following information:

   a. Its policy on classification of interest and penalties assessed by taxing authorities.

   b. As of the end of each annual reporting period presented:

      1) The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, assessed by taxing authorities.
      2) For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
         - The nature of the uncertainty
         - The nature of the event that could occur in the next 12 months that would cause the change
         - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
      3) A description of tax years that remain subject to examination by major tax jurisdictions.

2. Public companies *only* shall include the following additional disclosures as of the end of each annual reporting period presented:

   a. 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:

      1) The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
      2) The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.
      3) The amounts of decreases in the unrecognized tax benefits relating to settlements within taxing authorities.
      4) Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

   b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

   Observation: ASU 2009-06 amended FIN 48 to exempt non-public companies from the two disclosures noted in item (2)(a) and (2)(b), above. Consequently, only public companies must disclose a tabular reconciliation and the total amount of unrecognized tax benefits.

   In response to the issuance of the exposure draft, the FASB received numerous letters noting concerns that disclosures would tip off taxing authorities to positions taken on tax returns. To resolve some of that concern, in the final statement the FASB aggregated the information within the disclosure making it difficult for taxing authorities to obtain details on individual positions taken.

The following table summarizes the disclosures required for public and non-public companies alike.

Comparison of Required Disclosures- FIN 48			
Disclosure	**Disclosure reference**	**Public entities**	**Non-public entities**
The Company's policy on classification of interest and penalties assessed by taxing authorities.	1	Required	Required
The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities.	2	Required	Required
For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date: • The nature of the uncertainty. • The nature of the event that could occur in the next 12 months that would cause the change. • An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.	3	Required	Required
A description of tax years that remain subject to examination by major tax jurisdictions.	4	Required	Required
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 amount of decreases in the unrecognized tax benefits relating to settlements within taxing authorities. • Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.	5	Required	Not required
The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.	6	Required	Not required

Example Disclosures:

Following are sample disclosures. In parentheses, the author has included the disclosure reference from the table above.

Example 1 Disclosure: Public Company

Note X: Tax Uncertainties

The Company files income tax returns in the U.S. federal jurisdiction, and various states (not required).

The Company's federal and state tax returns are open for examination for the years 20X4, 20X5 and 20X6 (Disclosure 4).

The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8 (Disclosure 3).

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (public company disclosure only) (Disclosure 5):

Balance at January 1, 20X7	$ 0
Additions based on tax positions related to the current year	210,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(50,000)
Reductions due to settlements with taxing authorities	(40,000)
Reductions due to lapse in statute of limitations	(10,000)
Balance at December 31, 20X7	$140,000

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses (Disclosure 1).

For years ended December 31, 20X7, 20X6 and 20X5, the Company recognized approximately $12,000, $15,000 and $17,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $50,000 and $45,000, respectively (Disclosure 2).

Included in the balance at December 31, 20X7 and 20X6 are $30,000 and $25,000, respectively, of tax positions that relate to tax deductions that upon audit could be disallowed, resulting in a higher effective tax rate. Management believes that it is more likely than not that these tax positions would be sustained in the event of audit. (public company disclosure only) (Disclosure 6).

Example 2 Disclosure: Non-Public Company

Note X: Tax Uncertainties
The Company files income tax returns in the U.S. federal jurisdiction, and in the Commonwealth of Massachusetts (not required).
The Company's federal and state tax returns are open for examination for the years 20X4, 20X5 and 20X6 (Disclosure 4).
The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8 (Disclosure 3).
The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses (Disclosure 1).
For years ended December 31, 20X7 and 20X6, the Company recognized approximately $5,000 and $6,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $2,000 and $3,000, respectively (Disclosure 2).

Example 3 Disclosure: Non-Public Company- Abbreviated Disclosure

Most public companies do not have tax positions that require the recording of an unrecognized liability. In such cases, the minimum disclosures are as follows:

Note X: Tax Uncertainties
The Company's policy is to record interest expense and penalties in operating expenses (Disclosure 1). For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense recorded and no accrued interest and penalties (Disclosure 2).
The Company's federal and state tax returns are open for examination for the years 20X4, 20X5 and 20X6 (Disclosure 4).

Observation: At a minimum, a company must disclose three items regardless of whether it has any unrecognized liability adjustments under FIN 48:

1. The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses (Disclosure 1),
2. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities (Disclosure 2), and

3. A description of tax years that remain open subject to examination by major tax jurisdictions (Disclosure 4).

Are the three disclosures noted above (Disclosures 1, 2 and 4) required for an S corporation, LLC-partnership, a not-for-profit or tax-exempt entity, or an entity that has no liability for unrecognized tax benefit under FIN 48?

Yes. A literal reading of FIN 48 is that the above three disclosures (Disclosures 1, 2 and 4) apply to all entities that are subject to the requirements of FIN 48. FIN 48 specifically includes pass-through entities, tax-exempt entities and not-for-profit entities. Consequently, even if any entity has no liability recorded under FIN 48, the disclosures still apply. Thus, all entities must disclose, at a minimum,

1. The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses (Disclosure 1),

2. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities (Disclosure 2), and

3. A description of tax years that remain open subject to examination by major tax jurisdictions (Disclosure 4).

VI. <u>Implementing the Interpretation</u>

For public entities, the Interpretation was effective for *<u>fiscal years beginning after December 15, 2006</u>*. Earlier adoption was permitted as of the beginning of an entity's fiscal year provided the entity has not yet issued its financial statements, including financial statements for any interim period, for that fiscal year.

For non-public entities, FSP FIN 48-3 provided a deferred effective date for annual financial statements for fiscal years *<u>beginning after December 15, 2008</u>* (calendar 2009).

Although the effective date has expired, following are the rules that FIN 48 provided for implementation:

1. The provisions to FIN 48 applied to all tax positions upon initial adoption of the Interpretation.

2. Only tax positions that met the more-likely-than-not recognition threshold at the effective date were recognized at the adoption of the Interpretation.

3. The cumulative effect of applying the provisions of FIN 48 were reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the balance sheet), for that fiscal year, presented separately.

a. FIN 48 defines the amount of the cumulative effect adjustment as the difference between the net amount of assets and liabilities recognized in the balance sheet prior to the application of the Interpretation and the net amount of assets and liabilities recognized as a result of applying the provision of the Interpretation.

b. The cumulative-effect adjustment does not include any items that would not be recognized in earnings, such as the effect of adopting the Interpretation on tax positions related to business combinations.

Example:

Effective January 1, 2009, Company X is a non-public entity that adopted FIN 48.

The statute of limitations for both IRS and state audits is still open for 2006-2008 tax years.

X's tax rate is 40%.

X does an analysis of all of its tax positions and concludes that it has several tax positions that may result in the recording of a liability for unrecognized tax benefits.

Details follow as of January 1, 2009:

	Tax deductions of uncertain tax positions				
	2005	2006	2007	2008	Total
Expenses for personal items	$10,000	$20,000	$17,000	$23,000	$70,000
Repairs expensed in excess of amount that should be capitalized	25,000	30,000	18,000	27,000	100,000
					$170,000

The above items consist of tax deductions for which X believes it is more likely than not that the tax benefit will be sustained in audit. The above amounts represent the tax deductions for which X believes it is more than 50 percent likely to be obtained in settlement with the taxing authorities.

	Tax deduction	Tax rate	Tax	Interest Accrual (1)
Expenses for personal items	$70,000	40%	$28,000	$4,000
Repairs that should be capitalized	100,000	40%	40,000 (2)	6,000
Liability for unrecognized tax benefits	$170,000	40%	$68,000	$10,000

(1): Interest accrued from the year in which the deduction was taken until January 1, 2009.
(2): Offset to adjustment is deferred income taxes as the deduction is only a timing difference.

Entry: January 1, 2009:		
Deferred income tax liability	40,000	
Cumulative effect (retained earnings)	28,000	
Liability for unrecognized tax benefit		68,000
Accrued interest		10,000
Cumulative effect (retained earnings)	10,000	

What if a non-public company had no uncertain tax positions in 2009 and did not implement FIN 48 in 2009? What happens in 2010 and beyond?

If a company did not have any uncertain tax positions at the implementation date (assume January 1, 2009), there was no liability to record for uncertain tax positions and no cumulative effect to record through the income statement. However, that fact did not relieve the company of the requirement to make the disclosures required by FIN 48.

To recap, the three disclosures that must be made by a non-public entity regardless of whether there is any liability to record, are:

1. The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses (Disclosure 1),

2. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities (Disclosure 2), and

3. A description of tax years that remain open subject to examination by major tax jurisdictions (Disclosure 4).

Therefore, in 2009 (the year of implementation of FIN 48), non-public companies should have included the above three disclosures in their financial statements.

Then, what happens in 2010, 2011 and other subsequent years? Each year, an entity should review its tax positions and determine whether each position is supportable; that is, make sure that upon IRS or state audit, it is more likely than not that the position will be sustained. If the more-likely-than-not criterion is satisfied for each tax position, no liability for uncertain tax positions is required and the company continues to include the three disclosures noted above.

There may be a year in the future in which the company reviews is tax positions and determines that there should be a liability recorded. If so, the entry is as follows:

Entry:		
Income tax expense	XX	
Liability for unrecognized tax benefit		XX

For most non-public companies, the review of tax positions will result in no need for a liability being recorded. Instead, the extent to which the non-public entity will be required to comply with FIN 48 will be to include the three disclosures noted above in its financial statements.

VII. Impact of FIN 48 on the IRS and State Tax Agencies

Due to the required disclosures under FIN 48, there is far greater transparency into a company's tax positions than ever before. Under FIN 48, a company is required to record a tax benefit for those tax positions that have a more-than-50-percent probability of being sustained in audit. For those at 50 percent or less, a liability is required which is reflective of the uncertainty that exists in a tax position. Thus, the total liability represents the cumulative uncertainty of sustaining the tax benefit of all tax positions. That liability is not only presented separately on a company's balance sheet, but also must be reconciled in the notes to financial statements. In essence, FIN 48 lays out important information about a company's tax positions which can be used against it.

If a company has a sizeable balance in its unrecognized tax benefit account, that fact suggests that there are several significant positions that may be challengeable by the IRS and other tax jurisdictions. Those third parties have access to the footnotes that include information on the unrecognized tax benefits.

Who is going after companies tax positions under FIN 48?

The list of third parties interested in a company's FIN 48 information includes not only the IRS, but also state departments of revenue. Both the IRS and states have a vested interest in knowing a company's tax positions to assist in uncovering potential understated tax liabilities.

IRS's disclosures of uncertain tax positions- Schedule UTP

There are few instances where the Internal Revenue Service or other taxing authorities cross over to use GAAP information to assist them in conducting federal and state tax audits. The issuance of FIN 48 has given the IRS an opening to use FIN 48 working papers and disclosure information to uncover undisclosed tax positions.

With respect to the accountant's or auditor's tax accrual workpapers, the IRS has had a long-standing policy of restraint in seeking tax accrual workpapers,[3] requesting them in rare and unusual circumstances or where the taxpayer was involved in certain listed transactions.

In situations in which the IRS has demanded tax accrual workpapers, they have won in court such as in the case of *United States v. Textron, Inc*. (577, .3d 21 (1st Cir 2009)), in which the court held that tax accrual workpapers are not privileged work product.

In early 2010, the IRS issued Announcement 2010-9 to address disclosures of uncertain tax positions on an entity's federal tax return. Subsequently, the IRS issued Announcement 2010-75 to replace 2010-9.

In Announcement 2010-75, the IRS stated that it was releasing a schedule that certain taxpayers will be required to disclose uncertain tax positions on their Form 1120 corporate tax return or other returns. The Schedule UTP, *Uncertain Tax Position Statement*, is effective from 2010 through 2014 based on a phase-in depending on the entity's asset size.

[3] IRS Announcement 2002-63.

More specifically, the following rules apply under the Announcement:

a. Both public and non-public entities with total assets of $10 million or more, that issue or are *included in audited financial statements*[4], and file a Form 1120, must file the Schedule UTP.

b. On the Schedule UTP, the taxpayer must:

   - Disclose a concise description of each uncertain tax position, and

   - Rank all of the reported tax positions based on the federal income tax reserve recorded for the position taken on the tax return, and designate the tax positions to which the reserve exceeds 10 percent of the aggregate amount of reserve for all tax positions reported.

c. The types of tax positions that require disclosure on the Schedule UTP include:

   - Uncertain tax positions for which a taxpayer has recorded a reserve in its audited financial statements, and

   - Uncertain tax positions for which the corporation did not record a reserve because the corporation expects to litigate the tax position.

d. There is a five-year phase-in of the reporting requirement from 2010 to 2014, based on the corporation's asset size. The effective date of the new Schedule UTP is phased in based on the entity's asset size as follows:

   - Corporations with total assets of $100 million or more start filing in 2010.

   - Corporations with total assets of $50 million but less than $100 million start filing in 2012.

   - Corporations with total assets of $10 million but less than $50 million start filing in 2014.

e. The Schedule is not applicable to pass-through entities, although starting in 2011 the IRS can extend the application of Schedule UTP to pass-through entities or tax-exempt organizations.

What is the threshold used to determine a tax position under the IRS requirements?

The instructions to the new Schedule UTP state that the analysis of whether a reserve has been recorded for an uncertain tax position for purposes of completing the Schedule UTP is determined by reference to reserve decisions made for audited financial statement purposes. Therefore, if under audited GAAP financial statements, no liability (reserve) is recorded for a tax position using the more-like-than-not (more than 50 percent) threshold, the uncertain tax position is not disclosed on Schedule UTP.

[4] The Announcement specifies that entities on which financial statements are compiled or reviewed are not subject to the Schedule UTP requirements.

Moreover, if the amount of the reserve is immaterial under GAAP, no disclosure of the tax position is required in Schedule UTP.

Observation: The IRS has adopted the same threshold (more-likely-than-not) that GAAP uses for evaluating uncertain tax positions under FIN 48.

Previously, IRC Section 6694 used a greater-than-40-percent success rate in determining whether an undisclosed tax position had "substantial authority" to allow a tax preparer to avoid a preparer penalty.

In the *Small Business and Work Opportunity Tax Act of 2007*, the Act replaced the "substantial authority" threshold with a "more-likely-than-not" threshold. Specifically, the Act provided that a practitioner was not permitted to sign a tax return unless the practitioner had a reasonable belief that it is *more-likely-than not* (more than 50%) that the tax positions would be sustained on their merits. Signing a tax return that has unreasonable positions makes the preparer subject to preparer penalties. In the *2008 Tax Extenders and Alternative Minimum Tax Relief Act,* the more-likely-than-not threshold was changed back to "substantial authority" as the standard for avoiding preparer penalties only. The more-likely-than not threshold is retained for the reporting of uncertain tax positions, tax shelters, and other reportable transactions.

Will the IRS use the tax accrual workpapers and financial statement disclosures related to uncertain tax positions to assist it in auditing a company's tax return?

In Announcement 2010-76, the IRS stated that it has expanded its policy of restraint by requiring the completion of the Schedule UTP, but will forego seeking particular documents that relate to uncertain tax positions and the workpapers used to prepare the Schedule UTP.

Although the IRS may not seek use of tax accrual workpapers, the IRS has announced that it is using the footnote disclosures required by FIN 48 to audit uncertain tax positions. In 2007, the IRS Large Business and International Division (LB&I) issued *FIN 48 Implications LB&I Field Examiners' Guide* and published the following question:

Question: Are FIN 48 Disclosures a Roadmap for the IRS?

IRS Answer:

The disclosures required under FIN 48 should give the Service a somewhat better view of a taxpayer's uncertain tax positions; however, the disclosures still do not have the specificity that would allow a perfect view of the issues and amounts at risk. For example, there may be a contingent tax liability listed in the tax footnotes of a large multi-national taxpayer with a description called "tax credits," however, tax credits could be U.S., foreign, or state tax credits. So the "tax credits" in this example, may or may not have a U.S. tax impact.

Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 disclosures, should be carefully reviewed and analyzed as part of the audit planning process. For example, if a taxpayer reflecting a contingent tax liability in the year under audit for Subpart F income does not reflect Subpart F in the tax return, questions could develop about why Subpart F income does not appear in the tax return, but is mentioned in the tax footnotes as creating a contingent tax liability.

Revenue Agents should not be reluctant to pursue matters mentioned in FIN 48 disclosures, but should be mindful of our policy of restraint on Tax Accrual Workpapers (TAW) and not cross over the boundaries contained there. If, for example, there is discussion in the tax footnotes about a contingent tax liability being reversed because the statute of limitations related to the transfer of an intangible asset has expired, even though the statute may have run on that particular issue, this provides insight into how the taxpayer may be treating other intangible assets in other years where the statute of limitations is still open. In this example, this is public information that can be used without violating the TAW's policy.

State tax agencies and the search for nexus:

State tax agencies also have a strong interest in FIN 48 information. With sizeable budget shortfalls, going after companies that have underreported state taxes provides the states with the opportunity to retrieve significant tax revenue. In particular, states are using FIN 48 information to attack two particular areas of vulnerability for companies:

- Factors that lead to nexus within a particular state, and
- Computation of apportionment.

Because of the current state tax environment in which many states are creating their own rules as to whether there is state nexus, it may be difficult to conclude whether there is a more-than-50-percent likelihood that a company's position will be challenged.

VIII. <u>OCBOA and Avoiding FIN 48</u>

Some nonpublic companies may choose to avoid the applicability of FIN 48 altogether, particularly in situations in which there could be sizeable state income tax exposure. The question is whether FIN 48 applies to income tax basis financial statements or another form of other comprehensive basis of accounting (OCBOA) financial statements.

With respect to income tax basis financial statements, the recognition element of FIN 48 (e.g., whether to record a liability for an unrecognized tax effect that does not meet the more-likely-than-not threshold) does not apply because such a liability is not recognized under the Internal Revenue Code.

Even though FIN 48's recognition element does not apply to income tax basis statements, the disclosure elements do.

As it relates to disclosures in OCBOA financial statements, the authority is found in Interpretation No. 14 of SAS No. 62, *Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting: Interpretation of SAS No. 62, Special Reports.* Interpretation No. 14 requires that OCBOA financial statements include all similar informative disclosures to those required by GAAP. In the case of FIN 48, there are several disclosures that should be included in OCBOA (income tax basis) financial statements:

Following is a comparison of the FIN 48 disclosures required under GAAP with those disclosures that would be applicable to OCBOA:

Comparison of Required GAAP Disclosures to OCBOA			
Disclosure	**Disclosure reference**	**Non-public entities GAAP**	**Applicable to OCBOA?**
The Company's policy on classification of interest and penalties assessed by taxing authorities.	1	Required	Yes
The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities.	2	Required	Yes
For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date: • The nature of the uncertainty. • The nature of the event that could occur in the next 12 months that would cause the change. • An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made	3	Required	Not applicable No liability recorded under OCBOA
A description of tax years that remain subject to examination by major tax jurisdictions.	4	Required	Yes
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 unrecog-nized tax benefits relating to settlements within taxing authorities. • Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.	5	Not required for non-public entities	Not applicable
The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.	6	Not required for non-public entities	Not applicable

GAAP Departures

Another way to eliminate the applicability of FIN 48 is to ignore it and include a GAAP departure in the accountant's or auditor's report.

Sample Report: Compilation with GAAP Departure for FIN 48

Accountant's Compilation Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

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. 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 is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

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, 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.***

Accounting principles generally accepted in the United States of America require that the Company test its tax positions to determine whether it is more likely than not that upon audit, the tax positions would be sustained based on the merits, and include certain disclosures related to tax positions. For tax positions that do not satisfy the more-likely-than-not threshold, the Company would be required to record a liability for the unrecognized tax benefit and include certain additional disclosures. Management has informed us that the Company has not performed a test of its tax positions, has not included any required disclosures related to its tax positions, and has not determined whether any liability and related additional disclosures are warranted. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

James J. Fox & Company, CPA
[Date] (date of completion of compilation engagement)

Sample Review Report with GAAP Departure for FIN 48

Independent Accountant's Review Report

Board of Directors
XYZ Company
Nowhere, Massachusetts

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 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. Accordingly, we do not express such an opinion.

Management is 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.

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 us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, (***with the exception of the matter described in the following paragraph),*** 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 3 to the financial statements, accounting principles generally accepted in the United States of America require that the Company test its tax positions to determine whether it is more likely than not that upon audit, the tax positions would be sustained based on the merits, and include certain disclosures related to tax positions. For tax positions that do not satisfy the more-likely-than-not threshold, the Company would be required to record a liability for the unrecognized tax benefit and include certain additional disclosures. Management has informed us that the Company has not performed a test of its tax positions, has not included any required disclosures related to its tax positions, and has not determined whether any liability and related additional disclosures are warranted. The effects of this departure from generally accepted accounting principles on financial position and results of operations have not been determined.

James J. Fox & Company, CPA
Date:

Sample Audit Report with GAAP Departure for FIN 48

Independent Auditor's Report

To the Board of Directors
Company X
Nowhere, Massachusetts

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

As disclosed in Note 3, the Company has not performed a test to determine whether it is more likely than not that upon audit, the tax positions would be sustained based on the merits. For tax positions that do not satisfy the more-likely-than-not threshold, the Company would be required to record a liability for the unrecognized tax benefit and include certain disclosures. In our opinion, the company should perform the test and, if required by the test, should record a liability for the unrecognized tax benefit and include certain disclosures in the financial statements. The effects on the financial statements of the preceding practice are not reasonably determinable.

In our opinion, ***except for the effects of not testing tax positions and included certain required disclosures related to those tax positions****,* as discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

James J. Fox & Company
Date:

Note: If there is a GAAP departure in the report, the company would not only ignore any test of its tax positions, but would also avoid including any of the six disclosures required by FIN 48.

IX. Ethics FAQ Changes – FIN 48

As a result of the issuance of FIN 48, a question has arisen as to whether an accountant impairs his or her independence if he or she assists a client in applying FIN 48.

Background: FIN 48 permits a company to recognize the tax benefit of a tax position only if it is more likely than not that the position and benefit will be sustained upon audit. In many instances, the determination of whether a tax position satisfies the more-likely-than-not criterion is made with the assistance of an accountant or auditor. If an accountant or auditor does, in fact, assist a client in implementing and applying FIN 48, has that accountant or auditor impaired his or her independence by making management decisions?

In response to this issue, the AICPA Professional Ethics Division added the FIN 48 issue to its non-authoritative listing of Bookkeeping FAQs that appears on the AICPA website.

Question: Would assisting a client in applying FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, such as identifying potential uncertain tax positions, advising the client whether those tax positions meet the more-likely-than-not (MLTN) threshold, and calculating the related unrecognized tax benefits impair independence?

Answer: The provision of such services would not impair independence provided the client can make an informed judgment on the results of the member's services and the other requirements of Interpretation 101-3 are met. In meeting the requirements of Interpretation 101-3, the member may assist the client in understanding why the tax positions do or do not meet the MLTN threshold and the basis for any unrecognized tax benefit so that the client can accept responsibility for the amounts reported and disclosed 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 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. Which of the following disclosures is required for a non-public entity in connection with FIN 48:

   a) the entity's policy on classification of interest and penalties
   b) a tabular reconciliation of the total amounts of unrecognized tax benefits
   c) the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
   d) details about the tax positions for which a liability has been recognized

2. The cumulative effect of applying FIN 48:

   a) includes any items that would not be recognized in earnings
   b) is the net amount of assets and liabilities recognized in the balance sheet prior to its application
   c) shall be reported as an adjustment to the opening balance of retained earnings
   d) shall be reported as a cumulative effect on the income statement

3. Under IRS Announcement 2010-75, the disclosure rules for uncertain tax positions apply to entities that have which of the following attributes:

   a) must be a public entity
   b) there must be audited financial statements
   c) a Form 1120 or 1120S must be filed
   d) total assets must be $100 million or more

4. Which of the following disclosures would not be required if OCBOA financial statements are issued:

   a) the total amounts of interest and penalties recognized in the statement of operations
   b) the Company's policy on classification of interest and penalties assessed by taxing authorities
   c) a description of tax years that remain subject to examination by major tax jurisdictions
   d) a tabular reconciliation of the total amounts of unrecognized tax benefits

5. Facts: Company X hires an accountant to assist X with applying FIN 48. Which of the following is correct:

   a) such services automatically impair the accountant's independence
   b) such services do not impair independence as long as the accountant takes responsibility for the FIN 48 calculations
   c) the services impair independence only if the more-likely-than-not threshold is met
   d) such services do not impair independence as long as the client can make an informed judgment on the results of the services and other requirements of Interpretation 101-3 are met

SUGGESTED SOLUTIONS

1. **A: Correct.** A disclosure of an entity's policy on classification of interest and penalties is required for both public and non-public entities.

   B: Incorrect. A tabular reconciliation of the total amounts of unrecognized tax benefits is required for a public entity only.

   C: Incorrect. Only a public entity must disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

   D: Incorrect. FIN 48 does not require an entity to disclose the details about the tax positions for which a liability has been recognized.

   (See page 6-38 of the course material.)

2. A: Incorrect. The cumulative effect adjustment does not include any items that would not be recognized in earnings.

   B: Incorrect. The cumulative effect adjustment is the net amount of assets and liabilities recognized in the balance sheet prior to its application minus the net amount of assets and liabilities recognized as a result of its application.

   C: Correct. The cumulative effect of applying FIN 48 shall be reported as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately.

   D: Incorrect. The cumulative effect is not presented on the income statement, but rather as an adjustment to retained earnings.

   (See page 6-41 of the course material.)

3. A: Incorrect. It applies to both public and nonpublic entities.

   B: Correct. The entity must have had audited financial statements in order for the disclosure rules to apply.

   C: Incorrect. Only the filing of a Form 1120 makes the entity subject to the disclosure rules of the Announcement.

   D: Incorrect. The rules apply to entities with total assets of $10 million or more, not $100 million or more.

   (See page 6-45 of the course material.)

4. A: Incorrect. OCBOA, like GAAP, requires a disclosure of the total amounts of interest and penalties recognized in the statement of operations.

   B: Incorrect. OCBOA, like GAAP, requires a disclosure of the Company's policy on classification of interest and penalties assessed by taxing authorities.

   C: Incorrect. OCBOA, like GAAP, requires a description of tax years that remain subject to examination by major tax jurisdictions.

   D: Correct. A tabular reconciliation of the total amounts of unrecognized tax benefits is not required because no liability for unrecognized tax benefits is recorded under OCBOA statements.

   (See page 6-48 of the course material.)

5. A: Incorrect. Such services do not automatically impair the accountant's independence, but may impair independence if certain criteria are not met.

   B: Incorrect. The client, not the accountant, must take responsibility for the FIN 48 calculations.

   C: Incorrect. Whether the more-likely-than-not threshold is met or not is not a determinant to accountant independence.

   D: Correct. An ethics ruling states that such services do not impair independence as long as the client can make an informed judgment on the results of the services and other requirements of Interpretation 101-3 are met.

   (See page 6-52 of the course material.)

Chapter 7: Current Developments – Accounting and Financial Reporting

Table of Contents

Current Developments – Accounting and Financial Reporting

Upon completing this chapter, you will be able to:

- List ways in which companies recognize revenue prematurely
- Recognize the changes proposed to lease accounting
- Identify FASB's codification
- Compare the arguments in favor of and against Big GAAP-Little GAAP and the Blue Ribbon Panel Report
- Compute the valuation allowance required for a deferred tax asset
- Discuss the impact that the Obama Patient Protection and Affordable Care Act has on deferred tax assets
- Recognize the changes made by selected Accounting Standards Updates (ASUs) issued through 2011
- Discuss the conclusions reached by recently issued Technical Practice Aids

I. <u>Latest Developments on the Accounting Front</u>

A. SIGNIFICANT GAAP CHANGES COMING IN 2011 AND 2012

Get ready. 2011 and 2012 will be two of the most active years in the FASB's history as there is a slew of new statements about to be issued. A key driver to the FASB's rapid-fire approach is their goal to accelerate the international convergence project so that U.S. companies will adopt international accounting standards by 2015. The author addresses the international FASB-IASB joint convergence project further on in this course.

Not all of the projects in the works are jointly issued by the FASB and IASB. Many of them are not part of the international standards project and are being developed and ultimately issued by the FASB alone. What is clear is that companies will have significant implementation issues as each of these new FASB statements is issued and the effective date of adoption nears.

The most significant projects follow:

Major Project	**What it will do**
Revenue Recognition	Revenue would be recognized when control of the good or service is transferred to the customer.
Accounting for Financial Instruments	This statement would move more financial instruments to fair value.
Leases	The concepts of operating and capital leases would be eliminated. Most lease assets and liabilities would be capitalized.
Fair Value Measurement	The project revises the definition of fair value.
Financial Statement Presentation	This project makes drastic changes to the format of financial statements.

Except for the financial statement presentation project, the FASB expects to issue either an exposure draft or final statement on the other four projects in 2011.

B. REPORTING INFORMATION ABOUT THE FINANCIAL PERFORMANCE OF BUSINESS ENTERPRISES

1. FASB Looks at Changing Financial Performance Reporting

Should we change the way we report financial performance?

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.

In 2001, the FASB added a project to its agenda under the title *Financial Performance Reporting by Business Enterprises*. The primary objectives of the project are:

- To improve the quality of information displayed in financial statements so that third parties can better evaluate an entity's financial performance, and
- To determine whether sufficient information is contained in the financial statements to permit calculation of key financial measures used by investors and creditors.

The project focuses on the form and content, classification, aggregation, and display of specified items and summarized amounts on the face of all basic financial statements. This includes determining whether to require the display of certain items that are considered key measures.

Recent Developments With the FASB

The FASB and Europe's IASB are simultaneously working on separate 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 U.K.'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 statement, 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 proposed changes in Phase A are reflected within the Phase B staff exposure draft discussed below.

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.

In June 2010, the FASB and IASB decided to conduct outreach activities before finalizing and publishing an exposure draft on financial statement presentation.

In July 2010, the FASB staff issued *Staff Draft of an Exposure Draft on Financial Statement Presentation,* which reflects the FASB's and IASB's cumulative tentative decisions on financial statement presentation.

The FASB staff is conducting outreach projects with investors and financial statement preparers to obtain feedback on the format and tentative decisions made that are expected to be reflected in a forthcoming exposure draft and ultimately final statement issuance.

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:

1. <u>*Disaggregates information so that it is useful in predicting an entity's future cash flows:*</u> Disaggregation means separating resources by the activity in which they are used and by their economic characteristics.

2. <u>*Portrays a cohesive financial picture of an entity's activities:*</u> A cohesive financial picture means that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible.

Phase B would apply to all entities except:

- Not-for-profit entities, and

- Benefit plans within ASC 960, *Plan Accounting-Defined Benefit Pension Plans* (formerly FASB No. 35).

The proposed changes would apply to non-public entities except for certain disclosures that would not apply to non-public entities.

Investment companies and certain other entities would not be required to present a statement of cash flows.

Key proposed changes identified in the Staff Draft include:

1. A complete set of financial statements consists of two years of comparative information for the following:

    a. Statement of financial position as of the end of the period
    b. Statement of comprehensive income for the period
    c. Statement of cash flows for the period
    d. Statement of changes in equity for the period
    e. Notes comprising a summary of significant accounting policies and other explanatory information

2. A third statement of financial position would be required as of the beginning of the comparative period if an accounting principle is applied retrospectively with financial statements restated or items reclassified in the financial statements.

3. <u>Statement of Financial Position (Balance Sheet)</u>:

    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. Cash would be classified in the operating category in the balance sheet.

        - Cash would not include short-term investments regardless of their liquidity or nearness to maturity.

    d. 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.

4. <u>Statement of Comprehensive Income</u>:

    a. An entity would present all items of income and expense recognized in the statement of comprehensive income segregated into:

        - Net income
        - Other comprehensive income

    b. The proposal would eliminate 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.

c. In addition to the section, category, and subcategory subtotals, the statement of net income part of the statement of comprehensive income would include line items that present the following amounts:

- Revenue
- Income or loss from operating activities before operating finance activities
- Net income or loss
- Net income or loss attributable to noncontrolling interests and owners of the parent.

5. Statement of Cash Flows:

a. The direct method would be required, thereby eliminating the choice of using the indirect method.

b. The total amounts of cash shown at the beginning and end of the period would be the same as the cash in the statement of financial position.

c. An indirect reconciliation of operating income to operating cash flows would be required in the notes to financial statements.

d. Non-cash transactions would be presented as a supplement to the statement of cash flows in a way that provides information on the effect on the capital structure and effect on the asset structure of the entity.

6. 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:

- By component of equity, at the earliest period presented, the effects of any retrospective application or restatement in accordance with GAAP, and

- For each component of equity, an analysis of the changes in the carrying amount from the beginning to the end of the period.

7. Separating (disaggregating) information into categories:

All statements would be separated into five main categories as follows:

a. ***Business section:*** Includes operating activities and its investing activities, which shall be presented separately.

Business section would be further broken down into:

Operating activities: Would include assets that are used as part of the entity's day-to-day business and all changes in those assets. Operating activities generate revenue through the process that requires the interrelated use of the entity's resources such as the application of employee and management expertise.

Operating finance activities subcategory: Would include those transactions that are directly related to an entity's operating activities such as:

- Net post-employment benefit obligation
- Lease obligation
- Vendor financing
- Decommissioning liability
- Deferred compensation arrangements
- Structured settlements

The statement of cash flows would not include an operating finance activities subcategory.

Investing activities: Would include an asset or liability that an entity uses to generate a return and any change in that asset or liability. No significant synergies are created for the entity by combining an asset or liability classified in the investing category with other resources of the entity. An asset or liability classified as investing activities may yield a return in the form of dividends, interest, capital gain or loss, and royalties.

b. ***Financing section***: Would consist of items that are part of an entity's activities to obtain (or repay) capital, and provides transparency about an entity's capital structure and the financing activities in which the entity engages.

Financing section would include items that are part of an entity's activities to obtain (or repay) capital and would consist of two categories: debt and equity.

Debt category: Would consist of liabilities where the nature of those liabilities is a borrowing arrangement entered into for the purpose of raising (or repaying) capital.

Equity category: Consists of equity as defined in either IFRS or U.S. GAAP.

c. ***Income taxes section:*** Would include all current and deferred income tax assets, liabilities, and the activities related thereto.

d. ***Discontinued operations section:*** Would include all assets and liabilities related to discontinued operations and all changes in those assets and liabilities.

e. ***Multi-category transaction section:*** Would consist of the net effects on comprehensive income and cash flows of an acquisition that results in the recognition of assets and liabilities in more than one section or category in the statement of financial position. Similarly, the net effects of a disposal transaction resulting in the derecognition of assets and liabilities in more than one section or category in the statement of financial position would also be classified in the multi-category transaction section of the statements of comprehensive income and cash flows.

8. Proposed disclosures would include:

   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
   c. Disclosure of the amount of cash and short-term investments held that are not available for general use and the reasons why
   d. Disclosure about significant noncash activities unless that information is presented elsewhere in the financial statements
   e. Disclosure of the analysis of the changes in balances of all significant asset and liability line items
   f. Amount of undrawn borrowing facilities.

9. 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, and
      - Long-term: Any 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.

   d. An entity would be required to disclose in the balance sheet, statement of changes in equity, or the notes for each class of share capital:

      - Number of shares authorized, issued and fully paid, and issued, but not fully paid
      - Par value per share or that the shares have no par value
      - Reconciliation of the number of shares outstanding at the beginning and end of the period
      - Shares in the entity held by the entity or by its subsidiaries or affiliates.

10. *Non-public entities*: The proposed changes would apply to non-public entities except that certain disclosures related to changes between the beginning and ending balances of certain assets and liabilities that management regards as important would not apply to non-public entities.

The following table summarizes the proposed categories of the various financial statements:

<table>
<tr><th>Statement of Financial Position</th><th>Statement of Comprehensive Income</th><th>Statement of Cash Flows</th></tr>
<tr><td colspan="3">BUSINESS SECTION</td></tr>
<tr><td>Operating:
• Cash
• Accounts receivable
• Inventory
• Property, plant, and equipment
• Accounts payable</td><td>Operating:
• Revenue
• Cost of goods sold
• Depreciation
• Operating expenses
• Postemployment benefit service cost</td><td rowspan="2">Operating:
• Cash from customers
• Cash paid to suppliers
• Cash paid to employees
• Purchase of property, plant and equipment (1)
• Cash paid for operating expenses
• Cash contribution to pension plan
• Cash paid for leases</td></tr>
<tr><td>Operating finance:
• Net pension liability
• Lease liability</td><td>Operating finance:
• Expected return on plan assets
• Postemployment benefit interest costs
• Interest expense on leases</td></tr>
<tr><td>Investing:
• Short-term investments
• Investment in securities
• Equity method investment</td><td>Investing:
• Interest income
• Interest and dividends, gain/losses
• Equity income</td><td>Investing:
• Interest received (2)
• Net cash from short-term investments
• Purchase of securities
• Sale of securities
• Interest and dividends received (2)
• Cash invested in equity method investment</td></tr>
</table>

FINANCING SECTION		
Debt • Short-term debt • Long-term debt • Interest payable • Dividends payable Equity: • Common stock	Debt: • Interest expense	• Proceeds from issuance of debt • Repayment of debt • Interest paid (3) • Dividends paid • Cash received from issuance of shares
Source: *Staff Draft of an Exposure Draft on Financial Statement Presentation* (FASB Staff, July 1, 2010).		

Note: The author has highlighted a few key proposed classifications that differ from existing GAAP. For example:

1) The purchase of PP&E would be classified as part of operating activities while it is classified as an investing activity under existing GAAP.

2) Interest and dividends received (interest and dividend income) would be classified in investing activities while it is classified as operating activities under existing GAAP.

3) Interest paid, which is current part of operating activities, would be shown as part of financing activities.

FASB proposes to eliminate use of the term "cash equivalents"

ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), 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.

Impact on non-public companies

Previously, the FASB issued a Discussion Paper in which the FASB addressed whether non-public companies should be exempt from the proposed changes in financial statement presentation.

Some respondents believed that the existence of two presentation models (one for public business entities and another for nonpublic business entities) would cause undue confusion and a lack of comparability. Other respondents asserted that the proposed presentation model would be disproportionately difficult and costly for nonpublic business entities to apply, and that the benefits to users of nonpublic business entity financial statements would not justify the additional cost.

The current plan noted in the Staff Draft is for the financial statement presentation changes to *apply to both public and non-public entities with non-public entities being exempted from a few limited disclosures.*

In reaching its preliminary conclusion to include non-public entities within the scope of the proposed financial statement project, FASB members stated that having different reporting formats for public and nonpublic business entities could be confusing and reduce comparability of reported information. FASB members also concluded that the concerns expressed by respondents about the cost-benefit to nonpublic entities does not outweigh the importance of maintaining one overall method of presenting information in the financial statements.

Consequently, the FASB proposes that nonpublic business entities should be included in the scope of the proposed guidance and that all business entities, public and nonpublic, should use the same financial statement format. The FASB also proposes that a nonpublic business entity should be exempt from the requirement to disclose an analysis of changes in asset and liability line items, which is one of the required disclosures.

Note further that in 2010, the AICPA, in conjunction with the Financial Accounting Foundation, and the National Association of State Boards of Accountancy, established a special Blue Ribbon Panel to address how U.S. accounting standards can best meet the needs of users of private company financial statements. The panel provided recommendations on the future of standard setting for private companies, including whether separate or stand-alone accounting standards for private companies are needed. The Blue Ribbon Panel's report is discussed further in this course. The FASB will consider the Panel's recommendations before finalizing this phase of the financial statement presentation project.

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.

    1) 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 proposed format would be subject to manipulation by management. The proposal calls for categorization of transactions based on how those transactions fall into the entity's business. With management having latitude 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 would 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, making comparability a problem.

Sample of FASB's proposed financial statement format[1]

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:	
Operating assets and liabilities:	
Cash	$XX
Accounts receivable	XX
Less allowance for bad debts	(XX)
Accounts receivable, net	XX
Inventory	XX
Prepaid expenses	XX
Total short-term operating assets	XX
Property, plant and equipment	XX
Less accumulated depreciation	(XX)
Property, plant and equipment, net	XX
Investment in X	XX
Goodwill	XX
Other intangible assets	XX
Total long-term operating assets	XX
Accounts payable	(XX)
Accrued liabilities	(XX)
Advances from customers	(XX)

[1] Staff Draft of an Exposure Draft on Financial Statement Presentation (FASB Staff), (July 1, 2010)

Accrued stock compensation	(XX)
Current portion of lease liability	(XX)
Total short-term operating liabilities	(XX)
Net operating assets before operating finance	**XX**
Operating finance:	
Current portion of lease liability	XX
Total short-term operating finance liabilities	XX
Lease liability (excluding current portion)	(XX)
Accrued pension liability	(XX)
Total long-term operating finance liabilities	(XX)
Total operating finance liabilities	**XX**
Net operating assets	**XX**
Investing assets and liabilities:	
Short-term investments	XX
Available-for-sale securities	XX
Total short-term investing assets	**XX**
Equity method investment in Company A	XX
Investment in Company B at fair value	XX
Total long-term investing assets	**XX**
Total investing assets	**XX**
NET BUSINESS ASSETS	**(A) XX**
FINANCING:	
Debt:	
Short-term debt	(XX)
Interest payable	(XX)
Dividends payable	(XX)
Total short-term debt	(XX)
Long-term debt	(XX)
Total debt	**(XX)**
Equity:	
Common stock (par $.01, 100,000 shares authorized, issued and outstanding 78,000 shares)	(XX)
Retained earnings	(XX)
Treasury stock	
Accumulated other comprehensive income	(XX)
Total equity	**(XX)**
TOTAL FINANCING	**(A) (XX)**

INCOME TAXES:	
Short-term:	
Deferred tax asset	XX
Income tax payable	(XX)
Long-term:	
Deferred tax asset	XX
NET INCOME TAX (LIABILITY) ASSET	**(A) XX**
DISCONTINUED OPERATIONS:	
Assets of discontinued operation	XX
Liabilities of discontinued operation	(XX)
NET ASSETS OF DISCONTINUED OPERATION	**(A) XX**
Total short-term assets	**XX**
Total long-term assets	**XX**
TOTAL ASSETS	**XX**
Total short-term liabilities	**XX**
Total long-term liabilities	**XX**
TOTAL LIABILITIES	**XX**
Sum of (A) = zero	

Statement of Comprehensive Income- Proposed New Format	
BUSINESS:	
Operating:	
Revenue	$XX
Cost of goods sold	(XX)
Gross profit	XX
Selling expenses:	
General and administrative expenses	(XX)
Gain on disposal of property, plant and equipment	XX
Interest income on cash balances	XX
Realized gain on future contracts	XX
Loss on sale of receivables	(XX)
Impairment loss on goodwill	(XX)
Operating income before operating finance costs	XX
Operating finance costs	(XX)
Total operating income	XX
Investing:	
Equity in earnings of affiliate	XX
Dividend and interest income	XX
Realized gain on available-for-sale securities	XX
Gain on equity of affiliate B	XX
Total investing income	**XX**

TOTAL BUSINESS INCOME	**XX**
FINANCING:	
Interest expense	(XX)
TOTAL FINANCING EXPENSE	**(XX)**
Income from continuing operations before taxes	**XX**
INCOME TAXES:	
Income tax expense	(XX)
Net income from continuing operations	**XX**
DISCONTINUED OPERATIONS:	
Loss on discontinued operations	(XX)
Income 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	**$XX**
Net income per share- basic	**$XX**
Net income per share- diluted	**XX**

Statement of Cash Flows- Proposed New Format	
CASH FLOWS FROM BUSINESS ACTIVITIES:	
Cash flows from operating activities:	
Cash collected from customers	$XX
Cash paid for labor	(XX)
Cash paid for materials	(XX)
Other business related cash outflows	(XX)
Lease payments (b)	(XX)
Pension outflows	(XX)
Capital expenditures (b)	(XX)
Interest received on cash balances	XX
Disposal of property, plant and equipment (b)	XX
Settlement of cash flow hedge	XX
Sale of receivables	XX
Net cash from operating activities	**XX (a)**

Cash flows from investing activities:	
Purchase of investment in affiliate	(XX)
Purchase of available-for-sale investments	(XX)
Sale of available-for-sale investments	XX
Increase (decrease) in cash equivalents (c)	XX
Dividends received	XX
Net cash used in investing activities	**(XX)**
NET CASH FLOWS FROM BUSINESS ACTIVITIES	**(XX)**
CASH FLOWS FROM FINANCING ACTIVITIES:	
Dividends paid	(XX)
Interest paid	(XX)
Proceeds from issuance of short-term debt	XX
Proceeds from issuance of long-term debt	XX
NET CASH FLOWS FROM FINANCING ACTIVITIES	**XX**
Net cash from continuing operations before taxes	**XX**
CASH FLOWS FROM INCOME TAXES:	
Cash paid for current tax expense	(XX)
NET CASH FLOWS FROM INCOME TAXES	**(XX)**
Change in cash from continuing operations	**(XX)**
CASH FLOWS FROM DISCONTINUED OPERATION:	
Net cash outflows from discontinued operation	(XX)
Effect of Foreign Exchange	XX
Changes in cash (c)	XX
Beginning cash	**XX**
Ending cash	**$XX**
(a): See tie in to Reconciliation of Operating Income to Operating Cash Flows schedule. (b): Items were previously included in investing and financing activities. (c): The change in cash would exclude cash equivalents. Cash equivalents activity would be presented in the investing activities section.	

Observation: Notice in the proposed statement of cash flows 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					
	Common stock/APIC	Treasury stock	Retained earnings	Accumulated OCI	Total SE equity
Balance December 31, 20X1	$XX	$(XX)	$XX	$XX	$XX
Issue of share capital	XX				
Comprehensive income:					
Net income			XX		XX
Other comprehensive income				XX	XX
Total comprehensive income			XX	XX	XX
Dividends			(XX)		(XX)
Balance December 31, 20X2	$XX	$(XX)	$XX	$XX	$XX

Supplementary Cash Flows Disclosure: Note to Financial Statements:

Reconciliation of Operating Income to Operating Cash Flows:

Operating earnings	$XX
Adjustments to reconcile operating earnings to cash flow from operating activities of continuing operations:	
Realized loss (gain) on future contracts	XX
Loss (gain) on disposal of property, plant and equipment	(XX)
Interest expense on decommissioning obligation	XX
Depreciation and amortization	XX
Bad debt expense	XX
Loss on obsolete and damaged inventory	XX
Impairment loss on goodwill	XX
Litigation expense	XX
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 ledge 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)
Supplementary information about non-cash activities:	
Capitalization of equipment in exchange for lease	**XX**
(a) Agrees with *net cash from operating activities* on the statement of cash flows.	

The FASB has conducted an outreach program and working groups to evaluate the proposed changes to financial statement presentation. Although an exposure draft was scheduled to be issued in 2011, the FASB has deferred that exposure draft issuance date. No specific date for issuing an exposure draft has been announced.

C. 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.[2]

In addition to traditional revenue manipulation strategies, there are numerous methods that a company can use to recognize revenue, subject to certain limitation, including:

- 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[3]. 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.

Previously, 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

[2] *Financial Statement Fraud, Integrity of Financial Information Continue to Be Burner Issues* (AICPA)
[3] FASB *Proposal for a New Agenda Project: Issues Related to The Recognition of Revenues and Liabilities*

The four criteria mirrored the criteria for revenue recognition of software revenue noted in ASC 985, *Software Revenue Recognition* (formerly SOP 97-2).

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.

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

- 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 was subject to a comment period and reflected some of the general concepts the FASB and IASB expect to utilize in crafting final statements on revenue recognition.

In June 2010, the FASB and IASB issued an exposure draft entitled*, Revenue Recognition (Topic 605), Revenue from Contracts with Customers.*

The exposure draft would make the following changes to existing GAAP for revenue recognition:

- Remove inconsistencies in existing requirements

- Create a new criterion for revenue recognition which is based on a transfer of control

  Note: The percentage of completion method would be eliminated.

- Require that contracts be identified and segmented into performance obligations

- Require a determination of transaction price, taking into account certain factors such as credit risk and time value, among other factors

- Make changes to how contract costs are accounted for

- Provide a new presentation of revenue-related accounts in the statement of financial position

- Require expanded disclosures.

Details follow:

1. The proposal would create a single, principles-based revenue recognition standard for International Financial Reporting Standards (IFRSs) and U.S. generally accepted accounting principles (GAAP) that would be applied across various industries and capital markets.

2. The proposed statement would replace IAS 18 *Revenue,* IAS 11, *Construction Contracts* and related interpretations. In U.S. GAAP, the proposed statement would supersede most of the guidance on revenue recognition in ASC 605 of the *FASB Accounting Standards Codification* related to revenue recognition.

3. The proposed guidance would also apply to all contracts with customers except:

   a. Lease contracts
   b. Insurance contracts
   c. Contractual rights or obligations within the scope of the following:

      - Receivables
      - Debt and equity securities
      - Extinguishments of liabilities
      - Debt
      - Derivatives and hedging
      - Financial instruments
      - Transfers and servicing

   d. Guarantees (other than product warranties)
   e. Certain nonmonetary exchanges between entities in the same line of business.

   Note: The accounting for revenue (and some costs) arising from contracts within the scope of the proposed guidance would be the same in both U.S. GAAP and IFRSs. However, differences might exist between U.S. GAAP and IFRSs in the profit margin reported in those contracts because of differences in other standards relating to accounting for the costs of fulfilling a contract.

4. The core principle of the draft standard is that:

   "an entity should recognize revenue from contracts with customers when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer."

   a. To apply that principle, an entity would apply a *five-step approach*:

   Step 1: Identify the contract(s) with a customer;
   Step 2: Identify the separate performance obligations in the contract;
   Step 3: Determine the transaction price;
   Step 4: Allocate the transaction price to the separate performance obligations; and
   Step 5: Recognize revenue when the entity satisfies each performance obligation.

5. A review of the five steps to revenue recognition found in the proposed statement follows:

Step 1: Identify the contract(s) with a customer:

a. In most cases, an entity would apply the proposed guidance to a single contract. However, the proposal specifies when an entity would combine two or more contracts and account for them as a single contract or segment a single contract and account for it as two or more contracts.

b. A contract would exist when an agreement (written, oral or evidenced otherwise) between two or more parties creates enforceable obligations between those parties.

c. A contract would exist only if:

- The contract has commercial substance (that is, the entity's future cash flows are expected to change as a result of the contract);
- The parties to the contract have approved the contract and are committed to satisfying their respective obligations;
- The entity can identify each party's enforceable rights regarding the goods or services to be transferred; and
- The entity can identify the terms and manner of payment for those goods or services.

d. A contract would not exist for the purpose of applying the proposed guidance if either party can terminate a wholly unperformed contract without penalty. A wholly unperformed contract is a contract under which the entity has not transferred any goods or services and the customer has not paid any consideration.

e. Contract modifications would be accounted for as separate contracts if the modifications are priced independently of the existing contract.

1) A contract modification is any change in the scope or price of a contract.

   Examples include changes in the nature or amount of the goods or services to be transferred, changes in the method or timing of performance, and changes in the previously agreed pricing in the contract. A contract modification may be initiated by either the customer or the entity.

2) If the prices of the modification and the original contract are interdependent, then the effect of the modification would be recognized as a cumulative adjustment in the period of modification.

Step 2: Identify the separate performance obligations in the contract:

a. An entity is required to evaluate the terms of the contract and its customary business practice to identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation.

b. A performance obligation is an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer.

c. If an entity promises to provide more than one good or service, it would account for each promised good or service as a separate performance obligation if the good or service is distinct.

   1) A good or service is distinct if either:

      - The entity, or another entity, sells an identical or similar good or service separately, or
      - The entity could sell the good or service separately because the good or service has a distinct function and a distinct profit margin.

<u>Step 3: Determine the transaction price:</u>

a. The transaction price is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services (excluding amounts collected on behalf of third parties, such as taxes), promised in the contract.

b. If the amount of consideration is variable (for instance, because of rebates, bonuses, penalties, or the customer's credit risk), an entity would recognize revenue from satisfying a performance obligation if the transaction price can be *reasonably estimated*.

   1) The transaction price can be reasonably estimated only if both of the following conditions are met:

      - The entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and
      - The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

   Note: One key change in the proposed standard versus existing GAAP involves how variable consideration is handled. Existing GAAP generally provides that an entity records revenue when the price is fixed and determinable. The proposal allows for revenue to be recognized when consideration is variable provided the price can be reasonably estimated. The result is that some companies may be recording revenue earlier in their sales cycle under the proposal as compared with current GAAP.

c. When determining the transaction price, an entity would consider the effects of the following four elements:

   1) Collectibility;
   2) Time value of money;
   3) Noncash consideration; and
   4) Consideration payable to the customer.

d. Four elements of transaction price:

- *Collectibility*: In determining the transaction price, an entity would reduce the amount of promised consideration to reflect the customer's credit risk. Hence, when an entity satisfies a performance obligation, the entity would recognize revenue at the probability-weighted amount of consideration that the entity expects to receive.

  Once an entity has an unconditional right to consideration (that is, a receivable), the effects of changes in the assessment of credit risk associated with that right to consideration would be recognized as income or expense rather than as revenue.

- *Time value of money*: In determining the transaction price, an entity would adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicitly or implicitly).

- *Noncash consideration*: To determine the transaction price for contracts that have non-cash consideration an entity would measure noncash consideration (or promise of noncash consideration) at fair value. If an entity cannot reasonably estimate the fair value of the noncash consideration, it would measure the consideration indirectly by reference to the standalone selling price of the goods or services transferred in exchange for the consideration.

- *Consideration payable to the customer:* If an entity pays, or expects to pay, consideration to the customer (or to other parties that purchase the entity's goods or services from the customer) in the form of cash or credit, or other items that the customer can apply against amounts owed to the entity, the entity would determine whether that amount is a reduction of the transaction price, a payment for a distinct good or service separate from the sale, or a combination of both.

Step 4: Allocate the transaction price to the separate performance obligations:

a. An entity would allocate the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis).

b. The best evidence of a standalone selling price would be the observable price of a good or service when the entity sells that good or service separately. A contractually stated price or a list price for a good or service would not be presumed to represent the standalone selling price of that good or service. If a standalone selling price is not directly observable, an entity would estimate it.

c. The entity would update the transaction price over the life of the contract to reflect changes in circumstances and allocate changes in the transaction price to the separate performance obligations.

Step 5: Recognize revenue when a performance obligation is satisfied:

a. An entity would recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the *customer obtains control* of that good or service.

b. A customer obtains control of a good or service when the customer *has the ability to direct the use of, and receive the benefit from, the good or service*. The proposed guidance includes indicators to assist an entity in determining when a customer has obtained control of a good or service.

1) Indicators that the customer has obtained control of a good or service include the following:
   a) The customer has an unconditional obligation to pay with nothing other than the passage of time required before payment is due
   b) The customer has legal title
   c) The customer has physical possession, and
   d) The design or function of the good or service is customer specific so that it lacks an alternative use outside the customer.

c. When an entity satisfies a performance obligation, an entity would recognize as revenue the amount of the transaction price allocated to that performance obligation. If the transaction price changes after contract inception, the amount of the change allocated to performance obligations already satisfied at the time the transaction price changes would be recognized as revenue in the period in which the transaction price changes.

d. When the promised goods or services underlying a separate performance obligation are transferred to a customer continuously, an entity would apply to that performance obligation one revenue recognition method that best depicts the transfer of goods or services to the customer. Acceptable methods include methods based on an entity's outputs or inputs and methods based on the passage of time.

6. Onerous performance obligations

   a. An entity would recognize a liability and a corresponding expense if a performance obligation is onerous.

      1) A performance obligation is onerous if the present value of the probability-weighted costs that relate directly to satisfying that performance obligation exceeds the amount of the transaction price allocated to that performance obligation.

   b. Before an entity recognizes a liability for an onerous performance obligation, it would recognize any impairment loss that has occurred on assets related to the contract (for example, inventory).

   c. At each subsequent reporting date, an entity would update the measurement of the liability for an onerous performance obligation using current estimates. An entity would recognize changes in the measurement of that liability as an expense or as a reduction of an expense. When an entity satisfies the liability for an onerous performance obligation, it would recognize the corresponding income as a reduction of an expense.

7. Contract costs

   a. If the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other GAAP (for example, inventory or property, plant, and equipment, or software), an entity would recognize an <u>asset</u> only if those costs:

      1) Relate directly to a contract (or a specific contract under negotiation),
      2) Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is the costs relate to future performance), and
      3) Are expected to be recovered.

      Note: Costs that relate directly to a contract would include:

      - Direct labor (for example, salaries and wages of employees who provide services directly to the customer);
      - Direct materials (for example, supplies used in providing services to the customer);
      - Allocations of costs that relate directly to the contract or contract activities (for example, costs of contract management, and depreciation of tools and equipment used in fulfilling the contract);
      - Costs that are explicitly chargeable to the customer under the contract; and
      - Other costs that were incurred only because the entity entered into the contract (for example, subcontractor costs).

      Note: If an asset is recognized for a contract cost, it would be accounted for as follows:

      - The asset would be amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates;
      - The asset would be classified on the basis of the nature or function of the costs that gave rise to the asset (for example, intangible or work in process); and
      - An impairment loss would be recognized to the extent that the carrying amount of an asset recognized exceeds the amount of the transaction price allocated to the remaining performance obligations less the costs that relate directly to satisfying those performance obligations.

   b. An entity would recognize the following costs as expenses when incurred:

      1) Costs of obtaining a contract (for example, the costs of selling, marketing, advertising, bid and proposal, and negotiations);
      2) Costs that relate to satisfied performance obligations in the contract (that is, the costs that relate to past performance); and

        3) Costs of abnormal amounts of wasted materials, labor, or other resources used to fulfill the contract.

8. Sale of a product with a right of return

   a. An entity's promise to stand ready to accept a returned product during the return period would not be accounted for as a separate performance obligation in addition to the obligation to provide a refund. Instead, an entity would recognize both of the following:

      1) Revenue for the transferred goods that are not expected to be returned, and
      2) A refund liability.

   b. If an entity cannot reasonably estimate the probability of a refund to the customer, the entity would not recognize revenue when it transfers the product but would recognize any consideration received as a refund liability. In such cases, the entity would recognize revenue when it can reasonably estimate the probability of a refund (which may be only when the return period expires).

      Note: An entity would update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds and make a corresponding adjustment to the amount allocated to the satisfied performance obligations.

      An entity would recognize an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability. The asset would initially be measured by reference to the former carrying amount of the inventory less any expected costs to recover those products. Subsequently, an entity would update the measurement of the asset to correspond with changes in the measurement of the refund liability.

9. Presentation

   a. When either party to a contract has performed, the entity would present the contract in the statement of financial position as either a contract asset or a contract liability depending on the relationship between the entity's performance and the customer's performance.

   b. If an entity performs by transferring goods or services to a customer before the customer performs by paying consideration, the entity would present the contract as a contract asset. Conversely, if a customer performs before an entity performs, the entity would present the contract as a contract liability.

   c. An entity would present an unconditional right to consideration as a receivable (not as a contract asset) and would account for that receivable in accordance with the guidance on receivables in ASC 310, *Receivables*.

      Note: The right to consideration would be considered unconditional when nothing other than the passage of time is required before payment of that consideration is due.

d. The proposed statement states that an entity would present any asset recognized in accordance for contract costs separately from the contract asset or contract liability. An entity would present any liability recognized for an onerous performance obligation separately from any contract asset or contract liability.

10. Disclosures

a. An entity would disclose qualitative and quantitative information about:

1) Its contracts with customers, and
2) The significant judgments, and changes in judgments, made in applying the proposed guidance to those contracts.

b. An entity would consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements.

Note: An entity would aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.

c. Detailed disclosures that would be required include:

1) Information about its contracts with customers to help users understand the amount, timing, and uncertainty of revenue and cash flows from those contracts, including:

- A disaggregation of revenue for the periods,
- A reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities, and
- Information about the entity's performance obligations including additional information about its onerous performance obligations.

Note: An entity would disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.

2) A reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities and must reconcile those amounts to the amounts presented in the statement of financial position.

3) Information about its performance obligations in contracts with customers.

4) For contracts with an original expected duration of more than one year, the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period that are expected to be satisfied in each of the following periods: (a) not later than one year; (b) later than one year but not later than two years; (c) later than two years but not later than three years; and (d) later than three years.

5) The amount of any liability recognized for onerous performance obligations together with a discussion of: (a) the nature and amount of the performance obligations for which the liability has been recognized; (b) why those performance obligations have become onerous; and (c) when the entity expects to satisfy the liability.

6) A reconciliation from the opening to the closing balance of the liability recognized for onerous performance obligations.

7) The judgments, and changes in judgments, made in applying the proposed guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers.

8) For performance obligations satisfied continuously, (a) the methods (for example, output methods, input methods, and methods based on the passage of time) used to recognize revenue; and (b) an explanation of why such methods are a faithful depiction of the transfer of goods or services.

9) Information about the methods, inputs, and assumptions used: (a) to determine the transaction price; (b) to estimate standalone selling prices of promised goods or services; (c) to measure obligations for returns, refunds, and other similar obligations; and (d) to measure the amount of any liability recognized for onerous performance obligations (including information about the discount rate).

11. Effective date and transition

   a. An entity would apply the proposed guidance for annual periods beginning on or after effective date to be determined in the final statement.

   b. An entity would apply the proposed requirements retrospectively by applying the guidance on accounting changes and error corrections. In the period of adoption, an entity would provide the disclosures required.

What would be the impact of ultimately implementing the proposed revenue recognition model on present practice?

The FASB suggests that for some contracts (for example, many retail transactions), the proposed guidance would have little, if any, effect on current practice. However, the proposed guidance would differ from current practice in the following ways:

1. *Recognition of revenue only from the transfer of goods or services:* Contracts for the development of an asset (for example, construction, manufacturing, and customized software) would result in continuous revenue recognition only if the customer controls the asset as it is developed.

2. *Identification of separate performance obligations:* An entity would be required to divide a contract into separate performance obligations for goods or services that are distinct. As a result of those requirements, an entity might separate a contract into units of accounting that differ from those identified in current practice.

3. *Licensing and rights to use:* An entity would be required to evaluate whether a license to use the entity's intellectual property (for less than the property's economic life) is granted on an exclusive or nonexclusive basis. If a license is granted on an exclusive basis, an entity would be required to recognize revenue over the term of the license. That pattern of revenue recognition might differ from current practice.

4. *Effect of credit risk:* In contrast to some existing standards and practices, the effect of a customer's credit risk (that is, collectibility) would affect *how much* revenue an entity recognizes rather than *whether* an entity recognizes revenue.

5. *Use of estimates:* In determining the transaction price (for example, estimating variable consideration) and allocating the transaction price on the basis of standalone selling prices, an entity would be required to use estimates more extensively than in applying existing standards.

6. *Accounting for costs:* The proposed guidance specifies which contract costs an entity would recognize as expenses when incurred and which costs would be capitalized because they give rise to an asset. Applying that cost guidance might change how an entity would account for some costs.

7. *Disclosure:* The proposed guidance specifies disclosures to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. An entity would be required to disclose more information about its contracts with customers than is currently required, including more disaggregated information about recognized revenue and more information about its performance obligations remaining at the end of the reporting period.

The FASB has announced that it plans to issue a final statement in 2011.

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. Which of the following is not a category in the business section of financial statements proposed under the proposed financial performance project:

   a) investing
   b) operating finance
   c) operating
   d) debt

2. Which of the following is the FASB proposing would be the category of cash on the statement of cash flows:

   a) cash equivalents
   b) cash and cash equivalents
   c) cash only
   d) cash and short-term investments

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

4. The proposed revenue recognition standard has a core principle based on which of the following triggering event occurring:

   a) a contract being signed
   b) there must be a completion of the critical stage
   c) there must be a transfer of goods or services
   d) there must be a certain percentage of transaction completed

5. Under the proposed revenue recognition standard, a contract exists only if the contract has certain attributes that include which of the following:

   a) the contract lacks commercial substance
   b) the parties to the contract have not approved the contract
   c) the entity cannot identify each party's enforceable rights regarding the goods or services to be transferred
   d) the entity can identify the terms and manner of payment for those goods or services

6. Which of the following is not one of the four elements used to determine the transaction price:

   a) collectibility
   b) time value of money
   c) consideration in the form of cash or a cash equivalent
   d) consideration payable to the customer

7. Which of the following is an indicator that a customer has obtained control of a good or service:

   a) the customer has a conditional obligation to pay with nothing other than the passage of time required before payment is due
   b) the customer has an option to obtain legal title
   c) the customer has physical possession
   d) the design or function of the good or service has an alternative use

SUGGESTED SOLUTIONS

1. A: Incorrect. Investing is one of the categories in the business section.

   B: Incorrect. Operating finance is one of the categories in the business section.

   C: Incorrect. Operating is one of the categories in the business section.

   D: Correct. Debt is not part of the business section and instead is part of the financing section.

   (See pages 7-6 to 7-7 of the course material.)

2. A: Incorrect. The term "cash equivalents" would be eliminated.

   B: Incorrect. Although cash and cash equivalents is a term used under the current statement of cash flows, the FASB does not recommend that it be continued.

   C: Correct. The FASB wants to eliminate the term "cash equivalents" so that the statement of cash flows reconciles down to cash only.

   D: Incorrect. Cash and short-term investments is not a category recommended by the FASB.

   (See page 7-8 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 7-20 of the course material.)

4. A: Incorrect. There being a contract signed is not identified as a triggering event under the proposed revenue recognition standard.

   B: Incorrect. The proposal does not address whether a critical stage has to be surpassed in order for there to be revenue recognition.

   C: Correct. The core principle of the proposed standard is that an entity should recognize revenue when an entity transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

   D: Incorrect. The proposal does not deal with a percentage completion approach to revenue recognition.

   (See page 7-22 of the course material.)

5. A: Incorrect. The contract must have commercial substance and not lack it.

   B: Incorrect. The parties to the contract must have approved the contract which makes the statement incorrect.

   C: Incorrect. The entity must be able to identify each party's enforceable rights regarding the goods or services to be transferred, making the statement incorrect.

   D: Correct. One of the criteria is that the entity can identify the terms and manner of payment for those goods or services, making the statement correct.

   (See page 7-23 of the course material.)

6. A: Incorrect. Collectibility is identified as one of the four elements.

   B: Incorrect. Time value of money is listed as one of the four elements.

   C: Correct. One of the elements is noncash consideration and not consideration in the form of cash or a cash equivalent.

   D: Incorrect. One of the four elements is the consideration payable to the customer.

   (See page 7-24 of the course material.)

7. A: Incorrect. The obligation must be unconditional and not conditional.

   B: Incorrect. The customer must actually have legal title and not the option to obtain legal title.

   C: Correct. One of the indicators is that the customer has physical possession of a good or service.

   D: Incorrect. The design or function of the good or service must not have an alternative use.

   (See page 7-26 of the course material.)

D. CHANGES COMING WITH LEASE ACCOUNTING

Under current GAAP, ASC 840, *Leases* (formerly FASB No. 13), 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, one of 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:

<u>Lease 1</u>: The present value of minimum lease payments is 89% and the lease term is 74% of the remaining useful life of the asset.

<u>Lease 2</u>: 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 pushes toward changes in lease accounting

As previously noted in this course, 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 percent 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.

Moreover, 70 percent of all leases held by U.S. public companies involve the leasing of real estate.[4]

In its Report, the SEC noted that because of ASC 840's (formerly FASB No. 13's) bright-line tests (90%, 75%) small differences in economics can completely change the accounting (capital versus operating) of leases.

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, restating or adjusting their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Retailers have the largest amount of operating lease obligations outstanding that are not recorded on their balance sheets, as noted in the following table:

Operating Leases Outstanding- Major Retailers

Retailer	Lease Obligations (in thousands)
Office Depot Inc.	$1,104
Walgreens Co.	27,434
CVS	38,917
Whole Foods	6,322
Sears	7,608

Source: Credit Suisse, August 2010

FASB-IASB Lease Project

Since the Sarbanes-Oxley Act of 2002, 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 ASC 810, *Consolidation of Variable Interest Entities* (formerly FIN 46R). 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 ASC 840 (formerly FASB No. 13) and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, followed by the issuance of an exposure draft in 2010 entitled, *Leases (Topic 840).*

Conclusions reached in the exposure draft 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 proposed changes that are included in the exposure draft under the FASB and IASB proposed new lease model:

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a. The proposed new statement would replace ASC 840, *Leases* (formerly FASB No. 13) and IAS 17 in countries using international financial reporting standards.

   - The bright line test based on four requirements for capitalizing a lease under ASC 840 (formerly FASB No. 13) (e.g., 90% rule, 75% rule, etc.) would be eliminated.

   - The capital versus operating lease concept would be eliminated.

b. Most existing operating leases would be brought onto the balance sheet.

   - Income statement expense would be front-loaded as there would be a shift from straight-line rent expense to interest expense and amortization of the leased asset.

c. Both the lessees and lessors would use the *"right-of-use"* model to account for all leases (including leases of right-to-use assets in a sublease).

   - Leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties would be excluded from the application of the new statement.

d. Under the right-of-use model:

   Lessee:

   - At the inception of the lease, the lessee would recognize an asset representing its right to use the leased asset (right-of-use asset) for the lease term, and a liability to make lease payments.

     Asset: Recognizes the right-to-use asset at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee.

     Liability: Recognizes the liability to make lease payments at the present value of the lease payments discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee.

   - The following items would be recognized on its income statement:

     - Amortization expense based on amortizing the right-of-use asset over the expected lease term or the useful life of the underlying asset, if shorter.

     - Interest expense on the lease payments on the liability.

     - Any changes in the liability resulting from reassessment of the expected amount of contingent rentals or expected payments under term option penalties and residual value guarantees.

     - Any impairment losses on a right-of-use asset.

Lessor:

- At the inception of the lease, the lessor would recognize an asset for its right to receive lease payments based on the present value of lease payments receivable during the lease term on the basis of the expected outcome, and

- Would use one of two approaches to record the liability:

  Performance obligation approach: If the Lessor retains exposure to significant risk or benefits associated with the underlying asset, the Lessor would recognize a lease liability while continuing to recognize the underlying asset, or

  Derecognition approach: If the lessor does not retain exposure to significant risk or benefits associated with the underlying asset, the Lessor would derecognize the rights in the underlying asset that it transfers to the lessee, and would continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term.

e. Assets and liabilities recognized by lessees and lessors would be measured based on the following rules:

   - Present value of lease payments over the *lease term* by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease.

     - The exercise price of a purchase option would not be a lease payment and the purchase option would not be included in determining the present value of lease payments payable.

   - Lease term: Use the *longest possible lease term* that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.

   - Contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease would be included in the measurement of assets and liabilities using the expected outcome technique to reflect the lease payments.

   - Update the assets, liabilities and lease term when changes in facts and circumstances indicate that there would be a significant change in the assets and liabilities since the previous reporting period.

Note: Existing GAAP under ASC 840 (formerly FASB No. 13) includes optional periods in the lease term only if the lessee concludes at the lease inception that it is reasonably certain to exercise the right to renew the lease.

Example: Determining the lease term:

Company X has a lease that has a non-cancellable, 10-year term, an option to renew the lease for 5 years at the end of the 10 years, and an option to renew the lease for an additional 5 years at the end of 15 years. Assume X determines the probability for each term as follows:

% probability	Expected term
40%	10 years
70%	15 years
30%	20 years

Conclusion:

There is only a 40% probability that the lease term will be 10 years. There is a 70 % probability that the lease term will be 15 years or longer. There is only a 30% probability that the lease term will be 20 years. Therefore, the lease term used would be 15 years which is the longest possible term at which it is more likely than not (more than 50% probability) to occur.

Observation: The lessee and lessor each would evaluate their lease term independent of each other. That means that with respect to a lease that has lease options, the lessee may have a lease term that is different than the lessor's lease term solely because the lessee evaluates the likelihood that it will renew its lease options differently than the lessor does.

f. Simplified requirements would apply for leases with a lease term of 12 months or less.
    - Lessee would be permitted to elect on a lease-by-lease basis to measure the liability at the undiscounted amount of the lease payments and the asset at the undiscounted amount of lease payments plus initial direct costs.

    - Lessor would be permitted to elect on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease.

g. A lease contract would be accounted for as a purchase by the lessee, and a sale by the lessor only when the purchase option is exercised.

h. A transaction would be treated as a sale and leaseback transaction, only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases.

i. Both the lessee and lessor would present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows.

    - The lessee would present the lease obligation separately from other financial liabilities on the face of the balance sheet.

- The right-of-use asset would be presented with PP&E, but separately from other assets that are owned but not leased.

- Amortization and interest expense would be separated from other amortization and interest expense either on the face of the income statement or in the notes.

- Cash repayments and interest payments would be classified in the statement of cash flows as financing activities similar to how debt payments are handled.

j. The statement would provide additional disclosures including quantitative and qualitative information on the leases.

k. Existing leases would not be grandfathered thereby requiring existing operating leases to be brought onto the balance sheet.

   - All existing outstanding leases would be recognized and measured at the date of initial application using a simplified retrospective approach.

l. After the date of commencement of the lease, the lessee would reassess the carrying amount of the liability to make lease payments if facts or circumstances indicate that there would be a significant change in the liability since the previous reporting period.

m. *Effective date*: Although the FASB plans to issue a final statement in the second quarter 2011, based on the extensive responses to the Exposure Draft, a final statement is not likely to be issued until the end of 2011 or into 2012 with an effective date of 2013 or 2014.

Observation:

Through the end of the comment period, the FASB and IASB received more than 700 comment letters in response to the exposure draft.

Although the comments were diverse, there were several areas in which respondents identified a common concern about the exposure draft.

First, one area of confusion is in determining the lease term and how it is affected by lease renewal options. The proposed lease standard uses a *more-likely-than-not* (more than 50 percent) threshold to determine the lease term, while existing GAAP includes option periods in the lease term only if it is "*reasonably certain*" that the lessee will exercise its right to renew the lease. Many respondents believe this "more-likely-than-not" threshold is very subjective and may result in a wide range of results to the same set of facts. Further, the exposure draft defines the lease term as the "longest possible term" that is "more-likely-than-not" to occur. That means that lessees will be recording liabilities on their balance sheets for the lease payments within renewal option periods even though the lessee is not contractually obligated for those lease payments. Query whether it makes sense to record a liability that does not represent a contractual obligation?

A second concern for many parties is that the proposed standard would require a lessee and lessor to include contingent rent (such as rent increases tied to a CPI or percentage of sales increases) in computing assets and liabilities at the inception of the lease. The exposure draft also would require a probability-weighted approach to computing contingent payments. Existing GAAP requires use of minimum lease payments without contingent rent payments. By including contingent rent in the measurement of assets and liabilities, a company would be forced to estimate the future CPI or its sales. Further, the probability-weighted approach has its own problems in that there are too many variables in weighting contingent rent on a probability basis.

A third concern noted by many respondents is the fact that the exposure draft provides that purchase options would be accounted for only when they are exercised instead of being included as part of the lease value.

The following chart compares the proposed standard with existing GAAP for leases.

Comparison of Existing GAAP Versus Proposed GAAP for Leases

Description	Current GAAP for Operating Leases	Proposed GAAP
Lease type	Leases are classified as operating or capital leases (financing arrangements) based on satisfying one of four criteria: •75% rule •90% rule •Bargain purchase •Transfer of ownership	All leases classified as financing arrangements (as if purchases) Lease asset and lease obligation recorded at present value of payments over the lease term
Lease term	Non-cancellable periods Option periods generally not included in lease term	Lease term to include non-cancellable periods and option periods if it is more likely than not that the renewal options will be exercised
Contingent rents	Contingent rents excluded from lease payments. When paid, they are period costs	Contingent rents (variable rents) included in lease payments used to measure asset and liability
Income statement	Operating leases- lease expense straight-line basis Capital leases- depreciation and interest expense	Financing leases- amortization and interest expense
Assessment	Terms are not re-assessed	Requirement that there be a continual re-assessment of renewal options and contingent rents and adjustments made to leases as needed

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.[5] In particular, retailers would be affected the most.

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 lease obligations.

  Note: Including contingent lease payments and renewal options may result in overstated liabilities given the fact that contingent payments must be included in the lease payments and renewal options must be considered in determining the lease term if it is more likely than not that the renewal options will be exercised.

- 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.

  On average, a 10-year lease would incur approximately 15-20% higher annual lease expense in the earlier years if capitalized as compared with an operating lease. That higher lease amount would 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 amortization) 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 from rent expense under operating leases to interest and amortization expense under the proposed standard. Both interest and amortization are not deducted in arriving at EBITDA while rent expense is.

[5] Georgia Tech Financial Analysis Lab study.

   a. Changes in EBITDA may affect existing agreements related to compensation, earn-outs, bonuses, and commissions.

2. On the negative side, debt-equity ratios would be 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 amortization expense replacing rental expense.

How significant would the change to the proposed lease standard 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. That $1.25 trillion is magnified by the many non-public companies that have unpublished operating lease obligations that are unrecorded.

The author estimates that unrecorded lease obligations of non-public operating leases is at least $6.3 trillion based on the following computation:

Computation of Estimated Unrecorded Lease Obligations of Non-Public U.S. Companies	
Estimated annual lease payments ($5,000 x 12)	$60,000
Estimated average number of years remaining	5
Gross lease payments	$300,000
Present value factor, 5 years, 5%	4.212
Present value of lease obligation	$1,263,600
# nonpublic entities in USA with leases that would be subject to the proposed standard:	
20 million non-public companies x 25%	$5,000,000
Unrecorded lease obligations- U.S. non-public companies	$6.3 trillion
Source: The Author	

In the previous table, the author makes a rough computation as to the total amount of lease obligations that are unrecorded by non-public companies. Using what may be conservative numbers, the author computes the present value of unrecorded operating lease obligations at $6.3 trillion which is likely to be low. Add the $6.3 trillion for non-public companies to the $1.25 trillion for public companies results in $7.5 trillion of unrecorded lease obligations that would be recorded on company balance sheets under the proposed lease standard.

Consider the following estimated impacts of shifting those operating leases to capitalized right-to-use leases, for public companies, alone:

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.[6]

- Aggregate debt of nonfinancial S&P 500 companies would increase by 17 percent if all leases were capitalized.
- Return on assets would decline as total assets (the denominator) would increase by approximately 10 percent.
- The S&P 500 would record an estimate of $549 billion of additional liabilities under the proposed lease standard on existing operating leases.[7]
- U.S. companies, as a whole (public and non-public), would record approximately $7.5 trillion of additional liabilities if operating leases are capitalized.[8]

According to a Credit Suisse study,[9] there are 494 of the S&P 500 companies that are obligated to make $634 billion in total future minimum lease payments under operating leases. On a present value basis, including contingent rents, the $634 billion translates into an additional liability under the proposed standard of $549 billion. Of the $549 billion of additional liabilities, 15 percent of that total relates to retail companies on the S&P 500.

In some cases, the effect of capitalizing lease obligations under the proposed lease standard is so significant that the new lease liability would exceed the company's market capitalization.

Consider the following table:

Estimated Off-Balance Sheet Operating Lease Liability as a Percentage of Market Capitalization

(in millions)	Estimated off-balance sheet operating lease liability	Market cap (1)	Liability as % of market cap
Office Depot Inc.	$2,278	$1,104	206%
Walgreens Co.	29,614	27,434	108%
Supervalue Inc.	2,445	2,342	104%
CVS	23,826	38,917	61%
Whole Foods	4,545	6,322	72%
Sears	4,550	7,608	60%

(1) As of August 16, 2010
Source: Credit Suisse, August 2010

[6] Bear Stearns research study.
[7] Leases Landing on Balance Sheet (Credit Suisse), August 2010.
[8] Author's estimate: $1.2 trillion for public companies and $6.3 trillion for non-public companies.
[9] Leases Landing on Balance Sheet (Credit Suisse), August 2010.

The previous table identifies the sizeable problem that exists for many of the U.S. retailers which is that there are huge off-balance sheet operating lease liabilities as a percentage of the company market capitalization. Under the proposed lease standard, these obligations would be recorded, thereby having a devastating impact on those retailers' balance sheets. For example, look at Office Depot and its $2.2 billion liability in relation to its market capitalization of $1.1 billion.

Note further that in the previous table, the off-balance sheet liabilities are gross lease payments under operating leases. Under the proposed lease standard, these liabilities would have to be adjusted downward for the present value effect of the obligation but would also be increased for contingent rents and possibly a longer lease term due to extension options.

How would the proposed lease standard impact how leases are structured?

Companies are going to consider the balance sheet impact when structuring leases and in deciding whether to lease or buy the underlying asset, in the first place. There are several likely actions that would come from the proposed standard.

1. *Lease-versus-buy decision impacted*: By implementing the proposed standard, the GAAP differences between leasing and owning an asset would be reduced. Having to capitalize all leases may have a significant effect on the lease versus purchase decision, particularly with respect to real estate.

    a. Tenants, in particular those in single-tenant buildings with long-term leases, may choose to purchase a building instead of leasing it.

        - A similar amount of debt would be included on the tenant's balance sheet under a long-term lease as compared with a purchase.

        - GAAP depreciation under a purchase may actually be lower than a lease because the depreciable life under the lease (generally the lease term) is likely to be shorter than the useful life under a purchase.

          Example: A 10-year lease with two, 5-year lease options, has a maximum lease term of 20 years. If there is a lease, the right-to-use asset is amortized over 20 years (the shorter of the useful life (assume 30 years) or the lease term (20 years)) while it is depreciated over 30 years if it is owned.

        - The tenant would receive the reward of ownership in terms of appreciation of the asset and amortization of the mortgage.

    Note: 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.

b. *<u>Lease terms are likely to shorten</u>*: For many companies who do not wish to purchase the underlying leased asset, lease terms may shorten to reduce the amount of the lease obligation (and related asset) that is recorded at the lease inception.

- The proposed lease standard would affect not only the landlords and tenants, but also brokers as there would be much greater emphasis placed on executing leases for shorter periods of times, thereby increasing the paperwork over a period of time and the commissions earned.

c. *<u>Deferred tax assets would be created</u>*: Because many operating leases would now be capitalized, total GAAP expense (interest and amortization) would be greater than lease expense for tax purposes, resulting in deferred tax assets for the future tax benefits that would be realized when the temporary difference reverses in later years.

Under existing GAAP, most, but not all, operating leases are treated as operating leases (true leases) for tax purposes. Therefore, rarely are operating leases capitalized for tax purposes. Now, the game is about to change when operating leases are capitalized as right-to-use assets under GAAP, while they continue to be treated as operating leases (true leases) for tax purposes. As we have seen in the previous examples, most leases capitalized under the proposed standard will result in the creation of a deferred tax asset.

What about the impact on smaller nonpublic entities?

One leasing organization noted that more than 90 percent of all leases involve assets worth less than $5 million and have terms of two to five years.[10] That means that smaller companies have a significant amount of leases most of which are currently being accounted for as operating leases. Previously, the author estimated that the present value of unrecorded lease obligations under operating leases of non-public entities to be at least $6.3 trillion which is much higher than the estimated $1.2 trillion of unrecorded lease obligations of public companies.

Unless these smaller, non-public entities choose to use OCBOA for their financial statements, under GAAP these companies will be required to capitalize their operating leases.

What about related party leases?

Many, but not all, related party leases result in the lessee (parent equivalent) consolidating the lessor (subsidiary equivalent) under the consolidation of variable interest entity rules (ASC 810 (formerly FIN 46R)). The common example of a related party lease is where an operating company leases real estate from its related party lessor. In general, under FIN 46R, if there is a related party lessee and lessor, consolidation is required if:

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[10] Equipment Leasing and Financing Association (ELFA) "Companies: New Lease Rule Means Labor Pains" (CFO. com).

1. The real estate lessor is a variable interest entity (e.g., it is not self-sustaining), and

2. The lessee operating company and/or the common shareholder provide financial support to the real estate lessor in the form of loans, guarantees of bank loans, above-market lease payments, etc.

If these two conditions are met, it is highly likely that the real estate lessor must be consolidated in with the operating company lessee's financial statements. If there is consolidation, capitalizing the lease under the proposed standard would be moot because the asset and liability, and lease payments would be eliminated in the consolidation.

But there are many instances in which consolidation is not required between a related party lessor and lessee. For example, under ASC 810 (formerly FIN 46R), there is no consolidation if the real estate lessor is not a variable interest entity (VIE). The real estate entity is not a VIE if it has low leverage (usually 60% or less loan to value) so that the real estate entity could obtain a non-recourse bank loan without the assistance of guarantees given by the operating company lessee and/or the common owner. In such cases, there is no consolidation and the lease must be recorded.

When it comes to a related party lease, the parties will have to account for that lease as a right-to-use lease asset and obligation, just like any other lease transaction. Consequently, under the proposed standard, the operating company lessee would be required to record a right-to-use asset and lease obligation based on the present value of the lease payments.

Many related parties either do not have formal leases or the leases are short-term. If the operating company lessee is going to have to record a significant asset and liability, it may make sense to have a related party lease that is either a one-year term or a tenant-at-will arrangement.

With respect to a related party lease that is 12 months or less, the proposed standard would permit (but not require) use of the short-term lease simplified requirements as follows:

a. For the lessee, the right-to-use asset and liability would be recorded on the balance sheet at the undiscounted amount of the lease payments due for the 12-month (or less) period.

b. On the lessor side, at the date of inception of a lease, a lessor that has a short-term lease could elect not to recognize assets or liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset.

With many related party leases, the operating company lessee may issue financial statements while the real estate lessor does not. Therefore, how the lessee accounts for the transaction under GAAP may be more important than the lessor's accounting for the transaction.

Let's look at a simple example:

Example:

Company X is a real estate lessor LLC that leases an office building to a related party operating Company Y. X and Y are affiliated by a common owner.

The companies sign an annual 12-month lease with no renewals, and no obligations that extend beyond the twelve months.

Monthly rents are $10,000.

Y issues financial statements to its bank while X does not issue financial statements.

X is self-sustaining and the companies do not consolidate under the variable interest entity (VIE) rules.

Conclusion:

Because the entities have a short-term lease of 12 months or less, Y would qualify for the simplified requirements under the proposed lease standard. Thus, Y would record a right-to-use asset and lease obligation equal to the undiscounted lease payments over the 12-month period as follows:

Company Y Entry: Inception of new lease		
1		
Lease asset (right-to-use asset) ($10,000 x 12)	120,000	
Lease obligation		120,000
2		
Entry each month for 12 months:		
Lease obligation (b)	10,000	
Cash, AP		10,000
3		
Entry each month for 12 months:		
Amortization expense	10,000	
Accumulated amortization- lease asset		10,000

Observation: If the proposed standard is issued in final form, many non-public entities will take steps to avoid the arduous rules. One approach will likely be to make sure the related party leases have terms that are 12 months or less so that the asset and liability can be recorded on an undiscounted basis. A second approach is to use OCBOA (other comprehensive basis of accounting) such as income tax or cash basis. Lastly, a non-public company may elect to continue to record the leases as operating leases and include a GAAP exception in the accountant's or auditor's report.

As the author discusses elsewhere in this course, the Blue Ribbon Commission Report was issued and included recommendations to simplify GAAP for non-public companies. One area that might warrant exemption for non-public companies is the proposed lease standard due to its complexity.

Other considerations

The proposed lease standard casts a wide web across the accounting profession. By capitalizing leases that were previously off-balance sheet as operating leases, there may be consequences.

One example, is that many states compute the apportionment of income assigned to that state using a property factor based on real and tangible personal property held in that particular state. When it comes to rent expense, most states capitalize the rents using a factor such as eight (8) times rent expense. Although each state has its own set of rules, the implementation of the proposed standard may have a sizeable positive or negative impact on state tax apportionment based on shifting rent expense to capitalized assets.

On the other hand, capitalizing leases might have a positive effect in tax planning. One example is where there is a C corporation with accumulated earnings. The additional lease obligation liability would certainly help justify the accumulation of earnings under the Bardahl Formula.

Companies should also be aware that not only would the proposed standard increase liabilities, but would also increase total assets. In some states, there are total asset thresholds that drive higher taxes and reporting requirements.

Dealing with financial covenants

A critical impact of the proposed standard would be that certain loan covenants may be adversely impaired thereby forcing companies into violations of their loans.

Consider the following ratios:

Ratio	**Likely impact of new lease standard**
EBITDA: *[Earnings before interest, taxes, depreciation and amortization]*	Favorable impact due to shift from rental expense to interest expense and amortization expense, which are add backs to the EBITDA formula
Interest coverage ratio: *<u>Earnings before interest and taxes</u>* *Interest expense*	May be a negative impact from lower ratio
Debt-equity ratio: *<u>Total liabilities .</u>* *Stockholders' equity*	Negative impact from higher ratio

There would be a favorable impact on EBITDA by implementing the proposed standard. Rent expense recorded for operating leases under existing GAAP would be reduced while interest expense and amortization expense would increase once the leases are capitalized.

As to the interest coverage ratio, in many instances changes would have a negative impact on this ratio. Earnings before interest and taxes would likely be higher as rent expense is removed and replaced with interest and amortization expense. The denominator increases significantly due to the higher interest expense. On balance, the slightly higher earnings before interest and taxes divided by a higher interest expense in the denominator yields a lower interest coverage ratio.

Perhaps the most significant impact of capitalizing leases under the proposed lease standard would be on the debt-equity ratio. With piles of liabilities being recorded, this ratio would likely turn quite negative and severely impact company balance sheets. In some cases, the debt-equity ratio would result in violation of existing loan covenants, thereby requiring a company to renegotiate the covenants with its lenders or at least notify lenders in advance of the likely lack of compliance with loan covenants.

E. THE GAAP CODIFICATION

Effective July 1, 2009, the FASB completed its Accounting Standards Codification which consists of a single source of authoritative nongovernmental U.S. GAAP, that supersede existing FASB, AICPA, EITF, and related literature. After July 1, 2009, all other literature was considered non-authoritative.

The FASB's objective is to establish the *FASB Accounting Standards Codification*™ (Codification or ASC) 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.

The codification was established through the issuance of FASB No. 168: *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (currently ASC 105) which establishes a new Codification. FASB Accounting Standards Codification (FASB ASC) is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities.

Key elements of the codification follow:

1. FASB Statement No. 168 was the <u>*final standard*</u> issued by FASB in an individual statement format.

2. The FASB ASC contains the authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

    a. Categories (a), (b), (c), and a portion of (d) of the GAAP hierarchy are included in the new FASB Codification.

- 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.

3. The ASC is broken down by topics, rather than by pronouncements, segregated into five areas as follows:

FASB Codification (FASB ASC)		
Area	Description	Topic Codes
General Principles	Relates to conceptual matters and includes GAAP	105-199
Presentation	Relates to presentation matters	205-299
Financial Statement Accounts	Includes assets, liabilities, equity, revenue and expenses	305-700
Broad Transactions	Includes business combinations, derivatives and other	805-899
Industry	Relates to accounting that is unique to an industry or type of activity. Topics include airlines and financial services	905-999

The above table shows the general structure of the ASC which consists of 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:

Topic	XXX
Subtopic	YY
Section	ZZ

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 ASC 450, *Contingencies* (formerly FASB No. 5).

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 450-20-2*5 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.

All FASB statements (FASB No. 1-168) and other GAAP in existence as of *July 1 2009* were merged into the new FASB ASC.

Note: Previous GAAP 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.

Although the original FASB reference number was 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.

If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an 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.

Simplifying the language within the Codification

In writing the Codification, the FASB had a goal of using a simple, module writing style that was used consistently across the Codification. In doing so, the FASB followed a few guidelines:

- 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.

Accounting Standards Updates (ASUs)

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, and 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.

b. After the effective date of FASB No. 168 (currently ASC 105), all non-grandfathered non-SEC accounting literature not included in the Codification is superseded and deemed non-authoritative.

c. 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.

d. 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.

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 standards.

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 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. Under existing GAAP (*Leases* (ASC 840) (formerly FASB No. 13)), 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

2. Which of the following models does the proposed lease standard include:

   a) right-of-use model
   b) operating lease model
   c) capital lease model
   d) true lease model

3. Under the proposed lease standard, expense on the income statement would consist of which of the following components:

   a) rent expense
   b) interest and depreciation expense
   c) rent and interest expense
   d) amortization and interest expense

4. The proposed lease standard defines a lease term as which of the following:

   a) shortest possible lease term
   b) average lease term reflective of all options and extensions
   c) longest possible lease term
   d) useful life of the underlying asset

5. How should options to extend the lease term be accounted for in determining the lease term:

   a) the lease term should take into account the effect of any option to extend the lease
   b) lease options are only considered once they are exercised
   c) the proposed standard states that options are too vague and should not be considered in determining the lease term
   d) only certain options to extend within a short-term period are considered because it is difficult to estimate the likelihood of the options being exercised

6. One change that may occur as a result of the proposed lease standard being implemented is:

   a) companies that typically purchase a single-tenant building may choose to lease instead of buy
   b) tenants in multi-tenant buildings would likely sign longer-term leases
   c) tenants in single-tenant buildings with long term leases may choose to buy
   d) there is likely to be no change

7. Under ASC 810 (formerly FIN 46R), if there is a related party lessee and lessor, which of the following would require consolidation of the two entities:

   a) the real estate entity is self-sustaining
   b) the real estate lessor is a variable interest entity
   c) the real estate lessor guarantees its own loan
   d) the lease is at market value

8. 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

9. Which of the following is an example of how the FASB simplified the language within the FASB ASC:

   a) it has 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*

SUGGESTED SOLUTIONS

1. 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 (and not 10%) 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. If there is a bargain purchase at the end of the lease, the lease is a capital lease.

   D: Incorrect. If there is a transfer of ownership, the lease qualifies as a capital lease.

   (See page 7-37 of the course material.)

2. **A: Correct.** The proposal uses the right-of-use model under which a lease obligation is recorded at the present value of cash flows with the recording of a corresponding right-to-use asset.

   B: Incorrect. Operating leases are part of existing GAAP and have nothing to do with the proposed lease standard.

   C: Incorrect. The term "capital lease" is part of existing GAAP although the new model does capitalize leases.

   D: Incorrect. The concept of "true lease" is found in taxation and not in GAAP.

   (See page 7-39 of the course material.)

3. A: Incorrect. Operating leases record rent expense while the proposed standard does not account for a lease as an operating lease.

   B: Incorrect. Interest is recorded but amortization is the second component, not depreciation.

   C: Incorrect. Interest expense, but not rent expense, is a component of a lease recorded under the proposed standard. Rent expense applies to an operating lease and not a lease capitalized under the proposed standard.

   D: Correct. Both amortization and interest expense are components of expense recorded under the proposed standard. Amortization relates to the asset capitalized while interest expense relates to the payments of the lease obligation.

   (See page 7-39 of the course material.)

4. A: Incorrect. The proposed standard does not use the shortest possible lease term.

   B: Incorrect. The proposed standard does not use the average lease term but does reflect all options and extensions, making the answer not entirely correct.

   C: Correct. Longest possible lease term is used to measure the lease obligation and related lease asset.

   D: Incorrect. Although the useful life of the underlying asset may be applicable to how a lease asset is amortized, it does not relate to the lease term under the proposed standard.

   (See page 7-40 of the course material.)

5. **A: Correct.** The lease term should take into account the effect of any option to extend the lease or terminate the lease.

   B: Incorrect. The proposed standard does not provide for lease options being considered only once they are exercised.

   C: Incorrect. The proposed standard states that options should be considered making the statement incorrect.

   D: Incorrect. The proposed standard does not differentiate between an option to extend within a short-term period as compared with one that is long-term.

   (See page 7-40 of the course material.)

6. A: Incorrect. The proposed standard is not likely to expand leases because those leases will have lease obligations that have to be recorded on the lessee's balance sheet.

   B: Incorrect. Shorter, not longer leases will be the trend so that smaller liabilities are recorded on the lessee's balance sheet.

   C: Correct. Tenants in single-tenant buildings with long-term leases may choose to buy because they already have to record lease obligations that are similar to the debt they will have to record in a purchase.

   D: Incorrect. The status quo is not likely to be the case given the enormity of the impact of the proposed standard on company balance sheets.

   (See page 7-47 of the course material.)

7. A: Incorrect. Consolidation may be required only if the real estate entity is not self-sustaining.

   B: Correct. If the real estate lessor is a variable interest entity (VIE), consolidation may be required.

   C: Incorrect. If the lessee operating company or the common shareholder guarantee the lessor's loan, consolidation may be required. This is not the case where the real estate lessor guarantees its own loan.

   D: Incorrect. If the lease is above market, and not at market value, consolidation may be required.

   (See page 7-49 of the course material.)

8. 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 7-53 of the course material.)

9. 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 has a Master Glossary that allows a user to look up any term along with a separate glossary that exists within each subtopic.

   C: Incorrect. Just the opposite. 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 7-55 of the course material.)

F. BIG GAAP-LITTLE GAAP – BLUE RIBBON PANEL RECOMMENDATIONS

In January 2011, the Blue-Ribbon Panel on Standard setting for Private Companies (the Panel) issued a long-awaited *Report to the Board of Trustees of the Financial Accounting Foundation*. This Report provides recommendations on how to deal with accounting standards for private companies.

In December 2009, a group of organizations lead by the AICPA and Financial Accounting Foundation (FAF) (the parent organization of the FASB), and other organizations established a Blue Ribbon Panel to address accounting standards of private companies. The Panel was comprised of 18 members, all senior leaders including lenders, investors, owners, accountants and auditors. The Panel also invited regulators and other stakeholders to participate (but not vote) in the discussions of the Panel.

Although this effort appeared to be more déjà vu, and redundant with the actions of many other panels and committees, the Panel issued a report in January 2011 to the FAF.[11] That report made drastic recommendations as to how to resolve the accounting standards challenges for private companies.

Unlike previous panels and committees, the Panel made the following recommendations to the FAF:

<u>Problems with the current system:</u>

1. There are urgent and growing systemic issues that need to be addressed in the current system of U.S. accounting standard setting.

2. The current U.S. accounting standard-setting process has systemic issues including:

    a. An insufficient understanding of the needs of users of private company financial statements and how the needs of private companies differ from those of public companies, and

    b. An insufficient weighing of the costs and benefits of GAAP for use in private company financial reporting such as those on:

        - Variable interest entities
        - Uncertain tax positions
        - Fair value measurements
        - Goodwill impairment.

3. There is a lack of relevance in a number of accounting standards as they relate to private company financial statements, including an overall level of complexity and unnecessary cost.

[11] Report to the Board of Trustees of the Financial Accounting Foundation, issued January 2011.

a. Because of the lack of relevance, and the complexity, surrounding some GAAP standards, many private companies have chosen alternatives to GAAP including:

- Receiving a qualified or except-for opinion, or
- Using OCBOA (income tax or cash basis).

4. The FASB will not be able to fully assess and respond sufficiently and appropriately to the needs of the private company sector:

   a. Despite there being approximately 14,000 public companies in the United States as compared with 28 million private companies, the FASB's focus has been limited to public company sector.

5. Previous studies were practitioner-driven and the FASB did not formally research the needs of private companies:

   a. The last time that the FASB formally researched the needs of private companies was in 1983.

   b. Since the AICPA's Private Company Financial Reporting Task Force started working with the FASB in 2007, the FASB has not shown a willingness to carve out of new standards any private company differences.

      - The Task Force has submitted 40 recommendation letters to the FASB since 2007.

      - The FASB's modifications for private companies generally have been limited to allowing different effective dates, and in some cases different disclosures for private companies.

<u>International standards for private companies:</u>

1. Standard setters outside the United States have come to believe that there needs to be significant differences for private company reporting:

   a. Many countries around the world have adopted the IFRS for SMEs (small and medium-sized entities) for their private companies.

   b. The U.K. is planning to adopt the IFRS or SMEs for use by its private companies.

   c. Canada has created a standalone set of accounting standards for private companies.

<u>Recommendations by the Panel:</u>

The Panel recommends that in the near term, the system should focus on making <u>*exceptions and modifications to U.S. GAAP*</u> for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP.

The Panel recommends that the private company model consist of *"U.S. GAAP with Exceptions and Modifications (with Process Enhancements)."*

1. This new model should *retain existing GAAP* for both private and public companies, but there would be carve out exceptions and modifications for private companies.

   a. The exceptions and modifications would result in financial statements that provide relevant, decision-useful information that meets the needs of private company financial statement users in a cost-effective manner.

2. New separate private company standards board: There should be a *new separate private company standards board* to help ensure that appropriate and sufficient exceptions and modifications are made for private companies, for both new and existing standards.

   a. The new board would:

      - Consist of five to seven members that are representative of the private company sector and would work closely with the FASB.

      - Work closely with the FASB to achieve a coordinated and efficient standard-setting process.

      - Have final authority over establishing GAAP exceptions and modifications for private companies.

      - Have the power to initiate its own projects.

      - Go through a comprehensive review to be conducted in three-to-five years to evaluate its effectiveness and make additional process improvements to it, if needed.

   b. The FASB would be able to promulgate a GAAP exception or modification in a GAAP standard (with the support of the new board) or the new board would have authority to promulgate a difference if the FASB chose not to allow a difference.

   c. Most of the cost of the new board and staff would have to be funded by a viable, new source, such as mandatory annual or one-time (endowment) contributions from stakeholders and maybe a state board licensing fee allocation.

      - The annual budget is estimated at $4-6 million.

3. Different framework for private companies: There should be the creation of a differential framework to act as a guide for the new board to make appropriate, justifiable exceptions and modifications to GAAP for private companies.

4. Near-term relief: The FAF and FASB should provide near-term relief for private companies to help ensure a smooth transition to a new board.

Advantages of the *"U.S. GAAP with Exceptions and Modifications (with Process Enhancements)" model:*

The Panel identified numerous pros and cons of the proposed new model:

1. Pros:

A GAAP- with-exceptions-and-modifications model:

- Can be achieved more quickly than other models;
- Maintains a significant degree of consistency and comparability between public and private companies;
- Minimizes the costs to private companies that choose to go public;
- Avoids confusion and system complexity as compared with having two separate sets of U.S. GAAP; and
- Has lower education and training costs than other models.

A separate private company board:

- Could provide appropriate structural separate from the pressures that the FASB faces in addressing the needs of public company stakeholders, including the SEC, and
- Could better address the different needs of private company financial statement users given a targeted focus on one constituency.

2. Cons:

- A GAAP-with-exceptions-and-modifications model might not be perceived as being sufficiently responsive to complexity and cost issues for private companies;
- The new model may slow down the pace of standard-setting activities;
- There could be substantially different accounting standards for private companies resulting in a lack of comparability;
- Two boards having authority for one overall, single-GAAP model is unproven and has not been used in other countries;
- The model could make engagements in due process inefficient and even confusing for stakeholders; and
- Additional funding sources will be required.

G. DEFERRED INCOME TAXES AND NOLs

ASC 740 *Income Taxes* (formerly FASB No. 109) has been around for almost two decades. Yet, there are several key issues related to deferred income taxes that exist because of the recent economic climate and changes proposed by health care reform. In this section, the author addresses those issues which consist of:

1. Deferred income tax assets from NOLs and the need for valuation accounts, and
2. Deferred income taxes due to the change in the Obama *Patient Protection and Affordable Care Act (PPACA)*.

Deferred Income Tax Assets From NOLs

ASC 740, *Income Taxes* (formerly FASB No. 109), requires a company to record a deferred income tax asset for the tax benefit of a net operating loss carryforward. The asset represents the tax benefit that will be received when the company ultimately uses that NOL in future years. In order to actually use the NOL, the company must have future income to absorb that NOL.

Under existing federal tax law, a company can carry back a NOL two years, and then carry forward the unused NOL for 20 years. Of course, a company can elect to forego carryback of the NOL and instead carry forward the NOL.

Following is a simple example that demonstrates how the rules work.

Example 1:

Company X generates a federal income tax loss in 20X5 in the amount of $500,000.

X carries back $200,000 of the $500,000 to years 20X2, 20X3 and 20X4 by filing a Form 1139 and obtains a refund from the IRS.

The remaining $300,000 NOL is carried forward to years 20X6 and beyond and can be used through year 20X25.

For simplicity, assume there are no surtax rates and that the federal tax rate is 35%.

Conclusion:

The entry in 20X5 follows:

	dr	cr
IRS refund receivable (1)	70,000	
Income tax expense- current federal		70,000
Deferred income tax asset (2)	105,000	
Income tax expense- deferred federal		105,000

(1): NOL carryback: $200,000 x 35% = $70,000.
(2): Unused NOL carryforward: $300,000 x 35% = $105,000.

Now, the IRS refund of $200,000 will be received by the company. As to the deferred income tax asset, the tax benefit of $105,000 will be received only if and when the company has future federal taxable income of $300,000 to utilize the NOL carryforward. Moreover, the company has 20 years in which to generate a total of $300,000 of future taxable income to use the NOL. In many cases, an active going concern will have no problem using the NOL so that the full deferred income tax asset of $105,000 will be utilized.

But what if there is not enough future income to absorb the deferred tax asset?

ASC 740, *Income Taxes* (formerly FASB No. 109), requires a company to recognize a valuation account against a deferred income tax asset if based on the weight of available evidence, it is *more likely than not* (more than 50% probability) that some portion or all of the deferred tax asset will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

Ask the question:

Will the company have enough future taxable income during the NOL carryforward period to use the unused NOL?

If the answer is "yes," there is no need for a valuation account. If the answer is "no," a valuation account must be established for a portion or all of the deferred tax asset.

The only way in which a valuation account is needed is if there is more than a 50% probability that there will not be enough future income during the NOL carryforward period to utilize the unused NOL.

Future income can come from several sources as follows:

a. Reversal of existing taxable temporary differences into taxable income assuming taxable income is zero.

b. Estimated future taxable income (exclusive of reversing temporary differences and carryforwards).

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law.

d. Tax-planning strategies that the company would, if necessary, implement to utilize an expiring NOL such as:

    - Accelerate taxable amounts to utilize expiring carryforwards,
    - Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss, or
    - Switch from tax-exempt to taxable investments.

Although there are several sources of future income, in most cases involving a deferred income tax asset, future taxable income comes from two sources:

a. Estimated future taxable income during the 20-year carryforward period, and

b. Taxable temporary differences that will reverse into taxable income during the 20-year carryforward period as evidenced by the existing deferred income tax liabilities.

In most cases, if a company has deferred income tax liabilities equal to or in excess of the deferred income tax asset related to the NOL, that fact, in and of itself, means the company will have enough future income to utilize the NOL.

Similarly, if the company can estimate that there will be sufficient future taxable income during the 20-year NOL carryforward period, that means the deferred income tax asset will be utilized and no valuation account is needed.

ASC 740, *Income Taxes* (formerly FASB No. 109), does give a list of factors that should be considered in determining whether there will be sufficient future taxable income during the NOL carryforward period to utilize the deferred income tax asset:

EVIDENCE USED TO DETERMINE WHETHER A VALUATION ACCOUNT IS NEEDED	
Negative Evidence Leading to a Conclusion That a Valuation Account Is Needed	**Positive Evidence Leading to a Conclusion That a Valuation Account Is Not Needed**
Cumulative losses in recent years (usually the last three years including the current year)	Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
History of operating loss or tax credit carryforwards expiring unused	An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
Losses expected in early future years (by a presently profitable entity)	A strong earnings history, exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference), coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition
Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years	
A carryback or carryforward period that is so brief that it would limit realization of tax benefits if: (1) a significant deductible temporary difference is expected to reverse in a single year, or (2) the enterprise operates in a traditionally cyclical business.	

Negative evidence, by itself, makes it difficult to reach a conclusion that a valuation is not needed. However, the existence of positive evidence might support a conclusion that a valuation allowance is not needed when there is negative evidence. In particular, ASC 740 (formerly FASB No. 109) notes that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."

Following are a few examples that illustrate the author's points.

Example 1:

Company X has the following information for year ended 2011:

2011 tax net operating loss	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-11:	
Book	$2,000,000
Tax	3,500,000
Temporary difference	$1,500,000

The $(1,000,000) 2011 net operating loss is available for carryforward to 2031 (20 years).

The company had federal tax losses in the two carryback years (2009 and 2010) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2011 NOL available for carryback.

The temporary difference related to accumulated depreciation (AD) will reverse in years 2012 through 2021. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-11 as follows:

Deferred income tax asset (federal):	
2011 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2031, twenty years]	
Deferred income tax liability:	
Temporary difference: AD $1,500,000 x 35%	$(525,000)

Should X record a valuation account related to the $350,000 deferred income tax asset?

ASC 740, *Income Taxes*, requires a company to recognize a valuation account against a deferred income tax asset if it is *more likely than not* (more than 50% probability) that some portion or all of the deferred tax asset will not be realized. In making the assessment, the Company must consider whether there will be enough future taxable income during the 20-year NOL carryforward period to utilize the $1,000,000 NOL and $350,000 deferred tax asset.

One of the sources of future taxable income is if there are existing taxable temporary differences that will reverse into taxable income during the 20-year carryforward period. In this example, the company already knows that it has $1,500,000 of future taxable income from reversal of the accumulated depreciation temporary difference. That reversal will occur in years 2012 through 2021 which is within the NOL carryforward period.

Because the company has a taxable temporary difference ($1,500,000) in excess of $1,000,000 that will reverse in the NOL carryforward period, the deferred tax asset of $350,000 will be realized. No valuation account is required.

Observation: The easiest source of future taxable income is where a company has a deferred tax liability from a temporary difference that will result in future taxable income during the NOL carryforward period. This source of future taxable income does not require any forecasts because it is based on events that have already occurred.

Example 2:

Company X has the following information for year ended 2011:

2011 net operating loss- tax purposes	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-11:	
Book	$2,000,000
Tax	2,600,000
Temporary difference	$ 600,000

The $(1,000,000) 2011 net operating loss is available for carryforward to 2031 (20 years).

The company had federal tax losses in the two carryback years (2009 and 2010) which were carried back to earlier years to obtain a federal tax refund. The company also had a tax loss in 2008. There is no portion of the 2011 available for carryback.

The company also had pretax book losses in years 2008 through 2010 with no signs of improvement for 2011 and beyond.

The temporary difference related to accumulated depreciation ($600,000) will reverse in years 2012 through 2021. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-11 as follows:

Deferred income tax asset (federal):	
20X9 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2031, 20 years]	
Deferred income tax liability:	
Temp difference: AD $600,000 x 35%	$(210,000)

Conclusion:

The company can use the future taxable temporary difference of $600,000 as a source of future income that will utilize the $1,000,000 NOL carryforward. However, there appears to be no other sources of future income that can be justified. In particular, the company has had a series of book losses in 2008 through 2010. ASC 740 states that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." Given the fact that there is no positive evidence to support future taxable income beyond the $600,000 of future taxable income from the reversal of the temporary differences, a valuation account is required as follows:

Deferred income tax asset (federal): $1,000,000 x 35%	$350,000
Future income:	
Deferred income tax liability reversal: $600,000 x 35%	(210,000)
Valuation allowance required: $400,000 x 35%	$(140,000)

Entry:

Income tax expense- deferred federal	140,000	
Valuation allowance		140,000

Balance sheet presentation:

Assets:	
Deferred income tax asset	*$210,000
Long-term Liabilities:	
Deferred income tax liability	**(210,000)

* DIT asset of $350,000 less valuation of $140,000 = $210,000.
** DIT liability related to accumulated depreciation temporary difference.

Observation: In using existing taxable temporary differences (deferred income tax liabilities) to justify future taxable income to utilize a deferred income tax asset from an NOL carryforward, the analysis is done based on the assumption that *there is no other taxable income or loss during the years in which the taxable temporary differences reverse*. The taxable temporary difference is scheduled without regard to any other taxable income or loss.

In Example 1, the analysis indicates that there is $1,500,000 of future taxable income that the company will have when the accumulated depreciation reverses in future years. Notice that the analysis assumes that taxable income in those future years is zero and that the only taxable income in those future years is the reversal of the taxable temporary difference of $1,500,000.

What if a deferred tax asset relates to an unlimited state NOL carryforward?

There are certain states that allow net operating losses to be carried forward indefinitely. If this is the case, a deferred income tax liability related to an indefinite-lived asset (such as goodwill) can be used as a source of income that can support the realization of the deferred tax asset. The reason is because the temporary difference from the indefinite lived asset has no deadline to reverse into taxable income. When the temporary difference reverses from an ultimate sale or impairment writedown, that taxable income will utilize the net operating loss given the fact that the state NOL has an unlimited carryforward period.

Deferred tax liabilities related to indefinite-lived assets

There is an exception in ASC 740 in which a company is not permitted to use certain deferred tax liabilities to justify future income that will absorb a net operating loss carryforward.

ASC 740 states that a deferred tax liability that relates to an asset with an indefinite useful life, such as goodwill, indefinite-lived intangibles (such as a trademark), and land, cannot be used as a source of future income to absorb a deferred income tax asset. It is common to refer to a deferred tax liability related to an indefinite-lived asset as a "naked credit" because that credit cannot be used against the NOL.

The reason is because one cannot predict when a deferred tax liability related to an indefinite lived asset, such as goodwill, will reverse. Because such an asset is not amortized for GAAP, the only way it will reverse is when the asset is either sold or written down for impairment. In either case, the reverse may occur outside the 20-year NOL carryforward period, thereby resulting in that income not being utilized toward the unused NOL carryforward.

Example 3:

Company X has the following information for year ended 2011:

2011 net operating loss- federal tax purposes	$(1,000,000)
Temporary difference:	
Goodwill at 12-31-11:	
Book value- Book	$3,000,000
Book value- Tax	1,200,000
Temporary difference	$1,800,000

- The 2011 net operating loss of $(1,000,000) is available for carryforward for 20 years to 2031.

- The company had federal tax losses in the two carryback years (2009 and 2010) which were carried back to earlier years to obtain a federal tax refund. The company also had a tax loss in 2008. There is no portion of the 2011 available for carryback.

- The company also had pretax book losses in years 2008 through 2010 with no signs of improvement for 2011 and beyond.

- Goodwill is being amortized over 15 years for tax purposes and not amortized for GAAP.

- There are no other temporary differences.
- There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-11 as follows:

Deferred income tax asset (federal):	
2011 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2031, twenty years]	
Deferred income tax liability:	
Temp difference: Goodwill basis difference $1,800,000 x 35%	$(630,000)

Conclusion:

Typically, one source of future taxable income that can be used to justify that a deferred tax asset from an NOL carryforward will be utilized, is where a company has a deferred tax liability. That liability represents future taxable income that will occur when the temporary difference giving rise to the deferred tax liability reverses. However, in order for that liability to be used as future taxable income, the temporary difference must reverse and generate future taxable income within the NOL carryforward period, which in this case is by year 2031. The problem is that the goodwill is an asset with an indefinite life in that a deduction for that goodwill will only occur for book purposes if the goodwill is ultimately sold or written down for impairment. But when will that happen and can the company guarantee that such a sale or writedown will occur by the end of the year 2031 NOL carryforward period? The answer is unequivocally "no." After goodwill is amortized over 15 years for tax purposes, there will be a large deferred tax liability that will not reverse until the goodwill is sold or written down for impairment.

Therefore, the temporary difference related to the goodwill basis difference cannot be considered a source of future taxable income. Because the company has a history of recent cumulative book losses (2008 to 2010), it appears that the company cannot justify that there will be sufficient future taxable income to absorb the NOL. The result is that a valuation account should be recorded for the full amount of the deferred tax asset as follows:

Income tax expense- deferred federal	350,000	
Valuation allowance		350,000

Balance sheet presentation:

Assets:	
Deferred income tax asset	*$0
Liabilities:	
Deferred income tax liability	(630,000)

* DIT asset of $350,000 less valuation of $350,000 = $0.

Example 3A:

Same facts as Example 3 except that the Company has two deferred income tax liabilities as follows:

Deferred income tax asset (federal):	
2011 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2031, twenty years]	
Deferred income tax liability:	
Temp difference: AD $600,000 x 35%	(210,000)
Deferred income tax liability:	
Temp difference: Goodwill basis difference $1,800,000 x 35%	(630,000)

Conclusion:

In order to avoid having to record a valuation account against the deferred income tax asset, the company must justify that it is more likely than not that there will be sufficient future taxable income through 2031 to utilize the NOL. In considering sources of future income, the company can use future taxable income when taxable temporary differences reverse. That is, does the company have deferred tax liabilities that equal or exceed the deferred tax asset. In this case, the temporary difference of $600,000 related to accumulated depreciation can be considered future taxable income because it will reverse into income by 2031. The temporary difference related to goodwill is not considered because it relates to an indefinite lived asset.

Because the company has had a series of cumulative pre tax book losses in years 2008 to 2010, it would be difficult for it to justify that it will generate future taxable income from other sources.

The result is that the company can justify that there will be $600,000 of future taxable income from the accumulated depreciation temporary difference.

Deferred income tax asset (federal): $1,000,000 x 35%	$350,000
Future income:	
Deferred income tax liability reversal: $600,000 x 35%	(210,000)
Valuation allowance required: $400,000 x 35%	$(140,000)

Income tax expense- deferred federal	140,000	
Valuation allowance		140,000

Balance sheet presentation:

Assets:	
Deferred income tax asset	*$210,000
Liabilities:	
Deferred income tax liability	**(840,000)

* DIT asset of $350,000 less valuation of $140,000 = $210,000.
** DIT liability: $210,000 AD and $630,000 goodwill = $840,000.

What if a deferred tax asset relates to an unlimited state NOL carryforward?

There are certain states that allow net operating losses to be carried forward indefinitely. If this is the case, a deferred income tax liability related to an indefinite-lived asset (such as goodwill) can be used as a source of income that can support the realization of the deferred tax asset. The reason is because the temporary difference from the indefinite-lived asset has no deadline to reverse into taxable income. When the temporary difference reverses from an ultimate sale or impairment writedown, that taxable income will utilize the net operating loss given the fact that the state NOL has an unlimited carryforward period.

Future income and the cumulative losses situation: the three-year rule

Let's look at predicting future income. Previously, we addressed the situation in which future taxable temporary differences such as those related to accumulated depreciation are an easy source of future income that would absorb a deferred income tax asset.

Now let's assume there are no deferred tax liabilities related to future taxable temporary differences. Therefore, the only way to avoid having to record a valuation allowance is to estimate future taxable income (exclusive of reversing temporary differences) that the company will generate during the 20-year NOL carryforward period.

In concept, such an exercise should yield plenty of taxable income. After all, the company has 20 years of estimated taxable income to use the NOL carryforward.

Although it is true that estimating enough future taxable income over a 20-year period that is sufficient to use an unused NOL carryforward should be easy, it may be impossible to do under the "cumulative loss" rule.

Previously, the author discussed that in assessing whether a valuation allowance is needed, both positive and negative evidence must be considered. If it is more likely than not, based on the evidence, that the deferred tax asset will not be realized by future taxable income, a valuation is required for any shortfall.

ASC 740 states that cumulative losses in recent years is a negative factor that may be difficult to overcome with other positive factors.

The question is how many years of cumulative losses create a pattern of negative evidence that is so great that one cannot estimate that future taxable income will exist and, therefore, a valuation account is required?

In Appendix A to ASC 740, the FASB was quite careful not to create a bright-line test as it relates to cumulative losses. Although many companies and their accountants use three-years of losses (current year and two prior years) to define the term "cumulative losses," such an approach is non-authoritative but has become generally accepted. ASC 740 does not give any guidance as to how to determine cumulative losses and the number of years of losses that would suggest a negative trend.

Although not authoritative, many CPA firms and their clients are using a "soft" three-year period (current year and two prior years) to assess whether there are cumulative losses, based on the following structure:

1. "Cumulative losses" is based on the last three years of pre-tax book income (losses) consisting of the current year and two prior years.

2. Pre-tax GAAP income is used instead of taxable income.

Observation: Because the FASB places so much weight on the cumulative losses as a component of negative evidence, companies should be careful not to fall into the trap of doing a mechanical three-year computation of pre-tax GAAP losses to define cumulative losses.

What is more important is the direction in which the losses are headed and whether there are any non-recurring transactions that might distort the real upward or downward trend.

Consider the following scenarios:

Scenario 1:

At December 31, 20X3, Company X has a deferred tax asset in the amount of $1,000,000 due to an unused NOL carryforward. X has no deferred tax liabilities.

Pre-tax book income is:

Year	Pre-tax book income (loss)
20X3 (current year)	$(2,000,000)
20X2	(1,200,000)
20X1	(500,000)
	$(3,700,000)

Conclusion:

Cumulative losses total $(3,700,000) over the most recent three-year period and the trend appears to be leading toward greater losses in the most recent year 20X3. The fact that there are cumulative losses is strong negative evidence that it is more likely than not that the company will not have sufficient future taxable income to utilize the $1,000,000 deferred income tax asset during the NOL carryforward period. That is, the company cannot estimate future taxable income will exist. It is highly unlikely that X can gather sufficient positive evidence to override the cumulative losses negative evidence. Consequently, X should record a $1,000,000 valuation allowance to offset the $1,000,000 deferred income tax asset.

Entry:	1,000,000	
Income tax expense- deferred federal		
Valuation allowance		1,000,000

Scenario 2:

At December 31, 20X3, Company X has a deferred tax asset in the amount of $1,000,000 due to an unused NOL carryforward.

X has no deferred tax liabilities.

Pre-tax book income is:

Year	Pre-tax book income (loss)
20X3 (current year)	$(2,000,000)
20X2	1,100,000
20X1	600,000
	$ (300,000)

The pre-tax loss in 20X3 is due to a one-time loss from the writedown of inventories. Historically, the company has been profitable.

Conclusion:

Scenario 2 is a perfect example of why the FASB did not want to use a bright-line test of three-years cumulative losses. Here we have a company with a trend of profitability but one year of a significant loss. In the aggregate, cumulative losses over the past three years were $(300,000). However, the one-time loss of $(2,000,000) is based on a non-recurring event and cannot discount the fact that the company has been profitable and is likely to be profitable in future years. The company should not place significant weight on the cumulative losses over the past three years and, instead, should look at other evidence to assess whether a valuation allowance is needed.

Scenario 3:

At December 31, 20X3, Company X has a deferred tax asset in the amount of $1,000,000 due to an unused NOL carryforward.

X has no deferred tax liabilities.

Pre-tax book income (loss) is:

Year	Pre-tax book income (loss)
20X3 (current year)	$(800,000)
20X2	(700,000)
20X1	1,700,000)
	$ 200,000

Over the three-year period, the company has cumulative income of $200,000. Although this would suggest that there are no cumulative losses, a closer look shows a trend of losses over the past two years 20X2 and 20X3. ASC 740 does not use three-years as a bright-line test of cumulative losses. The fact that the company had two successive years of losses is certainly negative evidence of a trend. But, in this case, the author believes that the two years of losses could be overridden by positive evidence such as a) a previously strong earnings history, b) indication that the company was going to turn the corner toward profitability in 20X4, and c) a firm sales backlog, among other factors. Cumulative losses over the past two years, in and of itself, is not sufficient negative evidence to reach the conclusion that it is more than likely than not (more than 50% probability) that the deferred tax asset will not be realized by future taxable income. More evidence should be gathered to determine whether a valuation allowance is needed.

Deferred tax assets and the impact of health care reform

It is interesting to note that health care reform is going to have a sizeable impact across a broad range of industries and transactions. Oddly, one key change in Obama-care is going to affect the realization of deferred income tax assets.

In 2003, the *Medicare Prescription Drug and Modernization Act* (MMA) was signed into law and provided a prescription drug benefit under Medicare Part D. In addition, under MMA, prior to 2013, sponsors of retiree health benefit plans receive a federal subsidy (called the Retiree Drug Subsidy (RDS)) equal to 28% of covered prescription cost for their retirees. The RDS has been available to sponsors that provide a benefit that is at least actuarially equivalent to the benefits under Medicare Part D. Prior to 2013, RDS is not taxable to employers.

The primary goal of RDS was to encourage employers to continue offering prescription drug benefits to their retirees instead of terminating the prescription drug benefit plans. If a plan is terminated, those retirees would attempt to obtain those benefits through Medicare Part D at the taxpayer's expense.

Under the MMA, prior to 2013, employers are qualified to receive a subsidy equal to 28% of covered prescription drug costs for their retirees. Further, employers receive an income tax deduction upon receipt of the subsidy and are permitted to take into account this deduction when accounting for their retiree prescription drug expenses.

Changes under Obama-care

In March 2010, President Obama signed the *Patient Protection and Affordable Care Act* (PPACA) into law. As part of PPACA, in tax years beginning after 2012:

- RDS subsidies received continue to be non-taxable.
- Employers can no longer claim a full tax deduction for the entire cost of providing the prescription drug coverage. Instead, that portion of the drug coverage expense that is offset by the Medicare Part D subsidy is not deductible.

Example:

Company X provides prescription drug benefits as part of its post-retirement benefits plan to retirees. Drug benefits expense for tax purposes is $100,000 and the federal subsidy received is $28,000.

Conclusion:

Under the current tax law in effect prior to 2013, X would receive a tax deduction in the amount of $100,000 when the benefits are paid, and would receive a $28,000 subsidy as non-taxable income when received.

Effective in 2013, the tax deduction is reduced to $72,000 ($100,000 expense less the $28,000 subsidy). The $28,000 subsidy is still non-taxable income.

GAAP and deferred tax treatment

Under ASC 715 (formerly FASB No. 106), with respect to post-retirement benefit plans, GAAP requires the liability and related expense to be recorded at the present value of the benefit obligation, referred to as the accumulated postretirement benefit obligation (APBO). Prescription drug plans are a subset of post-retirement benefit plans.

For tax purposes, the plan expenses are not deductible until paid.

Under ASC 715-60, *Compensation-Retirement Benefits*, the RDS subsidy reduces the accumulative postretirement benefit obligation (APBO) and is presented on a net basis on the balance sheet. Further, the subsidy income reduces net periodic post retirement cost.

No deferred tax liability is recorded on the RDS receivable because the income will not be taxable and is treated as a permanent difference in the tax provision.

Starting in 2013, the tax deduction is reduced by the amount of the subsidy received. Consequently, the deferred tax asset that was previously set up to represent the future tax benefit is overstated and must be adjusted to reflect the lower amount of tax deduction the company will receive when the prescription drug benefit is ultimately paid.

Under ASC 740, *Income Taxes*, the adjustment to the deferred income tax asset is recognized on the income statement as part of income tax expense in continuing operations in the period the change in tax law is enacted, which is the first quarter 2010. Let's look at the following example:

Facts:

For the year ended December 31, 2009 (first year of operations), Company X recorded the following related to its prescription drug benefit plan for retirees:

- At December 31, 2009, X has a liability for prescription plan benefits in the amount of $100,000 which are payable after 2012.
- No benefits have been paid and no tax deduction has been taken.
- X is eligible to receive a 28% subsidiary from the federal government
- Federal and state tax rate is 40%.

The entries recorded at December 31, 2009:

Benefits expense	100,000	
Accumulated postretirement benefit obligation (APBO)		100,000**
AR- RDS subsidy	28,000**	
Benefits expense (non-taxable)		28,000*
Deferred income tax asset (40% x 100,000)	40,000	
Income tax expense-deferred		40,000

* Under pre-MMA law, the RDS subsidy received is non-taxable and treated as a permanent difference in the tax calculation.

** Under ASC 715-60, on the balance sheet, the APBO is reduced by the RDS subsidy receivable and the subsidy reduces the net periodic cost.

In March 2010, the PPACA and the Reconciliation Act were signed into law effective for years ended after December 31, 2012. Company X wants to know how to deal with the impact of the new law changes.

Conclusion:

For the quarter ended March 31, 2010, X should adjust its deferred tax asset to reflect the reduction in the tax benefit X will have when it ultimately pays the benefits under the new law.

Entry: March 31, 2010:

Income tax expense- deferred (continued operations)	11,200	
Deferred tax asset		11,200*

* Future tax deduction when paid:
APBO 100,000 – 28,000 subsidy = 72,000 x 40% = $28,800 future tax benefit when paid.
DIT asset $40,000 less $28,800 = $11,200 adjustment required.

Assume further that at December 31, 2010, the computation of liability related to benefits incurred after 2012 follows:

- Liability for prescription plan benefits in the amount of $150,000 which are payable after 2012.
- No benefits have been paid and no tax deduction has been taken.
- RDS subsidy receivable ($150,000 x 28%) $42,000.
- Computation of entries at 12-31-10:

	DIT asset	RDS subsidy receivable	APBO
Balances at 12-31-09	$40,000	$28,000	($100,000)
Adjustment on 3-31-10	(11,200)		
Corrected balances 3-31-10	$28,800	$28,000	$(100,000)
Adjustment on 12-31-10	14,500	14,000	(50,000)
Ending balances 12-31-10	$43,200 (a)	$42,000	($150,000)

(a) Calculation of DIT asset:

APBO	$150,000
RDS receivable	(42,000)
Future tax deduction, net	108,000
Tax rate	40%
DIT asset- future tax benefit	$43,200

Entries: December 31, 2010:

Benefits expense	50,000	
APBO		50,000
AR- RDS subsidy	14,000	
Benefits expense (non-taxable)		14,000
Deferred income tax asset (40% x 108,000)	14,500	
Income tax expense-deferred		14,500

What is likely to be the impact of the MMA change on employee benefits?

Prior to the passage of the PPACA, companies were already reducing benefits including post-retirement plan costs.

One study stated that the percentage of employers with 500 or more employees that offered post-retirement health insurance coverage to its Medicare-eligible retirees dropped from 40% in 1993 to 21% in 2009.[12]

The impact of reducing the tax deduction for prescription drugs is having a rippling effect on benefits provided to U.S. workers.

a. The Congressional Budget Office (CBO) estimates that between 31 to 37 percent of Medicare beneficiaries with employment-based drug coverage will lose it because the tax deduction has been reduced by the subsidy.[13]

b. In 2010, many companies recorded significant charges to earnings from a decrease in their deferred tax assets. The estimated aggregate charge on U.S. corporate financial statements was $14 billion if companies did not move their retirees out of drug subsidy plans.[14]

   Consider the following examples:

Sample of Company Charges Against 2010 Earnings-
Adjustment in Deferred Tax Asset

Company	Charge against 2010 earnings*
Caterpillar	$100 million
Deere & Company	150 million
3M	85-90 million
AT&T	1 billion
All U.S. companies, est.	$14 billion

Source: Implications of Health Reform for Retiree Health Benefits, Paul Fronstin, Employee Benefit Research Institute (2010)

* Adjustment of deferred tax asset.

[12] Implications of Health Reform for Retiree Health Benefits, By Paul Fronstin, Employee Benefit Research Institute, 2010.
[13] Implications of Health Reform for Retiree Health Benefits, By Paul Fronstin, Employee Benefit Research Institute, 2010.
[14] The Unintended Consequences of Eliminating the Tax Exclusion for the Medicare Retiree Drug Subsidy (RDS), Tower Watson, 2010.

Many companies are not willing to absorb the higher net cost of providing prescription drug coverage in light of losing a portion of the tax deduction.

a. Between 1.5 million and 2 million retirees (a 35-45% reduction) would not be able to keep the coverage they have because employers would be compelled to move them into Medicare Part D in order to avoid the accounting impact.[15]

b. For each employee who is dropped from company prescription drug coverage and moved to government Medicare Part D coverage, it costs the U.S. government $544 per employee, per year (net of the subsidy that would not be paid out).[16]

Let's look at an analysis of the change in cost per employee under an average employer provided plan compared with Medicare Part D coverage.

Prescription Drug Coverage Costs (Per Employee) - 2011			
	Employer provides Presc Drug Plan	Employer purchases Medicare Part D coverage	Cost difference
PREVIOUS LAW- PRESCRIPTION DRUGS 100% DEDUCTIBILITY			
Employer cost:			
Employer cost per employee (a)	$2,701	$420	
Subsidy per employee	(665)	0	
Tax deduction- 100% (35% x (a))	(945)	(147)	
Total cost (d)	$1,091	$273	$(818)
Government cost			
Medicare Part D cost	0	1,209	
Pay out subsidy per employee	665	0	
Lost taxes from employer deduction	945	147	
	$1,610	$1,356	(254)
Total cost: employer/government	***$2,701***	***$1,629***	**$(1,072)**
NEW LAW- PRESCRIPTION DRUGS PARTIAL DEDUCTIBILITY			
Employer cost:			
Employer cost per employee	$2,701	$420	
Subsidy per employee	(665)	0	
Tax deduction- portion	(945)	(147)	
Tax paid on government subsidy (b)	**233**	0	
Total cost (e)	$1,324	$273	(1051)

15 *Assessing the Coverage and Budgetary Implications of Legislation Modifying the Deductibility of Retiree Drug Spending Eligible for Subsidies*, The Moran Company, for the American Benefits Council, 2010.

16 *Implications of Health Reform for Retiree Health Benefits*, Paul Fronstin, Employee Benefit Research Institute, 2010.

Government cost			
Medicare Part D cost	0	1,209	
Pay out subsidy per employee	665	0	
Lost taxes from employer deduction	945	147	
Taxes received on government subsidy	(233)	0	
	$1,377	$1,356	(21)
Total cost: employer/government	***$2,701***	***$1,629***	**$(1,072)**
CHANGE IN EMPLOYER COST (e)- (d)	***$233***		***$233***
Source: *Implications of Health Reform for Retiree Health Benefits*, Paul Fronstin, Employee Benefit Research Institute (2010), as modified by Author. (b): $665 x 35% = $233 additional tax.			

Observation: The above analysis, illustrates some profound conclusions as companies evaluate their decision to maintain their employer prescription drug plan or terminate the plan and pay into the Medicare Part D.

Prior to the elimination of a portion of the tax deduction under PPACA, the cost of employer-provided prescription drug benefits was significantly higher than the cost for an employer to fund the Medicare Part D for its employees. In the previous chart, the average cost per employee of providing prescription drugs under an employer-sponsored plan was $1,091 per employee as compared with a far lower cost of $273 for Medicare Part D per employee for an additional cost of $818, net of taxes. With the change in the tax deduction under PPACA, the gap widens with the new cost per employee being $1,324 versus $273 per employee under a Medicare Part D enrollment, for an increase of $1,051 per employee.

What this means is that the cost-benefit decision as to whether an employer should maintain its prescription drug plan or terminate the plan and pay into the Medicare Part D plan is an easy one now that the spread in cost has increased by $233. Now, a company saves $1,051 per employee by eliminating the prescription plan and simply pays into the government's Medicare Part D program.

Now it is easy to see why companies are terminating their plans in large numbers in light of the fact that there is significant pressure to reduce payroll-related costs.

There have been several high-profile announcements by companies that are adjusting their post-retirement plan benefits to exclude prescription drugs. Instead of funding those drugs themselves, the companies have elected to give up the coverage and have their employees get the prescription drug coverage through Medicare.

Using the tax code to shift employees from employer plans to Medicare

In the previous analysis, the total net cost (employer after tax cost plus government's net cost) of providing prescription drugs under an employer-sponsored plan is $2,701 as compared with only $1,629 for providing prescription drugs under Medicare Part D, for a difference of $1,072. Prior to the change in the law on deductibility of prescription drug coverage, an employer paid an additional after-tax cost of $818 to provide its employees with a private employer-sponsored drug plan. Now, after the law change, the differential is $1,072 so that an employer has to pay an additional $233 per employee to retain its employer-sponsor plan in lieu of shifting employees over to Medicare Part D.

By making it more costly for an employer to retain an employer-sponsored prescription drug plan, Congress incentivized companies to eliminate their prescription drug plans and allow their employees to use Medicare Part D. Moreover, the more employees who are on Part D, the less expensive the total cost is to both the federal government and the employer. What is not discussed is that there are limitations in Medicare Part D coverage as compared with an employer plan. There is a reason why the cost of Medicare Part D is $1,072 cheaper than an employer plan. A portion of the cost savings is directly due to there being limitations on the types of drugs that are covered under Medicare Part D versus an employer plan.

The health care bill states that the prescription drug cost tax deduction change is expected to be a revenue raiser in the amount of $4.5 billion over 10 years (2010 to 2019).

As previously stated, the CBO estimates that the tax deduction limit will result in many employers eliminating their prescription drug plans, resulting in 1.5 to 2 million employees being shifted from employer plans to Medicare Part D coverage.

Impact of lowering the top corporate rate on deferred tax assets

It look inevitable that the top U.S. corporate tax rate is coming down. Congress wants it. President Obama wants it. Most major corporations want it. Presently, the top margin rate of 35 percent is among the highest worldwide.

In the joint committee report entitled *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*,[17] the committee recommended that the top corporate Federal tax rate be reduced from 35 percent to a rate within the range of 23-29 percent. Recently, the Treasury and White House mentioned a 25-percent target rate.

Whatever the reduced corporate rate is, implementing that rate will have a significant effect on deferred tax assets. Currently, many U.S. companies are carrying deferred tax assets that have been computed using a 35 percent federal marginal tax rate. If that rate is reduced to 25 percent, the deferred tax asset is overstated and must be adjusted downward with a charge to income tax expense as part of income from continued operations. The numbers could be staggering.

[17] Report issued by the National Commission on Fiscal Responsibility and Reform, issued December 2010.

Consider the following example:

Example:

At December 31, 2011, Company X has a deferred tax asset in the amount of $3,500,000 computed as follows:

NOL carryfoward $10,000,000 x 35% = $3,500,000.

Effective January 1, 2012, Congress changes the top effective tax rate to 25 percent.

Conclusion:

The deferred tax asset is overstated and must be reduced to reflect a 25% marginal tax rate as follows: $10,000,000 x 25% = 2,500,000.

Entry:

Income tax expense- federal deferred*	1,000,000	
Deferred tax asset-federal		1,000,000

Computation:
Deferred tax asset:

Originally computed	10,000,000 x 35% =	3,500,000
Revised rate	10,000,000 x 25% =	<u>2,500,000</u>
Adjustment		<u>1,000,000</u>

* Shown as a separate component of income tax expense related to continued operations.

If there is a valuation allowance account, it too should be adjusted to reflect the reduction in the federal margin tax rate with the offset to income tax expense as part of continued operations.

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. Which of the following is a recommendation made by the Blue Ribbon Panel in connection with a GAAP system for private companies:

   a) provide a new separate self-contained system for private companies
   b) make exceptions and modifications to U.S. GAAP
   c) leave current GAAP for private companies where it is presently
   d) use a hybrid OCBOA system

2. Under the Blue Ribbon Panel Report on GAAP for private companies, how does the Panel recommend that GAAP for private companies be monitored:

   a) establish a new separate private company standards board
   b) have the FASB add two new board members that are from private companies
   c) have the AICPA take over monitoring GAAP for private companies
   d) have the SEC carve out staff to monitor GAAP for private companies

3. A company is required to record a valuation account against a deferred income tax asset if it is ______ that some portion or all of the deferred tax asset will not be realized.

   a) probable
   b) reasonably possible
   c) more likely than not
   d) highly likely

4. With respect to deferred tax assets, future income can come from which of the following:

   a) estimated future taxable income, including the reversal of temporary differences and carryforwards
   b) switching from tax-exempt to taxable investments as part of a tax-planning strategy
   c) reversal of existing taxable temporary differences assuming taxable include is greater than book income
   d) current year tax losses

5. Facts: Company Y provides prescription drug benefits as part of its post-retirement benefits plan to retirees. The drug benefits expense for tax purposes was $200,000 and the federal subsidy received was $56,000. Effective in 2013, which of the following is correct:

   a) the tax deduction increases, but the deferred tax asset is reduced
   b) both the amount of the tax deduction and deferred tax asset are reduced
   c) the tax deduction is reduced, but the deferred tax asset is increased
   d) both the amount of the tax deduction and deferred tax asset are increased

6. According to the author, which of the following would be the impact of lowering the corporate tax rate:

   a) deferred tax assets would be adjusted downward
   b) deferred tax assets would be adjusted upward
   c) there would be no effect on deferred tax assets, but there is an impact on the accrued federal tax liability
   d) a larger valuation account would be required for deferred tax assets

SUGGESTED SOLUTIONS

1. A: Incorrect. The Panel did not recommend that a new, separate system for private companies be established.

   B: Correct. The Panel recommends that in the near term, a system for private companies should consist of making exceptions and modifications to existing U.S. GAAP rather than move toward a separate GAAP for private companies.

   C: Incorrect. The Panel recognized that the current GAAP system does not work for private companies.

   D: Incorrect. No one is recommending use of a hybrid OCBOA system, although many private companies do use OCBOA (income-tax basis of accounting) as an alternative to GAAP.

   (See page 7-64 of the course material.)

2. **A: Correct.** The Panel recommends that a new separate private company standard board be established to ensure that sufficient exceptions and modifications are made to GAAP for private companies.

   B: Incorrect. The Panel does not recommend that the FASB be involved in monitoring GAAP for private companies.

   C: Incorrect. The Panel does not mention having the AICPA take over monitoring GAAP for private companies.

   D: Incorrect. The SEC deals with public companies and not private companies.

   (See page 7-65 of the course material.)

3. A: Incorrect. The probable threshold is not used in determining whether a valuation account is required.

   B: Incorrect. The reasonably possible threshold is not used in determining whether a valuation account is required.

   C: Correct. GAAP uses the more-likely-than-not (more than 50% probability) threshold to determine whether a valuation account is required.

   D: Incorrect. GAAP does not use highly likely as a threshold for determining whether a valuation account is required.

   (See page 7-68 of the course material.)

4. A: Incorrect. Estimated future taxable income should exclude the reversal of temporary differences and carryforwards.

   B: Correct. Tax planning strategies that a company would implement to utilize an expiring NOL is one example of future income. Switching from tax-exempt to taxable investments is one of those strategies.

   C: Incorrect. Reversal of existing taxable temporary differences is a source of future income, but it is based on the assumption that taxable income is zero and not that taxable income is greater than book income.

   D: Incorrect. A current year tax loss does not create future income.

   (See page 7-68 of the course material.)

5. A: Incorrect. Under the Patient Protection Affordable Care Act (PPACA), the tax deduction decreases by the amount of the subsidy received and the deferred tax asset is reduced. Thus, the answer is incorrect.

   B: Correct. Under PPACA, the tax deduction is reduced and the corresponding deferred tax asset is reduced.

   C: Incorrect. The tax deduction is reduced, but the deferred tax asset is not increased, making the statement incorrect.

   D: Incorrect. The tax deduction and deferred tax asset are reduced, and not increased, making the answer incorrect.

   (See page 7-80 of the course material.)

6. **A: Correct.** If the federal rate is reduced, all deferred tax assets that were previously recorded at a higher 35% tax rate will have to be adjusted downward to reflect the lower tax benefit that would be received in future years.

   B: Incorrect. Deferred tax assets would be adjusted downward, not upward. If rates increase, the deferred tax assets would be adjusted upward.

   C: Incorrect. The deferred tax asset would be reduced making the statement incorrect.

   D: Incorrect. Reducing the deferred tax asset would affect the asset directly and not the valuation account.

   (See page 7-86 of the course material.)

II. Accounting Standards Updates (ASUs) and Technical Practice Aids

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 are 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 are 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 does not amend ASUs. It will only amend the FASB Codification.

Following the ASUs, the author has included selected Technical Practice Aids issued by the AICPA.

Following is a summary of the ASUs issued in 2009, 2010 and 2011.

ASUs Issued 2009 to 2011	
ASU	**Description**
Accounting Standards Update No. 2009-01	Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The *FASB Accounting Standards Codification*™ and the Hierarchy of Generally Accepted Accounting Principles
Accounting Standards Update No. 2009-02	Omnibus Update—Amendments to Various Topics for Technical Corrections
Accounting Standards Update No. 2009-03	SEC Update—Amendments to Various Topics Containing SEC Staff Accounting Bulletins (SEC Update)
Accounting Standards Update No. 2009-04	Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99 (SEC Update)
Accounting Standards Update No. 2009-05	Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value
Accounting Standards Update No. 2009-06	Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities

Accounting Standards Update No. 2009-07	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)
Accounting Standards Update No. 2009-08	Earnings per Share—Amendments to Section 260-10-S99 (SEC Update)
Accounting Standards Update No. 2009-09	Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees—Amendments to Sections 323-10-S99 and 505-50-S99 (SEC Update)
Accounting Standards Update No. 2009-10	Financial Services—Broker and Dealers: Investments—Other—Amendment to Subtopic 940-325 (SEC Update)
Accounting Standards Update No. 2009-11	Extractive Activities—Oil and Gas—Amendment to Section 932-10-S99 (SEC Update)
Accounting Standards Update No. 2009-12	Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)
Accounting Standards Update No. 2009-13	Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2009-14	Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2009-15	Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2009-16	Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets
Accounting Standards Update No. 2009-17	Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities
Accounting Standards Update No. 2010-01	Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-02	Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification
Accounting Standards Update No. 2010-03	Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures
Accounting Standards Update No. 2010-04	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)

Accounting Standards Update No. 2010-05	Compensation—Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation (SEC Update)
Accounting Standards Update No. 2010-06	Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements
Accounting Standards Update No. 2010-07	Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions
Accounting Standards Update No. 2010-08	Technical Corrections to Various Topics
Accounting Standards Update No. 2010-09	Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements
Accounting Standards Update No. 2010-10	Consolidation (Topic 810): Amendments for Certain Investment Funds
Accounting Standards Update No. 2010-11	Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives
Accounting Standards Update No. 2010-12	Income Taxes (Topic 740): Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts (SEC Update)
Accounting Standards Update No. 2010-13	Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-14	Accounting for Extractive Activities—Oil & Gas—Amendments to Paragraph 932-10-S99-1 (SEC Update)
Accounting Standards Update No. 2010-15	Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-16	Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-17	Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-18	Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-19	Foreign Currency (Topic 830): Foreign Currency Issues: Multiple Foreign Currency Exchange Rates (SEC Update)

Accounting Standards Update No. 2010-20	Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses
Accounting Standards Update No. 2010-21	Accounting for Technical Amendments to Various SEC Rules and Schedules Amendments to SEC Paragraphs Pursuant to Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies (SEC Update)
Accounting Standards Update No. 2010-22	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)
Accounting Standards Update No. 2010-23	Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-24	Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-25	Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-26	Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-27	Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-28	Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-29	Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2011-01	Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20

Selected ASUs:

Following is an analysis of selected ASUs issued in 2009-2011 that are not included in other chapters within this course.

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 Statement No. 160*, Noncontrolling Interests in Consolidated Financial Statements.*

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 resolute 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 ASC 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 ASC 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 ASC 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 ASC 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 ASC 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. <u>*Decrease in ownership in a subsidiary that is not a business or nonprofit activity*</u>:

1) If a decrease in ownership occurs in a subsidiary that is <u>*not a business or nonprofit activity*</u>, 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 ASC Subtopic 810-10, below.

b) <u>*Decrease in ownership in a subsidiary that is a business or nonprofit activity*</u>: (Guidance of ASC 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 ASC Subtopic 845-10 (*Nonmonetary Transactions)*, and not 810-10 applies.

2) Otherwise, if there is not a nonreciprocal transfer to owners, 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) = The aggregate of all of the following:

1. The fair value of any consideration received
2. 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. 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.

(B) The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

(A) – (B) = 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 ASC 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; and
- 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 ASC Subtopic 810-10, *Noncontrolling Interests in Consolidated Financial Statements* (formerly FASB No. 160).

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 ASC Subtopic 810-10, *Noncontrolling Interests in Consolidated Financial Statements* (formerly 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 (ASC 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 ASC 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 ASC 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 (ASC Subtopic 715-20). The amendments to ASC Subtopic 715-20 change the terminology from *major categories* of assets to *classes* of assets and provide a cross reference to the guidance in ASC 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.

Technical Practice Aids

TIS Section 6910, *Investment Companies*
Disclosure of an Investment in an Issuer When One or More Securities or One or More Derivative Contracts Are Held—Nonregistered Investment Partnerships (October 2010)

Inquiry—A nonregistered investment partnership may hold one or more securities of the same issuer and one or more derivative contracts for which the underlying is a security of the same issuer. How should such securities and derivative contracts be presented in the condensed schedule of investments when applying Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 946-210-50-6?

Response—When applying the guidance in FASB ASC 946-210-50-6, the disclosure on the condensed schedule of investments relating to securities should be consistent with the classification of the securities on the statement of assets and liabilities. It is important to note, however, that derivative contracts may be netted for statement of assets and liabilities presentation when the right of offset exists under FASB ASC 210-20 and FASB ASC 815-10, although the disclosures in the condensed schedule of investments should reflect all open contracts by their economic exposure (that is, long exposure derivative versus short exposure derivative). The netting concepts allowed by FASB ASC 210-20 and FASB ASC 815-10 are not considered for purposes of presentation in the condensed schedule of investments. Those securities (market value) and derivative contracts (appreciation or fair value) that are classified as period-end assets on a gross basis (for derivative contracts, regardless of whether they represent long or short exposures) should be aggregated. To the extent that the sum constitutes more than 5 percent of net assets, the positions should be disclosed in accordance with FASB ASC 946-210-50-6. The investment company should similarly sum all of the positions classified as liabilities on a gross basis and determine whether they exceed 5 percent of net assets. Separate computations should be performed for assets and liabilities. The document includes several examples which are not included in this course.

TIS Section 6931, *Financial Statement Reporting and Disclosure—Employee Benefit Plans (July 2010)*

Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009

Inquiry—On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the Recovery Act), which imposes new temporary Consolidated Omnibus Budget Reconciliation Act (COBRA) rules for employers sponsoring group health plans. The Recovery Act reduced the amount to be paid by a former employee to 35 percent of the plan's average cost, with the remaining 65 percent of the cost to be covered by the federal government through a payroll tax credit to the employer (COBRA premium subsidy). The 65 percent COBRA premium subsidy applies to certain former employees who become eligible for, and who elect, COBRA coverage between February 17, 2009, and February 28, 2010. The maximum length of time the COBRA premium subsidy will be provided is 15 months. How should the effects of the COBRA premium subsidy be reflected when calculating a health and welfare plan's postemployment benefit obligation?

Reply—When calculating a health and welfare plan's postemployment benefit obligation, the COBRA premium subsidy should be considered a replacement of a portion of the employee COBRA contribution and, therefore, should be recorded consistent with how employee contributions are currently required to be recorded.

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 965, *Plan Accounting—Health and Welfare Benefit Plans*, provides that the postemployment benefit obligation recorded in a plan's financial statements should be measured in accordance with FASB ASC 712, *Compensation—Nonretirement Postemployment Benefits*, with disclosure of information about the former employee's relative share of the plan's estimated cost of providing postemployment benefits. FASB ASC 712 provides for benefits that do not vest or accumulate to be accounted for using the principles of FASB ASC 450, *Contingencies*. Application of FASB ASC 450 to COBRA benefits results in the accrual of a liability for the present value of future benefits to be provided by the employer to the former employees who are currently receiving COBRA benefits, offset by the present value of contributions to be received from the affected former employees.

Accordingly, the amount of the present value of the former employee contributions, along with the present value of the COBRA premium subsidy, would have an offsetting effect on the COBRA liability when calculating the COBRA postemployment obligation to be included in the plan's financial statements. Also, disclosure should be made about the portion of the plan's estimated cost that is funded by the COBRA premium subsidy.

The accounting for the COBRA subsidy in a single employer plan differs from the accounting for the Medicare Part D subsidy for prescription drugs in TIS section 6931.05, "Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" (AICPA, *Technical Practice Aids*), because under the Medicare Part D subsidy, the employer is not obligated to transfer the subsidy to the plan, whereas with the COBRA subsidy, the employer has already incurred the cost of providing COBRA benefits (either by payment of a premium to an insurance company or by paying future claims if self-insured) and has paid benefits prior to receiving the subsidy. The COBRA premium subsidy is intended to subsidize the former employee's cost, not the employer's cost. Further, the COBRA premium subsidy is temporary, but the Medicare Part D subsidy can be anticipated for many years into the future. Actuarial valuations of postretirement medical plans make projections for 50 years or more. The COBRA subsidy has a maximum projection period of 15 months following the expiration date of the Recovery Act provision. Changing the measurement of the COBRA postretirement obligation for the periods impacted by the COBRA premium subsidy would affect comparability of the financial statements.

TIS Section 1800, *Notes to Financial Statements*

Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures,* to Certain Financial Instruments

Inquiry—Do the fair value measurement principles and disclosure requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, apply to financial instruments that are not recognized at fair value in the statement of financial position, but for which fair value is required to be disclosed in the notes to financial statements in accordance with paragraphs 10-19 of FASB ASC 825-10-50?

Reply—The measurement principles of FASB ASC 820 do apply when determining for disclosure purposes the fair value of financial instruments that are not recognized at fair value in the statement of financial position. FASB ASC 820-10-15-1, which establishes the scope of FASB ASC 820, provides that "guidance in this Topic applies to all entities, transactions, and instruments under other Subtopics that require or permit fair value measurements." FASB ASC 820-10-15-1A states: "The guidance in this Topic does not apply to nonfinancial assets or nonfinancial liabilities, *except for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually)*" [emphasis added]. FASB ASC 820-10-55-23B provides examples of items *not excluded* from the scope of FASB ASC 820 by paragraph 820-10-15-1A. Among those examples are "Items for which fair value disclosure is required by Section 825-10-50, *whether recognized or not*" [emphasis added]. Therefore, when determining for disclosure purposes the fair value of financial instruments that are not recognized at fair value in the statement of financial position, the measurement principles in FASB ASC 820 do apply. Nevertheless, the disclosure illustrations in FASB ASC 825-10-55 allow certain measurements in disclosures that may differ from the principles of FASB ASC 820.

The fair value disclosure requirements of FASB ASC 820-10-50 do not apply to financial instruments that are not recognized at fair value in the statement of financial position. The guidance in FASB ASC 820-10 is based on FASB Statement No. 157, *Fair Value Measurements*. Paragraph A33 of FASB Statement No. 157, which was part of the *Basis for Conclusions* of that statement but was only partially included in the FASB ASC, makes it clear that the disclosure requirements in that statement apply only to items recognized in the statement of financial position at fair value and provides as follows:

This Statement requires disclosures about the fair value of assets and liabilities *recognized in the statement of financial position* in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, trading securities) or on a nonrecurring basis (for example, impaired assets) [emphasis added]. Furthermore, it should be noted that for financial instruments that *are* recognized at fair value in the statement of financial position, FASB ASC 825-10-50-10 indicates that the disclosure requirements of FASB ASC 820 also apply (in addition to disclosures required by FASB ASC 825-10-50).

TIS Section 9070, *Subsequent Events:* Decline in Market Value of Assets Subsequent to the Balance Sheet Date (June 2010)

Inquiry—In light of overall market decline, should the decline in market value of an asset subsequent to the balance sheet date result in the adjustment of the financial statements?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855-10-25-1 states that "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."

FASB ASC 855-10-25-3 states that "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."

FASB ASC 855-10-55-2 provides a list of examples of nonrecognized subsequent events, including changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before financial statements are issued or are available to be issued.

TIS Section 6930, *Employee Benefit Plans (June 2010):* Defined Benefit Plan Measurement of a Life Insurance Policy

Inquiry—How should a defined benefit plan measure a cash value life insurance policy?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification (*ASC) 715-30-35-60 indicates that for defined benefit plans, insurance contracts with insurance entities (other than those that are, in substance, annuities) should be accounted for as investments and measured at fair value.

FASB ASC 715-30-35-60 also states that for some contracts, the best available evidence of fair value may be contract value; if a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

TIS Section 5250

***Tax Allocation:* Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes**

Inquiry—Does Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (codified in FASB *Accounting Standards Codification* [ASC] 740-10) apply to federal or state income taxes only, or does it apply to sales, payroll, and other taxes as well?

Reply—The scope of FASB Interpretation No. 48 or FASB ASC 740-10 applies to income taxes only. Entities should follow FASB ASC 450, *Contingencies*, to account for uncertainties related to payroll, sales, and other taxes.

Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions (June 2010)

Inquiry—FASB released Accounting Standards Update (ASU) No. 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. The ASU retains the disclosure requirements in FASB ASC 740-10-50-15(e), which requires a description of tax years that remain subject to examination. Is this disclosure requirement applicable to a nonpublic entity even if the entity has no uncertain tax positions?

Reply—Yes. ASU No. 2009-06 modifies the FASB ASC to eliminate the disclosure requirements in FASB ASC 740-10-50-15(a)-(b) for nonpublic entities, including pass-through and not-for-profit entities, but the disclosure requirements in paragraphs 15(c)-(e) remain in effect (if applicable), regardless of whether the entity has any uncertain tax positions.

TIS Section 2240, *Cash Surrender Value of Life Insurance (June 2010):* Measurement of Cash Value Life Insurance Policy

Inquiry—How should a company measure and record a cash value life insurance policy that it purchases for itself on the company's balance sheet?

Reply—In accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 325-30-25-1, "an investment in a life insurance contract shall be reported as an asset."

FASB ASC 325-30-35-1 states:

An asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position. It is not appropriate for the purchaser of life insurance to recognize income from death benefits on an actuarially expected basis. The death benefit shall not be realized before the actual death of the insured, and recognizing death benefits on a projected basis is not an appropriate measure of the asset.

FASB ASC 325-30-30-1 states that a policyholder shall consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the life insurance contract. When it is probable that contractual terms would limit the amount that could be realized under the life insurance contract, these contractual limitations shall be considered when determining the realizable amounts.

Those amounts that are recoverable by the policyholder at the discretion of the insurance entity shall be excluded from the amount that could be realized under the life insurance contract. FASB ASC 325-30-35-4 states that "amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy shall be discounted in accordance with Topic 835."

FASB ASC 325-30-35-5 states:

A policyholder shall determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). Any amount that ultimately would be realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. (See Example 1 (paragraph 325-30-55-1) for an illustration of this guidance.)

FASB ASC 325-30-35-6 states:

A policyholder shall not discount the cash surrender value component of the amount that could be realized under the insurance contract when contractual restrictions on the ability to surrender a policy exist, as long as the holder of the policy continues to participate in the changes in the cash surrender value as it had done before the surrender request. If, however, the contractual restrictions prevent the policyholder from participating in changes to the cash surrender value component, then the amount that could be realized under the insurance contract at a future date shall be discounted in accordance with Topic 835.

FASB ASC 325-30-3-7 states "if a group of individual-life policies or a group policy only allows for the surrender of all of the individual-life policies or certificates as a group, then the policyholder shall determine the amount that could be realized under the insurance contract on a group basis."

TIS Section 2130, *Receivables (June 2010)*

Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*

Inquiry—Are certificates of deposit within the scope of the disclosure requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*?

Reply—Generally not. Certificates of deposit that meet the definition of a security in FASB ASC 320, *Investments—Debt and Equity Securities*, are subject to the disclosure requirements of FASB ASC 820-10-50; those that do not meet the definition are not subject to those disclosure requirements. FASB ASC 320-10-20 defines a *security* as:

> A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:
>
> - It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
> - It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
> - It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Most certificates of deposit would not meet that definition. However, some negotiable certificates of deposit may meet the definition of a security and, therefore, may be subject to the disclosure requirements of FASB ASC 820-10-50 if they are not classified as held to maturity.

Balance Sheet Classification of Certificates of Deposit

Inquiry—Where should a certificate of deposit be classified on the balance sheet?

Reply—Certificates of deposit with original maturities of 90 days or less are commonly considered “cash and cash equivalents” under FASB ASC 305. A certificate of deposit with an original maturity greater than 90 days would not be included in cash and cash equivalents. If the certificate of deposit is not a security, as defined in FASB ASC 320, *Investments—Debt and Equity Securities*, it could be included in “investments—other.”

The following is an example of a policies and procedures note disclosure:

Investments:

Other certificates of deposit held for investment that are not debt securities are included in “investments—other.” Certificates of deposit with original maturities greater than three months and remaining maturities less than one year are classified as “short-term investments—other.” Certificates of deposit with remaining maturities greater than one year are classified as “long-term investments—other.”

Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*

Inquiry—Are certificates of deposit within the scope of FASB ASC 320, *Investments—Debt and Equity Securities*?

Reply—Generally not. FASB ASC 320-10-20 defines a *security* as:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Most certificates of deposit would not meet that definition. Certain negotiable certificates of deposit, however, may meet the definition of a security and, therefore, may be subject to FASB ASC 320.

Technical Questions and Answers (TIS) Section 1500, *Financial Statements Prepared Under an Other Comprehensive Basis of Accounting*

Disclosure Concerning Subsequent Events in Financial Statements Prepared on an Other Comprehensive Basis of Accounting (June 2009)

Inquiry: Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855, *Subsequent Events*, sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date on which the financial statements were issued or were available to be issued. Should full disclosure financial statements prepared on an other comprehensive basis of accounting (OCBOA) contain the disclosures set forth in FASB ASC 855?

Reply: Yes. Paragraph .10 AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), states, in part, “when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate.”

Therefore, the date through which an entity has evaluated subsequent events and the basis for that date should be disclosed. Furthermore, some nonrecognized subsequent events are of such a nature that they must be disclosed to keep the financial statements prepared on an OCBOA from being misleading. Such events should be disclosed following the guidance in FASB ASC 855.

TIS Section 1600, *Personal Financial Statements:* Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements (June 2009)

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 274, *Personal Financial Statements*, states that personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. FASB ASC 274 also defines estimated current values and current amounts. Are the definitions of *current values* (assets) and *current amounts* (liabilities) for personal financial statements meant to be the same as *fair value*, as defined in FASB ASC 820, *Fair Value Measurements and Disclosures*?

Reply—No. FASB ASC 820 did not contemplate the reporting of personal financial statements, and FASB did not amend the definitions of estimated current values and current amounts for personal financial statements as part of its codification process.

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. 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

2. 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

3. Facts: There is a decline in the market value of an asset after the balance sheet date and after the financial statements are issued. There is no evidence that the decline existed at the balance sheet date. Which of the following is correct:

   a) the decline should be recorded at the balance sheet date
   b) the decline should be disclosed only
   c) nothing should be done
   d) both an entry should be made at the balance sheet date and a disclosure made

SUGGESTED SOLUTIONS

1. 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 not constitute a business for a noncontrolling interest in an entity is not covered under the ASU.

   D: Correct. A subsidiary or a group of assets that is a business is included within the scope of the ASU.

   (See page 7-97 of the course material.)

2. 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 transfers both in and out of Levels 1 and 2, but not Level 3.

   (See page 7-100 of the course material.)

3. A: Incorrect. Because the condition (decline in market value) did not exist at the balance sheet date, the decline should not be recorded at the balance sheet date.

   B: Incorrect. The financial statements were issued. There is no requirement that a disclosure be made.

   C: Correct. Nothing should be done because the event occurred after the financial statements were issued.

   D: Incorrect. No entry should be made at the balance sheet date and no disclosure should be made making the answer incorrect.

   (See page 7-104 of the course material.)

Chapter 8: Compilation and Review Update

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Compilation and Review Update

Upon completing this chapter, you will be able to:

- Identify the extensive changes made by SSARS No. 19 and 20
- Describe 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

I. <u>Summary of Important and Recent Issues, Including SSARS No. 19 and 20</u>

A. INTRODUCTION

This chapter focuses on new developments affecting compilation and review engagements including two recently issued SSARSs and related interpretations:

- SSARS No. 19, *Compilation and Review Engagements*, and

- SSARS No. 20, *Revised Applicability of Statements on Standards for Accounting and Review Services*

This chapter also incorporates some of the matters discussed in the AICPA's *Compilation and Review Alerts*, which are non-authoritative practice aids designed to help accountants plan their compilation and review engagements. They clarify certain existing standards and assist accountants in implementing the SSARSs and related interpretations.

Throughout this chapter, the author uses the terms "CPA," "accountant" and "member" interchangeably.

B. SSARS NO. 19, COMPILATION AND REVIEW ENGAGEMENTS

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 previously issued body of SSARSs. In general, SSARS No. 19 is effective for years ending on or after December 15, 2010.

SSARS No. 19 supersedes SSARS No. 1 (AR section 100), SSARS No. 11 (AR section 50), and SSARS No. 16 (AR section 20), in addition to amending numerous other SSARSs.

Key changes made by SSARS No. 19 include:

1. Permits an accountant to include a description in the compilation report regarding the reason(s) for which his or her independence is impaired.
2. Recodifies the SSARSs into separate sections for compilation and review engagements.
3. Introduces a new term "review evidence" to review engagements.
4. Discusses 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. Introduces the concept of materiality to a review engagement.
6. Requires 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. Establishes enhanced documentation requirements for compilation and review engagements.
8. Changes the format of the compilation and review reports.

Although the final SSARS No. 19 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.

The following chart summarizes the effects SSARS No. 19 has on existing compilation and review standards.

Impact of SSARS No. 19 on Previous SSARS		
Previous SSARSs		**Changes Made by SSARS No. 19**
Document/Section	**Title**	
SSARS No. 1 AR 100	Compilation and Review of Financial Statements	Superseded by SSARS No. 19
SSARS No. 2 AR 200	Reporting on Comparative Financial Statements	No change
SSARS No. 3 AR 300	Compilation Reports on Financial Statements Included in Certain Prescribed Forms	No change
SSARS No. 4 AR 400	Communications Between Predecessor and Successor Accountants	No change
SSARS No. 5	Previously superseded by SSARS No. 7	NA
SSARS No. 6 AR 600	Reporting on Personal Financial Statements Included in Written Personal Financial Plans	No change
SSARS No. 7 (Part of AR 100 and AR 400)	Omnibus Statement on Standards for Accounting and Review Services-1992	Portion of SSARS No. 7 that is included in SSARS No. 1 (AR 100) is superseded by SSARS No. 19

SSARS No. 8 (Part of AR 100)	Amendment to Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements*	Superseded by SSARS No. 19
SSARS No. 9 (Part of AR 100 and AR 400)	Omnibus Statement on Standards for Accounting and Review Services-2002	Portion of SSARS No. 9 that is included in SSARS No. 1 (AR 100) is superseded by SSARS No. 19
SSARS No. 10 (Part of AR 100)	Performance of Review Engagements	Superseded by SSARS No. 19
SSARS No. 11 (AR 50)	Standards for Accounting and Review Services	Superseded by SSARS No. 19
SSARS No. 12 (Part of AR 100)	Omnibus Statement on Standards for Accounting and Review Services-2005	Superseded by SSARS No. 19
SSARS No. 13 (AR 110)	Compilation of Specified Elements, Accounts, or Items of a Financial Statement	No change
SSARS No. 14 (AR 120)	Compilation of Pro Forma Financial Information	No change
SSARS No. 15 (Part of AR 100 and other sections)	Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance into Statements on Standards for Accounting and Review Services	Portion of SSARS No. 15 that is included in SSARS No. 1 (AR 100) is superseded by SSARS No. 19
SSARS No. 16 (AR 20)	Defining Professional Requirements in Statements on Standards for Accounting and Review Services	Superseded by SSARS No. 19
SSARS No. 17 (Part of AR 100 and other sections)	Omnibus Statement on Standards for Accounting and Review Services-2008	Portion of SSARS No. 17 that is included in SSARS No. 1 (AR 100) is superseded by SSARS No. 19
SSARS No. 18 (Part of AR 100)	Applicability of Statements on Standards for Accounting and Review Services	Superseded by SSARS No. 19

In its November 2010 meeting, the ARSC approved the reissuance of the numerous interpretations previously issued as part of SSARS No. 1. The interpretations of SSARS No. 1, found in AR Section 9100 are now considered interpretations of SSARS No. 19. Many of the interpretations have been renumbered and replaced. Moreover, because SSARS No. 19 is separated into two sections (AR Section 80 for compilation engagements and AR Section 90 for review engagements), interpretations have been issued under each section.

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
1	Omission of Disclosures in Reviewed Financial Statements	Withdrawn December 2010
2	[Financial Statements Included in SEC Filings]	Withdrawn December 2010
3	Reporting on the Highest Level of Service	Withdrawn December 2010
4	[Discovery of Information After the Date of the Accountant's Report]	Withdrawn July 2007
5	Planning and Supervision	Withdrawn December 2010
6	Withdrawal From Compilation or Review Engagement	Withdrawn December 2010
7	Reporting When There Are Significant Departures From GAAP	Interpretation No. 1, "Reporting When There Are Significant Departures From the Applicable Financial Reporting Framework" of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19) Interpretation No. 1, "Reporting When There Are Significant Departures From the Applicable Financial Reporting Framework" of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19)
8	[Reports on Specified Elements, Accounts, or Items of a Financial Statement]	Withdrawn July 2005
9	Reporting When Management Has Elected to Omit All Disclosures	Withdrawn December 2010

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
10	Reporting on Tax Returns	Interpretation No. 2, “Reporting On Tax Returns” of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19) Interpretation No. 2, “Reporting on Tax Returns” of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19)
11	[Reporting on Uncertainties]	Withdrawn February 2007
12	[Reporting on a Comprehensive Basis of Accounting Other Than GAAP]	Withdrawn July 2007
13	Additional Procedures	Interpretation No. 3, “Additional Procedures Performed in a Compilation Engagement,” of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19) Interpretation No. 3, “Additional Procedures Performed in a Review Engagement,” of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2) (revised December 2010 to conform to SSARS No. 19)
14	[Reporting on Financial Statements When the Scope of the Accountant’s Procedures Has Been Restricted]	Withdrawn April 1990
15	Differentiating a Financial Statement Presentation From a Trial Balance	Interpretation No. 4, “Differentiating a Financial Statement Presentation From a Trial Balance,” of AR section 80 (revised December 2010 to conform to SSARS No. 19)

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
16	[Determining if the Accountant Has "Submitted" Financial Statements Even When Not Engaged to Compile or Review Financial Statements]	Withdrawn November 1992
17	Submitting Draft Financial Statements	Interpretation No. 5, "Submitting Draft Financial Statements," of AR section 80 (revised December 2010 to conform to SSARS No. 19) Interpretation No. 4, "Submitting Draft Financial Statements," of AR section 90 (revised December 2010 to conform to SSARS No. 19)
18	[Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions]	Withdrawn September 2005
19	Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading	Interpretation No. 6, "Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading," of AR section 80 (revised December 2010 to conform to SSARS No. 19) Interpretation No. 5, "Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading," of AR section 90 (revised December 2010 to conform to SSARS No. 19)
20	Applicability of Statements on Standards for Accounting and Review Services to Litigation Services	Interpretation No. 7, "Applicability of Statements on Standards for Accounting and Review Services to Litigation Services," of AR section 80 (revised December 2010 to conform to SSARS No. 19)

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
21	Applicability of SSARS No. 1 When Performing Controllership or Other Management Services	Interpretation No. 8, "Applicability of Statements on Standards for Accounting and Review Services When Performing Controllership or Other Management Services," of AR section 80 (revised December 2010 to conform to SSARS No. 19)
22	Use of "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included"	Interpretation No. 9, "Use of the Label 'Selected Information—Substantially All Disclosures required by [the applicable financial reporting framework] Are Not Included' in Compiled Financial Statements," of AR section 80 (revised December 2010 to conform to SSARS No. 19)
23	Applicability of Statements on Standards For Accounting and Review Services When an Accountant Engaged to Perform a Business Valuation Derives Information From an Entity's Tax Return	Withdrawn December 2010
24	Reference to the Country of Origin in a Review or Compilation Report	Withdrawn December 2010
25	Omission of the Display of Comprehensive Income in a Compilation	Interpretation No. 10, "Omission of the Display of Comprehensive Income in Compiled Financial Statements," of AR section 80 (revised December 2010 to conform to SSARS No. 19)
26	[Communicating Possible Fraud and Illegal Acts to Management and Others]	Withdrawn July 2005
27	Applicability of Statements on Standards for Accounting and Review Services to Reviews of Nonissuers Who Are Owned by or Controlled by an Issuer	Withdrawn December 2010

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
28	Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions	Interpretation No. 11, "Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions," of AR section 80 (revised December 2010 to conform to SSARS No. 19) Interpretation No. 6, "Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions," of AR section 90 (revised December 2010 to conform to SSARS No. 19)
29	Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern	Interpretation No. 12, "Reporting on an Uncertainty About an Entity's Ability to Continue as a Going Concern," of AR section 80 (revised December 2010 to conform to SSARS No. 19) Interpretation No. 7, "Reporting on an Uncertainty About an Entity's Ability to Continue as a Going Concern," of AR section 90 (revised December 2010 to conform to SSARS No. 19)
30	Considerations Related to Financial Statements Prepared in Accordance With International Financial Reporting Standards and Compilations and Reviews Performed in Accordance With International Standards	Interpretation No. 13, "Compilations of Financial Statements Prepared in Accordance With International Financial Reporting Standards," of AR section 80 (revised December 2010) Interpretation No. 14, "Compilations of Financial Statements Prepared in Accordance With A Financial Reporting Framework Generally Accepted in Another Country," of AR section 80 (revised December 2010) Interpretation No. 15, "Considerations Related to Compilations Performed in Accordance with International Standard on Related Services 4410, *Engagements to Compile Financial Statements*," of AR section 80 (revised December 2010)

Interpretations Reissued Under SSARS No. 19		
Old AR 100 Interpretation	**Old Title**	**Status under New SSARS No. 19**
30	(continued. Considerations Related to Financial Statements Prepared in Accordance With International Financial Reporting Standards and Compilations and Reviews Performed in Accordance With International Standards	Interpretation No. 8, "Reviews of Financial Statements Prepared in Accordance With International Financial Reporting Standards," of AR section 90 (revised December 2010) Interpretation No. 9, "Reviews of Financial Statements Prepared in Accordance With A Financial Reporting Framework Generally Accepted in Another Country," of AR section 90 (revised December 2010) Interpretation No. 10, "Considerations Related to Reviews Performed in Accordance with International Standard on Review Engagements 2400, *Engagements to Review Financial Statements*," of AR section 90 (revised December 2010)
31	Preparation of Financial Statements for Use by an Entity's Auditors	Interpretation No. 16, "Preparation of Financial Statements for Use by an Entity's Auditors," of AR section 80 (revised December 2010 to conform to SSARS No. 19)
Source: AICPA, as modified by author.		

There are additional compilation and review interpretations that are retained and found in AR Sections 9200, 9300, 9400, and 9600.

In 2011, the ARSC also approved and issued SSARS No. 20, *Revised Applicability of Statements on Standards for Accounting and Review Services*, which revises paragraph .01 of *AR section 90,* Review of Financial Statements*.* SSARS No. 20 is a minor change and is reflected in these materials.

Summary of Changes to SSARSs and Related Interpretations by SSARS No. 19

As previously noted, SSARS No. 19 supersedes SSARS No. 1 (AR section 100), SSARS No. 11 (AR section 50), and SSARS No. 16 (AR section 20), in addition to amending numerous other SSARSs.

SSARS No. 19 is segregated into three sections:

- SECTION 1: Framework for Performing and Reporting on Compilation and Review Engagements (AR Section 60)
- SECTION 2: Compilation Engagements (AR Section 80)
- SECTION 3: Review Engagements (AR Section 90)

In this first portion of the course, the author summarizes the three sections of SSARS No. 19. Further on in this course, the author addresses many of those issues addressed in SSARS No. 19 but in far greater detail such as going concern, legends, subsequent events, engagement and management representation letters, and more.

SECTION 1: SSARS No. 19: Framework for Performing and Reporting on Compilation and Review Engagements (AR Section 60)

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). Audit and review engagements are considered assurance engagements while a compilation engagement is not.

Attest engagement: An engagement that requires independence, as defined in AICPA *Professional Standards*. Attest engagements include a compilation, review, audit, and agreed-upon procedures engagements.

Interrelation of an assurance engagement with an attest engagement

It is quite common in practice for CPAs to confuse the term “assurance” with “attest” in describing the type of engagement that is performed. Yet, the two terms are not interchangeable.

An attest engagement is any engagement that requires independence and includes compilation, review and audit engagements. A compilation is an attest engagement even though an accountant may perform a compilation engagement if he or she lacks independence. All attest engagements are assurance engagements because the accountant must have independence to provide a level of assurance to the user of the financial statements.

An assurance engagement is any engagement in which the accountant provides some level of assurance to the users of the financial statements. Audit and review engagements are assurance engagements while a compilation engagement is not. An audit provides reasonable assurance and a review provides limited assurance, while a compilation engagement provides no assurance as to whether the financial statements are in accordance with GAAP or another financial reporting framework such as OCBOA.

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 (GAAP or other). 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 primarily the performance of inquiry and analytical procedures.

The following compares the levels of assurance among compilation, review and audit engagements.

Levels of Assurance in Types of Engagements				
	Compilation	Review	Audit	
Level of assurance	No assurance	Limited assurance	Reasonably assurance	Absolute (guarantee)
% assurance	0%	Not defined	High level of assurance 51-95% confidence	100%

The above table illustrates the range of possible interpretations as to responsibility under different engagements. On one end of the spectrum is no assurance, which is what an accountant gives in a compilation engagement. On the other is reasonable assurance which an auditor gives in his or her audit report. Reasonable assurance is defined in SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of*

Auditing Standards and Procedures ("Due Professional Care in the Performance of Work," as a high level of service which most commentators translate into somewhere between 51 to 95 percent depending on how the parties define "high level of assurance." What is clear is that reasonable assurance is less than an absolute 100 percent guarantee.

With respect to a review engagement, SSARS No. 19 states that the accountant provides "limited assurance" that the financial statements are free from material misstatement. Although SSARS No. 19 does not define the term "limited assurance," its threshold is less than an audit's reasonable assurance and greater than a compilation's no assurance.

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.

Example: A particular SSARS states that an accountant "should consider" performing a certain review procedure.

Conclusion: The accountant is presumptively required to consider whether the procedure should be performed. However, the accountant is not presumptively required to actually perform the procedure. Thus, the presumptive requirement only applies to the accountant considering whether he or she should perform the procedure and to the performance of the procedure.

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 that are considered explanatory material.

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 as follows:

SSARS No. 19 Hierarchy of Authority

Tier	Description	Level of authority
1	Compilation and Review Standards	Highest
2	Interpretative Publications	Middle
3	Other compilation and review publications	Lowest

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.

SSARS No. 19 defines a nonissuer as:

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. 78(d)), or

- Any entity 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.

In general, a nonissuer is the same as a nonpublic entity; that is, an entity that is not required to comply with the SEC Act of 1934.

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
- 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 Accountant Letter*
- Continuing professional education programs and other instructional materials, textbooks, guide books, compilation and review programs, and checklists
- 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.

The following chart summarizes the compilation and review hierarchy found in SSARS No. 19.

Compilation and Review Hierarchy (SSARS No. 19)		
Literature	**Issued by**	**Degree of authority**
Statements on Standards for Accounting and Review Services (SSARSs)	AICPA's Accounting and Review Services Committee (ARSC) after due process that includes deliberations in meetings open to the public, public exposure, and a formal vote.	Codified and at the highest level of authority for compilation and review engagements.
Interpretive Publications: Consist of SSARS Interpretations, Appendices, guidance included in AICPA Audit and Accounting Guides, and AICPA Statements of Position	AICPA's Accounting and Review Services Committee (ARSC) issues an interpretation after all ARSC members comment on whether the interpretation is consistent with the SSARSs.	Recommendations on applications of SSARSs in specific circumstances, including engagements for entities in specialized industries. If an accountant does not apply the guidance in an interpretative publication, the accountant should be prepared to explain how he or she complied with the SSARS provisions addressed by such guidance.
Other Compilation and Review Publications: Consisting of the AICPA Compilation and Review Alert, articles in the Journal of Accountancy and other journals, CPE programs, textbooks, etc.	Various	If an accountant applies the guidance included in another compilation and review publication, he or she should be satisfied that it is both *<u>relevant</u>* to the circumstances of the engagement, and *<u>appropriate</u>*. Factors to consider as to whether a publication is *<u>appropriate</u>* include: • Degree to which the publication is recognized as being helpful in understanding and applying the SSARSs • Degree to which the issuer or author is recognized as an authority in compilation and review matters. 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
- 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 (GAAP, OCBOA, etc.) and the preparation and presentation of the financial statements in accordance with that framework.

Management is defined under SSARS No. 19 as:

> *"the person(s) with executive responsibility for the conduct of the entity's operations. Management excludes those individuals that are charged with governance unless they also perform management functions."*

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.

A financial reporting framework is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

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
- IFRSs issued by the International Accounting Standards Board.

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.

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.

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.

SSARS No. 19 defines financial statements as:

> "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 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 related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.

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. In limited cases where analytical procedures and inquiries are not sufficient, SSARS No. 19 requires the accountant perform additional procedures as part of gathering review evidence.

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 which require the accountant to disclaim independence.

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

- 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
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 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. 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

SUGGESTED SOLUTIONS

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 8-13 of the course material.)

2. A: Incorrect. Assessing fraud risk is part of an audit engagement and not part of review evidence.

   B: Incorrect. Using confirmations is 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 8-14 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 8-15 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. The 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 pages 8-17 to 8-18 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 8-21 of the course material.)

SECTION 2: SSARS No. 19: Compilation Engagements:

1. Key Changes Found in SSARS No. 19 Related to Compilation Engagements:

Although there are many changes made to the compilation engagement by SSARS No. 19, the key changes are:

a. A written understanding (such as an engagement letter) is now required for a compilation engagement.

b. An accountant is now permitted to describe the reason(s) for a lack of independence in the compilation report.

c. Documentation requirements have been expanded in a compilation engagement to now require that the accountant document any findings or issues that, in the accountant's judgment, are significant.

d. The compilation report has been changed to more clearly outline the responsibility of the parties in a compilation engagement.

Most of the requirements for a compilation engagement that were previously found in the SSARSs have been retained in SSARS No. 19.

2. Establishing an Understanding With 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:

<u>Required elements in an engagement letter:</u>

- 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 (but are not required to) 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
- Indemnification provision for liability if management makes known misrepresentations.

Further on in this course, the author discusses the inclusion of additional matters, such as indemnification clauses, in engagement letters.

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
- Reference to supplementary information.

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

3. 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*: In a compilation engagement, the accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. If, however, 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.

4. 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 (new requirement under SSARS No. 19)

   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 (b) above).

5. Revised Reporting Requirements for Compilation Engagement:

a. Compilation report:

SSARS No. 19 changes the language in the standard compilation report. Most of the elements found in the previous SSARS No. 1 compilation report have been retained in the new compilation report, although these elements are found in different paragraphs within the new report.

The SSARS requires that a compilation report have the following basic elements:

Title and addressee:

- *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"

- *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
- 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.

Comparison of Old versus New Standard Compilation Report		
Paragraph	Old Compilation Report	New Compilation Report- SSARS No. 19
Title	None.	Compilation report should have a title such as "*Accountant's Compilation Report*" or "*Independent Accountant's Compilation Report*."
First Introductory paragraph	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.	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.
Second Management's responsibility	None	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.
Third Accountant's responsibility and conclusion	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.	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.
Separate paragraph if accountant's independence is impaired	I am (we are) not independent with respect to XYZ Company. [*The accountant is not permitted to disclose the reason(s) for the independence impairment*]	I am (we are) not independent with respect to XYZ Company. [*The accountant is permitted, but not required, to disclose the reason(s) for the independence impairment*]

Illustrative Standard Compilation Report
U.S. GAAP

Accountant's Compilation Report

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

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.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

Illustrative Standard Compilation Report
Income Tax Basis

Accountant's Compilation Report

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

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.

James J. Fox & Company, CPA

[Date] (date of completion of compilation engagement)

b. Reporting on financial statements that omit substantially all disclosures:

SSARS No. 19 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, "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

Board of Directors
XYZ Company
100 Smith Street
Nowhere, MA 02111

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 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.

[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.

James J. Fox & Company, CPA

[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

Board of Directors
XYZ Company

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.

James J. Fox & Company, CPA

[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, and 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*.
>
> 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
U.S. GAAP
Accountant Lacks Independence

Accountant's Compilation Report

Board of Directors
XYZ Company

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.

James J. Fox & Company, CPA
[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 describe, 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.

Question—Assuming an accountant's independence is impaired because the accountant maintains a number of controls for the client, does each area of internal control need to be listed by the accountant, or may the accountant merely say that his or her independence is impaired because he or she maintained internal controls?

Answer—The provision is flexible and allows an accountant to provide as much detail as he or she feels appropriate in the circumstances. Therefore, the accountant may either state the areas of internal control maintained by the accountant or provide a general description of the reason or give no reason at all and merely say that he or she is not independent. In making this decision, the accountant should make sure that his or her description is not misleading. For example, if the accountant is maintaining only small aspects of internal control over financial reporting, the accountant would not want to describe the reason by saying that he or she is maintaining all controls for the client. Such a statement would be misleading and inaccurate.

Question—May this provision be used for review reports?

Answer—No. Paragraph 3.2 of SSARS No. 19 states that the accountant is precluded from performing a review engagement if the accountant's independence is impaired for any reason.

Observation: Although SSARS No. 19 permits an accountant to disclose the reason for the lack of independence, there is a question as to whether the accountant should make that disclosure and whether such disclosure would be meaningful to the user of the financial statements. If, for example, the reason for lack of independence is that the accountant is a related party to the client, that information may be useful. However, if the lack of independence is due to the fact that the client has not paid two years' of accounting bills, that fact may not be meaningful to the user and may send the wrong message.

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.

Observation: Management-use only financial statements are essentially a compilation engagement without a compilation report being issued. All of the performance requirements for a compilation engagement under SSARS No. 19 must be adhered to.

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.

1) Emphasis paragraphs are optional at the sole discretion of the accountant.

2) 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.

Typically, more routine transactions such as purchases of assets in the normal course of business are not matters that would be included in an emphasis of a matter paragraph even though an accountant may choose not to do so.

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

Illustrative Standard Compilation Report
U.S. GAAP Departure

Accountant's Compilation Report

Board of Directors
XYZ Company

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.

[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:

> *"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.

6. 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.

7. 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]

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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 report date.

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.

8. 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.
    - 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.

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*,[2] 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:

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[2] Technical Practice Aid (TIS 9150) *The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report* (April 2010), references the fact that the term "applicable" applies to a situation in which financial statements have been issued to third parties. In such case, the revised report should be issued and include a reason for the financial statement revision as well as an explanation in the notes to financial statements.

- 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. <u>Details on required disclosure</u>: 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.

9. 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.

10. 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 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

11. 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 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. 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. Documenting:

   a) the understanding with the client
   b) communications to the appropriate level of management regarding fraud or illegal acts
   c) findings or issues that are significant
   d) 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 is not an example of a matter an accountant may wish to emphasize in a compilation or review report:

   a) uncertainties
   b) unusually important subsequent events
   c) significant transactions with related parties
   d) purchases of fixed assets in the normal course of business

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

SUGGESTED SOLUTIONS

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 8-29 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.

   C: 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 8-36 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 8-37 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 SSARSs issued by the AICPA.

   (See page 8-39 of the course material.)

5. A: Incorrect. The accountant is permitted, but not required to 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 not at all. Each year stands on its own.

   (See pages 8-47 to 8-48 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 pages 8-49 to 8-50 of the course material.)

7. A: Incorrect. An uncertainty is a matter than could give rise to an emphasis of a matter due to its importance to the reader.

   B: Incorrect. Unusually important subsequent events could be emphasized because, by definition, they are important to the reader of the financial statements.

   C: Incorrect. Significant transactions with related parties are listed by the author as an important item that might want to be emphasized.

   D: Correct. Purchases of fixed assets in the normal course of business may not be significant enough to warrant an emphasis of a matter in a report.

   (See page 8-50 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 elapsed 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 page 8-56 of the course material.)

9. A: Incorrect. The compilation report should not reference to 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 pages 8-60 to 8-61 of the course material.)

SECTION 3: SSARS No. 19: Review Engagements:

Like compilation engagements, SSARS No. 19 makes several changes to the existing codification related to review engagements.

1. Key Changes Found in SSARS No. 19 Related to Review Engagements:

Although there are many changes made to the review engagement by SSARS No. 19, the key changes are:

a. A written understanding (such as an engagement letter) is now required for a review engagement.

b. SSARS introduces the concept of "*review evidence*" to a review engagement.

c. Documentation requirements have been expanded to now require that the accountant document: 1) management's responses to inquiries regarding significant fluctuations in information from expected amounts, and 2) significant matters covered in the accountant's inquiry procedures and responses thereto.

d. The review report has been changed to more clearly outline the responsibility of the parties.

Most of the requirements for a review engagement that were previously found in the SSARSs have been retained in SSARS No. 19.

2. General Rules for Performing a Review Engagement:

Although a review engagement is found in the SSARSs, auditing literature provides guidance for a review of interim financial information. More specifically, an accountant who is auditing an entity's financial statements is permitted to review interim financial information under SAS No. 116, *Interim Financial Information*, (and not the SSARSs) if all of the following exist:

a. The entity's latest annual financial statements have been audited by the accountant or a predecessor.

b. The accountant either: 1) has been engaged to audit the entity's current year financial statements, or 2) audited the entity's latest annual financial statements and, in situations where it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review.

c. The entity prepares its interim financial information in accordance with the same financial reporting framework as the one used to prepare the annual financial statements.

If all three of the above-noted elements do not exist, the review must be performed under the SSARSs and not under SAS No. 116.

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 ARC 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 write-up work.

3. 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

Review Illustrative Engagement Letter
(Exhibit A of SSARS No. 19)

Board of Directors
XYZ Company

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.

f. 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 SSARSs 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

4. 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. Obtain knowledge of the entity
c. Understand 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 risk:

One of the performance requirements for a review engagement is that an accountant must focus his or her analytical procedures and inquiries in those areas in which risk of material misstatement is highest.

For example, if through inquiry an accountant discovers that the company does not maintain perpetual inventory records, the accountant may wish to focus analytical procedures to a greater degree in the inventory area.

Although an accountant should be aware of risk in performing procedures, the accountant is not required to perform risk assessment procedures like those that would be required in an audit.

Observation: In the exposure draft of SSARS No. 19, the document includes a description of the concept of *review risk.* In the final document, SSARS No. 19 makes reference to overall risk but does not mention the specific term "review risk."

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 explanation, or the explanation, together with review evidence obtained relevant to management's response, is not considered adequate.

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 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.

5. 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.

6. 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

Review Engagement
Management Representation Letter
(Exhibit B of SSARS No. 19)

[Date][3]

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.

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:

---

3 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.

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.*[4]
    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.

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4 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."*

13. The following have been properly recorded or disclosed in the financial statements:
    a. Related party transactions, including sales, purchases, loans, transfers, leasing arrangements, 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. See the following for additional illustrative representations.*]

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.[5]
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.

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.

5 If the accountant dual dates the report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.

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 updated 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*][6]

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…"

6 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.

7. 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.

8. 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"

Unlike a compilation report, SSARS No. 19 requires that the word "independent" be included in the title of the review report, while that word is optional for a compilation 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)
- 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.

Comparison of Old versus New Standard Review Report		
Paragraph or <u>Title</u>	<u>Previous Review Report</u>	<u>New Review- SSARS No. 19</u>
Title	None.	Must have a title and include the word "independent", such as "*Independent Accountant's Review Report.*"
First Introductory paragraph	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.	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.
Second Management's responsibility	None.	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.
Third Accountant's responsibility	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.	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.
Fourth Results of the engagement	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.	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.

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:

> "*See Independent Accountant's Review Report*."

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.

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 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 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 review 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 non-specified 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.

9. 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.

10. Subsequent Events:

A subsequent event may have a material effect on reviewed financial statements and may come to the attention of the accountant in one of two ways:

a. During the performance of review procedures, or

b. Subsequent to the date of the accountant's review report but prior to the release of the report.

Regardless of 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.

11. 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 review 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 review engagement). 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.

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. <u>Details on required disclosure</u>: 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.

12. 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.

13. 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 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.

14. 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.

15. 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.

a. 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 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 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 amounts
   b) expected amounts, recorded amounts
   c) budgeted amounts, computed amounts
   d) estimated amounts, budgeted amounts

3. 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

4. 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

5. 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

6. 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

7. An accountant is permitted to emphasize an uncertainty about an entity's ability to continue as a going concern in the review report provided that:

   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

8. 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

9. 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

SUGGESTED SOLUTIONS

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 8-73 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 8-75 of the course material.)

3. 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 8-81 of the course material.)

4. 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 8-84 of the course material.)

5. 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 8-84 of the course material.)

6. 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 8-92 of the course material.)

7. 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 8-93 of the course material.)

8. 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 8-94 of the course material.)

9. 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 8-97 of the course material.)

C. MISCELLANEOUS PRACTICE ISSUES

1. Client Records:

What responsibility does an accountant have to return records to a client who has not paid his or her bill?

Ethics Ruling 501-1: *Response to Requests by Clients and Former Clients for Records*, as revised, gives guidance on this matter.

Terminology used in the Ruling follows:

Client-provided records are accounting and other records belonging to the client that were provided to the member by or on behalf of the client.

Client records prepared by the member (accountant) are accounting or other records (such as tax returns, general ledgers, subsidiary journals, and supporting schedules such as detailed employee payroll records and depreciation schedules) that the accountant was engaged to prepare for the client.

Supporting records consist of information not reflected in the client's books and records that are otherwise not available to the client with the result that the client's financial information is incomplete. Examples include supporting records that include adjusting, closing, combining, or consolidating journal entries (including supporting computations for such entries) that are produced by the accountant during an engagement, such as an audit or review.

Member's (accountant's) working papers include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member.

Ethics Ruling 501-1 states:

1. When a client or former client makes a request for client-provided records, client records prepared by the member, or supporting records, that are in the custody or control of the member or the member's firm that have not previously been provided to the client, the member should respond to the client's request as follows:[7]

    a. *Client provided records* in the member's custody or control should be returned to the client.

    b. *Client records prepared by the member* should be provided to the client, except that client records prepared by the member may be withheld if the preparation of such records is not complete or there are fees due the member for the engagement to prepare those records.

[7] The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.

c. *Supporting records* relating to the completed and issued work product should be provided to the client, except that such supporting records may be withheld if there are fees due to the member for the specific work product.

d. *Member's working papers* are the member's property and need not be provided to the client under provisions of this Interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

2. Once the member has complied with these requirements, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such copies.

3. Charging for copies: In connection with any request for client-provided records, client records prepared by a member, or supporting records, the member may:

   a. Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client.

   b. Provide the requested records in any format usable by the client.[8]

   c. Make and retain copies of any records returned or provided to the client.

4. When a member is required to return or provide records to the client, the member should comply with the client's request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that state statutes may grant the member a lien on certain records, his or her custody or control does not relieve the member of his or her obligation to comply with this Interpretation. In addition, the member should comply with any state laws and regulations that impose obligations that are greater than the provisions of this Interpretation.

Observation: Ethics Ruling 501-1 gives accountants leverage in dealing with clients that have not paid their bills. More specifically, an accountant may withhold most client or accountant-prepared records until the bill is paid in full. Of course, many state licensing boards may not take the AICPA's accountant-friendly approach outlined in 501-1, and instead may require the accountant to give the client all applicable records and sue the client for collection of the unpaid bill.

Requests for Records Pursuant to Interpretation 501-1:

Question: Individuals associated with a client entity who are currently on opposing sides in an internal dispute have each issued separate requests calling for a member to supply them with records pursuant to Interpretation 501-1. Does the member have to comply with all such requests?

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8 The member is not required to convert records that are not in electronic format. However, if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client's request should be honored.

Answer: In providing professional services to individuals, partnerships, or corporations, a member will usually deal with an individual who has been designated or held out as the client's representative. Such a representative might include, for example, a general partner or a majority shareholder. A member who has provided the records to the individual designated or held out as the client's representative has no obligation to provide such records to other individuals associated with the client.

2. Ethics Interpretations

Ethics FAQ Changes- FIN 48

As a result of the issuance of FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes (ASC 740)*, a question has arisen as to whether an accountant impairs his or her independence if he or she assists a client in applying FIN 48.

Background: FIN 48 requires a company to recognize the tax benefit of a tax position only if it is more likely than not that the position and benefit will be sustained upon audit. In many instances, the determination of whether a tax position satisfies the more likely than not criterion is made with the assistance of an accountant or auditor. If an accountant or auditor does, in fact, assist a client in implementing and applying FIN 48, has that accountant or auditor impaired his or her independence by making management decisions?

In response to this issue, the AICPA Professional Ethics Division added the FIN 48 issue to its non-authoritative listing of Bookkeeping FAQs that appears on the AICPA website.

Question: Would assisting a client in applying FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, such as identifying potential uncertain tax positions, advising the client whether those tax positions meet the more-likely-than-not (MLTN) threshold, and calculating the related unrecognized tax benefits impair independence?

Answer: The provision of such services would not impair independence provided the client can make an informed judgment on the results of the member's services and the other requirements of Interpretation 101-3 are met. In meeting the requirements of Interpretation 101-3, the member may assist the client in understanding why the tax positions do or do not meet the MLTN threshold and the basis for any unrecognized tax benefit so that the client can accept responsibility for the amounts reported and disclosed in the financial statements.

Note: Assisting a client in applying FIN 48 is the performance of a non-attest service covered by Interpretation 101-3. The Interpretation requires an accountant to take certain actions to avoid impairing independence.

Those three actions are:

1. The accountant may not perform management functions or make management decisions as they relate to the tax return or tax positions taken.

2. The client must agree to perform certain functions in connection with the nonattest tax services such as:

   - Make all management decisions and perform all management functions
   - *Designate an individual who possesses the skill, knowledge, and/or experience*, preferably someone within senior management, to oversee the nonattest tax services
   - Evaluate the adequacy and results of the nonattest tax services performed
   - Accept responsibility for the results of the nonattest tax services
   - Establish and maintain internal controls, including monitoring ongoing activities.

3. *Written establishment and documentation with client*: The member should establish and *document in writing* his or her understanding with the client with respect to:

   - Objectives of the nonattest tax engagement
   - Nonattest tax services to be performed
   - Client's acceptance of its responsibilities
   - Member's responsibilities
   - Any limitations of the engagement

The written establishment (requirement 3 above) and documentation which is typically presented in the engagement letter, should have reference to tax positions.

3. Technical Practice Aids:

Determining Whether Financial Statements Have Been Prepared by the Accountant (Technical Practice Aid (TIS) Section 9150):

Inquiry: AR section 100, *Compilation and Review of Financial Statements,* states that the accountant should not submit unaudited financial statements of a nonissuer to his or her client or third parties unless, as a minimum, he or she complies with the provisions of AR section 100 applicable to a compilation engagement.

Submission of financial statements is defined in section 100 as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. If an accountant's work effort results in or contributes to the existence of financial statements, what should an accountant consider in determining whether he or she prepared those financial statements?

Reply: Due to computer technology, it is often unclear whether existing financial statements have been "prepared" by an accountant or by management. In considering whether an accountant is deemed to have prepared financial statements, an accountant needs to apply professional judgment to all the facts and circumstances which may include the following:

1. *The process used to create the financial statements:* If an accountant takes a client's trial balance and puts the accounts into a format that would represent a financial statement, then an accountant has probably prepared the financial statements. The less an accountant has to do with creating the statements, the less likely an accountant would be deemed to have prepared the statements.

2. *Whether the client engaged the accountant to prepare financial statements or reasonably expected that as part of the professional services engagement the accountant would prepare the financial statements*: An accountant may determine that he or she prepared financial statements even when not so engaged if, as part of an accounting or bookkeeping services engagement, in the accountant's professional judgment, the client reasonably expected that the existing financial statements were prepared as a product of that engagement.

3. *The extent of work effort that an accountant contributed to the existence of the financial statements:* If an accountant is intricately involved in adjusting the general ledger and other accounts that are, in turn, presented in a financial statement format, the more likely an accountant may be viewed as preparing the financial statements. On the other hand, if an accountant is not very involved in the accounting process, the less likely that he or she would be considered to have prepared financial statements.

4. *Where the underlying accounting information resides:* If all the accounting data resides on the accountant's computer, it is more likely that the accountant is deemed to have prepared the financial statements. However, based on the facts and circumstances of the situation, an accountant may conclude that he or she prepared financial statements through the use of accounting or bookkeeping software utilized by the client.

Factors such as who printed the financial statements or the location at which an accountant's services were performed (e.g., at the client's location or the accountant's office) are generally not factors in determining whether the accountant has prepared financial statements.

The above factors are not all-inclusive and are not meant to be used as a program or checklist for determining whether the accountant has prepared financial statements. Other factors may be considered in an accountant exercising his or her professional judgment.

TIS Section 9150, *Compilation and Review Engagements (Technical Practice Aid TPA 9150.26)* The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements (December 2009)

Inquiry: Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855-10-50-1 states, "An entity shall disclose 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." How does the entity's responsibility to disclose the date through which subsequent events have been evaluated affect the accountant's responsibilities for subsequent events in a compilation or review engagement?

Reply: FASB ASC 855, *Subsequent Events*, does not change the accountant's responsibilities under AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), which states that an accountant performing a review engagement should inquire of members of management who have responsibility for financial and accounting matters concerning events subsequent to the date of the financial statements that could have a material effect on the financial statements. In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information comes to the accountant's attention that a subsequent event that has a material effect on the financial statements has occurred. When such evidence or information comes to an accountant's attention during a compilation or review engagement, the accountant should request that management consider the possible effects on the financial statements, including the adequacy of any related disclosure. If the accountant determines that a subsequent event is not appropriately accounted for in the financial statements or disclosed in the notes, he or she should follow the guidance in paragraphs .56–.58 of AR section 100 regarding departures from generally accepted accounting principles.

Because the accountant's compilation or review report should be dated as of the completion of the compilation or review procedures, the date of the accountant's compilation or review report can never be earlier than management's subsequent event note date.

In a review engagement, because the accountant is concerned with events occurring through the date of the review report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the accountant's review report.

In most cases, the date that management discloses as the date through which they have evaluated subsequent events (in the notes to the financial statements and, in a review engagement, in the management representation letter) will be the same date as the accountant's compilation or review report. In order to coordinate that these dates (the note date, the representation letter date [in a review engagement], and the accountant's compilation or review report date) are the same, the accountant may want to discuss these dating requirements with management in advance of beginning the compilation or review engagement. The accountant also may want to include, in the accountant's understanding with the client regarding the services to be performed (engagement letter), that management will not date the subsequent event note earlier than the date of management's representations (in a review engagement) and the date of the accountant's compilation or review report.

TIS Section 9150, *Compilation and Review Engagements (Technical Practice Aid TPA 9150.27)* The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report

Inquiry: Paragraphs .77–.82 of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards,* vol. 2) provides requirements and guidance when the accountant becomes aware that facts may have existed at the date of the accountant's compilation or review report (or the date of submission of compiled financial statements not intended for third party use in which the accountant does not report) 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. Paragraph .79(a) states that when the accountant has concluded that action should be taken to prevent further use of the accountant’s report or the financial statements, and the effect on the accountant's report or the financial statements of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, where applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, where applicable, referred to in the accountant's report. Generally, only the most recently-issued compiled or reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years. What does the term *where applicable* refer to in paragraph .79(a)?

Reply: The use of the term *where applicable* refers to a situation in which the accountant has not reported on compiled financial statements not intended for third party use. In the case of a review or a compilation in which the accountant has issued a report, then a revised accountant's report should be issued and the reason for the financial statement’s revision usually should be described in the accountant’s revised report as well as in a note to the revised financial statements.

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. According to Ethics Ruling 501-1, which of the following must be returned to a client, even if there are unpaid fees:

   a) client provided records
   b) client records prepared by the member
   c) supporting records relating to the completed and issued work product
   d) member's working papers

2. Under the AICPA technical practice aid, which of the following may support a conclusion that the accountant prepared financial statements:

   a) accountant puts the client's trial balance into a general ledger format in order of account number
   b) the client reasonably expected that the existing financial statements were prepared as a product of that engagement
   c) accountant is not very involved in the accounting process
   d) accountant prints out the financial statements, but did not create them

SUGGESTED SOLUTIONS

1. **A: Correct.** Client provided records in the member's custody or control should be returned to the client.

   B: Incorrect. These records should be provided to the client, except when the preparation of these records is not complete or when there are fees due the member for the engagement to prepare those records.

   C: Incorrect. These records should be provided to the client except if fees are due to the member for the specific work product.

   D: Incorrect. These records are the member's property and need to be provided to the client under any provisions of this revised ruling.

   (See page 8-105 of the course material.)

2. A: Incorrect. The fact that the accountant put the trial balance in a format by account number (and not necessarily in a financial statement format) does not indicate that he or she prepared the financial statements.

   B: Correct. One factor that may support that the accountant prepared the financial statements is that the client reasonably expected that the existing financial statements were prepared as part of the accountant's engagement.

   C: Incorrect. The fact that the accountant is not very involved in the accounting process does not support that he or she prepared the financial statements.

   D: Incorrect. Printing out the financial statements has no bearing on who prepares them.

   (See page 8-109 of the course material.)

Chapter 9: Recently Issued Auditing Standards and Other Auditing Developments

Table of Contents

Recently Issued Auditing Standards and Other Auditing Developments

Upon completing this chapter, you will be able to:

- Read SASs with an understanding of the professional requirements imposed on auditors
- Discuss the audit requirements for a compliance audit
- Apply the compliance requirements for different types of supplementary information found in SAS No. 119-120
- Read the changes made by SAS No. 121 to interim financial information
- Identify the changes made by SSAE No. 16 to reports issued by service auditors
- Discuss how Dodd-Frank impacts accountants and auditors
- Explain the general requirements of newly issued PCAOB AS 8-15

I. Recently Issued Auditing Standards

SAS No. 118: Other Information in Documents Containing Audited Financial Statements

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:

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[1] 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

[1] *Designated accounting standard setter is defined in paragraph 4 of SAS No. 120.*

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 <u>*other information*</u> of which the auditor is aware in order to identify material inconsistencies, if any, with the audited financial statements.

   a. <u>*Other information*</u> 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.[2]

   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

[2] *Required supplementary information* is defined in paragraph 4 of Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*).

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.[3] 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 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.

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[3] See paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), for the definition of *report release date*.

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 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. 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

2. Facts: An auditor concludes that there is a material misstatement of fact in the 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

SUGGESTED SOLUTIONS

1. 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 9-3 of the course material.)

2. 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 9-6 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 SAS 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[4] requires to accompany an entity's basic financial statements.

SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*, 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[5] 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:

a. To evaluate the presentation of the supplementary information in relation to the financial statements as a whole, and
b. To report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

[4] Designated accounting standard setter is defined in paragraph 4 of SAS No. 120.
[5] *Required Supplementary Information* is defined in paragraph 4 of Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA*, Professional Standards*).

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 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
   - 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 under the standard 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. Withhold the auditor's report on the supplementary information if a separate report is being issued 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, 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 the 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 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, 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.

2. **Auditor procedures:**

   a. The auditor should apply the following procedures to required supplementary information:

      1) 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

2) 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

3) 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[6]

b. 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.

1) 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.

3. Reporting

a. <u>Explanatory paragraph</u>: The auditor should include an explanatory paragraph in the auditor's report on the financial statements to refer to the required supplementary information.

[6] 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.

1) 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 audit procedures.
- The auditor has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

b. If the entity has presented all or some of the required supplementary information, the explanatory paragraph referred to above should include the following elements:

1) 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

2) 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

c. If the auditor is *able* to complete the audit procedures:

1) 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

2) 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:

1) 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 of America because [*state the reasons*]

2) 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:

   1) 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

   2) 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

   3) 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.

h. If all of the required supplementary information is omitted, the explanatory paragraph should include the following elements:

   1) 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

2) 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

3) 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)*] require 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)]* require 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*] require 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)*] require 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)*] require 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 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. 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

SUGGESTED SOLUTIONS

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 page 9-12 of the course material.)

2. A: Incorrect. SAS No. 119 does not require that the auditor 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 a separate report 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 9-13 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 9-18 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 pages 9-21 to 9-22 of the course material.)

SAS No. 121, Revised Applicability of Statement on Auditing Standards No. 100, *Interim Financial Information*

Issue Date: February 2011

Effective Date:

This SAS is effective for interim reviews of interim financial information for periods beginning on or after December 15, 2011. Early application is permitted.

Objective:

In February 2009, SAS No. 116, *Interim Financial Information*, was issued and amended SAS No. 100, *Interim Financial Information,* to address the independent accountant's professional responsibilities when the accountant undertakes an engagement to review interim financial information of a nonissuer.

In February 2011, the ASB issued SAS No. 121 to further amend SAS No. 100 by amending paragraph .05 of SAS No. 100.

The purpose of this SAS is to revise paragraph .05 of SAS No. 100*, Interim Financial Information,* as amended. The SAS would be applicable when the accountant audited the entity's latest annual financial statements, and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review.

SAS No. 121 replaces SAS No. 116, *Interim Financial Information.*

Rules:

1. An accountant may conduct, in accordance with this section, a review of interim financial information if:

   a. The entity's latest annual financial statements have been audited by the accountant, or a predecessor;

   b. The accountant either:

      - Has been engaged to audit the entity's current year financial statements, or

      - Audited the entity's latest annual financial statements and, when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review;

   c. The entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements; and

d. When 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 such as:

  - FASB Accounting Standards Codification (ASC) 270*, Interim Reporting*
  - Article 10 of SEC Regulation S-X, or
  - IAS 34, *Interim Financial Reporting*.

- 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 website may be considered readily available, but being available upon request is not considered readily available).

SSAE No. 16: Report on Controls at a Service Organization

Issue Date: April 2010

Effective date: SSAE No. 16 is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.

Objective:

In April 2010, the Auditing Standards Board issued SSAE No. 16, *Reporting on Controls at a Service Organization,* which supersedes SAS No. 70, *Service Organizations.*

SSAE No. 16 addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities that need to rely on those internal controls.

In comparing SSAE No. 16 with its predecessor SAS No. 70, SSAE No. 16 does the following:

- Provides for more detailed requirements for the description of the service organization's system of controls

- Requires management to provide a written assertion

- Requires a risk analysis be performed

- Expands the reporting requirements for the use of subservice organizations

- Modifies the auditor's opinion to cover a period of time instead of a specific date.

Background

It is common for entities to outsource certain business tasks or functions to other entities. For example, an entity may outsource a reservations system, payroll processing, and other important business functions.

Examples of service organizations include:

- An investment adviser invests assets for user entities, including maintaining the accountability for those assets, and providing statements to user entities that contain information that is incorporated in the user entities' financial statements, (for example, the fair value of exchange traded securities, or dividend and interest income).
- A data center provides applications and technology to user entities to process financial transactions.
- A company processes claims for a health insurance company.

The entity that outsources a task or function is known as a user entity, while the entity that performs a service for user entities is known as a service organization. Similarly, the auditor who audits the financial statements for the user is referred to as the "user auditor" while the auditor for the service organization is called the "service auditor."

In auditing the financial statements of a user entity, the user auditor needs to obtain evidence to support assertions in the user entity's financial statements that are affected by information provided by the service organization. In some cases, the user entity is able to implement controls at the user entity over the service performed by the service organization. In other cases, the user entity relies on the service organization to initiate, execute, and record the transactions in which case it may be necessary for a user auditor to obtain information about the effectiveness of controls at the service organization that affect the quality of the information provided to user entities.

To obtain information about the effectiveness of controls at a service organization, a user auditor has two options:

a. With option one, the user auditor could visit the service organization and test the service organization's controls that are relevant to the user entity's internal control over financial reporting, or

b. With option two, the service organization can engage a service auditor to report on the fairness of the presentation of the description, the suitability of the design of the controls, and in certain engagements, the operating effectiveness of the controls, which is a service auditor's report.

The service auditor's report, including the description of the system, can be used by all the user auditors to obtain information about the controls at the service organization that are relevant to the user entities' internal control over financial reporting.

Prior to the issuance of SSAE No. 16, the requirements and guidance for service auditors and user auditors was included in SAS No. 70, *Service Organizations*. The AICPA's Auditing Standards Board, as part of its project to converge audit, attest, and quality control standards with those of the International Auditing and Assurance Standards Board (IAASB), decided that the guidance for service auditors in SAS No. 70 should be moved to SSAE No. 16, and the guidance for user auditors should be retained in SAS No. 70.

As a result, SAS No. 70 has been divided and replaced by two new standards as follows:

a. SSAE No. 16: Deals with service auditors reporting on controls at a service organization relevant to user entities internal control over financial reporting, and

b. SAS No. 70: Retains the audit requirements for a user auditor that audits the financial statements of a user organization.

The ASB has finalized but not issued a new statement that will replace SAS No. 70 as part of the clarification project.

SSAE No. 16 is based on the IAASB's International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*.

1. SSAE No. 16 applies to a service auditor who is hired to perform an examination and report on controls of a service organization.

2. SSAE No. 16 permits a service auditor to perform <u>two types of engagements</u> on the service organization.

    Type 1 engagement in which the service auditor reports on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.

    Type 2 engagement in which the service auditor reports on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.

    Note: In both a Type 1 and 2 engagement, the auditor reports as to whether management's description of the service organization's system fairly presents the system that was designed and implemented, and that the controls were suitably designed. The key difference is that a Type 2 engagement goes one step further by also opining as to whether the controls operated effectively. Thus, in a Type 2 engagement, the auditor must test the controls to make sure they are working effectively.

3. The service auditor is now required to obtain a written assertion from management of the service organization about the subject matter of the engagement.

a. The Type 1 engagement requires management to make two written assertions while there are three written assertions in a Type 2 engagement as shown in chart presented below.

4. Suitability criteria are used to measure, present, and evaluate the subject matter. The service auditor may not use evidence obtained in prior engagements about the satisfactory operation of controls in prior periods to provide a basis for a reduction in testing even if it is supplemented with evidence obtained during the current period.

Management Written Assertions Required	
Type 1 Engagement	**Type 2 Engagement**
Management's written assertions	
A written assertion by management of the service organization about whether, in all material respects, and based on suitable criteria:	A written assertion by management of the service organization about whether, in all material respects, and based on suitable criteria:
1. Management's description of the service organization's system fairly presents the service organization's system that was designed and implemented *as of a specified date.*	1. Management's description of the service organization's system fairly presents the service organization's system that was designed and implemented *throughout the specified period.*
2. The controls related to the control objectives stated in management's description of the service organization's system were suitably designed to achieve those control objectives *as of the specified date*.	2. The controls related to the control objectives stated in management's description of the service organization's system were suitably *designed throughout the specified period* to achieve those control objectives.
none	3. The controls related to the control objectives stated in management's description of the service organization's system operated effectively *throughout the specified period* to achieve those control objectives.

Observation: Notice that a Type 2 report includes a third assertion which is that "the controls related to the control objectives stated in management's description of the service organization's system operated effectively throughout the specified period to achieve those control objectives."

5. The service auditor should request that management provide written representations that:

   a. Reaffirm management's assertion included in or attached to the description of the service organization's system.

   b. State that management has provided the service auditor with all relevant information and access agreed to.

   c. State that management has disclosed to the service auditor any of the following of which it is aware:

      - Instances of noncompliance with laws and regulations or uncorrected errors attributable to the service organization that may affect one or more user entities

      - Knowledge of any actual, suspected, or alleged intentional acts by management or the service organization's employees, that could adversely affect the fairness of the presentation of management's description of the service organization's system or the completeness or achievement of the control objectives stated in the description

      - Design deficiencies in controls

      - Instances when controls have not operated, as described

      - Any events subsequent to the period covered by management's description of the service organization's system up to the date of the service auditor's report that could have a significant effect on management's assertion.

   Note: If a service organization uses a subservice organization and management's description of the service organization's system uses the inclusive method, the service auditor also should obtain the written representations identified above from management of the subservice organization. A *subservice organization* is a service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to those user entities' internal control over financial reporting.

6. Sample Reports

   The following illustrative reports are for guidance only and are not intended to be exhaustive or applicable to all situations.

Report Differences	
Type 1 Report	**Type 2 Report**
Opinion paragraph: In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion: a. The description fairly presents the service organization's system that was designed and implemented as of ______ [date]. b. The controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of ___________ [date]. none	Opinion paragraph: In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion on page xx. a. The description fairly presents the service organization's system that was designed and implemented throughout the period ____ to _____. b. The controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period ____ to _____. c. The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period ____ to ____.
none	Description of tests of controls: The specific controls tested and the nature, timing, and results of those tests are listed on pages xx- xx.

Type 1 Service Auditor's Report

Independent Service Auditor's Report on a Description of a Service Organization's System and the Suitability of the Design of Controls

XYZ Service Organization

[Scope]
We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] as of [*date*], and the suitability of the design of controls to achieve the related control objectives stated in the description.

[Service organization's responsibilities]
On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design of the controls to achieve the related controls objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for its assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.

[Service auditor's responsibilities]
Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance, in all material respects, about whether the description is fairly presented and the controls were suitably designed to achieve the related control objectives stated in the description as of [date].

An examination of a description of a service organization's system and the suitability of the design of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description of the system and the suitability of the design of the controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed to achieve the related control objectives stated in the description. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page [*aa*].

We did not perform any procedures regarding the operating effectiveness of the controls stated in the description and, accordingly, do not express an opinion thereon. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

[Inherent limitations]
Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. The projection to the future of any evaluation of the fairness of the presentation of the description, or any conclusions about the suitability of the design of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become ineffective or fail.

[Opinion]
In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion.

a. The description fairly presents the [*type or name of*] system that was designed and implemented **as of** [date], and

b. The controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of [date].

[Restricted use]
This report is intended solely for the information and use of XYZ, Service Organization, user entities of XYZ Service Organization's [*type or name of*] system as of [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities information and communication systems relevant to financial reporting. This report is not intended to be and should not be used by anyone other than these specified parties.

____
Service auditor's signature

Date of the service auditor's report
Service auditor's city and state

Type 2 Service Auditor's Report

Independent Service Auditor's Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls

XYZ Service Organization

[Scope]
We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

[Service organization's responsibilities]
On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.

[Service auditor's responsibilities]
Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description were achieved. **An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page xx.**

We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

[Inherent limitations]
Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

[Opinion]
In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion on page xx:

a. The description fairly presents the [*type or name of*] system that was designed and implemented **throughout the period [*date*] to [*date*].**

b. The controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively **throughout the period [*date*] to [*date*].**

c. The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

[Description of tests of controls]
The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy-zz*].

[Restricted use]
This report, including the description of tests of controls and results thereof on pages [*yy-zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

____
Service auditor's signature

Date of the service auditor's report
Service auditor's city and state

Observation: In reviewing the samples of Type 1 and 2 reports above, there are several obvious differences.

First, the Type 1 report is as of a specific date while a Type 2 report opines on controls in effect during a period of time.

Second, in a Type 1 engagement, the auditor opines on two elements: a) the description fairly presents the system that was designed and implemented, and b) the controls were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively. In a Type 2 engagement, the auditor opines on a third element, which is whether "the controls tested operated effectively throughout the period [date] to [date]."

Additionally, in a Type 2 report, the auditor must include a description of tests of controls.

Effective date: SSAE No. 16 is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.

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. Under SAS No. 121, an accountant may conduct a review of interim financial information if:

   a) the accountant has been engaged to review or compile the entity's current year financial statements
   b) the accountant reviewed or compiled the latest annual financial statements
   c) the entity prepares its interim financial information using a different financial reporting framework than the one used for its annual statements
   d) the accountant has been engaged to audit the entity's current year financial statements

2. Which of the following is a change made by SSAE No. 16:

   a) it moves the guidance for user auditors from SAS No. 70 to SSAE No. 16
   b) it moves the guidance for service and user auditors from SAS No. 70 to SSAE No. 16
   c) it replicates the guidance for both service and user auditors that was not in SAS No. 70
   d) it moves the guidance for service auditors from SAS No. 70 to SSAE No. 16

3. One key difference between a Type 1 and Type 2 Service Auditor's Report under SSAE No. 16 is:

   a) in a Type 1 report, the auditor opines as to whether the description fairly presents the system that was designed and implemented, while Type 2 does not
   b) in a Type 2 report, the auditor opines as to whether the controls stated in the description were suitably designed, while a Type 1 report does not
   c) in a Type 2 report, the auditor opines that the controls tested were achieved and operated effectively, while no such opinion is given in a Type 1 report
   d) in a Type 1 report, the auditor provides a description of tests of controls while such a description is not given in a Type 2 report

SUGGESTED SOLUTIONS

1. A: Incorrect. A review of interim financial information may be conducted if the accountant has been engaged to audit, but not review or compile, the entity's current year financial statements.

   B: Incorrect. If the accountant has audited, but not reviewed or compiled, the latest annual financial statements, a review of interim financial information may be conducted.

   C: Incorrect. The entity must prepare its interim financial information using the same, and not different, financial reporting framework than the one used for its annual statements.

   D: Correct. If the accountant has been engaged to audit the entity's current year financial statements, he or she may conduct a review of interim financial information.

   (See page 9-30 of the course material.)

2. A: Incorrect. It makes no change to the guidance for user auditors found in SAS No. 70.

   B: Incorrect. It does move the guidance for service auditors, but does not change the guidance for user auditors from SAS No. 70 to SSAE No. 16.

   C: Incorrect. It does not replicate the guidance for both service and user auditors that was not in SAS No. 70.

   D: Correct. SSAE No. 16 moves the guidance for service auditors from SAS No. 70 to SSAE No. 16, but has no effect on existing guidance for user auditors which is retained in SAS No. 70.

   (See page 9-33 of the course material.)

3. A: Incorrect. In both a Type 1 and Type 2 report, the auditor opines as to whether the description fairly presents the system that was designed and implemented.

   B: Incorrect. In both a Type 1 and Type 2 report, the auditor opines as to whether the controls stated in the description were suitably designed.

   C: Correct. One significant difference between the two types of report is that in a Type 2 report, the auditor opines that the controls tested were achieved and operated effectively, while no such opinion is given in a Type 1 report.

   D: Incorrect. In a Type 2 report (and not a Type 1 report), the auditor provides a description of tests of controls.

   (See page 9-33 of the course material.)

II. <u>Technical Practice Aids (TPAs) and Practice Alerts (PAs)</u>

TIS Section 8700, *Subsequent Events:* Auditor Responsibilities for Subsequent Events (September 2009)

Inquiry: FASB ASC 855-10-50-1 states, "An entity shall disclose 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." How does the entity's responsibility to disclose the date through which subsequent events have been evaluated affect the auditor's responsibilities for subsequent events?

Reply: FASB ASC 855 does not change the auditor's responsibilities under AU section 560, which requires the auditor to perform subsequent event procedures through the audit report date. Because the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion, the auditor's report date can never be earlier than management's subsequent event note date. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. In most cases, this will result in the date that management discloses as the date through which they have evaluated subsequent events being the same date as the auditor's report. In order to coordinate that these dates (note date, representation letter date, and auditor report date) are the same, the auditor may want to discuss these dating requirements with management in advance of beginning the audit and may also want to include, in the auditor's written understanding with the client regarding the terms of the engagement (engagement letter), that management will not date the subsequent event note earlier than the date of their management representation letter (also the date of the auditor's report).

TIS Section 8700, *Subsequent Events:* Effect of FASB ASC 855 on Accounting Guidance in AU Section 560 (September 2009)

Inquiry: How does Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855, *Subsequent Events*, affect the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1)?

***Reply*:** Preparers of financial statements for nongovernmental entities are required to follow the accounting guidance contained in FASB ASC 855. As a result, the accounting guidance contained in AU section 560 would no longer be applicable to audits of nongovernmental or state and local governmental entities. Such guidance will continue to apply to audits of federal governmental entities (for example, those entities that apply the accounting principles issued by the Federal Accounting Standards Advisory Board), until that board issues a subsequent event standard or until AU section 560 is amended. Preparers of financial statements for state and local governmental entities are required to follow the accounting guidance on subsequent events contained in Governmental Accounting Standards Board Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*.

TPA: Section 9100: Signing and Dating Reports: The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report

Inquiry: SAS No. 85, *Management Representations* (AU sec 333), establishes a requirement that the independent auditor obtain written representations from management as part of an audit of financial statements performed in accordance with generally accepted auditing standards. Additionally, paragraph 23 of SAS No. 103, *Audit Documentation*, states that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed, and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. Is the auditor required to have the signed management representation in hand as of the date of the auditor's report?

Reply: AU 530.01 states, in part, "The auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion [footnote omitted]." Such sufficient appropriate audit evidence includes management having asserted responsibility for the final financial statements. The requirement does not mean that the auditor needs to be in physical receipt of the representation letter on the date of the auditor's report. However, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report, since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion (see AU section 333).

TPA: Section 8350: Audit Evidence: Audit Documentation: Current Year Audit Documentation Contained in the Permanent File

Inquiry: SAS No. 103, *Audit Documentation* (AU sec 339.05), states that audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. SAS No. 103 is applicable to all audit documentation supporting the current year's auditor's report. Do the provisions of SAS No. 103 with respect to documentation completion and retention apply to current year audit documentation maintained in the permanent file?

Reply: Yes. SAS No. 103 applies to current year audit documentation maintained in any type of file if such documentation serves as support for the current year's audit report.

Practice Alert 2007-1: Dating of the Auditor's Report and Related Practical Guidance

SAS No. 103, *Audit Documentation*, amends AU section 530, *Dating of the Independent Auditor's Report*, to require the auditor's report not be dated any earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the audit opinion. Thus, use of the "last day of field work" as the date on which to date the report no longer applies.

Practice Alert 2007-1 provides guidance as to the application of SAS No. 103 as it applies to the dating of the auditor's report.

Three key dates are noted within SAS No. 103:

1. <u>Auditor's report date</u>: The auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion.

2. <u>Report release date</u>: Date on which the auditor grants the entity permission to use the report in connection with the financial statements. The report release date should be right after the audit report date.

   Note: The report release date starts the clock ticking on the documentation completion date as noted below.

3. <u>Documentation completion date</u>: The date that the auditor determines that the audit documentation has been assembled, is final and complete. The documentation completion date is a date that is not more than 60 days from the report release date.

After the documentation completion date, the auditor must not delete or discard audit documentation before the end of the specified retention period (five years from the report release date or later if required by state statute).

If the auditor must make additions or amendments to the audit documentation after the documentation completion date, the auditor should document the following with respect to additions to the file:

- When and by whom the changes were made and reviewed,
- The specific reasons for the changes, and
- The effect, if any, of the changes on the auditor's conclusions.

The auditor's report:

As previously noted, the auditor's report should not be dated any earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the audit opinion.

Sufficient appropriate audit evidence includes evidence that:

- Audit documentation has been reviewed,
- The entity's financial statements, including disclosures, have been prepared, and
- Management has asserted that it has taken responsibility for them.

Under SAS No. 103, the audit report date is typically later and very close to the report release date. The reason is because sufficient audit evidence must have been gathered before the audit report date can be identified. Conversely, under the previous rules, the audit report date was the last date of completion of field work which was a date earlier than the date on which sufficient audit evidence is obtained. The term completion of field work has been eliminated altogether under SAS No. 103. Thus, the physical location at which procedures are performed is not relevant.

Another key point is that one open unresolved audit procedure may keep the audit report date open. For example, an auditor may be waiting for receipt of a confirmation, an attorney's letter, or other information, or for a review of the workpapers while a partner is on vacation. All of these open tasks may extend the audit report date if individually or in the aggregate, they impact the auditor's ability to obtain sufficient appropriate audit evidence.

Attorney's letters:

An attorney's letter ordinarily represents a significant portion of "sufficient appropriate audit evidence." As a result, in order to avoid having a missing attorney's letter delay completion of the audit and extend the report date, an auditor should send out attorney's letters early in the audit process and obtain an updated response (via email or verbal) close to the audit report date.

Loan waiver letters:

If a client has a loan covenant violation and needs a waiver from a bank, such a waiver could delay the audit report date. Absent the waiver, a long-term liability may have to be classified as short term. Thus, obtaining the waiver early in the audit process is important to make sure it is received timely.

Subsequent events:

The subsequent event period extends the date of the auditor's report. Audit procedures performed during the subsequent event period are made to determine whether any subsequent events may require adjustment to the financial statements or disclosures, or both. Thus, performance of subsequent event procedures results in the audit report date being kept open since these procedures represent sufficient appropriate audit evidence.

The auditor has no responsibility after the audit report date to make any further inquiries or perform any other auditing procedures, unless new information that may affect the report comes to his or her attention.

Impact of financial statement preparation and management's assertions on the audit report date:

Sufficient appropriate audit evidence includes the preparation of financial statements and management's approval and review of those statements. This fact, in and of itself, significantly shifts forward the audit report date.

Moreover, obtaining a management representation letter as of the audit report date extends the report date. However, approval of financial statements by an audit committee would not impact or delay the dating of the auditor's report.

Review of audit documentation:

The SASs require that audit work should be reviewed to determine whether it has been adequately performed and to evaluate whether the results are consistent with the conclusions found in the auditor's report. Such review is considered sufficient appropriate audit evidence which must be performed prior to the date of the auditor's report.

TIS Section 1400, *Consolidated Financial Statements:* Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting (July 2010)

Inquiry: Paragraph .04 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), provides as an example of an other comprehensive basis of accounting (OCBOA) "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." In the case of brother-sister corporations in which each entity maintains its books and records on the basis of accounting used, or expected to be used, to file each entity's income tax return, may an auditor report on combining financial statements in accordance with the income tax basis of accounting even though a combined income tax return is not filed?

Reply: Nothing in AU section 623 prohibits or precludes an auditor from reporting on a combined presentation as long as the basis of accounting for each of the entities presented is the basis that they use, or expect to use, to file their income tax returns. In many instances, combining financial statements of brother-sister companies is more useful to users than the individual uncombined financial statements. As with all OCBOA presentations, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

TIS Section 1800, *Notes to Financial Statements:* Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures, t*o Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles (July 2010)

Inquiry: If management prepares an entity's financial statements using an other comprehensive basis of accounting (OCBOA), and those financial statements include accounts measured at fair value, what is the auditor's responsibility with respect to fair value disclosure requirements in FASB ASC 820-10-50?

Reply: As indicated in paragraph .10 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), "when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate." Furthermore, Interpretation No. 14 of AU section 623, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. 90–.95) provides:

If OCBOA financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations.

Therefore, if OCBOA financial statements reflect assets or liabilities measured at fair value in accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*, the auditor should consider whether the financial statements (including the accompanying notes) include the fair value disclosure requirements of FASB ASC 820 as appropriate for the basis of accounting used.

TIS Section 9110, *Special Reports:*
Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), to Other Comprehensive Basis of Accounting (OCBOA) Financial Statements – Recognition and Measurement Provisions (July 2010)

Inquiry: Does an auditor need to consider the recognition and measurement provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), when auditing financial statements prepared in conformity with an other comprehensive basis of accounting (OCBOA)?

Reply: Ordinarily, the recognition and measurement provisions of FASB ASC 740-10 (previously, FASB Interpretation No. 48) would not apply to OCBOA financial statements because a liability for an uncertain tax position would not be reported on an entity's income tax return, nor would it be based on cash receipts or disbursements. However, FASB ASC 740-10 may apply in order for an entity's financial statements to comply with the financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. If the recognition and measurement provisions do apply and the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, then the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

TIS Section 8700, *Subsequent Events:* Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor

***Inquiry*:** Entity A is a nonprofit conduit debt obligor with conduit debt securities that are traded in a public market. The entity has a June 30 year-end. Management of the nonprofit has scheduled its annual meeting for early August. During its annual meeting, audited financial statements will be distributed to the board of trustees, as well as to all other persons in attendance. At the same time, entity A will post a notice to its website that alerts the general public regarding the method(s) available for obtaining a copy of its audited financial statements.

Entity A plans to file its audited financial statements with the Electronic Municipal Market Access system in late September, after other filing information has been prepared. "Pending Content" in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855-10-25-1A (FASB ASC 855-10 was updated by Accounting Standards Update No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, dated February 2010) states in part that an entity that meets either of the following criteria shall evaluate subsequent events through the date the financial statements are issued:

a. It is an SEC filer.
b. 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).

The FASB ASC glossary defines *financial statements are issued* as follows:

> "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."

Management has asserted that the financial statements will be widely distributed as of the date of the annual meeting (and, therefore, would be considered issued) because the financial statements (in a form and format that complies with generally accepted accounting principles [GAAP]) are distributed to the board of trustees at the meeting, as well as made available to anyone else as of that date (either through their attendance at the annual meeting or through their being able to obtain a copy through the method(s) described on entity A's website).

How does FASB ASC 855-10, as updated in February 2010, affect the auditor's responsibility with respect to subsequent events and the date of the auditor's report?

This inquiry and response assumes an entity's financial statements have been prepared in accordance with generally accepted accounting principles promulgated by the Financial Accounting Standards Board. The accounting and disclosures for subsequent events may be different for other accounting standard setters.

Reply: Because Entity A is a conduit debt obligor with conduit debt securities that trade in a public market, management is required to evaluate subsequent events through the date the financial statements are first widely distributed (that is, issued).

The auditor, using his or her professional judgment, needs to evaluate management's assertion about the financial statement issuance date and decide whether the manner in which entity A has made its financial statements available does or does not constitute issuance for purposes of complying with GAAP and completing the auditor's subsequent event procedures. The auditor is required, in accordance with AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), to perform subsequent event procedures at or near the date of the auditor's report. As discussed more fully in Technical Questions and Answers section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), in most cases, this will be the same date that management discloses as the date through which they have evaluated subsequent events. In accordance with AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), the auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements, after the date of the auditor's report, unless new information that may affect the report comes to his or her attention.

TIS Section 9110, *Special Reports:* Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions (February 2010)

Inquiry: The Federal Deposit Insurance Corporation's (FDIC's) *Resolutions Handbook* (Handbook) states that a *loss sharing transaction* is a purchase and assumption (P&A) transaction that the FDIC commonly uses as a resolution tool for handling failed institutions with more than $500 million in assets. A *P&A* is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The Handbook also states that a loss sharing P&A uses the basic P&A structure, except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets.

How may an independent auditor respond to the requirement in the Handbook for P&A agreements that "within 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements relative to the accuracy of any computations made regarding shared loss assets?"

***Reply*:** When the FDIC requirement applies to an engagement covering an FDIC loss sharing P&A transaction, the auditor may respond to the requirement by issuing a report following the guidance in paragraphs .19–.21 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1). The following are illustrations of auditor reports for three possible outcomes for which the independent auditor might report:

Example A—Independent Auditor's Report on Compliance With Contractual Provisions

Independent Auditor's Report

[To the Board of Directors of *ABC Bank*] [*Address*] [*City, State*]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.,* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

1. The term *specified statements* is not defined in the Federal Deposit Insurance Corporation's (FDIC's) *Resolutions Handbook*. The practitioner is advised to read the terms of the loss share agreement and confirm that the audit requirement in that agreement provides for the receipt of a report expressing negative assurance.
2. Applicable depending on the nature of the agreement between the acquiring bank and the FDIC.

In connection with our audit, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

March 15, 20XY

Example B—Independent Auditor's Report on Compliance With Contractual Provisions: Assuming Amended Computations Are Attached

Independent Auditor's Report

[To the Board of Directors of *ABC Bank*] [*Address*] [*City, State*]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.,* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

In connection with our audit, after giving effect to the attached corrected computations, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

March 15, 20XY

Example C—Independent Auditor's Report on Compliance With Contractual Provisions: Noncompliance

Independent Auditor's Report

[To the Board of Directors of *ABC Bank*] [*Address*] [*City, State*]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.,* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

In connection with our audit except as stated in the following sentence, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. The Bank did not comply with [*state computational provision not met*]. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

March 15, 20XY

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. Under TPA Section 9100, with respect to obtaining a management representation letter, an auditor must have the signed representation letter in hand:

   a) on the report date
   b) prior to releasing the auditor's report
   c) as of the last date of field work
   d) as of the documentation completion date

2. Facts: An auditor is auditing financial statements prepared in conformity with OCBOA (income tax basis of accounting). Which of the following is correct:

   a) the requirements of ASC 740-10 do not apply
   b) the requirements of ASC 740-10 may apply to the liability provision but not other elements of ASC 740-10
   c) ASC 740-10 gives a company an option of complying with its requirement
   d) uncertain tax positions should still be evaluated

3. Facts: An entity plans to file its audited financial statements with the Electronic Municipal Market Access system. The entity is both an SEC filer and a conduit bond obligor. Management asserts that the financial statements will be widely distributed as of the date of the annual meeting (and, therefore, would be considered issued). What is the auditor's responsibility with respect to subsequent events and the date of the auditor's report:

   a) management is required to evaluate subsequent events through the balance sheet date
   b) management is required to evaluate subsequent events through the report date
   c) management is required to evaluate subsequent events through the date that the financial statements are first widely distributed
   d) management is exempt from evaluating subsequent events because it is a conduit debt obligor

SUGGESTED SOLUTIONS

1. A: Incorrect. On the report date, the auditor does not have to have physical receipt of the signed letter; however, management should have reviewed the letter and, at a minimum, have orally confirmed that they will sign the letter, without exception.

   B: Correct. At a minimum, the signed letter should be received prior to releasing the auditor's report.

   C: Incorrect. The term "last day of field work" is no longer applicable.

   D: Incorrect. The documentation completion date is a date after the financial statements are issued. The representation letter must be received prior to releasing the auditor's report.

   (See page 9-45 of the course material.)

2. **A: Correct.** The requirements of ASC 740-10 do not apply because a liability for uncertain tax positions is not recorded under the income tax basis of accounting.

   B: Incorrect. Because there is no liability recorded under the income tax basis of accounting, that element of ASC 740-10 does not apply, making the answer incorrect.

   C: Incorrect. ASC 740-10 does not give a company an option of complying with its requirement, making the answer incorrect.

   D: Incorrect. There is no requirement to record a liability for uncertain tax positions using the income tax basis of accounting. Therefore, uncertain tax positions should not be evaluated.

   (See page 9-49 of the course material.)

3. A: Incorrect. The balance sheet date is not a subsequent event period.

   B: Incorrect. The report date is not used as the subsequent events date.

   C: Correct. Management is required to evaluate subsequent events through the date that the financial statements are first widely distributed, which is considered issued.

   D: Incorrect. There is no exemption for a conduit debt obligor.

   (See page 9-50 of the course material.)

III. <u>Other Auditing Developments</u>

A. 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 Clarity Project, is similar to the one being done between the FASB and IASB on the GAAP side.

The ASB is redrafting all of the auditing sections in its Codification of Statements on Auditing Standards, applying drafting conventions to those standards, and converging the material with the ISAs. The redrafting process will include exposing clarity redrafts, considering comments, making changes, and finalizing the standards.

All existing auditing statements (SAS No. 1 to 116) are part of the new codification with SAS No. 117-120 being retained. Thus, upon the finalization of all clarified SASs (SAS No. 1 to 116), one SAS will be issued containing all clarified SASs in codified format and SAS Nos. 1 to 116 will be superseded. The new SAS is expected to have an effective date of 2012, although that date is likely to be extended. Early application will not be permitted.

Although most of the ISA requirements will be requirements of U.S. GAAS, there may be additional GAAS requirements.

In November 2009, the AICPA's Auditing Standards Board issued a FAQ entitled *Clarity Project: Update and Final Product,* which was further updated in November 2010. Below is the AICPA's FAQ:

November 2010
Clarity Project: Update and Final Product
(AICPA)

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 <u>Clarity Project</u>?

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 AU sections of currently effective Statements on Auditing Standards (SASs) in AICPA *Professional Standards* are being clarified over the next three years. More information on the Clarity Project is available on the "<u>Improving the Clarity of ASB Standards</u>" page on the AICPA's dedicated Web site.

Q. When does the ASB expect to complete the Clarity Project?

A. The ASB is working toward completing the project in the second half of 2011, with the possible exception of the following two AU sections:

- 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, and

- 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 delayed in order to enable the proposed SAS to align with the IAASB's revisions to the clarified ISA 610, *Using the Work of Internal Auditors*, which was issued in 2008. These revisions have resulted in the July 2010 issuance of proposed ISA 610 (Revised), *Using the Work of Internal Auditors*.

Q. Once all of the AU sections have been clarified, how will they be issued?

A. The ASB will issue many 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. AU sections that are clarified subsequent to the issuance of that ***one*** SAS will be issued as one or more separate SASs.

To address practice issues, certain SASs have been issued in advance. These standards have been assigned numbers and include SAS No. 117, which deals with compliance audits, and SASs No. 118, 119, and 120, which deal with supplementary information.

Q. Will the SAS numbering 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. 12X."

Q. What will happen to the SASs and AU sections when "SAS No. 12X" is issued?

A. When "SAS No. 12X" becomes effective, SASs issued prior to SAS No. 117 will be superseded. However, the superseded AU sections are expected to be retained until January 2014, at which time "SAS No. 12X" will be fully effective.

Q. Once finalized, when will the clarified SASs become effective?

A. Because SASs No. 117–120 have been issued, their effective dates have already been established as follows:

- SAS No. 117, *Compliance Audits*, is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Early application is permitted.

- SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*, is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

- SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*, is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

- SAS No. 120, *Required Supplementary Information*, is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

The effective date for all other clarified SASs is for audits of financial statements for periods ending on or after December 15, 2012. This date was changed by the ASB in May 2010 in order to allow more time for finalization of the standards as well as to give our members more time for training and updating of firm methodologies.

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 sections might be re-titled and assigned to different AU sections in "SAS No. 12X." View a schedule that shows the mapping of existing AU sections and the SASs that would supersede them.

In addition, the ASB has revised the AU section number order that was established by SAS No. 1 to follow the ISA number order for all clarified AU sections for which there are comparable ISAs. This revision was based on the desire to maintain consistency with ISA convergence, and simplicity for firms that use both ISAs and SASs. New AU section numbers have been assigned for all clarified AU sections for which there are no corresponding ISAs. View a master table of contents that reflects the new AU section number order.

Q. Will early adoption of "SAS No. 12X" be permitted?

A. The ASB has decided that early adoption of "SAS No. 12X" would not be appropriate. It is important that, for legal and practice inspection purposes, it be very clear which standards are in effect. Therefore, auditors should continue to comply with the current standards until the date that "SAS No. 12X" 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. 12X" 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. 12X" will impact the AU sections that "SAS No. 12X" will contain.

Q. How can I access the clarified exposure drafts that have been issued, or the clarified standards that have been finalized, 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 web site.

Please remember, however, that finalized clarified auditing standards are not effective yet.

Q. How can I get more information about Accounting and Auditing activities?

A. For more information, visit the "Accounting and Auditing" interest area home page on AICPA's dedicated Web site.

Observation: Although the ASB has already published many existing auditing standards under the clarification project, the newly published statements are not going to be effective until 2014 and will ultimately be issued under one, single statement. The exception is that SAS No. 117 to 120 will be retained and will not become part of the new codification of existing GAAS.

B. THE IMPACT OF DODD-FRANK ON AUDITORS

In 2010, the President signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act.* The two primary goals of Dodd-Frank are to lower the systemic risks to the financial system and enhance consumer protections.

Dodd-Frank makes monumental changes to many aspects of the financial services industry. Embedded in Dodd-Frank is a series of disclosures that public companies will be required to disclose in many of their public reports including those issued quarterly, annually and proxy statements. Obviously, auditors and board members must be aware of the disclosures:

1. *Section 951: Shareholder vote of executive compensation*: Not less frequently than once every three years, there shall be a shareholder vote to approve the compensation of executives.

2. *Section 952:*

    a. *Independence of compensation committee members:* Each member of the compensation committee of the board of directors of an issuer must be a member of the board of directors and be independent.

b. *Independence of compensation committee advisers:* The compensation committee of an issuer (public company) may only select a compensation consultant, legal counsel, or other adviser to the compensation committee who is independent.

3. *Section 982*: Makes auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight.

In addition, Dodd-Frank provides a series of required disclosures that auditors and board members should understand. Following is a chart that summarizes those disclosures.

New Disclosures Under Dodd-Frank Act	
Section and required disclosure	**When required**
Section 942: Requires issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, including: • Data having unique identifiers relating to loan brokers or originators, • The nature and extent of the compensation of the broker or originator of the assets backing the security, and • The amount of risk retention by the originator and the securitizer of such assets.''	Registration statements
Section 951: Requires disclosure of: • Any agreements that a company has with its executive officers concerning any compensation that a company will pay out to its executive officers that is based on the acquisition, merger, consolidation, sale, or disposition of substantially all of the assets, and • The total compensation that may be paid and the conditions upon which it will be paid	Proxy or consent material
Section 952: Requires disclosure of whether: • A company's compensation committee retained or obtained the advice of a compensation consultant, and • The work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.	Proxy or consent material

Section 953: Requires disclosure of: • The median of the annual total compensation of all employees of the issuer, except the chief executive officer (a), • The annual total compensation of the chief executive officer (or any equivalent position) of the issuer (b), and • The ratio of (a) to (b).	Proxy or consent material
Section 955: Requires disclosure as to whether any employee or member of the board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities: • Granted to the employee or member of the board of directors as part of the company compensation, or • Held, directly or indirectly, by the employee or member of the board of directors.	Proxy or consent material
Section 1502: Requires disclosure when a company uses “conflict minerals” (gold, wolframite, columbite-tantalite, etc.) that are necessary to the functionality or production of its product (such as jewelry manufacturing, etc.): • Whether conflict minerals originated in the Democratic Republic of the Congo (DRC) or an adjoining country. **Note:** If “conflict minerals” did originate in the DRC, the company must submit an audited report to the SEC that includes a description of the measures taken to exercise due diligence on the source and chain of custody of such minerals. • A description of the products manufactured that are not DRC conflict free, the entity that conducted the independent private sector audit, the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity. **Note:** “DRC conflict free” means products that do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of the Congo (or an adjoining country).	Annual reports and filings

<table>
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<td>Section 1503: If a company or its subsidiary is an operator of a coal or other mine, the company must disclose the following:

1. For each coal or other mine:
• The total number of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of a coal or other mine safety or health hazard for which the operator received a citation from the Mine Safety and Health Administration
• The total number of orders
• The total number of citations and orders for unwarrantable failure of the mine operator to comply with mandatory health or safety standards
• The total number of flagrant violations
• The total number of imminent danger orders issued
• The total dollar value of proposed assessments from the Mine Safety and Health Administration
• The total number of mining-related fatalities
• The receipt of an imminent danger order issued by the Federal Mine Safety and Health Act
• The receipt of written notice from the Mine Safety and Health Administration that the coal or other mine has a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or the potential to have such a pattern.

2. A list of such coal or other mines, of which the company or its subsidiary is an operator, that receive written notice from the Mine Safety and Health Administration of:
• A pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or
• The potential to have such a pattern.

3. Any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine.</td>
<td>Quarterly and 8K reports</td>
</tr>
</table>

Section 1504: Requires each resource extraction company (oil, natural gas, or minerals) to disclose any payment made by the company (directly or indirectly) to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals, including: • The type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals, and • The type and total amount of such payments made to each government.	Annual reports and filings
Source: Dodd-Frank Wall Street Reform and Consumer Protection Act (2010)	

There are other bills pending that would require companies to disclose information ranging from political contributions to details about business dealings with Iran.

Observation: As you look at the list of disclosures required in Dodd-Frank, few of them have anything to do with providing meaningful information to investors. Instead, information such as the purchase of conflict minerals in the Democratic Republic of Congo, or the safety record of coal mine operators, are politically charged and most likely forced into the Dodd-Frank law by constituents with an agenda. Because Congress funds the SEC, it can use the SEC to force public companies to adopt certain actions to avoid being "shamed" through public disclose. For example, shareholders of a diamond company may not care whether the company purchases diamonds from the Congo as long as the company is profitable and stock price remains high. Now change that fact as the company is required to disclose that it purchases certain materials from the Congo. Once that disclosure becomes public, stakeholders may place pressure on the company to change its policy to avoid the publicity that may result from the disclosure. Similarly, how much a company pays its executives in relation to its employees as executive compensation is generally the responsibility of a company's board of directors who, in turn, represent the shareholders. Section 953 of Dodd-Frank adds a new disclosure in which a company is required to disclose the ratio of compensation made to its employees as a multiple of executive compensation. Why is this information relevant if the company has a board of directors? The answer is that it is not relevant and is required solely to appease certain groups that believe executives are overpaid.

In light of the recent expansion of company disclosures lead by Dodd-Frank, one has to ask where disclosures are headed and whether Congress, through the SEC, will continue with its effort to expand company disclosures as a means to promote a political agenda instead of doing its job, which is to protect investors within the marketplace.

C. WHISTLEBLOWING – THE NEW PROFESSION

As the author discussed earlier in this course, one of the most effective ways in which a company can prevent fraud is to have a tip hotline of whistleblowing mechanism within the organization.

In the *2010 Report to the Nation*, by the Association of Certified Fraud Examiners supports the effectiveness of a company having an employee hotline and/or whistleblowing mechanism:

1. In 38% of the cases reported, the initial method of fraud detection was tips or whistleblowing from various sources.

2. In those cases where companies had implemented a tip hotline and whistleblowing mechanism, the median fraud loss declined from $245,000 to $100,000, or a 59% reduction.

3. Granting rewards for whistleblowing is ranked as the number one most effective control in detecting and limiting financial statement fraud schemes, while having a fraud hotline is ranked number three.

There is heightened pressure on public companies to establish effective anonymous hotlines and whistleblowing systems, including compensation for coming forward as a whistleblower.

1. Section 806 of Sarbanes-Oxley provides whistleblowing protection for employees of public companies in that it:

   a. Prevents a company from discharging, demoting, suspending, threatening, harassing, or discriminating an employee for providing information or assisting in an investigation that the employee <u>*reasonably believes*</u> constitutes fraud,

   b. Requires a company to rehire an employee with back pay (and interest) if an employee is violated for whistleblowing, and

   c. Requires company boards to establish procedures for hearing whistleblowing complaints.

2. Section 922 of Dodd-Frank expands the protections and offers financial incentives for whistleblowers[7] by:

   a. Establishing a whistleblower rewards fund to pay awards to whistleblowers equal to between 10-30 percent of the total collected when monetary sanctions exceeding $1 million are imposed on a public company for securities law violations that exceed $1 million, based on information that is:

[7] Dodd-Frank defines a whistleblower as any individual (or individuals) who provides information to the SEC about a company's securities law violation. The definition expands well beyond an employee to any third party, investor, etc.

- Derived from the whistleblowers original knowledge,
- Not known by the SEC from any other source, and
- Not exclusively derived from any judicial or administrative hearing, or other report or news media.

b. Providing legal remedies for an individual who alleges discharge or other discrimination due to whistleblowing with such relief consisting of:

- Reinstatement with the same seniority status that the individual would have had, but for the discrimination;

- Two times the amount of back pay otherwise owed to the individual, with interest; and

- Compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

Although whistleblowing can be useful, the legal remedies and rewards included in Sarbanes coupled with those in the recently passed Dodd-Frank Act, provide employees with the means by which to leverage certain proprietary corporation information for financial gain. In fact, recent cases suggest that some employees are using the whistleblowing protections to retaliate against management or to extract concessions in a contract negotiation or severance pay package.

Two recent cases suggest that auditors or boards that ignore whistleblowers, do so at their own peril.

In the first case, the State of New York v. Ernst & Young, the State of New York alleges that Ernst & Young failed to disclose whistleblower allegations in connection with Lehman's use of Repo 105, among other matters.

Secondly, under obvious pressure from regulators, Renault inadvertently terminated several employees based on information obtained from a whistleblower.

In the Ernst & Young case, the auditors received a letter from a whistleblower, sent to Lehman's audit committee. The auditors interviewed the whistleblower and dismissed the allegations. Subsequently, in the State of New York complaint, the plaintiff alleged that the auditor failed to disclose the results of the whistleblower's interview to the Lehman audit committee.

In the Renault case, a whistleblower claimed that a Renault executive was engaged in a bribe. After an intensive investigation, Renault terminated three employees and announced publicly it had evidence against them, even though there was no such evidence of any bribes or improprieties. Subsequently, Renault admitted it had committed an error and has exonerated the three employees.

It is obvious that the Ernst & Young and Renault cases are examples at opposite ends of the spectrum, with Ernst & Young being accused of not taking enough action in a whistleblower case while Renault being criticized for being overly aggressive in handing its case.

With the financial incentives of Dodd-Frank, there is a new whistleblowing industry that has cropped up including web sites, blogs, and law firms that advertise the represent whistleblowers.

Is there an incentive for a whistleblower to overreact and report to the SEC prematurely?

There is an obvious incentive for a whistleblower to be the first one to notify the SEC. Dodd-Frank provides that in order for a whistleblower to collect his or her reward, the information provided to the SEC must be fresh, meaning it must be a) derived from the whistleblowers original knowledge, b) not known by the SEC from any other source, and c) not exclusively derived from any judicial or administrative hearing, or other report or news media. Once information is already divulged, the whistleblower's information is stale and there is no reward. Also, there is no real penalty for a whistleblower to exaggerate or to be wrong about his or her allegation. Section 806 of Sarbanes-Oxley provides that an employee has to "reasonably believe" there is a fraud in order to be protected from company retaliation.

How good is the financial incentive to whistleblow?

Dodd-Frank has certainly enhanced the financial incentive to whistleblow against a company and to do it early. Dodd-Frank allows an employee-whistleblower who a company retaliates against to receive two times the amount of back pay (including interest), and reimbursement of compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

The reward, itself, is 10-30 percent of the money that the SEC receives for a company's securities law violations that include fraudulent financial reporting, Foreign Corrupt Practices Act (FCPA) violations, and insider trading, among others. Some violations, such as violation of the FCPA can result in fines that are millions of dollars.

Is there an incentive for a company to offer a mechanism for employees to report a violation to the company first, before going to the SEC?

The SEC is considering regulations that would allow an employee to whistleblow to a company before going to the SEC and still collect the SEC reward. In providing this structure, companies would be more likely to establish a corporate culture that promotes employees to come forward with SEC violations, and allow companies to correct the actions internally. However, such a structure would have to include a company-level financial incentive for whistleblowers.

D. PCAOB AUDITING STANDARDS

Auditing Standard (AS) No. 8 to 15:

In December 2010, the PCOAB issued a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit, as follows:

- AS No. 8: Audit Risk
- AS No. 9: Audit Planning
- AS No. 10: Supervision of the Audit Engagement

- AS No. 11: Consideration of Materiality in Planning and Performing an Audit
- AS No. 12: Identifying and Assessing Risks of Material Misstatement
- AS No. 13: The Auditor's Responses to the Risks of Material Misstatement
- AS No. 14: Evaluating Audit Results
- AS No. 15: Audit Evidence

The suite of risk assessment standards, Auditing Standards No. 8 through No. 15, establishes requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements.

The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results.

The PCAOB initially proposed a suite of standards on October 21, 2008. Changes were made in response to comments received and the PCAOB reproposed the standards on December 17, 2009. These standards supersede six PCAOB interim standards and related amendments: AU sec. 311, *Planning and Supervision*; AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*; AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*; AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*; AU sec. 326, *Evidential Matter*; and AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

The standards are effective for audits of fiscal periods beginning on or after December 15, 2010.

Following is a summary of each of the eight standards:

Auditing Standard 8 (AS No. 8)-*Audit Risk:* This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.

Auditing Standard 9 (AS No. 9)-*Audit Planning:* This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.

Auditing Standard 10 (AS No. 10)-*Supervision of the Audit Engagement:* This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.

Auditing Standard 11 (AS No. 11)-*Consideration of Materiality in Planning and Performing an Audit:* This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.

Auditing Standard 12 (AS No. 12)-*Identifying and Assessing Risks of Material Misstatement:* This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.

Auditing Standard 13 (AS No. 13)-*The Auditor's Responses to the Risks of Material Misstatement:* This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.

Auditing Standard 14 (AS No. 14)-*Evaluating Audit Results:* This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.

Auditing Standard 15 (AS No. 15)- *Audit Evidence:* This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

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. Under the auditing standards convergence project, which of the following is correct:

   a) all auditing standards are part of the new codification
   b) upon the finalization of all clarified SASs, all of the SASs will be issued as individual statements
   c) SAS No. 117-120 are retained in their present form
   d) SAS No. 1 to 120 will be superseded

2. Dodd-Frank makes several changes that affect both auditors and board members. Which of the following is one of those changes:

   a) no less frequently than once every three years, there shall be a shareholder vote to approve executive compensation
   b) no less frequently than once every five years, there shall be a board of directors vote to approve dividends to be paid
   c) once every year, there shall be a shareholder vote to select the auditor
   d) once every two years, there shall be a vote of senior management to approve dividends

3. Which of the following is a change made by Dodd-Frank that affects whistleblowers:

   a) provides companies with a legal remedy if an employee makes a false claim as a whistleblower
   b) allows for the reinstatement of an employee who whisteblows
   c) provides for five times the amount of any back pay
   d) allows an attorney to collect legal fees from a whistleblower

SUGGESTED SOLUTIONS

1. A: Incorrect. SAS Nos. 1-116 are part of the new codification, while SAS No. 117-120 are retained in their existing form.

   B: Incorrect. One SAS will be issued for SAS No. 1-116.

   C: Correct. Although SAS No. 1-116 will be issued as one new SAS, SAS No. 117-120 are retained in their present form.

   D: Incorrect. SAS No. 1-116 will be superseded, but not SAS No. 1 to 120.

   (See page 9-57 of the course material.)

2. **A: Correct.** Dodd-Frank requires that not less frequently than once every three years, there shall be a shareholder vote to approve executive compensation.

   B: Incorrect. There is no provision dealing with five years, and no requirement for the board to approve dividends to be paid at each five-year interval.

   C: Incorrect. First, in general the board selects the auditor, and second there is no annual voting requirement in Dodd-Frank.

   D: Incorrect. The board of directors approves dividends and not senior management.

   (See page 9-60 of the course material.)

3. A: Incorrect. Dodd-Frank provides whistleblowers, not companies, with a legal remedy if an employee makes a false claim as a whistleblower.

   B: Correct. Dodd-Frank allows for the reinstatement of an employee who whisteblows in certain instances.

   C: Incorrect. It provides for two times, not five times, the amount of any back pay.

   D: Incorrect. It allows for a whistleblower to collect legal fees from a company who violates Dodd-Frank.

   (See page 9-66 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.

Acquiree: The business or businesses that the acquirer obtains control of in a business combination.

Acquirer: The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity is always the acquirer.

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

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.

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*.

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.

Business combination: A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as “true mergers” or “mergers of equals” are also business combinations.

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.

Class of Financing Receivable: A group of financing receivables determined on the basis of all of the following: 1) initial measurement attribute (for example, amortized cost or purchased credit impaired), 2) risk characteristics of the financing receivable, and 3) an entity's method for monitoring and assessing credit risk.

Credit Quality Indicator: A statistic about the credit quality of financing receivables. Examples of credit quality indicators include consumer credit risk scores, credit-rating-agency ratings, an entity's internal credit risk grades, loan-to-value ratios, collateral, collection experience, other internal metrics, and more.

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.

Effective settlement: A threshold related to a tax position under which certain conditions are met including: a) The taxing authority has completed its examination procedures, b) The entity does not intend to appeal or litigate any aspect of the tax position, and c) It is remote that the taxing authority would examine or reexamine any aspect of the tax position.

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 board.

Factoring Arrangements: A means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee.

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.

Financial asset: Cash, evidence of an ownership interest in an entity, or a contract.

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.

Financing receivable: A financing arrangement that has <u>both</u> of the following characteristics: 1) It represents a contractual right to receive money in either of the following ways: on demand or on fixed or determinable dates, and 2) It is recognized as an asset in the entity's statement of financial position.

Finite useful life: A life that is not indefinite.

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

Indefinite useful life: A life where there is no legal, regulatory, contractual, competitive, economic, or other factor that limits the useful life of an intangible asset. That is, there is no limit placed on the end of the assets useful life to the reporting entity.

Intangible assets: Assets (not including financial assets) that lack physical substance.

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.

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).

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.

More likely than not: More than a 50 percent likelihood of occurring.

Nonissuer: All entities except for those defined in Section 3 of the Securities Exchange Act of 1934 (the Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of the Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

Not-for-profit organization: An entity that possesses the following characteristics that distinguish it from a business enterprise: (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 like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees (Concepts Statement 4, paragraph 6). Entities that clearly fall outside this definition include all investor owned entities and mutual enterprises.

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.

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.

Participant loan: A loan in which a participant in a defined contribution plan directs the investment of their plan account balance into an investment in a loan to himself.

Portfolio Segment: The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. Examples of portfolio segments include: 1) type of financing receivable, 2) industry sector of the borrower, and 3) risk rate(s).

Prescribed guidelines: The authoritative guidelines established by the designated accounting standard setter for the methods of measurement and presentation of the required supplementary information.

Public Company Accounting Oversight Board (PCAOB): A regulatory body created by the Sarbanes-Oxley Act of 2002, which regulates audits of SEC registrants, and operates under the U.S. Securities and Exchange Commission.

Reasonable assurance: A high level of assurance, about whether the financial statements are free of material misstatements (whether caused by error or fraud).

Rebates: Refunds of portions of the pre-computed finance charges on installment loans or trade receivables, if applicable, that occur when payments are made ahead of schedule.

Receivables in General: Receivables that may arise from credit sales, loans, or other transactions. Receivables may be in the form of loans, notes, and other types of financial instruments and may be originated by an entity or purchased from another entity.

Reporting unit: The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment.

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.

Residual value: The estimated fair value of an intangible asset at the end of its useful life to an entity, less any disposal costs.

Review evidence: Information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.

Revised financial statements: Consist of financial statements revised only for either of the following conditions a) correction of an error, or b) retrospective application of U.S. GAAP.

SEC filer: Is an entity that is required to file or furnish its financial statements with either the a) SEC or, b) with respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Standby Commitment to Purchase Loans: A forward standby commitment to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is at the option of the seller of the loans and would result in delivery to the entity only if the contract price equals or exceeds the market price of the underlying loan or security on the settlement date.

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.

Tax position: A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.

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.

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.

Useful life: The period over which an asset is expected to contribute directly or indirectly to future cash flows.

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