

How This Alert Helps You

.01 This alert helps you plan and perform your audits and can be used by an entity's internal management to identify issues significant to the industry. It also provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the risks that may result in the material misstatement of financial statements, including significant risks requiring special audit consideration. For developing issues that may have a significant impact in the near future, the "On the Horizon" section provides information on these topics. Refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. Auditors obtain audit evidence to draw reasonable conclusions on which to base their opinion by performing the following:

- Risk assessment procedures
- Further audit procedures that comprise the following:
 - Tests of controls, when required by generally accepted auditing standards (GAAS) or when the auditor has chosen to do so
 - Substantive procedures that include tests of details and substantive analytical procedures

.03 The auditor should develop an audit plan that includes the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.¹ AU-C section 315 defines *risk assessment procedures* as "the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels." *A relevant assertion* "has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls." As part of obtaining the required understanding of the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the "industry, regulatory, and other external factors, including the applicable financial reporting framework," relevant to the entity. This alert assists the auditor with this aspect of the risk assessment procedures and further expands the auditor's understanding of other important considerations relevant to the audit.

Economic and Industry Developments

The Current Economy

.04 When planning an audit or review engagement, auditors need to understand the economic conditions facing the industry and marketplace in which

¹ All AU-C sections can be found in AICPA *Professional Standards*.

an entity operates, as well as the effects of these conditions on the entity itself. These external factors, such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's business and, therefore, its financial statements. Considering the effects of external forces on an entity is part of obtaining an understanding of the entity and its environment. Recognizing that economic conditions and other external factors relevant to an entity and its environment constantly change, auditors should evaluate whether changes have occurred since the previous audit that may affect their reliance on any information obtained from their previous experience with the entity. These changes may affect the risks and risk assessment procedures applicable to the current year's engagement.

.05 During 2016 and into 2017, the U.S. economy continued to recover. The S&P 500 and the Dow Jones Industrial Average both reached all-time highs during 2017. The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock option prices and is considered by many to be a reliable indicator of investor sentiment and market volatility and the best gauge of fear in the market. The VIX continued to show an overall decline during 2016 and into 2017. During that time, prices ranged from 14.40 to 9.36. The volatility shows that there is still some uncertainty; however, the continued downward trend shows that investors believe the economy and market are improving.

Key Economic Indicators

.06 The following key economic indicators reaffirm the recovery of the economy during 2016 and into 2017: gross domestic product (GDP), unemployment, and the federal fund rate. The GDP measures output of goods and services by labor and property within the United States. GDP increases as the economy grows and decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.6 percent in the second quarter of 2017, based on the advance estimate (first estimate). The increase in real GDP in the second quarter has been attributed to positive contributions from personal consumption expenditures, nonresidential fixed investment, exports, and federal government spending that were partially offset by negative contributions from private residential fixed investments, private inventory investment, and state and local government spending.

.07 According to the Bureau of Labor Statistics (BLS) from July 2016 to July 2017, the unemployment rate fluctuated between 4.9 percent and 4.3 percent. A rate of 4.9 percent represents approximately 87.4 million people who are unemployed. During that same time period, the number of long-term unemployed (those jobless for 27 weeks or more) was steady. According to the BLS, the number of people employed part-time for economic reasons decreased to 5.3 million during the second quarter of 2017. Together, these statistics illustrate the continued improvement in the economy.

.08 The Board of Governors of the Federal Reserve System (Federal Reserve) increased the target for the federal funds rate in June of 2017 to 1.0 percent. This was the second raise of the rate during 2017 after keeping the rate at 0.5 percent for over a year.

Legislative and Regulatory Developments

Inspections of Broker-Dealer

.09 On August 18, 2017, the PCAOB released its annual inspection report, *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*. During 2016, the PCAOB inspected 75 firms covering portions of 115 audits related to attestation engagements. The attestation engagements comprised 20 related to compliance reports and 95 related to exemption reports. This was the second annual cycle in which all audits and related attestation engagements were required to be performed in accordance with PCAOB standards and amended SEC Rule 17a-5 and the second annual cycle in which the new attestation engagements were included in the inspections.

.10 The report notes that independence findings were identified in 11 audits representing 10 percent of the audits covered by the inspections in 2016 compared to 7 percent of the audits covered by the inspections in this area in 2015. All audits with independence findings in 2016 were conducted by firms that did not audit issuers.

.11 In response to the report findings, PCAOB Director of Registration and Inspections, Helen Munter stated, "PCAOB inspectors continued to find high levels of deficiencies in the work of auditors of broker-dealers, I hope auditors will use the information in this report to help plan and perform their audit and attestation engagements."

.12 To give some context to the numbers, note that 3,933 broker-dealers filed audited annual financial statements with the SEC for fiscal years ended during the period from July 1, 2015 through June 30, 2016, and 531 registered public accounting firms audited broker-dealer filings for these periods. Of those, 207 of the firms auditing broker-dealers also audited issuers, and 324 firms performed audits of broker-dealers and are registered with the PCAOB only because they audit nonissuer broker-dealers.

.13 A summary of the deficiencies follows—for detailed report findings, see PCAOB Release No. 2017-004, *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, available at <https://pcaobus.org/inspections/documents/bda-interim-inspection-program-2017.pdf>.

Findings Related to Failures to Satisfy Independence Requirements

.14 *Failure to satisfy auditor independence requirements.* The PCAOB identified independence findings in 11 of the 115 audits selected for inspection. The following further describes the identified findings:

- These firms performed bookkeeping or other services related to broker-dealer accounting records, or prepared, or assisted in the preparation of, the broker-dealer's financial statements, supplemental information, or exemption reports.
- One firm's independence also appeared to be impaired because the terms of the engagement letter for the audit stated that the broker-dealer would indemnify the firm from all claims, liabilities, losses, and all expenses arising in connection with the audit engagement when there was a knowing misrepresentation by the broker-dealer's management.

Deficiencies Related to the Financial Statement Audit

.15 *Deficiencies related to auditing revenue.* The PCAOB identified one or more deficiencies in 76 of the 115 audits selected for inspection. The following list further describes the identified deficiencies:

- In 24 of the audits inspected, firms did not perform or sufficiently perform risk assessment procedures for revenue, which contributed to deficiencies in these firms' revenue testing procedures.
- In 43 of the audits inspected, the extent of testing was insufficient for material classes of revenue transactions.
- In 9 of the audits inspected, firms performed substantive analytical procedures that did not provide the necessary level of assurance because the firms failed to do one or more of the following:
 - Develop any expectation when performing analytical procedures intended to be substantive in nature.
 - Develop expectations that were sufficiently precise to identify misstatements.
 - Establish that there was a plausible and predictable relationship between the current year and prior year revenue balances.
 - Evaluate the reliability of the data from which the auditors' expectations were developed.
 - Determine an amount of difference from the expectation that could be accepted without further investigation.
 - Obtain corroboration of management's explanations for significant unexpected differences.
- In 25 of the audits inspected, firms did not perform sufficient procedures on information produced by service organizations used in the performance of audit procedures.
 - In 14 of the 25 audits, the firms obtained a service auditor's report, but did not sufficiently evaluate the service auditor's report or consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon.
 - In 11 of the 25 audits, for which firms used as audit evidence statements or other information the broker-dealers obtained from their service organizations, the firms did not obtain and evaluate the service auditor's report or perform procedures to test the accuracy and completeness of the information the firms used in their audits.
- In 16 of the audits inspected, when auditing revenue, firms did not test the accuracy and completeness of the information produced by the broker-dealer that was used as audit evidence.
- In 55 of the audits inspected, firms did not perform sufficient procedures to test the relevant assertions for revenue. For example, firms did not do one or more of the following:

- Evaluate whether the terms of the underlying contractual arrangements were appropriately considered in revenue recognition.
- Evaluate whether the revenue recognition criteria under FASB *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*, were satisfied.
- Determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements, or test the accuracy and completeness of the quantities and prices of security purchases or sales used to calculate commission revenue.
- Test whether the values used to calculate fees were accurate or complete.
- Perform procedures to test the completeness of revenue.
- Evaluate whether revenue recognition policies were in conformity with generally accepted accounting principles (GAAP).
- Evaluate the effect on the financial statements of recognizing commission revenue based on settlement date rather than trade date, as required under FASB ASC 940, *Financial Services—Brokers and Dealers*.

.16 *Deficiencies related to auditing risks of material misstatement due to fraud.* The PCAOB identified one or more deficiencies in 30 of 53 audits selected for inspection. The following list further describes the identified deficiencies:

- In 12 of 13 audits, firms did not identify improper revenue recognition as a fraud risk, and there was no documentation or other persuasive evidence indicating how the firms overcame the presumption that improper revenue recognition is a fraud risk. In 1 audit, the firm did not perform inquiries of management, or others, within the broker-dealer about potential fraud risks.
- In 15 of the audits inspected, firms did not perform sufficient procedures to test journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements because the firms did not perform 1 or more of the required procedures. In 2 audits, the firms did not test journal entries made at the end of the reporting period. In 4 audits, the firms did not test journal entries to address management override of controls. In 6 audits, the firms did not test the completeness of the population of journal entries from which they selected a sample for testing.
- In 13 of the audits inspected, firms did not perform sufficient audit procedures to specifically address assessed fraud risks related to improper revenue recognition.

.17 *Deficiencies related to auditing financial statement presentation and disclosures.* The PCAOB identified one or more presentation and disclosure deficiencies in 45 of the 115 audits selected for inspection. The following further describes the identified deficiencies:

- In 29 of the audits inspected, firms did not identify the omission of required disclosures pertaining to areas such as the policy for

revenue recognition, related parties, related party transactions, the correction of an accounting error related to revenue, or contingent liabilities.

- In 12 of the audits inspected, disclosures in the financial statements appeared to be incomplete or inaccurate, but the firms either did not identify that these disclosures were incomplete or inaccurate, or perform sufficient procedures to test the disclosures included in the financial statements.
- In 6 of the audits inspected, firms did not evaluate, or sufficiently evaluate, whether the broker-dealer's fair value disclosures were in accordance with FASB ASC 820, *Fair Value Measurement*.
- In 16 of the audits inspected, firms did not perform sufficient procedures regarding whether the broker-dealer's financial statements were presented fairly in conformity with GAAP.
 - In 9 audits, for example, the firms did not do one or more of the following:
 - Evaluate whether the accounting for office space provided by a related party at no cost was properly accounted for and disclosed.
 - Identify that the statement of cash flows did not separately present, or incorrectly presented, the cash flows of operating, financing, and investing activities.
 - Identify discrepancies in amounts presented on different statements comprising the broker-dealer's financial statements.
 - Evaluate whether a related party receivable should have been presented separately from other assets in accordance with FASB ASC 850, *Related Party Disclosures*.
 - Sufficiently evaluate the accuracy of individual revenue amounts presented as individual line items on the statement of income because the firm's procedures were limited to comparing total revenue presented to total revenue shown on the trial balance. In addition, SEC Rule 17a-5(d)(2)(i) requires the financial statements to be presented in a format that is consistent with the statements contained in Form X-17A-5 Part II or Part IIA.
- In 7 audits, firms did not identify and appropriately address instances in which the broker-dealer's financial statements were inconsistent with the requirements of Form X-17A-5. Specifically, in all 7 audits, the broker-dealer presented multiple significant categories of revenue as a single line item on the statement of income.

.18 *Deficiencies related to auditing related party relationships and transactions.* The PCAOB identified deficiencies in 30 of the 92 audits in which the auditor's procedures to test related parties and related party transactions were selected for inspection. The following further describes the identified deficiencies:

- In 9 of the audits inspected, firms failed to perform sufficient risk assessment procedures.
- In 28 of the audits inspected, firms did not perform procedures, or did not design and perform procedures, in a manner that addressed the risks of material misstatement associated with related parties and relationships and transactions with related parties.
- In 4 of the audits inspected, there was a deficiency identified in evaluating the broker-dealer's identification of related party relationships and transactions. In one of these audits, the firm obtained a listing of related parties from the broker-dealer that identified a specific foreign bank as being under common control with the broker-dealer as well as a schedule of notes payable from the broker-dealer that identified material liabilities owed to entities similarly named as the foreign bank. However, the firm did not perform procedures to corroborate management's representation that the notes payable related to entities that were not related parties.

.19 *Deficiencies related to auditing fair value measurement.* The PCAOB identified one or more deficiencies related to fair value measurement in 8 of the 33 audits selected for inspection. The following list further describes the identified deficiencies:

- In 5 of the audits inspected, firms did not obtain a sufficient understanding of the methods and assumptions, either internally developed by the broker-dealer or its specialists or obtained from an external pricing source, that were used by the broker-dealer to determine the fair value of securities.

For example, in one of these audits in which the broker-dealer's securities were valued based on unobservable inputs, the firm's understanding of the methods and assumptions was limited to obtaining the broker-dealer's own estimate of fair value, as well as an external party's valuation report on which the broker-dealer based its estimate, and the firm did not perform procedures to evaluate important inputs used by the external party to estimate fair value, such as testing adjustments in the valuation report for marketability or limitations of shareholder rights.

- In 7 of the audits inspected, firms did not perform or sufficiently perform procedures to test the fair value of securities when firms decided either to test management's process or develop an independent estimate for corroborative purposes. For example, some firms did one or more of the following:
 - Selected an insufficient sample or sampled in a manner that would not provide a sample that was representative of the population being tested
 - Did not determine whether prices obtained from external pricing sources used to develop its own estimate of fair value were independent of the external pricing source used by the broker-dealer to value its securities
 - Used a valuation report prepared by an external party as of a date other than the balance sheet date to test the fair

value of securities at the balance sheet date without assessing whether the valuation report provided sufficient appropriate audit evidence for the securities as of the balance sheet date

- For securities that did not appear to be valued using quoted prices for identical securities in active markets, limited their procedures to comparing the broker-dealer's recorded fair value to prices on the statements from a clearing broker-dealer.

.20 *Deficiencies related to auditing receivables and payables.* In 16 of the 65 audits selected for inspection, the PCAOB identified one or more deficiencies related to receivables and payables. The following list further describes the identified deficiencies:

- In 9 of the audits inspected, the extent of testing was insufficient for a receivable or payable account balance, including commission receivables and payables to broker-dealers and clearing organizations.
- In one of the audits inspected, there was a deficiency related to the external confirmation procedures in which the firm did not perform procedures to determine whether the individual to whom the confirmation was directed was knowledgeable about the information to be confirmed.
- In 6 of the audits inspected, deficiencies were identified related to the testing of receivables and payables that were the result of auditors not obtaining sufficient appropriate audit evidence about the accuracy and completeness of information the auditor used in its audit that was produced by the broker-dealer or the broker-dealer's service organization.
- In 4 of the audits inspected, other deficiencies were identified related to the testing of receivables and payables.
 - For example, in 1 audit, the firm did not evaluate whether the broker-dealer's practice of only reporting receivables (and the related revenues) at year end when cash had been collected after year end and prior to the issuance of the financial statements, resulted in a complete and accurate receivables balance reported at year end.
 - In another audit, the firm did not sufficiently test the broker-dealer's estimate of commissions receivable at year end because its testing of the estimate was limited to recalculation without testing the process used by management to develop the estimate, developing its own independent estimate to corroborate the broker-dealer's estimate, or reviewing subsequent events after year end that could have been important to evaluating the reasonableness of the estimate.

Deficiencies Related to Supporting Schedules

.21 *Deficiencies related to the net capital rule.* In 35 of the 115 audits selected for inspection, the PCAOB identified one or more deficiencies related to the net capital rule. The following further describes the identified deficiencies:

- In 9 of the audits inspected, firms did not test whether the broker-dealer's required minimum net capital reported in the supporting schedule was determined by the broker-dealer in accordance with SEC Rule 15c3-1(a)(2).
- In 6 of the audits inspected, firms did not evaluate, or sufficiently evaluate, the completeness and accuracy of the adjustments to net worth that the broker-dealer reported in the supporting schedule.
- In 19 of the audits inspected, firms did not perform sufficient procedures to test the broker-dealer's classification of allowable and non-allowable assets as reported in its supporting schedule.
- In 4 of the audits inspected, firms did not perform sufficient procedures to evaluate whether the appropriate haircuts were applied by the broker-dealer to reported securities, including evaluating the relevant characteristics of the securities in accordance with SEC Rule 15c3-1(c)(2)(vi).
- In 13 of the audits inspected, firms did not evaluate, or sufficiently evaluate, the completeness and accuracy of the amounts of operational charges and other deductions reported by the broker-dealer on its supporting schedule.
- In 6 of the audits inspected, other deficiencies related to net capital were observed:
 - In 4 of these audits, the firms did not obtain written representations from management required by AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AICPA, PCAOB Standards and Related Rules) and in 2 audits, the firms did not perform procedures to determine whether the supporting schedule reconciled to the underlying accounting and other records or to the broker-dealer's financial statements.
 - In one of these audits, the firm did not obtain an understanding of the methods of preparing the supplemental information and evaluate the appropriateness of those methods.

.22 Deficiencies related to the customer protection rule. In 13 of the 25 audits selected for inspection, the PCAOB identified one or more deficiencies related to the customer protection rule. The following list further describes the identified deficiencies:

- In 12 of the audits inspected, firms did not test, or sufficiently test, the completeness and accuracy of debits or credits included in the customer and PAB account reserve computations reported on the supporting schedules.
- In 5 of the audits inspected, firms did not perform sufficient procedures to test the information related to the broker-dealer's possession or control requirements as reported on the supporting schedule.
- In 2 of the audits inspected, deficiencies were identified regarding other procedures performed on the supporting schedules related to compliance with SEC Rule 15c3-3.

- In one of these audits, the firm appeared to be aware that the balance in the broker-dealer's special reserve bank account was less than the balance the broker-dealer reported in its customer reserve schedule and less than the required deposit reported by the broker-dealer. The misstatement appeared to be material, due to the effect of the misstatement in light of its relationship to the broker-dealer's reporting concerning its compliance with the reserve requirement, and the firm appeared to have failed to identify and address that fact.
- In another audit, the firm failed to obtain any of the required written representations from management.

Other Deficiencies Related to the Audit

.23 *Deficiencies related to auditor's reporting on the financial statements and supporting schedules.* In 15 of the 115 audits selected for inspection, the PCAOB identified one or more deficiencies related to financial statements and supporting schedules. The following further describes the identified deficiencies:

- In 12 of the audits inspected, it was observed that the auditor's report on the supplemental information did not include, or include properly, one or more of the elements required by PCAOB AS 2701. Following are examples:
 - Firms did not identify a supporting schedule that the firm had audited and that the broker-dealer filed with its financial statements
 - Firms incorrectly identified the broker-dealer's exemption report as supplemental information
 - Firms identified supporting schedules that the broker-dealer did not file with its financial statements
 - Firms did not include a required statement that the audit procedures performed included performing procedures to test the completeness and accuracy of the information presented in the supplemental information
 - Firms did not include a required statement that in forming its opinion, the firm evaluated whether the supplemental information, including its form and content, complied, in all material respects, with the specified regulatory requirements
 - Firms stated that the firm conducted its audit in accordance with GAAS rather than in accordance with PCAOB standards, as required by SEC Rule 17a-5(g)(1)
 - Firms referenced the incorrect regulatory requirement with which the supplemental information was to comply.
- In 2 of the audits inspected, the auditor's report on the financial statements did not include the word independent in the title of the report or did not identify statements that the firm had audited and that the broker-dealer filed with its financial statements.

- In 5 of the audits inspected, the auditor's report was dated prior to the date on which the auditor concluded that it had obtained sufficient, appropriate evidence.

.24 *Deficiencies related to audit documentation.* In 32 of the 115 audits selected for inspection, the PCAOB identified one or more deficiencies related to audit documentation. The following list further describes the identified deficiencies:

- In 9 of the audits inspected, firms did not complete an engagement completion document. In these audits, the firms also did not complete an engagement completion document in the related review engagements.
- In 21 of the audits inspected, firms prepared an engagement completion document, but did not include one or more relevant required items, such as significant findings or issues, including the results of auditing procedures performed in response to significant risks or the identification and evaluation of uncorrected misstatements.
- In 3 of the audits inspected, deficiencies related to other audit documentation matters.
 - In 2 of the 3 audits, the firms did not assemble a complete and final set of audit documentation by the documentation completion date.
 - In 2 of the 3 audits, the firms added documentation to the audit file after the documentation completion date but did not document the date the information was added, the name of the person who prepared the additional documentation, or the reasons for adding it.

.25 *Deficiencies related to engagement quality review.* In 66 of the 115 audits selected for inspection, the PCAOB identified one or more deficiencies related to engagement quality review. The following list further describes the identified deficiencies:

- In 8 of the audits inspected, firms did not have an engagement quality review performed for the audit prior to issuance of the engagement report, which compares to 7 audits identified in 2015. These firms also did not have an engagement quality review performed for the related review attestation engagement.
- In 57 of the audits inspected, the engagement quality review performed was not sufficient. For example, through inspection of the documentation relating to the engagement quality review performed, the engagement quality reviewer did not or did not sufficiently do one or more of the following:
 - Evaluate the engagement team's assessment of, and audit responses to, significant risks identified by the engagement team, including fraud risks
 - Review the engagement team's evaluation of the firm's independence in relation to the engagement

- Review the engagement completion document and confirm with the engagement partner that there were no significant unresolved matters
- Review the financial statements and the related engagement report.
- In 4 of the audits inspected, the engagement quality reviewer did not meet the required qualifications.

Deficiencies Related to Independence Communications

.26 *Deficiencies related to independence communications to the audit committee.* In 22 of the audits selected for inspection, the PCAOB identified one or more deficiencies related to independence communications. The following list further describes the identified deficiencies:

- In 11 of the 22 audits, the firm failed to make any written communication to the broker-dealer's audit committee, including failing to affirm in writing that the firm was independent of the broker-dealer in compliance with PCAOB Rule 3520, *Auditor Independence* (AICPA, *PCAOB Standards and Related Rules*).
- In the other 11 audits, the firm's independence was impaired because of certain non-audit service relationships (including book-keeping services and preparation of financial statements), but the firm failed to describe those relationships in writing to the audit committee (or equivalent) as relationships that may reasonably be thought to bear on independence.

Deficiencies Related to Attestation Engagements

.27 *Deficiencies related to examination procedures.* In 14 of the 20 attestation engagements selected for inspection, the PCAOB identified one or more deficiencies related to examination procedures. The following list further describes the identified deficiencies:

- In 5 of the examinations inspected, firms did not sufficiently plan the examination procedures over certain of the financial responsibility rules, because the firms failed to do one or more of the following:
 - Obtain an understanding, or a sufficient understanding, of the broker-dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules
 - Assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the net capital rule and the reserve requirements rule and the effectiveness of internal controls over compliance (ICOC)
 - Assess the risks associated with related parties that were relevant to compliance and controls over compliance
 - Inquire of management or other individuals at the broker-dealer who have relevant knowledge regarding regulatory examinations and correspondence between

the broker-dealer and regulatory agencies that are relevant to the broker-dealer's assertions

- Obtain an understanding of the nature and frequency of customer complaints that were relevant to compliance with the financial responsibility rules
- In 12 of the examinations inspected, firms did not test or sufficiently test controls over compliance with the financial responsibility rules.
- In 9 of the examinations inspected, the firms' performance of compliance tests to support their conclusions regarding whether the broker-dealer was in compliance with the net capital rule or the reserve requirements rule as of the end of its fiscal year.
- In one of the examinations inspected, firm appeared to be aware that the broker-dealer's amount on deposit in the broker-dealer's special reserve bank account at year end was less than the required deposit as reported in its customer reserve schedule, but that the broker-dealer's compliance report included an assertion that the broker-dealer was in compliance with the reserve requirements rule at year end. The firm did not modify its examination report to indicate that the broker-dealer was not in compliance with the reserve requirements rule as of the end of its fiscal year. In addition, the firm appeared to not have evaluated whether a material weakness in ICOC with the reserve requirements rule existed related to this matter.
- In one of the examinations inspected, the firm did not obtain written representations from management of the broker-dealer required by Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (AICPA, PCAOB Standards and Related Rules).

.28 *Deficiencies related to review procedures.* The PCAOB identified one or more deficiencies in 27 of the 95 attestation engagements selected for inspection related to review procedures. The following further describes the identified deficiencies:

- In 6 of the reviews inspected, firms did not gain an understanding of the broker-dealer's exemption conditions and did not consider certain risk factors in performing necessary inquiries and other review procedures.
- In 25 of the reviews inspected, the firms' inquiries and other review procedures were insufficient.
 - In 19 of these reviews, the firms did not perform all required inquiries, including those which involve obtaining an understanding of management's controls and monitoring activities in place to comply with the claimed exemption provisions.
 - In 14 of these reviews, the firms did not perform other procedures necessary to assess whether a material modification was necessary for the broker-dealer's assertions to be fairly stated.

- In one of the reviews inspected, the auditor's evaluation of the results of its review procedures was insufficient. Although information came to the auditor's attention indicating that one or more exceptions to the exemption provisions occurred during the year or might have existed at year-end, that were not disclosed in the exemption report and that might have caused one or more of the broker-dealer's assertions not to be fairly stated in all material respects, the auditor failed to perform additional procedures to address the matter.
- In 7 of the reviews inspected, firms did not obtain written representations from management of the broker-dealer required by Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (AICPA, PCAOB *Standards and Related Rules*).

Other Deficiencies Related to Examination Engagements

.29 *Deficiencies related to the examination report.* The PCAOB identified deficiencies in 2 of the 20 examinations selected for inspection. The following list further describes the identified deficiencies:

- In one of the examinations inspected, the firm stated in its examination report that the broker-dealer's responsibility for maintaining ICOC with respect to SEC Rule 15c3-3 was limited to SEC Rule 15c3-3(e), which is inconsistent with the definition of *ICOC* in Attestation Standard No. 1.
- In one of the examinations inspected, the firm did not express an adverse opinion in its examination report, even though it identified a material weakness in ICOC in its examination, and also did not include a statement in its examination report that 1 or more material weaknesses in ICOC had been identified during and as of the end of the fiscal year.

.30 *Deficiencies related to examination documentation.* The PCAOB identified deficiencies in one of the examinations selected for inspection.

In this one examination inspected, the firm did not complete an engagement completion document for the examination or include required documentation related to the examination in an engagement completion document prepared in connection with the corresponding audit. In addition, the firm did not assemble a complete and final set of audit documentation by the documentation completion date.

.31 *Deficiencies related to engagement quality review in an examination engagement.* The PCAOB identified one or more deficiencies in 4 of the 20 examinations selected for inspection. The following list further describes the identified deficiencies:

- In 4 of the examinations inspected, the engagement quality reviewer did not perform a sufficient review, including instances in which the engagement quality reviewer did not review the engagement report, failed to detect one or more errors in the engagement report, or failed to identify the absence of an engagement completion document.

- In one of the 4 examinations inspected, it appeared that the engagement quality reviewer's concurring approval of issuance of the examination report was provided despite the engagement quality reviewer being aware of the following:
 - The broker-dealer's amount on deposit in the broker-dealer's special reserve bank account at year end was less than the required deposit as reported in its customer reserve schedule.
 - The broker-dealer's compliance report included an assertion that the broker-dealer was in compliance with the reserve requirements rule at year end.
 - The engagement team had not evaluated whether a material weakness in ICOC with the reserve requirements rule existed related to this matter.
- In one of the 4 examinations inspected, the reviewer also did not appear to possess the level of knowledge and competence related to attestation procedures required in order to serve as the engagement partner on the engagement under review, given that the engagement quality reviewer had no experience with broker-dealer engagements.

Deficiencies Related to Review Engagements

.32 *Deficiencies related to the review report.* The PCAOB identified one or more deficiencies in 13 of the 95 attestation engagements selected for inspection related to review procedures. The following list further describes the identified deficiencies:

- In 13 of the reviews inspected, the auditor's review report did not comply with the requirements of Attestation Standard No. 2. For example, in these review reports, one or more of the following were true:
 - Report omitted the independent reference in the report title.
 - Report identified a different exemption than the exemption the broker-dealer operated under and specified in its exemption report.
 - Report omitted any reference to the provisions of SEC Rule 15c3-3 under which the broker-dealer claimed an exemption in its exemption report.
 - Report inaccurately stated that the broker-dealer met the identified exemption provision without exception when the broker-dealer's exemption report either indicated there were exceptions or the exemption report contained no such statement.
 - Report incorrectly made reference to the broker-dealer's assertions included within a supporting schedule of the broker-dealer, which was not an exemption report.
 - Report covered a different period than the period covered by the broker-dealer's exemption report.

- In 4 of the reviews inspected, the firm's review report was dated prior to the date of the broker-dealer's exemption report.

.33 *Deficiencies related to the review documentation.* The PCAOB identified one or more deficiencies in 20 of the 95 attestation engagements selected for inspection related to review procedures. The following further describes the identified deficiencies:

- In 9 of the reviews inspected, firms did not complete an engagement completion document for the review or include required documentation related to the review in an engagement completion document prepared in connection with the corresponding audit.

In one of these 9 reviews inspected, the firm did not assemble a complete and final set of audit documentation by the documentation completion date and did not document the date and explain the reasons for adding documentation after the documentation completion date.
- In 11 of the reviews inspected, firms prepared an engagement completion document, but did not include in it one or more required items related to the review, such as actions taken to address significant findings or issues, including risks requiring special consideration.

.34 *Deficiencies related to engagement quality review in a review engagement.* The PCAOB identified one or more deficiencies in 25 of the 95 attestation engagements selected for inspection related to review procedures. The following list further describes the identified deficiencies:

- In 8 of the reviews inspected, firms did not have an engagement quality review performed for the review engagement.
- In 15 of the reviews inspected, the engagement quality reviewer did not perform a sufficient review, including instances in which the engagement quality reviewer did not review the engagement report, failed to detect one or more errors in the engagement report, failed to identify the absence of an engagement completion document, or failed to review the engagement team's evaluation of the firm's independence.
- In 3 of the reviews inspected, the engagement quality reviewer did not meet the required qualifications.

.35 The PCAOB stated that it plans to perform inspections of 75 firms covering portions of approximately 115 audit and attestation engagements of brokers and dealers during 2017. The PCAOB will continue to focus on areas with deficiencies noted from past inspections.

.36 The interim inspection program was designed to cover a cross-section of audits of SEC-registered broker-dealers. The inspection program will continue until new rules for a permanent program are adopted and become effective. In accordance with the temporary rule regarding the interim inspection program, a report containing results of the inspections performed must be issued annually. As directed by the rule, the report does not name audit firms inspected, unlike the individual inspection reports of public company auditors. However, during an inspection, deficiencies were discussed with the firm. Any deficiencies that were considered to be significant were communicated to the firm in writing.

.37 The report states that the PCAOB is continuing to take a careful and informed approach in establishing a permanent inspection program recognizing the complexity and diversity of the broker-dealers. The PCAOB staff continue to work to further develop the contours of a potential rule proposal for a permanent inspection program. Until a permanent inspection program is in place, audits of issuer and nonissuer broker-dealers will remain subject to inspection under the PCAOB interim inspection program. Additionally, audits of nonissuer broker-dealers will remain subject to peer review under the AICPA peer review standards until such time that the AICPA Peer Review Board votes to exclude them from the scope of the standards.

Audit and Attestation Issues and Developments

The AICPA Enhancing Audit Quality Initiative

.38 The AICPA supports audit quality by attracting highly qualified individuals to enter the profession; developing a comprehensive examination for licensure; establishing auditing standards for private entities; supporting firms with educational guidance, tools, resources and implementation materials; monitoring the quality of performance while requiring appropriate remedial action where needed; and establishing and enforcing the AICPA Code of Professional Conduct.

.39 In 2014, in light of the increasingly complex business environment, the AICPA initiated a comprehensive effort to consider auditing of private entities through multiple touch points, particularly where quality issues have emerged. The goal was to align the objectives of all AICPA audit-related efforts to enhance audit performance.

.40 In 2015, the AICPA issued Enhancing Audit Quality—A 6-Point Plan to Improve Audits (aicpa.org/auditquality).

.41 This six-point plan (see figure 1) is a road map of current and future activities designed to enhance audit quality profession-wide at every step by doing the following:

- Attracting the best and brightest to the profession and preparing them for a career in auditing
- Developing and maintaining a robust CPA exam that reflects the realities of real-world practice and assesses the knowledge and skills needed by newly licensed CPAs
- Developing, updating, and communicating comprehensive standards to support quality performance
- Providing guidance and training to support competency
- Evolving the Peer Review Program to more effectively monitor practice, including detecting deficiencies and remediating firms, when necessary
- Conducting an enforcement program that is robust and meaningful when quality issues persist

.42 Following are some of the key accomplishments under each component of the six-point plan.

.43 *Point 1: Pre-licensure.* To encourage students to pursue CPA licensure, the pipeline is a coordinated and continuous process with established touch points along the way so that students have regular and consistent interaction as they move from high school to accounting major to exam candidate. The AICPA recognizes that evolving the CPA Exam provides another opportunity to enhance audit quality in the pre-licensure phase. The newest version of the CPA Exam, launched in April 2017, increases focus on higher-order skills, such as critical thinking, problem-solving, and analytical ability. Specifically, the audit and attestation (AUD) section of the exam expands testing to the analysis and evaluation levels, using more simulations that allow a candidate to demonstrate competence in recognizing issues, identifying errors, challenging assumptions and applying both professional judgment and skepticism.

.44 *Point 2: Standards and Ethics.* The Auditing Standards Board (ASB) continues to monitor the implementation of the clarified Statements on Auditing Standards and is working to improve the communicative value and relevance of the auditor's report through proposed revisions to generally accepted auditing standards. The Assurance Research Advisory Group was formed to drive practice-oriented assurance research to inform the standard-setting process.

.45 *Point 3: CPA Learning and Support.* The AICPA | CIMA Competency and Learning website provides a means for auditors to assess and improve their knowledge and competencies in various subject matter areas, including employee benefit plan (EBP) audits, governmental audits, information technology assurance, not-for-profit, financial accounting and reporting, and other assurance. Competency-based learning programs specific to EBP and single audit engagements include intermediate and advanced offerings that allow proficient practitioners to distinguish themselves in the marketplace through a certificate provided as a digital badge. These efforts underscore the AICPA's commitment to professional competency development by transitioning CPAs from a compliance- to a competency-based professional development model. New tools, resources and courses have been developed to support practitioners as they implement Statements on Quality Control Standards. AICPA Governmental and Employee Benefit Plan Audit Quality Centers and the Center for Plain English Accounting have continued to make major contributions driving quality improvements.

.46 *Point 4: Peer Review.* The AICPA has instituted reforms directed at enhancing the accountability of enrolled firms and their peer reviewers.

- The Enhanced Oversight Program, piloted in 2014 and expanded through 2016, has identified where peer review can be strengthened and has informed the Peer Review Program of changes that are needed, particularly regarding issue detection and remediation. In 2016, the number of engagements subject to enhanced oversight doubled and root cause analysis was added to the process.
- Reviewers are looking more deeply at certain industries and high-risk areas identified by the Peer Review Board (PRB), including EBP audits and single audits.
- New procedures instituted in January 2015 expedite removal from the Peer Review Program of poor performing firms that fail to remediate.

- New peer reviewer training requirements now in place facilitate detection and remediation of deficiencies by reviewers.
- A new data-matching program instituted in 2016 to increase the likelihood that all firms that should be enrolled in peer review are enrolled and that all engagements that should be subject to review are included in the scope of peer review.
- The Office of Management and Budget (OMB), *Uniform Guidance for Federal Awards*, requires a study of audit quality be performed every six years, and the results must be made public. The first study will occur in 2019 or 2020, as determined by OMB (on single audits reports submitted to the Federal Audit Clearinghouse no earlier than 2018). The AICPA is helping firms prepare for these quality reviews through outreach to raise awareness of the Uniform Guidance and educating firms on identifying and addressing quality issues.

.47 *Point 5: Practice Monitoring of the Future.* Response to the purposely provocative concept paper on transforming peer review into a near real-time practice monitoring process was robust, with more than 70 responses received before the end of the comment period. Responses recognized that peer review needs to evolve while expressing concern about what that evolution may entail. Those responses, together with the pilot of a self-monitoring tool for firms' internal use, will help inform next steps for the initiative.

.48 *Point 6: Enforcement.* The AICPA Professional Ethics Division is collaborating with the National Association of State Boards of Accountancy and the U.S. DOL on an initiative that allows the AICPA Ethics Division and U.S. Department of Labor to share investigative files with state boards of accountancy. Additionally, the Ethics Division is mining publicly available databases to identify potential issues for outreach to firms.

.49 You can find more information and additional EAQ resources at www.aicpa.org/interestareas/peerreview/pages/eaq.aspx.

Cybersecurity

.50 Malicious cyberattacks against public and private companies and various agencies of the federal government have highlighted the growing cybersecurity risk to organizations of all sizes, in all sectors. As trusted advisors, CPAs play a multifaceted role in cybersecurity risk management:

- They protect client and customer data. With cybersecurity attacks on the rise and CPA firms of all sizes having additional risk due to centralizing information for many clients in a single location, CPA firms must increase their awareness of potential internal risks and take proactive steps to safeguard valuable client and customer information.
- They advise clients. CPAs, especially those with a specialization in information technology, can share their expertise and best practices with clients, helping them address risks associated with cybersecurity.
- They provide assurance. As trusted business advisors, CPAs are uniquely positioned to provide an examination on an entity's cybersecurity risk management program to help instill confidence in an entity's efforts to address cybersecurity risks.

.51 The AICPA has developed a new guide to help practitioners. AICPA Attestation Guide *Reporting on an Entity's Cybersecurity Risk Management Program and Controls* is available at www.aicpastore.com. Additional resources are also available at the AICPA Cybersecurity Resource Center at www.aicpa.org/interestareas/frc/assuranceadvisoryservices/pages/cybersecurity-resource-center.aspx.

Auditing Standards Board

Auditor's Involvement With Exempt Offering Documents

.52 In July 2017, the AICPA's ASB issued Statement on Auditing Standards (SAS) No. 133, *Auditor Involvement With Exempt Offering Documents* (AICPA, *Professional Standards*, AU-C sec. 945).

.53 SAS No. 133 does not amend or supersede any previous SAS, and will be effective for exempt offering documents with which the auditor is involved that are initially distributed, circulated, or submitted on or after June 15, 2018.

.54 The primary objective in the development of SAS No. 133 was to establish when an auditor is involved with an exempt offering document and the procedures required when involved.

Background

.55 Prior to the issuance of SAS No. 133, the AICPA provided best practices regarding the auditor's responsibilities with respect to exempt offerings through industry-specific auditing guidance appearing in AICPA Audit and Accounting Guides *State and Local Governments* and *Health Care Entities*. Given both the size of the exempt market and the added complexities and risk in the market since the original best practice guidance was developed, the ASB decided to establish standards-level responsibilities for auditor involvement in exempt offerings. Professional standards already address other offerings through AU-C section 925, *Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933*. The best practices addressed in AICPA guides were specific to issuances of municipal securities; the ASB broadened the scope of the project to address auditor involvement with offerings of securities exempt from registration under the Securities Act of 1933, as amended, and to franchise offerings.

The Role of the SEC and Current SEC Requirements

.56 Certain securities, whether the transaction or the securities themselves, are exempt from the provisions of the Securities Act of 1933 (1933 act) and the Securities Exchange Act of 1934 (1934 act) except for the antifraud provisions of those acts, which prohibit any person from misrepresenting or omitting material facts in an offering or sale of securities.

.57 Given the exemption from the provisions of the 1933 and 1934 acts, the SEC cannot directly regulate those offering exempt securities and there are no laws or regulations requiring auditors to participate in or undertake any procedures with respect to an exempt offering document. Instead, there is an indirect system of regulation in which the SEC imposes certain regulatory requirements on the underwriters of exempt offerings related to the entity's disclosure at the time of issuance as well as post-issuance. In the case of municipal securities, offerings are subject to primary market disclosures at the time of sale which are made by issuing an official statement.

The Role of the FTC and Current FTC Requirements

.58 Franchise offerings are regulated at the federal level via the Federal Trade Commission (FTC). A franchise disclosure document (FDD) serves as the exempt offering document for franchise offerings. The FDD is updated at least annually for use in selling franchises. The FTC rule requires annual audited financial statements (with a phase-in period) within 120 days of the close fiscal year. Certain states require an auditor's consent to use the auditor's report in the FDD.

Unique Considerations With Exempt Offerings

.59 Several areas of SAS No. 133 contrast an auditor's professional liability under exempt offerings to an auditor's statutory liability under registered offerings. Among other consequences, exemption from the regulatory scheme of the 1933 act means that no rules exist for delineating responsibility (and liability) among the parties involved in preparation of an offering document or providing the basis for a statutory due diligence defense.

.60 Section 11 of the 1933 act imposes civil liability on, among others, the underwriters and "experts" involved in the preparation of a registration statement (such as, auditors, engineers, appraisers, or other professionals who have consented to be named as having certified the portion of the registration statement covered by their reports). If the registration statement contains inaccurate or misleading statements or omissions that are material, investors can bring legal action against those parties.

Experts

.61 Section 11 of the 1933 act delineates "expertized" information in a registration statement from "non-expertized" information. The expertized sections contain statements made on the authority of experts who have prepared or certified certain information in the registration statement. (The term *expert* has a specific statutory meaning under the 1933 act.) Most registration statements related to underwritten offerings will contain a section titled "Experts" identifying those parties. Experts have civil liability for the portions of the registration they have prepared or certified; accordingly, their consent to be named in the registration statement must be obtained. An auditor's report on audited financial statements in a registration statement is an example of an expert's opinion. Standardized language used in the experts section to describe the auditor's role typically indicates that the auditor's report has been given "on the auditor's authority as an expert in accounting and auditing."

Underwriter Due Diligence

.62 The underwriter (or lead underwriter) in a registered offering must conduct an in-depth due diligence investigation of the entity issuing the offering and the information contained in the registration statement before offering the securities to potential investors. For the expertized sections of the registration statement, underwriters place extensive reliance on the experts' reports certifying those sections. For non-expertized portions of the registration statement, an underwriter will often seek outside professional assistance if appropriate. For example, an underwriter might request a comfort letter from the entity's auditor in connection with unaudited financial information included in the offering, or might request that an attestation engagement be performed to support due diligence on matters such as historic compliance with revenue or debt covenants.

Scope and Requirements of the Standard

.63 SAS No. 133 includes performance requirements when the auditor is involved with an exempt offering document. Exempt offerings are defined as securities exempt from registration under the 1933 act, as amended, or franchise offerings regulated by the FTC (as discussed in exhibit A of SAS No. 133). Examples include the following:

- Municipal bonds
- Securities issued by non-profit religious, education or charitable organizations
- Crowdfunding
- Small issues of securities (for example, Regulation A offerings)
- Franchise offerings

.64 Involvement is determined by a two-benchmark model:

- The auditor's report on financial statements or the auditor's review report on interim financial information is included or incorporated by reference in an exempt offering document.
- The auditor performs one or more specified activities with respect to the exempt offering document. Specified activities which trigger involvement are as follows:
 - Assisting the entity in preparing information included in the exempt offering document
 - Reading a draft of the exempt offering document at the entity's request
 - Issuing a comfort or similar letter in accordance with AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties*, or an agreed-upon procedures report in accordance with AT-C section 215, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), in lieu of a comfort or similar letter on information included in the exempt offering document
 - Participating in due diligence discussions with underwriters, placement agents, broker-dealers, or other financial intermediaries in connection with the exempt offering
 - Issuing a practitioner's attestation report on information relating to the exempt offering
 - Providing written agreement for the use of the auditor's report in the exempt offering document
 - Updating an auditor's report for inclusion in the exempt offering document

.65 When the auditor is involved with an exempt offering document, SAS No. 133 requires the auditor to perform the following:

- Procedures described in paragraphs .06–.18 of AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*, on the exempt offering document

- Procedures designed to identify events occurring between the date of the auditor's report and the date of the distribution, circulation, or submission of the exempt offering document that, had they been known to the auditor as of the date of the auditor's report, may have caused the auditor to revise the auditor's report

.66 The SAS discusses requirements and considerations when the auditor identifies subsequent events or subsequently discovered facts.

.67 Although an auditor is not required to become involved in an exempt offering document unless the benchmarks defining involvement are met, auditors are not precluded from becoming voluntarily involved with an offering document in other circumstances.

Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

.68 In February 2017, the ASB issued SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU-C sec. 570).

.69 SAS No. 132 supersedes SAS No. 126 of the same title and will be effective for (a) audits of financial statements for periods ending on or after December 15, 2017, and (b) reviews of interim financial information (as defined in AU-C section 930, *Interim Financial Information*) for interim periods beginning after fiscal years ending on or after December 15, 2017.

.70 The primary objective in the development of SAS No. 132 was to consider the accounting provisions of FASB Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements—Going Concern* (Subtopic 205-40): *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, and GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* (GASB Statement No. 56).

Background

.71 SAS No. 126, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (Redrafted) was issued by the ASB in June 2012 to apply the clarity drafting conventions to, and to supersede, SAS No. 59 of the same title, as amended.

.72 At the time SAS No. 126 was issued, FASB standards did not address management's responsibilities for evaluation of substantial doubt about an entity's ability to continue as a going concern. As a result, SAS No. 126 clarified SAS No. 59, as amended, but did not converge with the International Auditing and Assurance Standards Board's (IAASB) International Standard on Auditing (ISA) 570 (Revised), *Going Concern* (ISA 570 Revised), which was subsequently issued in January 2015. In August 2014, FASB issued ASU No. 2014-15, which is effective for annual periods ending after December 15, 2016, and for interim periods thereafter.

.73 Additionally, GASB Statement No. 56 establishes guidance related to management's responsibilities for assessing going concern for governmental entities.

.74 In January 2015, the IAASB issued its revised auditor reporting standards which, among other things, included revisions to ISA 570 (Revised). The

IAASB's auditor reporting standards, including ISA 570 (Revised), are effective for audits of financial statements for periods ending on or after December 15, 2016.

.75 Also in January 2015, the ASB issued four new auditing interpretations to SAS No. 126, which were withdrawn with the issuance of SAS No. 132.

.76 In July 2016, the ASB released Proposed SAS, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to supersede SAS No. 126, in light of the impending effective date of FASB ASU No. 2014-15. The ASB used ISA 570 (Revised) as the base and wrote the proposed SAS in a neutral accounting framework manner.

.77 The ASB's strategy is to converge its standards with those of the IAASB. Accordingly, in developing SAS No. 132, the ASB used ISA 570 (Revised) as the base. However, SAS No. 132 does not reflect any revisions to ISA 570 (Revised) related to the convergence with the IAASB's other auditor reporting standards.

.78 SAS No. 132 is intended to be applicable to audits of financial statements prepared under different financial accounting frameworks and, accordingly, was written in a neutral accounting framework manner. However, in discussing certain concepts, reference to certain accounting terms is necessary. To better explain and illustrate those concepts, the ASB used terminology that is more common in the United States, such as terminology from the FASB standards and GASB statements.

Changes From Existing Standards

.79 The following paragraphs discuss what the ASB believes are the most significant changes to the existing auditing standards resulting from the issuance SAS No. 132.

.80 *Auditor's objectives and related conclusions.* SAS No. 132 clarifies that the auditor's objectives include separate determinations and conclusions with respect to (1) the use of the going concern basis of accounting, when relevant, in the preparation of the financial statements, and (2) the audit evidence obtained whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists.

.81 *Financial support by third parties or the entity's owner-manager.* SAS No. 132 includes a new requirement with respect to financial support by third-parties or the entities' owner-manager. In circumstances in which management's plans include financial support by third parties or the entity's owner-manager and such evidence is necessary in supporting management's assertions about the entity's ability to continue as a going concern for a reasonable period of time, the auditor is required to obtain sufficient appropriate audit evidence about the intent and ability of such parties to provide the necessary financial support.

.82 The application material of SAS No. 132 explains that the intent to provide the necessary financial support may be evidenced by either (a) obtaining from management written evidence about the third party commitment or (b) confirming directly with the supporting party. The application material further explains that when the financial support is provided by an owner-manager, the evidence regarding intent may be in the form of a support letter or a written

representation. Finally, the application material provides illustrative wording of a third party support letter.

.83 *Period beyond management's assessment.* SAS No. 132 includes a requirement for the auditor to inquire of management regarding its knowledge of conditions or events beyond the period of management's evaluation that may have an effect on the entity's ability to continue as a going concern. The inquiries are not intended to require management to extend its evaluation period but may affect other disclosure requirements or consideration of whether the financial statements are fairly presented.

.84 *Use of emphasis paragraphs when substantial doubt is alleviated.* The application material of SAS No. 132 includes an example of an emphasis of matter paragraph that an auditor may choose to include to highlight the liquidity issues related to management disclosures when the auditor concludes that substantial doubt has been alleviated by management's plans.

.85 *Interim financial information.* In issuing SAS No. 132, the ASB also amends AU-C section 930. Under extant AU-C section 930, the auditor is required to perform inquiries and consider the adequacy of disclosures to address the issue of substantial doubt about the entity's ability to continue as a going concern if (a) conditions or events that may indicate substantial doubt about an entity's ability to continue as a going concern existed at the date of the prior period financial statements, regardless of whether the substantial doubt was alleviated by the auditor's consideration of management's plans or (b) in the course of performing review procedures on the current period interim financial information, the auditor becomes aware of conditions or events that might be indicative of the entity's inability to continue as a going concern. AU-C section 930 provides the auditor an option to include an emphasis-of-matter paragraph in the review report when management's disclosures are adequate.

.86 The ASB decided to require the performance of review procedures to address the situations in which the applicable financial reporting framework includes requirements for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing interim financial information. The amendments to AU-C section 930 reflect a new requirement for the auditor to include an emphasis-of-matter paragraph in the review report when certain conditions or events exist related to substantial doubt about an entity's ability to continue as a going concern. This decision was based on the ASB's desire to achieve consistency in auditor reporting in both the annual audit and interim financial information.

.87 *Financial statements prepared in accordance with a special purpose framework.* In the scope section, SAS No. 132 makes it clearer that the issues of going concern basis of accounting and whether substantial doubt exists are separate issues. As a result, when the going concern basis of accounting is not relevant, the requirement of SAS No. 132 to obtain sufficient appropriate audit evidence regarding, and to conclude on, the appropriateness of management's use of the going concern basis of accounting does not apply. However, irrespective of whether the going concern basis of accounting is relevant in the preparation of special purpose financial statements, the requirements of SAS No. 132 apply regarding the auditor's responsibilities to conclude, based on the audit evidence obtained, whether substantial doubt exists and to evaluate the possible financial statement effects.

Accounting and Review Services Committee

Preparation and Compilation of Prospective Financial Information

.88 In October, 2016 the AICPA's Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016*, to amend AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Accounting and Review Services*; AR-C section 70, *Preparation of Financial Statements*; AR-C section 80, *Compilation Engagements*; and AR-C section 90, *Review of Financial Statements* (AICPA, *Professional Standards*).

.89 This standard amends AR-C section 60 as follows:

- Revises the applicability so that SSARSs apply to engagements performed on subject matter other than financial statements
- Includes definitions of *financial statements* and *prospective financial information*, harmonizes the definitions of *engagement team* and *professional judgment* to those included in the clarified auditing standards, and clarifies the definitions of *other preparation, compilation, and review publications*
- Includes a mandatory requirement for the accountant to document the justification for a departure from a relevant presumptively mandatory requirement and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of the requirement
- Revises the requirement for the accountant to obtain the agreement of management that it acknowledges and understands its responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error, so that the requirement does not apply if the accountant decides to accept responsibility for such internal control

.90 This standard amends AR-C section 70 as follows:

- Expands the subject matter to which the section should be applied to include prospective financial information and to clarify when the section applies, when the section may be applied, and when the section does not apply
- Clarifies that AICPA Guide *Prospective Financial Information* provides comprehensive guidance regarding prospective financial information including suitable criteria for the preparation and presentation of prospective financial information and clarifies that the accountant is not prohibited from preparing prospective financial information prepared and presented in accordance with other suitable criteria
- Clarifies the nature of an engagement letter and makes clear that an oral understanding of the terms of the engagement is insufficient
- Clarifies that when the accountant is unable to include a statement on each page of the financial statements indicating, at a

minimum, that "no assurance is provided" on the financial statements that the accountant may withdraw from the engagement

- Includes a requirement that because the summary of significant assumptions is essential to the user's understanding of prospective financial information, the accountant should not prepare prospective financial information that excludes disclosure of the summary of significant assumptions or a financial projection that excludes either an identification of the hypothetical assumptions or a description of the limitations on the usefulness of the presentation

.91 This standard amends AR-C section 80 as follows:

- Expands the subject matter to which the section should be applied to include prospective financial information, pro forma financial information, and other historical financial information
- Clarifies that AICPA Guide *Prospective Financial Information* provides comprehensive guidance regarding prospective financial information including suitable criteria for the preparation and presentation of prospective financial information; and clarifies that the accountant is not prohibited from performing a compilation engagement on prospective financial information prepared and presented in accordance with other suitable criteria
- Clarifies the nature of an engagement letter and makes clear that an oral understanding of the terms of the engagement is insufficient
- Harmonizes guidance with respect to the requirement that the accountant's compilation report include the signature of the accountant or the accountant's firm with that included in AR-C section 90 for an accountant's review report
- Includes requirements when the accountant is issuing a compilation report on prospective financial information
- Clarifies that the accountant is required to disclose known departures from the applicable financial reporting framework in the accountant's compilation report and that when the accountant becomes aware of a departure from the applicable financial reporting framework that is material to the financial statements and the financial statements are not revised, the accountant is required to consider whether modification of the standard report is adequate to disclose the departure

.92 This standard amends AR-C section 90 as follows:

- Clarifies that AR-C section 90 applies to reviews of all historical financial information, excluding pro forma financial information
- Clarifies the definition of *supplementary information*
- Clarifies the nature of an engagement letter and makes clear that an oral understanding of the terms of the engagement is insufficient
- Revises the requirement that the engagement letter or other suitable form of written agreement be signed by

— the accountant or the accountant's firm and

- management or those charged with governance as appropriate to use language consistent with that used in corresponding paragraphs in AR-C section 70 and AR-C section 80
- Harmonizes the requirement that the accountant's review report include the signature of the accountant or the accountant's firm with that included in AR-C section 80 for an accountant's compilation report
- Revises the accountant's reporting responsibilities when supplementary information accompanies reviewed financial statements and the accountant's review report thereon

.93 The revisions to AR-C section 60 and AR-C section 90 became effective upon issuance in October, 2016.

.94 The revisions to AR-C section 70 became effective upon issuance with the exception of the revisions to paragraphs .01 and .A1 and new paragraphs .19 and .A1–.A2, which became effective for prospective financial information prepared on or after May 1, 2017.

.95 The revisions to AR-C section 80 became effective upon issuance with the exception of the revisions to paragraphs .01 and .A1 and new paragraphs .24–.25, .A1–.A2, and .A5 which became effective for compilation reports on prospective financial information dated on or after May 1, 2017.

Compilation of Pro Forma Financial Information

.96 As part of its clarity project, in September 2016, the ARSC issued SSARS No. 22, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, AR-C section 120), which superseded SSARS No. 14, of the same title, as amended. SSARS No. 22 became effective for compilation reports on pro forma financial information dated on or after May 1, 2017.

The Public Company Accounting Oversight Board

Auditor's Report

.97 In June 2017, the PCAOB adopted a new auditor reporting standard, AS 3101, *The Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (AICPA, *PCAOB Standards and Related Rules*), and related amendments to its auditing standards that will require the auditor to provide new information about the audit.

.98 The final standard retains the pass or fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters. These are matters communicated or required to be communicated to the audit committee and that
 - relate to accounts or disclosures that are material to the financial statements and
 - involved especially challenging, subjective, or complex auditor judgment.

- Disclosure of auditor tenure. This is the year in which the auditor began serving consecutively as the company's auditor.
- Other improvements to the auditor's report. A number of other improvements to the auditor's report were added to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

.99 Investors are the beneficiaries of the audit and the auditor's report is the primary means by which the auditor communicates with them. Currently, however, the auditor's report conveys little of the information obtained and evaluated by the auditor as part of the audit. Also, though the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global and the financial reporting frameworks have evolved toward an increasing use of estimates, including fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, but the auditor's report does not communicate this information to investors. The PCAOB believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. Outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

.100 The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment and how the auditor addressed these matters. The PCAOB believes that these matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as these:

- Significant management estimates and judgments made in preparing the financial statements
- Areas of high financial statement and audit risk
- Significant unusual transactions
- Other significant changes in the financial statements

.101 The final standard is designed to elicit more information about the audit directly from the auditor. The PCAOB believes that the critical audit matter requirements will respond to requests from investors for more information from the auditor while appropriately addressing concerns raised by other commenters.

.102 AS 3101 also includes a new required statement in the auditor's report disclosing the year in which the auditor began serving consecutively as the company's auditor, as well as a number of other improvements to the auditor's report, such as a statement regarding the requirement for the auditor to be independent. Requiring disclosure of auditor tenure in the auditor's report will make this information readily accessible in a timely way for investors who find it useful. The other improvements to the auditor's report are intended to enhance the user's understanding of the auditor's role and responsibilities related to the audit of the financial statements, make the auditor's report easier to read, and provide a consistent format.

.103 AS 3101 will generally apply to audits conducted under PCAOB standards. However, communication of critical audit matters is not required for audits of brokers and dealers reporting under Rule 17a-5 of the 1934 act,

investment companies other than business development companies, employee stock purchase, savings, and similar plans, and emerging growth companies, as defined in Section 3(a)(80) of the 1934 act. Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily. The other requirements of the final standard will apply to these audits.

.104 Critical audit matters are determined using a principles-based framework and the PCAOB anticipates that the level of auditor effort will depend on the nature and complexity of the audit.

.105 Subject to approval by the SEC, the final standard and amendments will take effect as follows:

- All provisions other than those related to critical audit matters will take effect for audits of fiscal years ending on or after December 15, 2017.
- Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers, and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

.106 Auditors may elect to comply before the effective date at any point after SEC approval of the final standard.

Developments in Peer Review

.107 The Peer Review Information System Manager has been replaced with an all-electric, interactive system called the Peer Review Integrated Management Application. This new platform will allow for faster updates for the needs of practice monitoring and other users, such state boards and Peer Review Administrators. It will bring new and improved features and more opportunities for firm self-service. Updated functionality for the public file, reviewer search and facilitated state board access will be integrated into this new website, with continued access at www.aicpa.org. Additional information related to the new system can be found at www.aicpa.org/interestareas/peerreview/pages/prima.aspx.

Common Peer Review Findings

.108 In order to be admitted to or retain their membership in the AICPA, members who are engaged in the practice of public accounting in the United States or its territories are required to be practicing as partners or employees of firms enrolled in an approved practice-monitoring program. If practicing in firms that are not eligible to enroll, members must enroll in an approved practice-monitoring program if the services performed by such a firm or individual are within the scope of the AICPA's practice-monitoring standards, and the firm or individual issues reports purporting to be in accordance with AICPA professional standards.

.109 Firms have peer reviews because of the public interest in the quality of the accounting, auditing, and attestation services provided by public accounting firms. In addition, firms indicate that peer review contributes to the quality and effectiveness of their practices. Furthermore, most state boards of accountancy require their licensees to undergo peer review, or compliance assurance, to practice in their state. Other regulators require peer review in order to perform engagements and issue reports under their standards.

.110 Firms are required to perform engagements in accordance with professional standards, and accordingly the standards are the basis for peer reviews. You can find training and frequently asked questions about the AICPA Peer Review Program at www.aicpa.org/interestareas/peerreview/pages/peerreviewhome.aspx.

.111 The most common findings in recent peer reviews, as released by the peer review division of the AICPA follow.

.112 *Failure to date the auditor's report appropriately, such as dating the report significantly earlier than the date of the review of the working papers and the release date.* Paragraph .41 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that

- the audit documentation has been reviewed;
- all statements that the financial statements comprise, including the related notes, have been prepared; and
- management has asserted that they have taken responsibility for those financial statements.

.113 *Failure to adequately document sampling methodology.* AU-C section 530, *Audit Sampling*, provides guidance about how to perform sampling during an audit engagement. However, if the sampling methodology is not documented, then the reviewer may not be able to evaluate whether the procedure provided appropriate audit evidence.

.114 *Failure to include audit documentation that contains sufficient competent evidence to support the firm's opinion on the financial statements.* AU-C section 230, *Audit Documentation*, addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. The specific documentation requirements of other AU-C sections do not limit the application of this section. Law, regulation, or other standards may establish additional documentation requirements.

.115 *Failure to update the auditor's report for the clarified auditing standards.* The clarified auditing standards became effective for audits of financial statements for periods ending on or after December 15, 2012. The exhibit "Illustrations of Auditor's Reports on Financial Statements" in AU-C section 700 provides examples of clarified auditor's reports.

.116 *Failure to appropriately address fraud considerations.* AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, addresses the auditor's responsibilities relating to fraud in an audit of financial statements. It expands on how AU-C section 315 and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, are to be applied regarding risks of material misstatement due to fraud.

.117 *Failure to appropriately document planning procedures relating to risk assessment and the linkage of risks to the procedures performed.* AU-C section 315 addresses the auditor's responsibilities relating to risk assessment and the linkage of the identified risks to the planned audit procedures. AU-C section 330 addresses the auditor's responsibility to design and implement responses

to the risks of material misstatements identified and assessed by the auditor during the planning of the audit.

.118 *Failure to communicate or document required communications with those charged with governance.* AU-C section 260, *The Auditor's Communication With Those Charged With Governance*, establishes guidance regarding the auditor's requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance regarding the audit. AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, addresses the auditor's responsibility to appropriately communicate to those charged with governance any significant deficiencies or material weaknesses in internal control that the auditor has identified in an audit of financial statements.

.119 *Failure to obtain appropriate management representation letters including failure to update the letter in conformity with the clarified auditing standard's requirements, date the letter appropriately, include the appropriate financial statement periods, and include required representations.* AU-C section 580, *Written Representations*, addresses the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance in an audit of financial statements. Examples and required representations are included in the AU-C section 580 to help the auditor in drafting the letter for management.

Attestation Clarity Project

.120 The ASB has completed clarifying Statements on Standards for Attestation Engagements (SSAEs or attestation standards) and has issued its clarified attestation standards as SSAE No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*). SSAE No. 18 was issued in April 2016 and became effective for practitioners' reports dated on or after May 1, 2017.

.121 The attestation standards establish requirements for performing and reporting on examination, review, and agreed-upon procedures engagements that enable practitioners to report on subject matter ordinarily other than historical financial statements, for example, an entity's compliance with laws or regulations, the effectiveness of an entity's controls over the security of a system, or the fairness of the presentation of a statement of greenhouse gas emissions.

.122 The attestation standards are developed and issued in the form of SSAEs and are codified into sections. The identifier "AT-C" is used to differentiate the sections of the clarified attestation standards (AT-C sections) in AICPA *Professional Standards* from the sections of the attestation standards that are superseded by SSAE No. 18 (AT sections).

.123 In clarifying the attestation standards, the ASB used the same drafting conventions as those used to clarify the auditing standards to make the standards easier to read, understand, and apply.

Restructuring the Attestation Standards

.124 The attestation standards provide for three types of services—examination, review, and agreed-upon procedures. SSAE No. 18 restructures the attestation standards so that the applicability of any AT-C section of the

attestation standards to a particular engagement depends on the type of service provided and the subject matter of the engagement.

.125 AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*), contains requirements and application guidance applicable to all attestation engagements. AT-C sections 205, *Examination Engagements*; 210, *Review Engagements*; and 215 (AICPA, *Professional Standards*), each contain additional requirements and application guidance specific to the type of service performed. The applicable requirements and application guidance for any attestation engagement are contained in at least two AT-C sections: AT-C section 105 and either AT-C sections 205, 210, or 215, depending on the type of service provided.

.126 Incremental performance and reporting requirements and application guidance unique to five subject matters are included in the subject matter-specific AT-C sections. Those sections address prospective financial information, pro forma financial information, compliance attestation, controls at a service organization relevant to user entities' internal control over financial reporting, and management's discussion and analysis. The applicable requirements and application guidance for a subject matter-specific engagement are contained in three AT-C sections: AT-C section 105; AT-C section 205, 210, or 215, depending on the type of service provided; and the applicable subject matter section.

AT-C Sections

.127 SSAE No. 18 contains the following AT-C sections:

- AT-C Preface
- AT-C section 105
- AT-C section 205
- AT-C section 210
- AT-C section 215
- AT-C section 305, *Prospective Financial Information* (AICPA, *Professional Standards*) (formerly AT 301)
- AT-C section 310, *Reporting on Pro Forma Financial Information* (AICPA, *Professional Standards*) (formerly AT 401)
- AT-C section 315, *Compliance Attestation* (AICPA, *Professional Standards*) (formerly AT 601)
- AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* (AICPA, *Professional Standards*) (formerly AT 801)
- AT-C section 395, *Management's Discussion and Analysis* (AICPA, *Professional Standards*) (formerly AT 701)

Revenue Recognition

Overview

.128 On May 28, 2014, the International Accounting Standards Board (IASB) and FASB issued a joint accounting standard on revenue recognition

to address a number of concerns regarding the complexity and lack of consistency surrounding the accounting for revenue transactions. Consistent with each board's policy, FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued International Financial Reporting Standard (IFRS) 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 will amend the FASB ASC by creating topic 606, *Revenue from Contracts with Customers*, and subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in ASU No. 2014-09 provides what FASB describes as a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, as well as guidance within the 900 series of industry-specific topics.

.129 As part of the boards' efforts to converge U.S. GAAP and IFRSs, the standard eliminates the transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replaces it with a principles-based approach for revenue recognition. The intent is to avoid inconsistencies of accounting treatment across different geographies and industries. In addition to improving comparability of revenue recognition practices, the new guidance provides more useful information to financial statement users through enhanced disclosure requirements. FASB and the IASB have essentially achieved convergence with these standards, with some minor differences related to the collectibility threshold, interim disclosure requirements, early application and effective date, impairment loss reversal, and nonpublic entity requirements.

.130 The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Effective or Applicability Date

.131 On August 12, 2015, FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, to allow entities additional time to implement systems, gather data, and resolve implementation questions. This update allows for public business entities, certain not-for-profit entities, and certain employee benefit plans to apply the new requirements to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

.132 All other entities will now apply the guidance in ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Application is permitted earlier only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in ASU No. 2014-09. It is not expected that any additional deferrals of ASU No. 2014-09 will be issued.

Overview of the New Guidance

.133 The core principle of the revised revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services

to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those good or services.

.134 To apply the proposed revenue recognition standard, ASU No. 2014-09 states that an entity should follow these five steps:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

.135 Under the new standard, revenue is recognized when a company satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). See the following discussion of the five steps involved when recognizing revenue under the new guidance.

Understanding the Five-Step Process

Step 1: Identify the Contract(s) With a Customer

.136 ASU No. 2014-09 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." The new standard affects contracts with a customer that meet the following criteria:

- It has the approval (in writing, orally, or in accordance with other customary business practices) and commitment of the parties.
- The rights of the parties are identified.
- The payment terms are identified.
- The contract has commercial substance.
- It is probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

.137 A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties).

Step 2: Identify the Performance Obligations in the Contract

.138 A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer.

.139 At contract inception, an entity should assess the goods or services promised in a contract with a customer and identify as a performance obligation (possibly multiple performance obligations) each promise to transfer to the customer either

- a good or service (or bundle of goods or services) that is distinct or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

.140 A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Step 3: Determine the Transaction Price

.141 The transaction price is the amount of consideration (fixed or variable) the entity expects to receive in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity should consider the effects of

- variable consideration,
- constraining estimates of variable consideration,
- the existence of a significant financing component,
- noncash considerations, and
- consideration payable to the customer.

.142 If the consideration promised in a contract includes a variable amount, then an entity should estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. An entity would then include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

.143 An entity should consider the terms of the contract and its customary business practices to determine the transaction price.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

.144 The transaction price is allocated to separate performance obligations in proportion to the standalone selling price of the promised goods or services. If a standalone selling price is not directly observable, then an entity should estimate it. Reallocation of the transaction price for changes in the standalone selling price is not permitted. When estimating the standalone selling price, entities can use various methods, including the adjusted market assessment approach, expected cost plus a margin approach, and residual approach (only if the selling price is highly variable and uncertain).

.145 Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to one of the performance obligations in a contract. Guidance under the new standard specifies when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s), rather than to all the performance obligations in the contract.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

.146 The amount of revenue recognized when transferring the promised good or service to a customer is equal to the amount allocated to the satisfied performance obligation, which may be satisfied at a point in time or over time.

Control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Control also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

.147 When a performance obligation is satisfied over time, the entity should select an appropriate method for measuring its progress toward complete satisfaction of that performance obligation. The standard discusses methods of measuring progress, including input and output methods, and how to determine which method is appropriate.

Additional Guidance Under the New Standard

.148 In addition to the five-step process for recognizing revenue, ASU No. 2014-09 also addresses the following areas:

- Accounting for incremental costs of obtaining a contract, as well as costs incurred to fulfill a contract
- Licenses
- Warranties

.149 Lastly, the new guidance enhances disclosure requirements by requiring entities to include more information about specific revenue contracts entered into, including performance obligations and the transaction price.

Transition Resource Group

.150 Due to the potential for significant changes that may result from the issuance of the new standard, FASB and the IASB have received an abundance of implementation questions from interested parties. To address these questions, the boards have formed a joint Transition Resource Group (TRG) for revenue recognition to promote effective implementation and transition to the converged standard.

.151 Since the issuance of the standard, the TRG has met several times to discuss implementation issues raised by concerned parties and actions to take to address these issues. Refer to FASB's TRG website (www.fasb.org/jsp/fasb/page/landingpage&cid=1176164065747) for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Latest Developments

.152 Based on discussions held thus far on individual areas affected by the new standard, the TRG informed the boards that technical corrections are needed to further articulate the guidance in the standard. As a result, FASB has issued updates to clarify guidance on performance obligations, licensing, principal versus agent considerations, and other narrow-scope improvements and practical expedients.

.153 ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, was issued in March 2016 to clarify the guidance in FASB ASC 606 with respect to principal versus agent. There is little disagreement that an entity who is a principal recognizes revenue in the gross amount of consideration when a performance obligation is satisfied. An entity who is an agent (collecting revenue on behalf of the principal) recognizes revenue only to the extent

of the commission or fee that the agent collects. With this ASU, FASB hopes to eliminate the potential diversity in practice when determining whether an entity is a principal or an agent by clarifying the following:

- An entity determines whether it is a principal or an agent for each distinct good or service.
- An entity determines the nature of each specified good or service (including whether it is a right to a good or service).
- When an entity is a principal, it obtains control of the following:
 - A good or another asset from another party that it then transfers to the customer
 - A right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf
 - A good or service from another party that the entity combines with other goods or services to provide the specified good or service to the customer
- Indicators in the assessment of control may be more or less relevant or persuasive, or both, to the control assessment, depending on the facts and circumstances.

.154 Additional illustrative examples are provided in ASU No. 2016-08 to further assist practitioners in applying this guidance. The effective date of this update is with the same as the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

.155 ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, was issued in April 2016 to reduce potential for diversity in practice at initial application of FASB ASC 606, as well as to reduce the cost and complexity of applying FASB ASC 606 at transition and on an ongoing basis. When identifying promised goods and services in a contract, this ASU states that entities

- are not required to assess whether promised goods or services are performance obligations if they are immaterial to the contract.
- can elect to account for shipping and handling activities as an activity to fulfill promises within the contract rather than as an additional promised service.

.156 When assessing whether promised goods or services are distinct, this ASU emphasizes the need to determine whether the nature of the promise is to transfer

- each of the goods or services or
- a combined item (or items) to which the promised goods or services are inputs.

.157 With regard to licensing, ASU No. 2016-10 clarifies, as follows, whether revenue should be recognized at a point in time or over time based on whether the license provides a right to use an entity's intellectual property or a right to access the entity's intellectual property:

- If the intellectual property has significant standalone functionality, the license does not include supporting or maintaining that intellectual property during the license period. Therefore, the performance obligation would be considered satisfied at a point in time. Examples of this type of intellectual property include software, biological compounds or drug formulas, and media.
- Licenses for symbolic intellectual property include supporting or maintaining that intellectual property during the license period and, therefore, are considered to be performance obligations satisfied over time. Examples of symbolic intellectual property include brands, team or trade names, logos, and franchise rights.

.158 Lastly, ASU No. 2016-10 provides clarification on implementation guidance on recognizing revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property. The effective date of this ASU is with the same as the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

.159 In addition to ASU Nos. 2016-08 and 2016-10, ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, was issued in May 2016. Topics covered in this ASU include the following:

- Clarification on contract modifications. This amendment permits an entity to determine and allocate the transaction price on the basis of all satisfied and unsatisfied performance obligations in a modified contract as of the beginning of the earliest period presented in accordance with the guidance in FASB ASC 606. An entity would not be required to separately evaluate the effects of each contract modification. An entity that chooses to apply this practical expedient would apply the expedient consistently to similar types of contracts.
- How to assess the collectibility criterion. The amendment introduces new criteria to meet the collectibility requirement. An entity should assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer, rather than assessing the collectibility of the consideration promised in the contract for all the promised goods or services.
- How to report sales taxes and similar taxes. This amendment states that an entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process should be excluded from the scope of the election. An entity that makes this election should exclude from the transaction price all taxes in the scope of the election and should comply with the applicable accounting policy guidance, including disclosure requirements.

- When to measure noncash consideration. This amendment clarifies that the measurement date for noncash consideration is contract inception. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity should apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.
- How to apply transition guidance. This amendment clarifies that, for purposes of transition, a completed contract is a contract for which all (or substantially all) the revenue was recognized under legacy GAAP before the date of initial application. Accounting for elements of a contract that do not affect revenue under legacy GAAP is irrelevant to the assessment of whether a contract is complete. In addition, the amendment permits an entity to apply the modified retrospective transition method either to all contracts or only to contracts that are not completed contracts.

.160 The effective date of this ASU is the same as the revised effective date of the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

.161 In December 2016, FASB issued ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*. The proposed amendments affect narrow aspects of guidance in ASU No. 2014-09, including guidance on the following:

- Impairment testing. When performing impairment testing, an entity should consider expected contract renewals and extensions. In addition, the assessment should include both the amount of consideration it already has received but has not yet recognized as revenue and the amount it expects to receive in the future.
- Additional scope exceptions. The term "insurance" is removed from the scope exceptions of FASB ASC 606 to clarify that all contracts within the scope of FASB ASC 944, *Financial Services—Insurance*, are excluded.
- Provisions for losses on construction-type and production-type contracts. Such provisions should be determined at least at the contract level; however, an entity can make an accounting policy election to determine the provision for losses at the performance obligation level.
- Disclosure of remaining performance obligations. Optional exemptions from the disclosure requirement are provided for remaining performance obligations when an entity is not required to estimate variable consideration to recognize revenue.

.162 Consistent with the other ASUs, the effective date of ASU No. 2016-20 is with the same as the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

Conclusion

.163 Upon implementation of the new standard, consistency of revenue recognition principles across geography and industries will be enhanced, and financial statement users will be provided better insight through improved disclosure requirements. To provide CPAs with guidance during this time of transition, the AICPA's Financial Reporting Center (FRC) offers resources on the

topic, including a roadmap to ensure that companies take the necessary steps to prepare themselves for the new standard. In addition, the FRC includes a list of conferences, webcasts, and other products to keep you informed on upcoming changes in revenue recognition. To stay updated on the latest information available on revenue recognition, refer to www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/revenuerecognition.aspx.

New Leases Standard Will Change Financial Statement Presentation

Issuance and Objective

.164 On February 25, 2016, FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The objective of the ASU is to increase transparency and comparability in financial reporting by requiring balance sheet recognition of leases and note disclosure of certain information about lease arrangements. This ASU codifies FASB ASC 842, *Leases*, which replaces FASB ASC 840, *Leases*, and makes conforming amendments to other FASB ASC topics.

.165 FASB ASC 842 consists of these subtopics:

- Overall
- Lessee
- Lessor
- Sale and Leaseback Transactions
- Leveraged Lease Arrangements

Applicability and Effective Date

.166 ASU No. 2016-02 is applicable to any entity that enters into a lease and is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public companies, which include public business entities, certain not-for-profit entities with conduit financing arrangements, and employee benefit plans	December 15, 2018	December 15, 2018
All other entities	December 15, 2019	December 15, 2020

.167 FASB ASC 842 applies to all leases and subleases of property, plant, and equipment; it specifically does not apply to the following nondepreciable assets accounted for under other FASB ASC topics:

- Leases of intangible assets
- Leases to explore for or use nonregenerative resources such as minerals, oil, and natural gas

- Leases of biological assets, such as timber
- Leases of inventory
- Leases of assets under construction

Main Provisions

Identifying a Lease

.168 Key changes in the guidance are illustrated by comparing the definition of a *lease* in FASB ASC 840, (extant GAAP) and FASB ASC 842.

<i>FASB ASC 840</i>	<i>FASB ASC 842</i>
An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

.169 The identification of a lease under FASB ASC 842 should be based on the presence of key elements in the definition.

Separating Components of a Lease Contract

.170 Under FASB ASC 842, a contract that contains a lease should be separated into lease and nonlease components. Separation should be based on the right to use; each underlying asset should be considered to be separate from other lease components when both of the following criteria are met:

- The lessee can benefit from the right-of-use of the asset (either alone or with other readily available resources).
- The right-of-use is neither highly dependent on nor highly inter-related with other underlying assets in the contract.

.171 The consideration in the contract should be allocated to the separate lease and nonlease components in accordance with provisions of FASB ASC 842.

.172 Lessees can make an accounting policy election to treat both lease and nonlease elements as a single lease component.

Lease Classification

.173 When a lease meets any of the following specified criteria at commencement, the lease should be classified as a finance lease by the lessee and as a sales-type lease by the lessor. These criteria can be summarized as follows:

- The lease transfers ownership to the lessee.
- The purchase option is reasonably certain to be exercised.
- The lease term is for the major portion of asset's remaining economic life.

- The present value of lease payments and the residual value exceeds substantially all of the fair value of the underlying asset.
- The specialized nature of the underlying asset results in no expectation of alternative use after the lease term.

.174 If none of the preceding criteria are met, the lease should be classified as follows:

Lessee—classify as an operating lease

Lessor—classify as an operating lease unless (1) the present value of the lease payments and any residual value guarantee equals or exceeds substantially all of the fair value of the underlying asset and (2) it is probable that the lessor will collect the lease payments plus any residual value guarantee. If both of these summarized criteria from FASB ASC 842-10-25-3 are met, the lessor should classify the lease as a direct financing lease.

Lease Term and Measurement

.175 The lease term is the noncancellable period of the lease together with all of the following:

- The period covered by the option for the lessee to extend the lease if the option is reasonably certain to be exercised
- The period covered by the option for the lessee to terminate the lease if reasonably certain not to be exercised
- The period covered by the option for the lessor to extend or not terminate the lease if the option is controlled by the lessor

.176 Lease payments relating to use of the underlying asset during the lease term include the following at the commencement date:

- Fixed payments less incentives payable to lessee
- Variable lease payments based on an index or other rate
- The exercise price of an option to purchase the underlying asset if the option is reasonably certain to be exercised
- Payments for penalties for terminating a lease if the lease term reflects exercise of the lessee option
- Fees paid by the lessee to the owners of a special purpose entity for structuring the lease
- For the lessee only, the amounts probable of being owed under residual value guarantees

.177 Lease payments specifically exclude the following:

- Certain other variable lease payments
- Any guarantee by the lessee of the lessor's debt
- Certain amounts allocated to nonlease components

.178 Reassessment of the lease term and purchase options and subsequent remeasurement by either the lessee or lessor are limited to certain specified circumstances.

Lessee Accounting

Recognition and Measurement

Commencement Date

.179 At the commencement date of the lease, a lessee should recognize a right-of-use asset and a lease liability; for short-term leases, an alternative accounting policy election is available.

.180 The lease liability should be measured at the present value of the unpaid lease payments. The right-of-use asset should consist of the following: the amount of the initial lease liability; any lease payments made to the lessor at or before the commencement date minus any incentives received; and initial direct costs.

.181 A *short-term lease* is defined by the FASB ASC master glossary as "a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise." The accounting policy election for short-term leases should be made by class of underlying asset. The election provides for recognition of the lease payments in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

After the Commencement Date

.182 After the commencement date, the lessee should recognize in profit or loss (unless costs are included in the carrying amount of another asset) the following:

- Finance leases
 - Amortization of the right-of-use asset and interest on the lease liability
 - Variable lease payments not included in the lease liability in the period obligation is incurred
 - Any impairment
- Operating leases
 - A single lease cost calculated such that the remaining cost is allocated on a straight-line basis over the remaining lease term (unless another allocation is more representative of the benefit from use of the asset)
 - Variable lease payments not included in the lease liability in the period in which the obligation is incurred
 - Any impairment

Subsequent Measurement

.183 FASB ASC 842-20-35 provides guidance for subsequent measurement. Topics addressed in this ASC section include the following:

- Remeasuring the lease liability
- Amortizing the right-of-use asset

- Assessing impairment of the right-of-use asset
- Amortizing leasehold improvements
- Subleases

Presentation and Disclosure

.184 Key presentation matters include the following:

- Statement of financial position
 - Separate presentation of right-of-use assets and lease liabilities from finance leases and operating leases
- Statement of comprehensive income
 - For finance leases, the interest expense on the lease liability and amortization of right-of-use assets in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets
 - For operating leases, the expense to be included in the lessee's income from continuing operations
- Statement of cash flows
 - For presentation within financing activities, the repayment of the principal portion of the lease liability arising from finance leases
 - For presentation within operating activities, the payments arising from operating leases; interest payments on the lease liability; variable lease payments and short-term lease payments not included in lease liability

.185 Disclosure requirements include qualitative and quantitative information for leases, significant judgements (such as significant components of a lease), and amounts recognized in the financial statements, including certain specified information and amounts.

Lessor Accounting

Recognition and Measurement

.186 FASB ASC 842 provides recognition guidance for sales-type leases, direct financing leases, and operating leases. The following table summarizes the guidance:

<i>Sales-Type Leases</i>	
<i>At the Commencement Date</i>	<i>After the Commencement Date</i>
<p>Lessor should derecognize the underlying asset and recognize the following:</p> <ul style="list-style-type: none"> a. Net investment in the lease (lease receivable and unguaranteed residual asset) b. Selling profit or loss arising from the lease c. Initial direct costs as an expense 	<p>Lessor should recognize all of the following:</p> <ul style="list-style-type: none"> a. Interest income on the net investment in the lease b. Certain variable lease payments c. Impairment
<i>Direct Financing Leases</i>	
<i>At the Commencement Date</i>	<i>After the Commencement Date</i>
<p>Lessor should derecognize the underlying asset and recognize the following:</p> <ul style="list-style-type: none"> a. Net investment in the lease (lease receivable and unguaranteed residual asset reduced by selling profit) b. Selling loss arising from the lease, if applicable 	<p>Lessor should recognize all of the following:</p> <ul style="list-style-type: none"> a. Interest income on the net investment in the lease b. Certain variable lease payments c. Impairment
<i>Operating Leases</i>	
<i>At the Commencement Date</i>	<i>After the Commencement Date</i>
<p>Lessor should defer initial direct costs.</p>	<p>Lessor should recognize all of the following:</p> <ul style="list-style-type: none"> a. The lease payments as income in profit or loss over the lease term on a straight-line basis (unless another method is more representative of the benefit received) b. Certain variable lease payments as income in profit or loss c. Initial direct costs as an expense over the lease term on the same basis as lease income

.187 FASB ASC 842-30-35 provides guidance for subsequent measurement. Topics addressed in this ASC section include the following:

- Impairment of the net investment in the lease

- Sale of the lease receivable
- Accounting for the underlying asset at the end of the lease term
- Subleases

Presentation and Disclosure

.188 Key presentation matters for sales-type and direct financing leases include the following:

- Statement of financial position
 - Separate presentation of lease assets (that is, aggregate of lessor's net investment in sales-type leases and direct financing leases) from other assets
 - Classified as current or noncurrent based on the same considerations as other assets
- Statement of comprehensive income
 - Presentation of income from leases in the statement of comprehensive income or disclosure of income from leases in the notes with a reference to the corresponding line in the statement of comprehensive income
 - Presentation of profit or loss recognized at commencement date in a manner appropriate to lessor's business model
- Statement of cash flows
 - For presentation within operating activities, cash receipts from leases

.189 Key presentation matters for operating leases include the following:

- Statement of financial position
 - Presentation of an underlying asset subject to an operating lease, in accordance with other FASB ASC topics
- Statement of cash flows
 - For presentation within operating activities, cash receipts from leases

.190 Disclosure requirements include qualitative and quantitative information for leases, significant judgements, and amounts recognized in the financial statements, including certain specified information and amounts.

Sale and Leaseback Transactions

.191 FASB ASC 842 provides guidance for both the transfer contract and the lease in a sale and leaseback transaction (a transaction in which a seller-lessee transfers an asset to a buyer-lessor and leases that asset back). Determination of whether the transfer is a sale should be based on provisions of FASB ASC 606. FASB ASC 842-40-25 provides measurement guidance for a transfer that is either determined to be a sale or determined not to be a sale.

.192 FASB ASC 842-40 provides guidance for subsequent measurement, financial statement presentation, and disclosures.

Leveraged Lease Arrangements

.193 The legacy accounting model for leveraged leases continues to apply to those leveraged leases that commenced before the effective date of FASB ASC 842. There is no separate accounting model for leveraged leases that commence after the effective date of FASB ASC 842.

Accounting for Financial Instruments

Overview

.194 On January 5, 2016, FASB issued ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, to enhance the reporting model for financial instruments and to provide users of financial statements with more decision-useful information. The amendments in the ASU are intended to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

.195 The new guidance will accomplish the following:

- Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.
- Replace the impairment model for equity investments without readily determinable fair values with a qualitative impairment assessment.
- Eliminate the requirement to disclose the fair values of financial assets and financial liabilities measured at amortized cost for entities that are not public business entities.
- Eliminate the requirement for public business entities to disclose the methods and significant assumptions used to estimate fair value that is required to be disclosed for financial assets and financial liabilities measured at amortized cost on the balance sheet.
- Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
- Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with an entity's other deferred tax assets.

- Eliminate an entity's ability to estimate the disclosed fair values of financial assets and financial liabilities on the basis of entry prices.

Applicability and Effective Date

.196 ASU No. 2016-01 affects all entities that hold financial assets or have financial liabilities and is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities	December 15, 2017	December 15, 2017
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960–965 on plan accounting	December 15, 2018	December 15, 2019

.197 All entities that are not public business entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

.198 Early application by public business entities to financial statements of fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of the following amendments in this ASU are permitted as of the beginning of the fiscal year of adoption:

- An entity should present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk if the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
- Entities that are not public business entities are not required to apply the fair value of financial instruments disclosure guidance in the "General" subsection of FASB ASC 825-10-50.

.199 With the exception of this early application guidance, early adoption of the amendments in this ASU is not permitted.

Impairment

Overview

.200 On June 16, 2016, FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. Upon the effective date of this ASU, the incurred loss impairment methodology in current GAAP is replaced with a methodology that reflects

expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

Assets Measured at Amortized Cost

.201 ASU No. 2016-13 eliminates the probable initial recognition threshold under current GAAP and requires entities that measure financial assets (or a group of financial assets) at amortized cost basis to present such assets at the net amount expected to be collected. The amendments in this ASU broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. In addition to past events and current conditions, entities should also consider reasonable and supportable forecasts that affect the collectibility of the reported amount. However, an entity may revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts.

.202 An entity may apply any method for measuring expected credit losses as long as the method reasonably reflects its expectations of the credit loss estimate.

.203 *Purchased Financial Assets With Credit Deterioration.* ASU No. 2016-13 defines purchased financial assets with credit deterioration (PCD assets) as acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by the acquirer's assessment. The allowance for credit losses for PCD assets that are measured at amortized cost basis is determined in a similar manner to other financial assets measured at amortized cost basis. The initial allowance for credit losses is added to the purchase price, rather than being reported as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense for PCD assets. Furthermore, an entity should recognize interest income for PCD assets based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

.204 *Disclosures.* In an effort to increase users' understanding of underwriting standards and credit quality trends, ASU No. 2016-13 requires the current disclosure on credit quality indicators in relation to the amortized cost of financing receivables to be further disaggregated by year of origination (or vintage). Entities that are not public business entities are not required to disclose the disaggregation by year of origination.

Available for Sale Debt Securities

.205 Entities will now be required to present credit losses on available-for-sale debt securities as an allowance rather than as a permanent write-down.

.206 An entity will now be able to record reversals of credit losses on debt securities (in situations in which the estimate of credit declines) in current period net income. Thus, aligning the income statement recognition of credit losses with the reporting period in which changes occur. However, an entity may not record an allowance for credit losses exceeding the amount by which fair value is below amortized cost.

.207 *Purchased Debt Securities With Credit Deterioration.* The allowance for credit losses for purchased available-for-sale debt securities with a more-than-insignificant amount of credit deterioration since origination is also determined in a similar manner to other available-for-sale debt securities. However, ASU No. 2016-13 requires an entity to add the initial allowance for credit losses to the purchase price, rather than reporting it as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense. Furthermore, an entity should recognize interest income based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

Troubled Debt Restructurings

.208 The ASU does not change the definition or derecognition guidelines for troubled debt restructurings (TDRs), but, rather, changes the impairment recognized on restructuring. Credit losses for TDRs now will be measured using the current expected credit loss model. The ASU eliminates the current GAAP requirement to use a discounted cash flow technique. Credit losses, including concessions given to a borrower under a TDR, will be recognized through an allowance account.

Applicability and Effective Date

.209 ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. It also affects loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

.210 Because there is diversity in practice in applying the incurred loss methodology, ASU No. 2016-13 will affect entities to varying degrees depending on the credit quality of the assets held by the entities, their duration, and how the entity applies current GAAP.

.211 ASU No. 2016-13 is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities that are SEC filers	December 15, 2019	December 15, 2019
All other public entities	December 15, 2020	December 15, 2020
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960–965 on plan accounting	December 15, 2020	December 15, 2021

.212 All entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Transition Resource Group

.213 Due to the potential for significant changes that may result from the issuance of FASB ASU No. 2016-13, FASB has formed the TRG for Credit Losses with the following goals:

- To solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance
- To inform FASB about those implementation issues, which will help FASB determine what, if any, action will be needed to address those issues
- To provide a forum for stakeholders to learn about the new guidance from others involved with implementation

.214 The TRG will meet to discuss and share its views on potential implementation issues raised by concerned parties and, subsequent to each meeting, FASB will determine what actions, if any, will be taken on each issue. Refer to the page "Transition Resource Group for Credit Losses" on FASB's website for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Hedge Accounting

Overview

.215 Hedge accounting is the third phase in FASB's overall project on accounting for financial instruments. The objective of this project is to make targeted improvements to the hedge accounting model based on the feedback received from preparers, auditors, users, and other stakeholders. FASB has also noted it will consider opportunities to align with IFRS 9, *Financial Instruments*.

Latest Developments

.216 In September 2016, FASB issued a proposed ASU, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. FASB staff are currently in process of drafting a final ASU, which is expected to be issued during the second half of 2017. Readers are encouraged to visit the "Technical Agenda" page under "Projects" at www.fasb.org for the latest developments regarding the hedge accounting phase.

Conclusion

.217 The extent of the effect of the new financial instruments standards will depend upon the relative significance of financial instruments to an entity's operations and financial position as well as the entity's business strategy. To provide CPAs with guidance during this time of transition, the AICPA's FRC offers invaluable resources on the topic. In addition, the FRC includes a list of conferences, webcasts, and products to keep you informed on the latest developments in accounting for financial instruments. Refer to www.aicpa.org/interestareas/frc/accountingfinancialreporting/financialinstruments/pages/default.aspx to stay updated on the latest information available on accounting for financial instruments.

Other Accounting Issues and Developments

.218 Because the financial reporting standards are in a constant state of change, it may be challenging to keep up with all the new standards as they are issued. In the following sections, we provide an overview of recently issued and soon effective FASB ASUs that auditors and preparers need to be aware of.

Income Taxes

.219 In October 2016, FASB issued ASU No. 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory* as part of its simplification Initiative. Current GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. In addition, interpretations of this guidance have developed in practice over the years for transfers of certain intangible and tangible assets. This prohibition on recognition is an exception to the principle of comprehensive recognition of current and deferred income taxes in GAAP. Stakeholders informed FASB that the limited amount of authoritative guidance about the exception has led to diversity in practice and is a source of complexity in financial reporting, particularly for an intra-entity transfer of intellectual property. The board also learned from stakeholders that this exception results in an unfaithful representation of the economics of an intra-entity asset transfer because the exception requires deferral of the income tax consequences of the transfer, including income taxes payable or paid.

.220 FASB decided that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Consequently, the amendments in this ASU eliminate the exception for an intra-entity transfer of an asset other than inventory. Two common examples of assets included in the scope of this ASU are intellectual property and property, plant, and equipment. On the basis of stakeholders' feedback about the anticipated benefits and costs, FASB decided not to change GAAP for an intra-entity transfer of inventory.

.221 The amendments in this ASU do not include new disclosure requirements; however, existing disclosure requirements might be applicable when accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. For example, GAAP requires an entity to disclose a comparison of income tax expense (benefit) with statutory expectations (a rate reconciliation for public entities or a description of the nature of each significant reconciling item for nonpublic entities) and also requires an entity to disclose the types of temporary differences and carryforwards that give rise to a significant portion of deferred income taxes.

.222 For public business entities, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements.

.223 The amendments in this ASU should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.

Consolidation

.224 In October 2016, FASB issued ASU No. 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*. FASB issued this ASU to amend the consolidation guidance on how a reporting entity that is the single decision maker of a variable interest entity (VIE) should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The primary beneficiary of a VIE is the reporting entity that has a controlling financial interest in a VIE and, therefore, consolidates the VIE. A reporting entity has an indirect interest in a VIE if it has a direct interest in a related party that, in turn, has a direct interest in the VIE.

.225 The amendments in this ASU affect reporting entities that are required to evaluate whether they should consolidate a VIE within the Variable Interest Entities Subsections of FASB ASC 810-10, *Consolidation—Overall*, in certain situations involving entities under common control. Specifically, the amendments change the evaluation of whether a reporting entity is the primary beneficiary of a VIE by changing how a reporting entity that is a single decision maker of a VIE treats indirect interests in the entity held through related parties that are under common control with the reporting entity.

.226 The amendments in this ASU do not change the characteristics of a primary beneficiary in current GAAP. Therefore, a primary beneficiary of a VIE has both of the following characteristics: (1) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

.227 If a reporting entity satisfies the first characteristic of a primary beneficiary (such that it is the single decision maker of a VIE), the amendments in this ASU require that reporting entity, in determining whether it satisfies the second characteristic of a primary beneficiary, to include all of its direct variable interests in a VIE and, on a proportionate basis, its indirect variable interests in a VIE held through related parties, including related parties that are under common control with the reporting entity. That is, under the amendments, a single decision maker is not required to consider indirect interests held through related parties that are under common control with the single decision maker to be the equivalent of direct interests in their entirety. Instead, a single decision maker is required to include those interests on a proportionate basis consistent with indirect interests held through other related parties.

.228 If, after performing that assessment, a reporting entity that is the single decision maker of a VIE concludes that it does not have the characteristics of a primary beneficiary, the amendments continue to require that reporting entity to evaluate whether it and one or more of its related parties under common control, as a group, have the characteristics of a primary beneficiary. If the single decision maker and its related parties that are under common control, as a group, have the characteristics of a primary beneficiary, then the party

within the related party group that is most closely associated with the VIE is the primary beneficiary.

.229 The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity opts for early adoption of the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

.230 Entities that have not yet adopted the amendments in FASB ASU No. 2015-02 are required to adopt the amendments in this ASU at the same time they adopt the amendments in FASB ASU No. 2015-02 and should apply the same transition method elected for the application of FASB ASU No. 2015-02.

.231 Entities that already have adopted the amendments in FASB ASU No. 2015-02 are required to apply the amendments in this ASU retrospectively to all relevant prior periods beginning with the fiscal year in which the amendments in FASB ASU No. 2015-02 initially were applied.

Restricted Cash

.232 In November 2016, FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash, a consensus of the FASB Emerging Issues Task Force*, because stakeholders indicated that diversity exists in the classification and presentation of changes in restricted cash on the statement of cash flows under FASB ASC 230, *Statement of Cash Flows*. Entities classify transfers between cash and restricted cash as operating, investing, or financing activities, or as a combination of those activities, in the statement of cash flows. Also, some entities present direct cash receipts into, and direct cash payments made from, a bank account that holds restricted cash as cash inflows and cash outflows, but others disclose those cash flows as noncash investing or financing activities. This ASU addresses that diversity.

.233 GAAP currently does not include specific guidance on the cash flow classification and presentation of changes in restricted cash or restricted cash equivalents other than limited guidance for not-for-profit entities. Specifically, there is no guidance to address how to classify and present changes in restricted cash or restricted cash equivalents that occur when there are transfers between cash, cash equivalents, and restricted cash or restricted cash equivalents and when there are direct cash receipts into restricted cash or restricted cash equivalents or direct cash payments made from restricted cash or restricted cash equivalents. The amendments in this ASU are an improvement to GAAP because they provide guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows, thereby reducing the diversity in practice.

.234 The amendments in this ASU require a statement of cash flows to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents as well as a reconciliation of total cash, cash equivalents, and restricted cash from the cash flow statements to the amounts reported on the balance sheet. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when

reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this ASU do not provide a definition of *restricted cash* or *restricted cash equivalents*.

.235 The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity opts for early adoption of the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

.236 The amendments in this ASU should be applied using a retrospective transition method to each period presented.

Business Combinations

.237 In January 2017, FASB issued ASU No. 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*, to clarify the definition of a *business* with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition of a *business* affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. Concerns about the definition of a *business* were the primary issues raised in connection with the Post Implementation Review Report on FASB Statement No. 141 (revised 2007), *Business Combinations* (Statement 141(R)), now codified in FASB ASC 805, *Business Combinations*. The guidance in this ASU addresses those concerns.

.238 In addition to concerns about the broad application of the definition of a *business*, the scope of FASB ASC 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets* (created as part of the amendments in FASB ASU No. 2014-09, raised questions about the interaction of the definition of a *business* and the term in substance nonfinancial asset as it is used in FASB ASC 610-20.

.239 Until the amendments in FASB ASU No. 2014-09 are effective, the derecognition of real estate should be accounted for consistently, regardless of whether the real estate is an asset or a business. The amendments in FASB ASU No. 2014-09 remove existing industry- or transaction-specific real estate guidance so that, for purposes of determining what derecognition model to apply in sales transactions with noncustomers, an entity must determine whether a real estate transaction is a sale of a business or a sale of a nonfinancial asset (or an insubstance nonfinancial asset). The amendments in FASB ASU No. 2014-09 refer to a business that is an in-substance nonfinancial asset.

.240 Under the current implementation guidance in FASB ASC 805, there are three elements of a business—inputs, processes, and outputs. An integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs; however, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes.

.241 The amendments in this ASU provide a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated.

.242 If the screen is not met, the amendments in this ASU (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The amendments provide a framework to assist entities in evaluating whether both an input and a substantive process are present. The framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, outputs generally are a key element of a business; therefore, FASB has developed more stringent criteria for sets without outputs.

.243 Lastly, the amendments in this ASU narrow the definition of the term *output* so that the term is consistent with how outputs are described in FASB ASC 606.

.244 Public business entities should apply the amendments in this ASU to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

.245 The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition.

.246 Early application of the amendments in this ASU is allowed as follows:

- For transactions for which the acquisition date occurs before the issuance date or effective date of the amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance
- For transactions in which a subsidiary is deconsolidated or a group of assets is derecognized that occur before the issuance date or effective date of the amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance

Simplifying the Test for Goodwill Impairment

.247 In January 2017, FASB issued ASU No. 2017-04, *Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, to simplify how an entity is required to test goodwill for impairment by eliminating step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. In computing the implied fair value of goodwill under step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be

required in determining the fair value of assets acquired and liabilities assumed in a business combination.

.248 Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable.

.249 FASB also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform step 2 of the goodwill impairment test. Therefore, the same impairment assessment applies to all reporting units. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets.

.250 An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary.

.251 The amendments in this ASU are required for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. Private companies that have adopted the private company alternative for goodwill but not the private company alternative to subsume certain intangible assets into goodwill are permitted, but not required, to adopt the amendments in this ASU without having to justify preferability of the accounting change if it is adopted on or before the effective date. Private companies that have adopted the private company alternative to subsume certain intangible assets into goodwill, and, thus, also adopted the goodwill alternative, are not permitted to adopt this guidance upon issuance without following the guidance in FASB ASC 250, *Accounting Changes and Error Corrections*, including justifying why it is preferable to change their accounting policies.

.252 An entity should apply the amendments in this ASU on a prospective basis. An entity is required to disclose the nature of and reason for the change in accounting principle upon transition. That disclosure should be provided in the first annual period and in the interim period within the first annual period when the entity initially adopts the amendments in this ASU.

.253 A public business entity that is an SEC filer should adopt the amendments in this ASU for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019.

.254 A public business entity that is not an SEC filer should adopt the amendments in this ASU for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020.

.255 All other entities, including not-for-profit entities, that are adopting the amendments in this ASU should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.

.256 Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

Other Income

.257 In February 2017, FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, to clarify the scope of FASB ASC 610-20 and to add guidance for partial sales of nonfinancial assets.

.258 A contract may involve the transfer of both nonfinancial assets and financial assets (for example, cash and receivables). The amendments in this ASU clarify that a financial asset is within the scope of FASB ASC 610-20 if it meets the definition of an *in-substance nonfinancial asset*. The amendments define the term *in-substance nonfinancial asset*, in part, as a financial asset promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty are in-substance nonfinancial assets within the scope of FASB ASC 610-20.

.259 The amendments in this ASU also clarify that nonfinancial assets within the scope of FASB ASC 610-20 may include nonfinancial assets transferred within a legal entity to a counterparty. For example, a parent may transfer control of nonfinancial assets by transferring ownership interests in a consolidated subsidiary. A contract that includes the transfer of ownership interests in one or more consolidated subsidiaries is within the scope of FASB ASC 610-20 if substantially all of the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets. For purposes of that evaluation, the amendments require an entity to evaluate the underlying assets in consolidated subsidiaries to determine whether those assets are within the scope of FASB ASC 610-20.

.260 In some cases, substantially all of the fair value of the assets that are promised to the counterparty in a contract is not concentrated in nonfinancial assets; however, substantially all of the fair value of the assets promised to a counterparty in an individual consolidated subsidiary within a contract is concentrated in nonfinancial assets. To address those situations, the amendments in this ASU also define an *in-substance nonfinancial asset* as a financial asset that is held in an individual consolidated subsidiary within a contract if substantially all the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in that subsidiary is concentrated in nonfinancial assets.

.261 The amendments in this ASU exclude all businesses and nonprofit activities from the scope of FASB ASC 610-20. Therefore, the derecognition of all businesses and nonprofit activities (except those related to conveyances of oil and gas mineral rights or contracts with customers) should be accounted for in accordance with FASB ASC 810-10, *Consolidation—Overall*.

.262 The amendments in this ASU clarify that an entity should identify each distinct nonfinancial asset or in-substance nonfinancial asset promised to a counterparty and derecognize each asset when a counterparty obtains control

of it. The amendments also clarify that an entity should allocate consideration to each distinct asset by applying the guidance in FASB ASC 606 on allocating the transaction price to performance obligations.

.263 A partial sale of a nonfinancial asset (or in-substance nonfinancial asset) may be structured in different ways. For example, an entity may transfer a nonfinancial asset to a counterparty and, in exchange, receive a noncontrolling interest in the legal entity to which the asset was transferred. Alternatively, a parent may transfer ownership interests in a consolidated subsidiary that includes a nonfinancial asset but retain a noncontrolling interest in its former subsidiary. The amendments in this ASU require an entity to derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset in a partial sale transaction when it (1) does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with FASB ASC 810, *Consolidation* and (2) transfers control of the asset in accordance with FASB ASC 606. Once an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset, it is required to measure any noncontrolling interest it receives (or retains) at fair value.

.264 If an entity transfers ownership interests in a consolidated subsidiary and continues to have a controlling financial interest in that subsidiary, it does not derecognize the assets and liabilities of the subsidiary and accounts for the transaction as an equity transaction. Therefore, no gain or loss is recognized.

.265 The amendments in this ASU supersede the guidance in "Exchanges of a Nonfinancial Asset for a Noncontrolling Ownership Interest" in FASB ASC 845-10-15 because that guidance is similar to the guidance for partial sales of nonfinancial assets within the scope of FASB ASC 610-20. The amendments also clarify that partial sales transactions within the scope of FASB ASC 610-20 include contributions of nonfinancial assets to a joint venture or other non-controlled investee. In addition, the amendments require an entity to recognize a full gain or loss on transfers of nonfinancial assets within the scope of FASB ASC 610-20 to equity method investees.

.266 The amendments in this ASU are effective at the same time as the amendments in FASB ASU No. 2014-09. Therefore, for public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Public entities may apply the guidance earlier but only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

.267 A public entity is an entity that is any one of the following:

1. A public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements with or to the SEC

.268 For all other entities, the amendments in this ASU are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance earlier as of annual reporting

periods beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance earlier as of annual reporting periods beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance.

.269 An entity is required to apply the amendments in this ASU at the same time that it applies the amendments in ASU No. 2014-09.

.270 An entity may elect to apply the amendments in this ASU in either of the following ways:

1. Retrospectively to each period presented in the financial statements in accordance with the guidance on accounting changes in paragraphs 5–10 of FASB ASC 250-10-45 (retrospective approach)
2. Retrospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption (modified retrospective approach)

.271 An entity may elect to apply all of the amendments in this ASU and FASB ASU No. 2014-09 using the same transition method. Alternatively, an entity may elect to apply a different transition method to transactions with customers (for example, transactions within the scope of FASB ASC 606) than to transactions with noncustomers (for example, transactions within the scope of FASB ASC 610-20). For example, an entity may elect to apply the retrospective approach to transactions within the scope of FASB ASC 606 and the modified retrospective approach to transactions within the scope of FASB ASC 610-20. Regardless of which transition method an entity applies to contracts with noncustomers, the entity is required to apply the amended definition of a *business* in FASB ASU No. 2017-01, to those contracts. If an entity concludes that a transaction previously recorded as the disposal of a business is no longer a business, the entity should not reinstate amounts previously allocated to goodwill associated with that disposal.

Retirement Benefits

.272 In March 2017, FASB issued ASU No. 2017-07, *Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost.

.273 The amendments in this ASU require an employer to report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost as defined in paragraphs 4 and 9 of FASB ASC 715-30-35 are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed.

.274 The amendments in this ASU also allow only the service cost component to be eligible for capitalization when applicable (for example, as a cost of internally manufactured inventory or a self-constructed asset).

.275 The amendments in this ASU apply to all employers, including not-for-profit entities, that offer to their employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under FASB ASC 715.

.276 The amendments in this ASU are effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. For other entities, the amendments in this ASU are effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, early adoption should be within the first interim period if an employer issues interim financial statements. Disclosures of the nature of and reason for the change in accounting principle are required in the first interim and annual periods of adoption.

.277 The amendments in this ASU should be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement benefit cost in the income statement and prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit in assets. The amendments allow a practical expedient that permits an employer to use the amounts disclosed in its pension and other postretirement benefit plan note for the prior comparative periods as the estimation basis for applying the retrospective presentation requirements. Disclosure that the practical expedient was used is required.

Nonrefundable Fees and Other Costs

.278 In March 2017, FASB issued ASU No. 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*, to amend the amortization period for certain purchased callable debt securities held at a premium.

.279 The amendments in this ASU shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity.

.280 Under current GAAP, premiums and discounts on callable debt securities generally are amortized to the maturity date. An entity must have a large number of similar loans to consider estimates of future principal prepayments when applying the interest method. However, an entity that holds an individual callable debt security at a premium may not amortize that premium to the earliest call date. If that callable debt security is subsequently called, the entity records a loss equal to the unamortized premium.

.281 The amendments in this ASU more closely align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities. In most cases, market participants price securities to the call date that produces the worst yield when the coupon is above current market rates (that is, the security is trading at a premium) and price securities to maturity when the coupon is below market rates (that is, the security is trading at a discount) in anticipation that the borrower will act in its economic

best interest. As a result, the amendments more closely align interest income recorded on bonds held at a premium or a discount with the economics of the underlying instrument.

.282 The amendments in this ASU affect all entities that hold investments in callable debt securities that have an amortized cost basis in excess of the amount that is repayable by the issuer at the earliest call date (that is, at a premium).

.283 For public business entities, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity opts for early adoption of the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

.284 An entity should apply the amendments in this ASU on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle.

Stock Compensation

.285 In May 2017, FASB issued ASU No. 2017-09, *Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting*, to provide clarity and reduce both (1) diversity in practice and (2) cost and complexity when applying the guidance in FASB ASC 718, *Compensation—Stock Compensation*, to a change to the terms or conditions of a share-based payment award.

.286 Stakeholders observed that the definition of the term *modification* is broad and that its interpretation results in diversity in practice. Some entities evaluate whether a change to the terms or conditions of an award is substantive. When those entities conclude that a change is substantive, they apply modification accounting in FASB ASC 718. When those entities conclude that a change is not substantive, they do not apply modification accounting. FASB ASC 718 does not contain guidance about what changes are substantive.

.287 Some entities apply modification accounting for any change to an award, except for a change they deem to be purely administrative in nature. However, FASB ASC 718 does not provide guidance about what changes are purely administrative. Still, other entities apply modification accounting when a change to an award changes the fair value, the vesting, or the classification of the award. In those cases, an evaluation of a change in fair value, vesting, or classification may be used in practice to evaluate whether a change is substantive.

.288 The amendments in this ASU provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in FASB ASC 718.

.289 An entity should account for the effects of a modification unless all the following are met:

1. The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is

the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification.

2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified.
3. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified.

.290 The current disclosure requirements in FASB ASC 718 apply regardless of whether an entity is required to apply modification accounting under the amendments in this ASU.

.291 The amendments in this ASU are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for (1) public business entities for reporting periods for which financial statements have not yet been issued and (2) all other entities for reporting periods for which financial statements have not yet been made available for issuance.

.292 The amendments in this ASU should be applied prospectively to an award modified on or after the adoption date.

Service Concession Arrangements

.293 In May 2017, FASB issued ASU No. 2017-10, *Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (a consensus of the FASB Emerging Issues Task Force)*, due to diversity in practice in how an operating entity determines the customer of the operation services for transactions within the scope of FASB ASC 853, *Service Concession Arrangements*.

.294 A service concession arrangement is an arrangement between a grantor and an operating entity whereby the operating entity will operate the grantor's infrastructure (for example, airports, roads, bridges, tunnels, prisons, and hospitals) for a specified period of time. The operating entity also may maintain the infrastructure, and it also may be required to provide periodic capital-intensive maintenance (major maintenance) to enhance or extend the life of the infrastructure. The infrastructure already may exist or may be constructed by the operating entity during the period of the service concession arrangement.

.295 FASB ASC 853 provides guidance for operating entities when they enter into a service concession arrangement with a public-sector grantor who does the following:

- a. Controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price

- b. Controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement

.296 In a service concession arrangement within the scope of FASB ASC 853, the operating entity should not account for the infrastructure as a lease or as property, plant, and equipment. An operating entity should refer to other topics to account for various aspects of a service concession arrangement. For example, an operating entity should account for revenue relating to construction, upgrade, or operation services in accordance with FASB ASC 605 or FASB ASC 606. In applying the revenue guidance under FASB ASC 605, stakeholders noted that it is not clear whether the customer of the operation services is the grantor or the third-party users for certain service concession arrangements. In turn, this uncertainty resulted in diversity in practice when applying certain aspects of FASB ASC 605. Similar issues could also arise under FASB ASC 606.

.297 The main provisions of this ASU are illustrated by the following example: A public-sector entity grantor (government) enters into an arrangement with an operating entity under which the operating entity will provide services (which include operation and general maintenance of the infrastructure) for a toll road that will be used by third-party users (drivers). The amendments in this ASU clarify that the grantor (government), rather than the third-party drivers, is the customer of the operation services in all cases for service concession arrangements within the scope of FASB ASC 853.

.298 For an entity that has not adopted FASB ASC 606 before the issuance of this ASU, the effective date and transition requirements for the amendments in this ASU generally are the same as the effective date and transition requirements for FASB ASC 606 (and any other topic amended by ASU No. 2014-09). ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, deferred the effective date of ASU No. 2014-09 by one year.

.299 Specifically, an entity that adopts FASB ASC 606 after the issuance of this ASU (whether the adoption of FASB ASC 606 is at the required effective date or earlier) should adopt the amendments in this ASU at the same time that the entity adopts FASB ASC 606 and should apply the amendments in this ASU using the same transition method elected for the application of FASB ASC 606 (including applying the same practical expedients, to the extent applicable), unless the entity elects early adoption of the amendments in this ASU before adopting FASB ASC 606.

.300 An entity may apply the amendments in this ASU earlier, including within an interim period, even though the entity has not yet adopted FASB ASC 606. An entity that adopts this ASU early is required to apply the amendments in this ASU using either (1) a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption or (2) a retrospective approach. The transition disclosures depend on the transition method that the entity elects for the amendments in this ASU. If an entity opts for early adoption of the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that applies the amendments in this ASU early, prior to adopting FASB ASC 606, is not permitted to use any of the practical expedients provided in FASB ASC 606-10-65-1f.

.301 For an entity that has adopted FASB ASC 606 before the issuance of this ASU, the effective date of the amendments in this ASU is as follows:

1. For a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the SEC, the amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.
2. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

.302 An entity that already has adopted FASB ASC 606 is required to apply the amendments in this ASU using either (1) a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the fiscal year of adoption or (2) a retrospective approach. The transition method that the entity uses for the amendments in this ASU is not required to be the same as the transition method that the entity used when adopting FASB ASC 606. However, when applying the amendments in this ASU, an entity is required to use the same practical expedients that the entity elected to use in FASB ASC 606-10-65-1f when initially applying FASB ASC 606, to the extent applicable. The transition disclosures depend on the transition method that the entity uses for the amendments in this ASU.

.303 An entity that already has adopted FASB ASC 606 may apply the amendments in this ASU earlier, including within an interim period. If an entity opts for early adoption of the amendments in this ASU in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

Financial Instruments With Characteristics of Liabilities and Equity

.304 In July 2017, FASB issued ASU No. 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features; II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*, to address issues identified with GAAP for certain financial instruments with characteristics of liabilities and equity.

.305 Part I of this ASU addresses the complexity of accounting for certain financial instruments with down round features. *Down round features* are features of certain equity-linked instruments (or embedded features) that result in the strike price being reduced on the basis of the pricing of future equity offerings. Current accounting guidance creates cost and complexity for entities that issue financial instruments (such as warrants and convertible instruments) with down round features that require fair value measurement of the entire instrument or conversion option.

.306 Stakeholders asserted that accounting for freestanding and embedded instruments with down round features as liabilities subject to fair value measurement on an ongoing basis creates a significant reporting burden and unnecessary income statement volatility associated with changes in value of an entity's own share price. Stakeholders also suggested that this accounting does not reflect the economics of the down round feature, which exists to protect

certain investors from declines in the issuer's share price under certain circumstances. That is, current accounting guidance requires changes in fair value of an instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered and a decrease will cause an adjustment to the strike price only if and when an entity engages in a subsequent equity offering.

.307 The amendments in part I of this ASU change the classification analysis of certain equity-linked financial instruments (or embedded features) with down round features. When determining whether certain financial instruments should be classified as liabilities or equity instruments, a down round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity's own stock. The amendments also clarify existing disclosure requirements for equity-classified instruments. As a result, a freestanding equity-linked financial instrument (or embedded conversion option) no longer would be accounted for as a derivative liability at fair value as a result of the existence of a down round feature. For freestanding equity classified financial instruments, the amendments require entities that present earnings per share (EPS) in accordance with FASB ASC 260, *Earnings per Share* to recognize the effect of the down round feature when it is triggered. That effect is treated as a dividend and as a reduction of income available to common shareholders in basic EPS.

.308 Convertible instruments with embedded conversion options that have down round features are now subject to the specialized guidance for contingent beneficial conversion features (in FASB ASC 470-20, *Debt—Debt with Conversion and Other Options*), including related EPS guidance (in FASB ASC 260).

.309 Part II of this ASU addresses the difficulty of navigating FASB ASC 480, *Distinguishing Liabilities from Equity*, because of the existence of extensive pending content in the FASB ASC. This pending content is the result of the indefinite deferral of accounting requirements about mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests. The amendments in part II of this ASU recharacterize the indefinite deferral of certain provisions of FASB ASC 480 that now are presented as pending content in FASB ASC, to a scope exception. Those amendments do not have an accounting effect.

.310 For public business entities, the amendments in part I of this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments in part I are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an entity opts for early adoption of the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

.311 The amendments in part I of this ASU should be applied in either of the following ways:

- a. Retrospectively to outstanding financial instruments with a down round feature by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first

fiscal year and interim period or periods in which the pending content that links to this paragraph is effective

- b. Retrospectively to outstanding financial instruments with a down round feature for each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 5–10 of FASB ASC 250-10-45.

.312 The amendments in part II of this ASU do not require any transition guidance because those amendments do not have an accounting effect.

Financial Instruments With Characteristics of Liabilities and Equity

.313 In August 2017, FASB issued ASU No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition to that main objective, the amendments in this ASU make certain targeted improvements to simplify the application of the hedge accounting guidance in current GAAP based on the feedback received from preparers, auditors, users, and other stakeholders.

Alignment of Risk Management Activities and Financial Reporting

.314 The amendments in this ASU better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. To meet that objective, the amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements.

Risk Component Hedging

.315 Current GAAP contains limitations on how an entity can designate the hedged risk in certain cash flow and fair value hedging relationships. To address those current limitations, the amendments in this ASU permit hedge accounting for risk components in hedging relationships involving nonfinancial risk and interest rate risk.

Accounting for the Hedged Item in Fair Value Hedges of Interest Rate Risk

.316 In some cases, current GAAP contains limitations on how an entity can designate the hedged item in a fair value hedge of interest rate risk. In other cases, current GAAP contains limitations on how an entity can measure changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. Those limitations may not align with an entity's risk management strategies or the way in which interest rate risk can be hedged in the cash flow hedging model. To resolve those issues, the amendments in this ASU change the guidance for designating fair value hedges of interest rate risk and for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk.

Recognition and Presentation of the Effects of Hedging Instruments

.317 FASB determined that achieving the objective of better portraying the economic results of an entity's risk management activities in its financial statements can be accomplished only through a combination of changes to the designation and measurement guidance for qualifying hedging relationships and the method of presenting hedge results. Therefore, in addition to the amendments to the designation and measurement guidance for qualifying hedging relationships, the amendments in this ASU also align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements to increase the understandability of the results of an entity's intended hedging strategies.

.318 The amendments in this ASU require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This presentation enables users of financial statements to better understand the results and costs of an entity's hedging program. Also, relative to current GAAP, this approach simplifies the financial statement reporting for qualifying hedging relationships. Current GAAP provides special hedge accounting only for the portion of the hedge deemed to be "highly effective" and requires an entity to separately reflect the amount by which the hedging instrument does not offset the hedged item, which is referred to as the "ineffective" amount. However, the concept and reporting of hedge ineffectiveness were difficult for financial statement users to understand and, at times, for preparers to explain. Thus, FASB decided on an approach that no longer separately measures and reports hedge ineffectiveness.

Amounts Excluded From the Assessment of Hedge Effectiveness

.319 Current GAAP permits an entity to exclude option premiums and forward points from the assessment of hedge effectiveness. The amendments in this ASU continue to allow an entity to exclude those components of a hedging instrument's change in fair value from the assessment of hedge effectiveness. Additionally, the amendments permit an entity to exclude the portion of the change in fair value of a currency swap that is attributable to a cross-currency basis spread from the assessment of hedge effectiveness.

Other Simplifications of Hedge Accounting Guidance

.320 The amendments in this ASU also include certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. Current GAAP contains specific requirements for initial and ongoing quantitative hedge effectiveness testing and strict requirements for specialized effectiveness testing methods that allow an entity to forgo quantitative hedge effectiveness assessments for qualifying relationships (for example, "shortcut" method and "critical terms match" method).

Disclosures

.321 Given FASB's revised view on presentation of hedging activities, the amendments in this ASU modify disclosures required in current GAAP. Those modifications include a tabular disclosure related to the effect on the income statement of fair value and cash flow hedges and eliminate the requirement to disclose the ineffective portion of the change in fair value of hedging instruments. The amendments also require new tabular disclosures related to cumulative basis adjustments for fair value hedges.

.322 For public business entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020.

.323 Early application is permitted in any interim period after issuance of this ASU. All transition requirements and elections should be applied to hedging relationships existing (that is, hedging relationships in which the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not removed the designation of the hedging relationship) on the date of adoption. The effect of adoption should be reflected as of the beginning of the fiscal year of adoption (that is, the initial application date).

Recent Pronouncements at a Glance

Recent Auditing and Attestation Pronouncements and Guidance

.324 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

<i>Recent Auditing and Attestation Pronouncements and Related Guidance</i>	
Statement on Auditing Standards (SAS) No. 132 (February 2017)	<i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i> (AICPA, Professional Standards, AU-C sec. 570)
SAS No. 133 (July 2017)	<i>Auditor Involvement With Exempt Offering Documents</i> (AICPA, Professional Standards, AU-C sec. 945)
Statement on Standards for Attestation Engagements (SSAE) Interpretation No. 4 (May 2017)	<i>Performing and Reporting on an Attestation Engagement Under Two Sets of Attestation Standards</i> (AICPA, Professional Standards)
Statement on Standards for Accounting and Review Services (SSARS) No. 22 (September 2016)	<i>Compilation of Pro Forma Financial Information</i> (AICPA, Professional Standards, AR-C sections)
SSARS No. 23 (October 2016)	<i>Omnibus Statement on Standards for Accounting and Review Services—2016</i> (AICPA, Professional Standards, AR-C sec. 120)

Recent Accounting and Financial Reporting Guidance

.325 The following table presents, by codification area, a list of recently issued ASUs through the issuance of ASU No. 2017-12. However, this table does not include ASUs that are SEC updates or that are technical corrections to

various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but content labeled as "SEC staff guidance" does not constitute rules or interpretations of the SEC, nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Presentation Area of FASB Accounting Standards Codification® (ASC)	
Accounting Standards Update (ASU) No. 2017-11 (July 2017)	<i>Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception</i>
ASU No. 2016-18 (November 2016)	<i>Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)</i>
Assets Area of FASB ASC	
ASU No. 2017-08 (March 2017)	<i>Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities</i>
ASU No. 2017-04 (January 2017)	<i>Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment</i>
Revenue Area of FASB ASC	
ASU No. 2017-05 (February 2017)	<i>Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets</i>
ASU No. 2016-20 (December 2016)	<i>Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers</i>
Expenses Area of FASB ASC	
ASU No. 2017-09 (May 2017)	<i>Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting</i>
ASU No. 2017-07 (March 2017)	<i>Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost</i>
ASU No. 2016-16 (October 2016)	<i>Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory</i>

(continued)

<i>Recent Accounting Standards Updates—continued</i>	
Broad Transactions Area of FASB ASC	
ASU No. 2017-12 (August 2017)	<i>Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities</i>
ASU No. 2017-10 (May 2017)	<i>Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (a consensus of the FASB Emerging Issues Task Force)</i>
ASU No. 2017-01 (January 2017)	<i>Business Combinations (Topic 805): Clarifying the Definition of a Business</i>
ASU No. 2016-17 (October 2016)	<i>Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control</i>
Other	
ASU No. 2017-06 (March 2016)	<i>Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): Employee Benefit Plan Master Trust Reporting (a consensus of the Emerging Issues Task Force)</i>
ASU No. 2017-02 (January 2017)	<i>Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity</i>

Recently Issued Technical Questions and Answers

.326 The following table presents a list of recently issued nonauthoritative audit, attest, and accounting technical questions and answers issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/interestareas/frc/pages/recentlyissuedtechnicalquestionsandanswers.aspx.

<i>Recently Issued Technical Questions and Answers</i>	
Investment Companies	
Technical Questions and Answers (Q&A) section 6910.36 (October 2016)	"Determining Whether Loan Origination Is a Substantive Activity When Assessing Whether an Entity Is an Investment Company" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.37 (October 2016)	"Considering the Length of Time It Will Take an Investment Company to Liquidate Its Assets and Satisfy Its Liabilities When Determining If Liquidation Is Imminent" (AICPA, <i>Technical Questions and Answers</i>)

Recently Issued Technical Questions and Answers—continued	
Q&A section 6910.38 (October 2016)	"Determining If Liquidation Is Imminent When the Only Investor in an Investment Company Redeems Its Interest, and the Investment Company Anticipates Selling All of Its Investments and Settling All of Its Assets and Liabilities" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.39 (October 2016)	"Presentation of Stub Period Information by an Investment Company" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.40 (October 2016)	"Applying the Financial Statement Reporting Requirements in FASB ASC 946-205-45-1 When an Investment Company Presents a Stub Period" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.41 (October 2016)	"Separation of Final-Period Financial Statements Between Going Concern and Liquidation Periods for Certain Investment Companies That Liquidate Over a Short Period of Time" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.42 (October 2016)	"Presenting Financial Highlights Under the Liquidation Basis of Accounting for an Investment Company" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 6910.43 (October 2016)	"Accrued Income When Using the Liquidation Basis of Accounting" (AICPA, <i>Technical Questions and Answers</i>)
Internal Control	
Q&A section 8200.17 (April 2017)	"Obtaining an Understanding of Business Processes Relevant to Financial Reporting and Communication" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 8200.18 (April 2017)	"Obtaining an Understanding of Internal Control Relevant to the Audit" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 8200.19 (April 2017)	"Obtaining an Understanding of the Controls Relevant to the Audit" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 8200.20 (April 2017)	"Control Activities That Are Always Relevant to the Audit" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 8200.21 (April 2017)	"Control Activities That May Be Relevant to the Audit" (AICPA, <i>Technical Questions and Answers</i>)

(continued)

Recently Issued Technical Questions and Answers—continued**Auditor's Reports**

Q&A section 9160.31 (July 2017)	"Following Accounting Standards as Promulgated by FASB by a State or Local Governmental Entity" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 9160.32 (July 2017)	"Reporting on Accounting Standards as Promulgated by FASB by a State or Local Government" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 9160.33 (July 2017)	"Engagement Acceptance When a State or Local Government Elects to Follow a Special Purpose Framework" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 9160.34 (July 2017)	"Accounting Standards as Promulgated by FASB as a Special Purpose Framework" (AICPA, <i>Technical Questions and Answers</i>)
Q&A section 9160.35 (July 2017)	"Reporting on Indian Tribe Financial Statements Prepared in Accordance With Accounting Standards as Promulgated by FASB" (AICPA, <i>Technical Questions and Answers</i>)

Recent AICPA Independence and Ethics Developments

AICPA Conceptual Frameworks Toolkits

.327 The AICPA developed conceptual framework toolkits for all three of the conceptual frameworks. The toolkits will assist members in understanding and applying the conceptual framework concepts to their specific situations. Specifically, the toolkits include the following:

- Steps of the conceptual framework to provide members with detailed guidance on what to do when applying the conceptual framework approach
- A flowchart that serves as a visual aid for breaking down the steps of the conceptual framework approach
- A worksheet to aid members with applying the steps of the conceptual framework and an example of how to use this worksheet
- Examples of relationships or circumstances that are not addressed in the AICPA code and how the conceptual framework may be applied in such situations

.328 The toolkits are available at www.aicpa.org/interestareas/professional_ethics/resources/pages/default.aspx.

Definition of a *Client*

.329 In July 2017, the Professional Ethics Executive Committee (PEEC) adopted revised definitions for the term *client* and *attest client*. These revised definition of *client* makes it clear that there may be two separate clients on an

engagement, an entity that engages the member and an entity that is subject to the member's services. The revised definition of *attest client* better reflects the notion of affiliates.

New Independence Interpretation—Hosting Services

.330 In June, 2017, PEEC adopted a new independence interpretation, "Hosting Services," (ET sec. 1.295.143) which appears under the "Independence Rule" (ET sec. 1.200.001) in the AICPA Code of Professional Conduct (the code), and applies to members in public practice who provide attest services to a client.

.331 Under the new rule, hosting services impair independence when a member takes responsibility for maintaining internal control over an attest client's data or records. Specifically, a member performs hosting services when he or she takes responsibility for the following:

- Being the sole host of a client's financial or nonfinancial information system
- Custody or storage of the client's data, leaving the client's data incomplete and accessible only through the member
- Providing data or records security or back-up services for a client's electronic data or records

.332 Because members may have access, take possession, or retain copies of client records for various reasons, the interpretation provides several examples of activities that do and do not result in a member providing hosting services.

Hosting Services Defined

.333 The new interpretation provides three examples of situations that create hosting services, that is, if the attest client engages the member to be responsible for any of the following activities, independence is impaired:

- The member houses the client's website or other nonfinancial information system on the member's servers (whether the member owns or leases the servers).
- The member keeps the client's financial data or records (for example, general ledger, legal documents, amortization schedules) on the member's servers (whether leased or owned) or hardcopies of data or records in a physical location the member maintains.
- The member provides business continuity or disaster recovery services to the client for its data or records.

Nonhosting Services Defined

.334 Not all custody or control of a client's records results in hosting services because a member's access, use, custody, or control of the client's data may be appropriate and necessary when rendering professional services. The primary question is whether the member has accepted responsibility to maintain custody or control of the client's information. For example, a member may do the following without being considered a provider of hosting services:

- Have custody of the client's records to support a nonattest service. For example, the client provides payroll data to the member to support the member's preparation of a payroll tax return.

- Retain copies of work product, or data collected to support the member's work product, when providing a professional service for a client.
- Provide bookkeeping services using accounting software, such as QuickBooks, if the member and client separately maintain the software on their respective servers. Or, the client can contract with a third-party cloud-based software provider, such as Xero, and give the member permission to access the client's books via the software to perform the services.
- Exchange data, records, or the member's work product with the client electronically (for example, through a portal). Exchanges are related to performance of the member's professional services to the client or to deliver the member's work product to third parties at the client's request. To avoid hosting services when exchanging client data or records through a portal, the member should terminate the client's access to the data or records in the portal on a timely basis once the engagement is complete.
- License software to a client for the client's own use, provided the software performs an activity that the member could provide under the "Independence Rule." For example, under the "Appraisal, Valuation, and Actuarial Services" interpretation (ET sec. 1.295.110),² the member should not license business valuation software to the client that requires significant subjectivity and material to the client because independence would be impaired. However, the member could license software that performs only tax-related valuations and appraisals because the member is permitted to perform those types of valuations under the "Independence Rule."
- Hold depreciation schedules the member prepared for the client; the member should supply the schedules and calculations to the client so their books and records are complete.
- Possess a client's original data or records to facilitate performance of a nonattest services, such as tax return preparation; the member should return the data or records at the completion of the engagement (or if the engagement is ongoing, on an annual basis).

.335 Members are reminded to comply with requirements of other interpretations in the "Nonattest Services" subtopic (ET sec. 1.295). For example, all nonattest services are subject to certain general requirements, including documentation, and because elements akin to hosting may arise when a member performs tax, bookkeeping, or other nonattest services, members should comply with all applicable rules in that section of the code.

.336 The interpretation will be effective September 1, 2018.

Knowing Misrepresentations in the Preparation and Presentation of Information

.337 In June, 2017, PEEC adopted a revised version of this interpretation following review of a similar provision in the International Ethics Standards

² You can find all ET sections referenced in this alert in AICPA *Professional Standards*.

Board for Accountants (IESBA) ethics code. This rule applies only to members in business and, as before, appears under the "Integrity and Objectivity Rule" (ET sec. 2.100.001).

.338 The interpretation has traditionally applied to members preparing financial statements and records by barring them from knowingly and materially misrepresenting such information or directing others to do so.

.339 The revised interpretation expands the current rule to include information beyond the financial statements that is distributed both within and outside the member's employing organization. *Information* is described as follows:

[F]inancial and non-financial information that may be made public or used for internal purposes such as the following:

- a. Operating and performance reports
- b. Decision support analyses
- c. Budgets and forecasts
- d. Information provided to the internal and external auditors
- e. Risk analyses
- f. General and special purpose financial statements
- g. Tax returns
- h. Reports filed with regulators for legal and compliance purposes.

.340 The interpretation also addresses information that is not subject to a reporting framework.

.341 The "Integrity and Objectivity Rule" provides safeguards the member should apply to resolve a matter when he or she becomes associated with misleading information as described previously.

.342 A member who intends to rely on the work of others, either internal or external to the organization, is instructed to use professional judgment to determine steps to take to ensure that the requirements of the interpretations are met. For example, factors to consider in determining whether reliance on others is reasonable would include the reputation, expertise, objectivity, and resources available to the individual or organization and whether the other individual is subject to applicable professional and ethical standards. The member may have gained this information through prior association with others or by consulting others about the individual or the organization.

.343 Under the revised interpretation, if a member suspects he or she may be associated with misleading information, the member should apply the following safeguards:

- Consult the employing organization's policies and procedures (for example, an ethics or whistleblowing policy) regarding how such matters should be addressed internally.
- Discuss concerns that the information is misleading with the member's supervisor or the appropriate levels of management within the member's employing organization or those charged with governance and request such individuals take appropriate action to resolve the matter.

.344 Additional actions, including refusal to be associated with the misleading information, will be required if the member applies the preceding safeguards and the situation is not resolved because threats will be at an unacceptable level if the member remains associated with the misleading information. In addition, the member may decide to resign from the employing organization. Following is an excerpt from the interpretation.

If, after exhausting all feasible options, the member determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the member should refuse to be or to remain associated with the information. The member also should consider whether to continue a relationship with the employing organization.

.345 Members are encouraged to thoroughly document the facts and circumstances, actions taken, and other relevant factors about the matter.

.346

The interpretation became effective August 31, 2017.

Pressure to Breach the Rules

.347 In June, 2017, PEEC adopted this new interpretation following review of a similar provision in the IESBA ethics code. The "Pressure to Breach the Rules" interpretation (ET sec. 2.170.010) applies only to members in business and falls under the "Integrity and Objectivity Rule". This interpretation provides guidance to members who come under pressure (whether explicit or implicit) from various parties when they perform professional services and provides several examples, factors to consider, and safeguards.

.348 The interpretation addresses pressures that could result in a member taking actions that breach or cause others to breach the rules and guides the member on addressing threats (for example, undue influence threats) to compliance with the "Integrity and Objectivity Rule" when undertaking a professional service.

.349 Pressure may be explicit or implicit and can come from different sources:

- Within the employing organization, for example, from a colleague or superior
- An external individual or organization, such as a vendor, customer, or lender
- The need to meet internal or external targets and expectations

.350 A member should not allow pressure from others to result in a breach of the "Integrity and Objectivity Rule" and should also not place pressure on others that the member knows, or has reason to believe, would result in the other individuals breaching the rules of the AICPA Code of Professional Conduct.

Examples

.351 Examples of pressure that could result in a breach of the "Integrity and Objectivity Rule" include the following:

- Pressure related to conflicts of interest, for example, pressure from a family member bidding to act as a vendor to the member's

employing organization to select that vendor over another prospective vendor

- Pressure to influence the presentation of information; for example, the following:
 - Pressure to report misleading financial results to meet investor, analyst, or lender expectations
 - Pressure from elected officials to misrepresent programs or projects to voters
 - Pressure from colleagues to misstate income, expenditure, or rates of return to bias decision-making on capital projects and acquisitions
 - Pressure from superiors to approve or process expenditures that are not legitimate business expenses
 - Pressure to suppress internal audit reports containing adverse findings
 - Pressure to act without sufficient competence or due care (for example, without sufficient skills or training or under unrealistic deadlines)
 - Pressure to manipulate performance indicators from superiors, colleagues, or others, such as those who may benefit from participation in compensation or incentive arrangements
 - Related to gifts or entertainment (for example, offering gifts or entertainment to inappropriately influence the judgment or decision-making process of an individual or organization or accept inappropriate gifts or entertainment from potential vendors in a bidding process)

.352 In determining whether the pressure could result in a breach of the "Integrity and Objectivity Rule," the member may consider the following factors:

- The intent of the individual who is exerting the pressure and the nature and significance of the pressure.
- The application of relevant laws, regulations, and professional standards to the circumstances.
- The culture and leadership of the employing organization, including the extent to which it emphasizes the importance of ethical behavior and the expectation that employees will act in an ethical manner. For example, a corporate culture that tolerates unethical behavior may increase the likelihood that the pressure would result in a breach of the rules.
- Policies and procedures, if any, that the employing organization has established, such as ethics or human resources policies that address pressure.

.353 In considering the preceding factors, members may wish to consult with the following:

- A colleague, superior, human resources personnel, internal compliance personnel, or another professional accountant

- Relevant professional or regulatory bodies or industry associations
- Legal counsel

.354 If the member determines that the pressure would result in a breach of the "Integrity and Objectivity Rule," the member might consider safeguards, including the following:

- Discuss the matter with the individual who is exerting the pressure to seek to resolve it.
- Discuss the matter with the member's supervisor if the supervisor is not the individual exerting the pressure.
- Escalate the matter within the employing organization, for example, with higher levels of management, internal or external auditors, or those charged with governance, including independent directors and, when appropriate, explaining any consequential risks to the organization.
- Request restructuring or segregating certain responsibilities and duties so that the member is no longer involved with the individual or entity exerting the pressure, when doing so would eliminate the pressure to breach the "Integrity and Objectivity Rule." For example, if a member is pressured in relation to a conflict of interest, the pressure to breach the rule may be eliminated if the member avoids being associated with the matter creating the conflict.
- Disclose the matter in accordance with the employing organization's policies, including ethics and whistleblowing policies, using an established mechanism, such as a confidential ethics hotline.
- Consult with legal counsel.

.355 When the member determines that the pressure to breach the "Integrity and Objectivity Rule" has not been eliminated, the member should do the following:

- Decline to undertake or discontinue the professional activity that would result in a breach of the rule.
- Consider whether to continue a relationship with the employing organization.

.356 The member is also encouraged to document the facts, communications, courses of action considered, the parties with whom these matters were discussed, and how the matter was addressed.

On the Horizon

.357 To remain competent, auditors need to keep abreast of accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing current practice.

.358 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here.

Auditing and Attestation Pipeline—Nonissuers

Auditor Reporting Projects

.359 The ASB continues to work on improving the communicative value and relevance of the auditor's report. In January 2015, a special task force of the ASB was formed to consider a proposal to improve the quality of employee benefit plan audits by strengthening the employee benefit plan auditor's report. The chief accountant of the DOL requested the ASB take a fresh look at the auditor reporting model for audits of financial statements of employee benefit plans subject to the ERISA to provide better insight to the public regarding the scope of the responsibilities of management and the auditor, including when management imposes a limitation on the scope of the audit, as permitted by the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. The chief accountant of the DOL and DOL staff provided the task force with insights and recommendations as to areas where the DOL believes the auditor's report can be strengthened. The task force considered this information as a proposed SAS was developed.

.360 In April 2017, the ASB released an exposure draft of a proposed SAS that reflects the ASB's proposal for a new reporting model for audits of ERISA plans that, among other things, changes the form and content of the auditor's report for an unmodified opinion and creates a new form of opinion when management imposes a limitation on the scope of the audit, as permitted by ERISA. In addition, the proposed SAS includes a requirement to report findings from procedures performed on specific plan provisions relating to the financial statements. The changes in the proposed SAS would also require certain performance requirements in addition to those existing AU-C sections. Questions relating to these proposed requirements are included in the "Issues for Consideration" section in the exposure draft.

.361 We urge all practitioners with employee benefit plan clients to stay aware of the progress of this project. The ASB has also been working on several other areas of auditor reporting including a project to converge with the auditor reporting projects of the IAASB and PCAOB.

.362 The following list summarizes what the ASB believes would be the most significant changes resulting from the project:

- The "Opinion" section would be presented first in the auditor's report, followed by the "Basis for Opinion" section, unless law or regulation prescribe otherwise.
- The "Basis for Opinion" section of the auditor's report would include an affirmative statement about the auditor's independence, and fulfillment of the auditor's other ethical responsibilities, in accordance with relevant ethical requirements relating to the audit.
- Option to communicate key audit matters in auditor's report; a new standard would contain applicable requirements if that option is exercised as part of the terms of the audit engagement.
- Expands the description of the responsibilities of management for the preparation and fair presentation of the financial statements, and expands the description of the responsibilities of the auditor and key features of an audit.
- Expands the auditor's reporting requirements regarding other information and going concern considerations.

Auditing and Attestation Pipeline—Issuers

Using the Work of a Specialist

.363 The PCAOB is proposing amendments to its standards for using the work of specialists, under which two existing standards would be amended and a third existing standard would be retitled and replaced with an updated standard. In the PCAOB's view, the proposed amendments would further investor protection by strengthening the requirements for evaluating the work of a company's employed or engaged specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.

.364 Companies across many industries use specialists to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including, among others, actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors might use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

.365 Accounting estimates are also becoming more prevalent and more significant as financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements. As a result, the use of the work of specialists continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

.366 Under current PCAOB standards, auditor-employed specialists are subject to supervision under AS 1201, *Supervision of the Audit Engagement* (AICPA, *PCAOB Standards and Related Rules*), and auditors' responsibilities with respect to other specialists (employed or engaged by the company or engaged by the auditor) are primarily set forth in AS 1210, *Using the Work of a Specialist* (AICPA, *PCAOB Standards and Related Rules*). As a result, requirements that apply to auditor-employed specialists differ from the requirements that apply to auditor-engaged specialists, though both serve similar roles in helping auditors obtain and evaluate audit evidence. In addition, AS 1210 imposes the same auditor responsibilities with respect to both a company's specialist and an auditor-engaged specialist, even though those specialists have fundamentally different roles (for example, the company uses the work of its specialist in the preparation of the financial statements).

.367 Observations from PCAOB oversight activities indicate that there is substantial diversity in practice regarding the use of the work of specialists, such as how auditors use employed or engaged specialists and what procedures auditors perform to evaluate the work of companies' specialists. Moreover, PCAOB inspections staff continues to observe deficiencies related to auditors' use of specialists' work, such as failures to evaluate the assumptions of company specialists in fair value measurements or failures to consider contradictory evidence or issues raised by an auditor's specialist.

.368 The PCAOB is proposing to amend AS 1105, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*), to add a new appendix that addresses

using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. The PCAOB also is proposing to amend AS 1201 to add a new appendix on supervising the work of auditor-employed specialists and to replace AS 1210 with proposed AS 1210, which would set forth requirements for using the work of auditor-engaged specialists.

.369 The proposal is intended to strengthen PCAOB auditing standards in the following respects:

- Strengthen requirements for evaluating the work of a company's specialist.
- Apply a risk-based approach to supervising and evaluating the work of both auditor-employed and auditor-engaged specialists.

.370 The PCAOB has observed that, in many cases, auditors use the work of a specialist to test or assist in testing the company's process to develop an accounting estimate or in developing an independent expectation of an accounting estimate. In a companion release, the PCAOB is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard. Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (AICPA, PCAOB Standards and Related Rules), sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates. In the estimates release, the PCAOB is proposing to retitle and replace AS 2501, *Auditing Accounting Estimates*, and supersede AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Proposed AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the estimates release in order to illustrate how the proposed requirements in the two releases would work together.

Accounting and Financial Reporting Pipeline

Consolidation

.371 In June 2017, FASB issued proposed ASU *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*. This proposed ASU would affect reporting entities that are required to determine whether they should consolidate a legal entity under the guidance within the VIE subsections of FASB ASC 810-10, *Consolidation—Overall*, including private companies that have elected the accounting alternative for leasing arrangements under common control.

.372 This proposed ASU for the private company accounting alternative applies to all entities except for public business entities, not-for-profit entities, and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, 962, *Plan Accounting—Defined Contribution Pension Plans*, and 965, *Plan Accounting—Health and Welfare Benefit Plans* on plan accounting.

.373 Under the proposed amendments, a private company (reporting entity) would not have to apply VIE guidance to legal entities under common

control (including common control leasing arrangements) if neither the parent nor the legal entity being evaluated for consolidation are public business entities.

.374 The accounting alternative would provide an accounting policy election that a private company would apply to all current and future legal entities under common control that meet the criteria for applying this alternative and, therefore, could not be applied to select common control arrangements. If the alternative is elected, a private company still would be required to follow other consolidation guidance unless another scope exception applies.

.375 Under the accounting alternative, a private company would provide detailed disclosures about its involvement with and exposure to the legal entity under common control.

Debt

.376 In January 2017, as part of its simplification initiative, FASB issued for exposure proposed ASU *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*.

.377 FASB ASC 470, *Debt*, includes guidance on various narrow-scope, fact-specific debt transactions and this proposed ASU would replace the current, fact-specific guidance with an overarching, cohesive principle. The proposed amendments should reduce the cost and complexity for preparers and auditors when determining whether debt should be classified as current or non-current in the balance sheet.

.378 This proposed ASU relates to separate classifications of current debt and noncurrent debt within a classified balance sheet, thus an entity that does not present a classified balance sheet would be unaffected by the proposed amendments. The proposed amendments would apply to all entities that enter into a debt arrangement, that is, an arrangement that provides a lender with a contractual right to receive consideration and a borrower with a contractual obligation to pay consideration on demand or on fixed or determinable dates. The proposed amendments also would apply to convertible debt instruments and liability-classified mandatorily redeemable financial instruments.

Stock Compensation

.379 In March 2017, FASB issued for exposure proposed ASU *Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share Based Payment Accounting Service Concession Arrangements (Topic 853)*. The areas for simplification in this proposed ASU involve several aspects of the accounting for nonemployee share-based payment transactions resulting from expanding the scope of FASB ASC 718, to include share-based payment transactions for acquiring goods and services from nonemployees. Some of the areas for simplification apply only to nonpublic entities.

.380 This proposed ASU would affect all entities that enter into share-based payment transactions for acquiring goods and services from non-employees.

.381 The amendments in this proposed ASU would expand the scope of FASB ASC 718 to include share-based payment transactions for acquiring goods and services from nonemployees. An entity would apply the requirements of FASB ASC 718 to nonemployee awards except for specific guidance on inputs to an option pricing model and the attribution of cost.

.382 The proposed amendments would stipulate that share-based payments to nonemployees within the scope of FASB ASC 718 would need to be for goods or services purchased by the grantor for use or consumption in its own operations and not effectively issued to raise capital.

Independence and Ethics Pipeline

Proposed "Leases" Interpretation

.383 At its July 2017 meeting, PEEC voted to expose a proposed interpretation on leases in response to the revised accounting standards on leases issued by FASB. The proposed interpretation provides guidance that when a covered member enters into a lease with an attest client during the period of professional engagement, independence will be impaired unless certain safeguards are met. Once those safeguards are met, the proposal requires a conceptual framework approach to any other threats caused by the lease or leases, which may require additional safeguards. Examples of factors for members to consider in the evaluation are included in the proposed interpretation.

Proposed "Long Association of Senior Personnel With an Attest Client" Interpretation

.384 In July 2017, PEEC issued a proposed interpretation "Long Association of Senior Personnel With an Attest Client" after considering the new ethics standard *Long Association of Personnel with an Audit Client* of the IESBA code.

.385 The proposed interpretation does not include partner. However, partner rotation is a suggested safeguard in the proposed interpretation. Thus, the proposed interpretation is similar to the existing guidance in the AICPA code; however, the proposal is more robust and will better guide members when addressing familiarity threats due to long association with an attest client.

Proposed "State and Local Government Entities" Interpretation

.386 In July 2017, PEEC issued a proposed interpretation "State and Local Government Entities (formerly *Entities Included in State and Local Government Financial Statements*)" to incorporate the threats and safeguard approach into the "Entities Included in State and Local Government Financial Statements" interpretation and to determine whether a conceptual framework assessment could be used to decide when a member needs to be independent of state and local governmental (SLG) entities for which he or she is not providing financial statement attest services. PEEC also sought to clarify who at the firm and which immediate family members the interpretation should extend to and whether the interpretation should contain any exceptions.

.387 PEEC began its analysis by looking at the "Client Affiliates" interpretation (ET sec. 1.224.010) and related affiliate definition (ET sec. 0.400.02) that is applicable to commercial sector entities to determine whether this guidance could be extended to the SLG sector. PEEC does not believe the "Client Affiliates" interpretation is effective at identifying relationships requiring independence in the SLG sector because of the fundamental differences in the financial reporting objectives and financial statement presentation of these two sectors. However, PEEC tried to be conceptually consistent with the underlying principles of that affiliate's guidance, unless there was a compelling reason to differ from those principles.

.388 The financial reporting objectives in the commercial sector rely heavily on FASB definitions of *control* and *significant influence*, which are not used in GASB's reporting standards. Instead, GASB uses a concept of financial accountability to identify when an entity should be included in a state or local government's financial statements. As a result, financial accountability may require inclusion of an entity in the financial reporting entity of a primary government that might not meet the FASB definitions of *control* or *significant influence* by the primary government over the entity. Some of the more significant examples of how GASB standards differ from commercial financial reporting include the following:

- The view that capital assets are primarily used to provide services to citizens, rather than to contribute to future cash flows
- The measurement and recognition of certain types of revenues (for example, taxes and grants)
- The use of fund accounting and budgetary reporting to meet public accountability needs
- The view that governments and their pension plans generally are ongoing entities with the ability to take a career-long view of the employment exchange

.389 In the SLG sector, entities included in a set of financial statements are usually referred to as funds or component units. A fund is a fiscal and accounting entity with a self-balancing set of accounts that are segregated for the purpose of carrying on specific activities or attaining certain objectives. Funds are not legally separate entities.

.390 Component units are legally separate entities. Primary governments may not have control or significant influence over component units in the same way that a commercial sector entity has over its subsidiaries. Component units that are included in a governmental financial reporting entity can operate autonomously from each other, for example, by having separate governing boards, accounting systems, financial reporting systems, operations, and even separate strategic directions. The financial accountability criteria requiring inclusion in the financial reporting entity may merely be due to the appointment of a majority of the otherwise autonomously operating governing board, along with a significant financial benefit or burden relationship in which the governmental financial reporting entity is legally obligated to provide significant operating subsidies or financial support to that entity. Component units may interact with the primary government in an adversarial fashion that is typically foreign in a corporate environment. Officials at a component unit may not report up an organizational structure to someone at the primary government as they would in a corporate environment. Often, there is no communication regarding governance or operations between a component unit and the primary government, which includes the component unit in its financial reporting entity. Affiliate guidance does not effectively identify entities requiring independence in the SLG sector because the assumptions of control and significant influence that underpin the guidance in FASB ASC affiliates definition is not the basis for inclusion in a governmental financial reporting entity.

.391 SLG financial statements are not consolidated into a single column like commercial sector entities. Instead, government-wide financial statements and fund financial statements are presented in columnar formats. Interfund activities are not always eliminated as they would be in a consolidated presentation. Different fund categories and, in certain circumstances, different fund

types within the same fund category, will not be included on a single set of fund financial statements but will be spread across multiple fund financial statements.

.392 Furthermore, auditors may not necessarily opine solely on the financial statements as a whole. Instead, auditors (often multiple auditors) typically opine separately on the financial statements by auditing individual opinion units. Opinion units may be composed of a single entity, such as a discretely presented component unit, or may include several discretely presented component units or funds.

Resource Central

.393 The following are various resources that practitioners may find useful.

Publications

.394 Practitioners may find the following publications useful. Visit www.aicpastore.com and choose the format best for you—print, ebook, or online. Although the most current editions available at the date of writing of this alert are subsequently identified, you will want the newest edition available at the time of purchase:

- Audit Guide *Analytical Procedures* (2012) (product no. AAGANP12P [paperback], AAGANP12E [ebook], or WAN-XX [online])
- Audit Guide *Special Considerations in Auditing Financial Instruments* (2016) (product no. AAGAFI16P [paperback], AAGAFI16E [ebook], or AAGAFIO [online])
- Guide *Preparation, Compilation, and Review Engagements* (2017) (product no. AAGCRV17P [paperback], AAGCRV17E [ebook], or WRC-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2016) (product no. AAGARR16P [paperback], AAGARR16E [ebook], or WRA-XX [online])
- Audit Guide *Audit Sampling* (2017) (product no. AAGSAM17P [paperback], AAGSAM17E [ebook], or WAS-XX [online])
- Audit Guide *Revenue Recognition* (2016) (product no. AAGREV16P [paperback] or WAR-XX [online])
- Attestation Guide *Reporting on and Entity's Cybersecurity Risk Management Program and Controls* (2017) (product no. AAGCYB17P [paperback], AAGGCYB17E [ebook], or AAGCYBO [online])
- Alert *Developments in Review, Compilation, and Financial Statement Preparation Engagements: Engagements Performed in Accordance With SSARs—2017/18* (product no. ARACRV17P [paperback], ARACRV17E [ebook] or ARACRVO [online])
- Alert *Revenue Recognition: Accounting and Auditing Considerations—2016/17* (product no. ARAREV16P [paperback], ARAREV16E [ebook], or ARAREVO [online])

- *Internal Control—Integrated Framework: Executive Summary, Framework and Appendices, and Illustrative Tools for Assessing Effectiveness of a System of Internal Control* (3 volume set) (product no. 990025P [paperback], 990025E [ebook], ACOSO2O [online])
- *U.S. GAAP Financial Statements—Best Practices in Presentation and Disclosure* (formerly *Accounting Trends & Techniques*) (product no. ATTATT17P [paperback] or ABPPDO [online])
- *Audit and Accounting Manual* (2017) (product no. AAMAAM17P [paperback] or WAM-XX [online])
- *The Auditor's Report: Comprehensive Guidance and Examples* (product no. APAARMO [online])
- *The Engagement Letter: Best Practices and Examples* (product no. APAEGLO [online])
- *Audit Risk Alert Understanding the Responsibilities of Auditors for Audits of Group Financial Statements* (product no. ARA-GRP13P [paperback], ARAGRP13E [ebook], or ARAGRPO [online])

Continuing Professional Education

.395 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *Annual Accounting and Auditing Workshop* (product no. 736193 [text], 187241 [DVD/manual], or 156563 [online with video]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *IFRS Certificate Program* (product no. 159770). Using a scenario-based series of courses with audio, video, and interactive exercises and case studies, this program will guide you through the concepts of each area of IFRS.
- *Internal Control and COSO Essentials for Financial Managers, Accountants, and Auditors* (product no. 731909 [text] or 159825 [on-demand]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *U.S. GAAP: Review for Business and Industry* (product no. 163972 [on-demand]). Comprehensive coverage of recent FASB and IASB pronouncements geared to the specific interests of the CPA in corporate management.

.396 Visit www.aicpastore.com for a complete list of CPE courses.

Online CPE

.397 CPEExpress, offered exclusively through www.aicpastore.com, is the AICPA's flagship online learning product. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, CPEExpress offers hundreds of hours of learning in a wide variety of topics. Subscriptions

are available at www.aicpastore.com/ast/main/cpa2biz_primary/prdovr~pc-byf-xx/pc-byf-xx.jsp (product no. BYF-XX). Some topics of special interest may include the following:

- Accounting and Auditing Update
- Small Business Accounting and Auditing Update
- Fair Value Accounting
- Accounting for Goodwill and Other Intangibles
- Uncertainty in Income Taxes
- Revenue Recognition
- Fraud and the Financial Statement Audit
- Public Company Update
- SEC Reporting

.398 To register for individual courses or to learn more, visit www.aicpastore.com.

Webcasts

.399 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available for viewing. For additional details on available webcasts, please visit www.aicpastore.com/ast/aicpa_cpa2biz_nav/responsive_top_nav/webcasts.jsp.

Member Service Center

.400 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.401 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. ET on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/research/technicalhotline/pages/default.aspx.

.402 Members can also email questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a technical inquiry form found on the same website.

Ethics Hotline

.403 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline

at 888.777.7077 (select 6 on your phone's keypad, followed by 1) or by email at ethics@aicpa.org.

Center for Plain English Accounting

.404 The Center for Plain English Accounting (CPEA) is a service available to Private Companies Practice Section member firms. It provides expertise and resources in a straightforward and clear style. Written responses to technical inquiries, webcasts on hot topics, and monthly A&A reports and alerts help practitioners understand and implement the authoritative professional literature when they are auditing, reviewing, preparing, and compiling financial statements. To join the CPEA and take advantage of these valuable resources, visit the CPEA website at www.aicpa.org/interestareas/centerforplainenglishaccounting/pages/cpea.aspx.

AICPA Online Professional Library: Accounting and Auditing Literature

.405 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. You can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC; the AICPA's latest *Professional Standards*, *Technical Questions and Answers*, Audit and Accounting Guides, Audit Risk Alerts, *Best Practices in Presentation and Disclosure*; and more. To subscribe to this essential online service for accounting professionals, visit www.aicpastore.com.

Financial Reporting Center of AICPA.org

.406 CPAs face unprecedented changes in financial reporting. As such, the AICPA has created the FRC to support you in the execution of high-quality financial reporting. This center provides exclusive member-only resources for the entire financial reporting process and can be accessed at www.aicpa.org/frc.

.407 The FRC provides timely and relevant news, guidance, and examples supporting the financial reporting process. You will find resources for accounting, preparing financial statements, and performing various types of engagements, including compilation and review, audit and attest, and assurance and advisory.

.408 For example, the FRC offers a section dedicated to the FASB revenue recognition standard. For the latest resources available to help you implement the revenue recognition standard, visit the "Revenue Recognition" page at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/default.aspx.

Industry Websites

.409 The internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for auditors include those shown in the following table:

<i>Website Name</i>	<i>Content</i>	<i>Website</i>
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.aicpastore.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as the Accounting Standards Executive Committee)	Summaries of recently issued guides, white papers, and technical questions and answers containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/interestareas/frc/accountingfinancialreporting/pages/finrec.aspx
AICPA Accounting and Review Services Committee	Summaries of preparation, review, and compilation standards and interpretations	www.aicpa.org/research/standards/compilationreview/arsc/pages/default.aspx
Committee of Sponsoring Organizations of the Treadway Commission	Information about the committee and the internal control framework developed by the committee	www.coso.org
Moody's Analytics	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.ifrs.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standard-setting activities in the international arena	www.ifac.org

(continued)

<i>Website Name</i>	<i>Content</i>	<i>Website</i>
Private Company Council	Information on the initiative to further improve FASB's standards-setting process to consider needs of private companies and their constituents of financial reporting	www.fasb.org/pcc
PCAOB	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
SEC	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
