

# CHECKPOINT LEARNING

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Topics for future editions may include:

- IFRS Sustainability Disclosures
- Compilation Reporting
- New SEC cybersecurity disclosures

## EXECUTIVE SUMMARY

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### PART 1. ACCOUNTING

#### To Capitalize or Not .....3

Russ Madray, CPA reviews the accounting guidance related to when expenditures need to be capitalized.

*[Running time: 55:05]*

**Learning Objectives:** Upon completion of this segment, the user should be able to:

- Define an asset and an expense
- Determine the appropriate guidance for capitalization of self-constructed assets and the stages involved
- Identify the amount of interest to capitalize for a self-constructed asset
- Determine when expenditures for repairs should be capitalized
- Identify what R&D costs can be capitalized
- Define start-up costs

### PART 2. AUDITING

#### FAQs on Evaluating ECL Estimates.....27

Jennifer Louis, CPA discusses frequently asked questions on evaluating expected credit loss estimates.

*[Running time: 31:34]*

**Learning Objectives:** Upon completion of this segment, the user should be able to:

- Identify how the allowance for credit losses will be presented in the financial statements and who is responsible for the determination
- Determine what provides sufficient evidence to support management's allowance estimate for the auditor
- Determine the use of pooling of assets when assessing potential credit loss.

## ABOUT THE SPEAKERS

**Russ Madray, CPA, CGFM**, has more than 30 years of professional experience, including stints at two Big 4 accounting firms. Russ is a nationally-known accounting and auditing thought leader, writer, and advisor helping CPAs throughout the country understand and implement technical accounting and auditing issues.

**Jennifer Louis, CPA**, is a CPA and president of Emergent Solutions Group, LLC. She has more than 25 years experience in designing and instructing high-quality training programs. Ms. Louis was previously executive vice president and director of training services at AuditWatch Inc., a premier training and consulting firm serving the auditing profession. She also served as financial/operational audit manager for the AARP, and as an audit manager for Deloitte.

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### PART 1. ACCOUNTING

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#### To Capitalize or Not?

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Costs related to assets providing future benefits to an organization are required to be capitalized by U.S. GAAP. While capitalizing the costs associated with a building or certain equipment can be straightforward, there are times when the decision isn't so clear cut and questions may arise.

For more on when to capitalize costs expended on an asset, let's join Russ Madray, a CPA in Greenville, South Carolina, and CPE Network's Debi Grove Casey.

#### Ms. Grove Casey

Today we want to talk a little bit about capitalization, and U.S. GAAP requires capitalization of costs when a future benefit for the expenditure exists. Usually, that's beyond the length of the operating cycle of whatever organization it is, so typically, it's over a year. In some cases, the decision to capitalize is fairly straightforward. You can tell that the asset is going to last a while so, therefore, you would capitalize it and go through the process there. But there are other situations where that decision is, really, just not as clear whether we should capitalize or expense it. So, to begin with, could you give us an overview of what U.S. GAAP says about this?

#### Mr. Madray

Sure. U.S. generally accepted accounting principles, or U.S. GAAP, as you just mentioned, requires capitalization of a cost when there's a future benefit associated with that expenditure. For example, if a company purchases a building, it's clear and obvious that the benefits of the building are expected to extend into the future. Therefore, the company would record an asset and depreciate that building over time. So, in some cases, like a building or purchase of equipment, things like that, the decision is pretty easy and pretty straightforward. But there are, as you mentioned, some situations where it's not as clear.

We've listed several on our first slide here where questions could arise about whether or not, and by how much, we capitalize costs associated with things like self-constructed assets, repairs and maintenance of existing capital assets, research and development costs, internally developed intangible assets, patent defense costs, start-up costs, pre-production costs, contract costs, advertising costs, and website development costs. That's not an exhaustive list; I'm sure there are some other things out there where questions arise, but those are some that I have run into and had questions about and, depending on the type of business and the type of industry, some of those may be more prevalent than others.

The starting point for this whole discussion regarding all of those on that list we just saw is what, really, is an asset? While there's no specific authoritative guidance that is applicable to certain types of transactions, the underlying issue will always be, does the expenditure represent an asset or an expense? So, let's start there.

On the next slide, we have the definition of an *asset*. That's from a Statement of Financial Accounting Concepts [SFAC] 6. Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. There are three essential characteristics you see there. First, it embodies a probable future benefit that involves a capacity to contribute directly or indirectly to the future cash flows of an entity; secondly, a particular entity can obtain the benefit and control others' access to it; and finally, the transaction or event that gave rise to the entity's right to control the benefit has already occurred.

Now, compare that with the definition of *expense* we have on the next slide, which is also found in SFAC 6. Expenses are defined as outflows or other using up of assets or incurrences of liabilities, or even a combination of both of those, from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

So, taking those two things together, you can think of it this way: an asset represents a probable future benefit, while an expense represents a benefit that has already been received. We are going to go through each of those situations on our first list there, and you'll see this relationship where the authoritative guidance takes us to a conclusion. That relationship between asset and expense will be evident in the conclusions related to what we capitalize versus what we expense. So that's the starting point. I always like to say, an asset is a benefit waiting to happen and an expense is a benefit already received, and we'll see that play out in each of the situations and examples that we're going to take a look at.

### Ms. Grove Casey

I like the fact that you use the word *benefit* in both. Let's begin looking at some of these situations. One of the things is that it's not that people don't recognize that it's an asset, it's just that you're incurring the costs in little bits at a time—well, hopefully, little bits at a time from a cashflow standpoint. When we self-construct assets, sometimes those need to be put on the books and capitalized, but sometimes, the expenditures that go towards that asset don't all occur at the same time. So, it's not that it's questionable, it's just, how do we go about doing it?

### Mr. Madray

Sure. Well, with self-constructed assets, the starting point is property, plant, and equipment, generally, is going to be reported at its historical cost which is the amount of cash or cash equivalent that's paid to acquire the asset, then subsequently accounted for through amortization, depreciation, impairment, and so on. The guidance for the costs to be capitalized when acquiring long-lived assets is found in [FASB ASC] Topic 360, which is *Property, Plant, and Equipment*, and it states, as you see here, the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.

Topic 360 doesn't include any specific guidance on cost capitalization for capital projects that are constructed or acquired for an entity's own use. What we do is look to some concepts that were included in a proposed statement of position—and we're going way back to 2001. The Financial Reporting Executive Committee of the AICPA proposed a statement of position, and this was back when that committee issued SOPs, or statements of position, and they became GAAP. (This was pre-Accounting Standards Codification.) That statement of position was never finalized and adopted and never technically became GAAP, but that statement of position, it was called *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, reflected current practice regarding the accounting treatment for capitalization of costs for capital projects. That was proposed in 2001. In 2003, they re-deliberated and submitted a proposed statement of position to the FASB for approval. Again, it was never approved for issuance by the FASB, but going back and looking, there was a lot of work and research that went into putting that together. That SOP does include a lot of guidance related to capitalization of costs that are constructed or obtained for a reporting entity's own use that can still be helpful. So, this technically is not GAAP, but it is something that a lot of folks look to, to help reach conclusions about these self-constructed types of assets.

Identifying and determining which costs should be capitalized is a key focus in the accounting for assets that are self-constructed. Those costs might include labor, material, supplies, transportation, all kinds of things. As a side note, Topic 970, which deals with real estate, does include some specific guidance on capitalizing the costs of real estate developed for sale or rental, but that guidance explicitly excludes capital projects that are constructed for a reporting entity's own use. Again, that could be a place that you might look to apply guidance by analogy in determining your overall capitalization policies.

So, back to our proposed SOP, keeping in mind the cost of acquiring an asset includes the costs necessary to bring it to the condition and location necessary for its intended use, based on that, that proposed SOP identified four stages during which costs might be incurred related to self-constructing assets. They divided it into the preliminary stage, the pre-acquisition stage, the construction stage, and the in-service stage. Again, this is not GAAP, but it is a document that reflects a lot of research, discussion, and so on, and a lot of folks do look to this for at least non-authoritative guidance on making decisions about capitalizing costs related to self-constructed assets. I'm sorry, would you repeat that?

**Ms. Grove Casey**

I said, [we use] Concepts Statements, as well, and they aren't authoritative GAAP. So, let's say that GAAP is not our only resource when it comes to making these kinds of decisions.

**Mr. Madray**

Exactly. We do have to remember there are other places to look. And this one might be a little bit above what I heard at a conference one time, but it's still not authoritative.

So, let's start with the preliminary stage. During what they define as the preliminary stage, there are activities that are performed to explore opportunities for acquisition or construction of a particular piece of property, plant, and equipment. This might include feasibility studies or other activities related to the asset selection. Costs could be incurred here, related maybe to obtaining an option to acquire one or more items of property, plant, or equipment during this stage. Other costs might include things like surveying, zoning, engineering studies, traffic studies, or obtaining management approval to move forward with a particular acquisition or construction. The key is, during the preliminary stage (as defined here), the project is not considered probable of being constructed. Therefore, as you see on this next slide, given the high degree of uncertainty about the future economic benefits, costs incurred in the preliminary stage should be expensed as incurred. The preliminary stage is defined as commencing at the beginning of a project and lasting until the acquisition or construction of the specific asset is considered probable. So, that's the preliminary stage.

Once you get to the point where acquisition or construction is considered probable, then that would take us to the pre-acquisition stage. That stage begins when the construction of the specific asset is probable, but we haven't actually started construction. So, the SOP (again, the proposed SOP that was never adopted), differentiates between costs that are directly identifiable and those that are allocated or some type of overhead cost. Directly identifiable costs, according to this SOP, should be capitalized in the pre-acquisition stage, whereas any allocated or other overhead costs would be expensed during that period.

We have examples of directly identifiable costs on this next slide. Incremental direct costs of the pre-acquisition activities that are incurred for the specific asset in transactions with independent third parties; certain costs that are directly related to pre-acquisition activities that are performed by the entity, or even by third parties who are not independent of the entity, for the specific asset. These could include things like payroll and payroll benefit-related costs for employees who devote time to the pre-acquisition stage activity, to the extent of time the employee spent directly on that activity and in proportion to the total hours that they're employed. Other [directly identifiable costs] could include payments to obtain an option to acquire the property, plant, and equipment. In this case, the option would be carried at the lower of cost or fair value. Any reductions in the recorded value of the option would be charged to expense. If the fair value less cost to sell of the option subsequently increases, any amounts previously charged to expense would not be reinstated, in that case.

As I mentioned, general, admin, and overhead costs in this stage should be expensed as incurred, regardless of whether they're incurred internally or by a third party. Those would include all costs of things like support functions (executive management, corporate accounting, acquisitions, purchasing, legal, human resources, things like that). Pre-acquisition costs would then, ultimately, be reclassified to construction work in progress once construction begins on the actual asset.

Now, as a side note, if during that pre-acquisition stage the construction or acquisition is determined to no longer be probable, then any costs that have been capitalized need to be assessed for impairment under Topic 360. When evaluating whether those capitalized costs are no longer probable of being completed, whether or not they're impaired, the entity will need to determine whether the asset is going to be sold, abandoned, or held and possibly completed and used in some future period.

That, then, takes us to the construction stage. The construction stage would begin at the time the entity obtains ownership of the asset or obtains the right to use the asset through an agreement like a lease. During that stage, costs that are incurred to acquire, construct, or install the property, plant, and equipment would be capitalized. This stage

would include costs that are incurred prior to the asset being available for its intended use. Those include things like planning for construction or installation [once] ownership or the right to use has been acquired, constructing or actually installing the equipment or asset, supervising the construction of the asset, and so on. Similar to that pre-acquisition stage we just discussed, costs that are incurred during the construction stage that are directly identifiable should be the ones capitalized. Directly identifiable costs in this stage typically would be incremental direct costs of acquiring, constructing, or installing the asset incurred in transactions with independent third parties, and certain costs that are directly related to activities performed by the entity [for the] construction and installation of the asset.

Like we said earlier, rent, depreciation, and occupancy costs associated with the physical space [occupied by] employees that are working on the project would not be considered directly identifiable and would simply be expensed as incurred. So, directly identifiable costs in this stage would be capitalized. Other costs, as we said, overhead, admin, and so on, would be expensed as incurred. And again, specifically, overhead costs that are not directly related to the construction of the asset certainly should be expensed as incurred.

Finally, that leads us to the in-service stage. The in-service stage begins when the asset is substantially complete and ready for its intended use. Costs from that point forward (or in that stage) would include things like repair and maintenance, replacing of components, purchase of additional components, and so on. Costs incurred in this stage to acquire additional components or replace existing components typically would be capitalized. Costs of normal recurring periodic repairs and maintenance typically would be expensed as incurred. We're going to revisit repairs and maintenance in a moment because there is some specific guidance that we can apply in that case, but up until this point, everything we looked at came from that proposed SOP.

Now, when we're talking about self-constructed assets, we inevitably talk about interest capitalization, as well. Guidance related to this is found in Topic 835, specifically [ASC] 835-20, dealing with capitalization of interest. In that guidance it says that the objectives of capitalizing interest are to obtain a measure of cost that more closely reflects the entity's total investment in the asset and a charged cost that relates to the acquisition of the resource that will benefit future periods against the revenues of that period that it benefits.

As we said before, the historical cost of acquiring an asset would include all costs necessary to bring it to the condition and location necessary for its intended use. Therefore, the costs incurred in financing expenditures for an asset during a construction or development period is itself a part of the asset's historical acquisition cost. So, the cause-and-effect relationship between acquiring an asset and the occurrence of interest costs makes interest cost analogous to something like a direct cost that is readily and objectively assignable to an acquired asset.

I mentioned Topic 835, and that's where we find the definition of a qualifying asset that we see on the next slide here. That will include assets that are constructed or otherwise produced for an entity's own use, including assets constructed or produced for the entity by others where deposits or progress payments have been made; it includes assets that are intended for sale or lease that are constructed or otherwise produced as discrete projects, as opposed to regular assembly-line types of construction; it will include investments [such as] equity, loans, and advances accounted for by the entity by the equity method while the investee has activities in progress that are necessary to commence the planned principal operations provided that the investee's activities do include the use of funds to acquire those qualifying assets for the operations. In this case, the investor's investment in the investee, rather than the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization. Out of all this, the most common that we think of are self-constructed assets.

The idea behind interest capitalization and determining the amount to capitalize is that interest costs that could theoretically have been avoided if the expenditures for these qualifying assets had not been made, that's what we're going to capitalize. So, the interest that we're going to capitalize is determined by applying a capitalization rate to the weighted-average carrying amount of the expenditures that have been made for the asset during the period. Keep in mind that the amount of interest cost capitalized cannot exceed the amount of interest cost that is actually incurred by the entity during that period.

The guidance in Topic 835 does give us some flexibility in determining that capitalization rate. It might be the rate of a specific new borrowing that can be associated with the qualifying asset, or it might be a rate determined by a

weighted-average technique. Most entities would use that weighted-average technique since proceeds from a specific borrowing are typically not always identifiable with a particular qualifying asset. So, in identifying the borrowings that need to be included in the weighted-average carrying amount, the objective would be to obtain a reasonable measure of the cost of financing the asset while getting the asset ready for its intended use.

With that, let's take a look at an example I have on this next slide. Let's assume here that Richards Corp begins construction on a new corporate office building on September 1 of 2020. Construction continues without interruption through March 31 of 2021. There are some directly attributable expenditures for that first year that we see: in September, \$200,000; in October, \$300,000; in November there's \$500,000; and in December, \$300,000. They're going to use a mid-month convention for the attributable expenditures.

To determine the weighted-average carrying amount of the asset during the period, we would look at September. With September, you've got October, November, December, and half of September, so 3.5 months out of 12  $\times$  \$200,000 is \$58,333. October is \$300,000  $\times$  2.5 over 12; November is 1.5 over 12, and December is 0.5 over 12. Total expenditures during that period were \$1.3 million, but for our weighted-average qualifying expenditures, we're going to come up with \$195,833.

Assume here that they've not taken out any specific borrowing to finance the construction of this asset, but they do have some other debt. They have a \$1 million loan outstanding with a 3.5% interest rate and a \$2 million loan outstanding with a 5.5% interest rate. These loans are not for specific expenditures. So, if we look at those, the annualized interest cost on our general borrowing would be the 3.5%  $\times$  \$1 million plus the 5.5%  $\times$  \$2 million, which is \$145,000. If we take the \$145,000 and divide it by the total debt of \$3 million, we get a weighted-average interest rate of 4.83%. So, going back to the amount that we will capitalize as part of this construction project, we would take our weighted-average qualifying expenditures that we determined a moment ago, \$195,833, times our weighted average interest rate, 4.83%, and we get \$9,459. So, in addition to the expenditures on the project which, again, totaled \$1.3 million, we would add another \$9,459 for interest capitalized.

We'll continue going through that through the entire capitalization period, which Topic 835 defines as you see here. The capitalization period begins when these three conditions are present: expenditures have been made, activities that are necessary to get the asset ready for its intended use are in progress, and interest cost is being incurred. We will continue the interest capitalization as long as those three conditions are present. When any one of those three is no longer present, we would stop capitalizing interest.

One other note here, the primary objective in Topic 835 is to require capitalization of interest on major construction projects when the financial statement effect of capitalization versus expensing that interest is likely to be material. Topic 835, in fact, speaks to minimum thresholds that require capitalization, which are common in accounting for property, plant, equipment. That is designed to minimize an entity's burden of capitalizing interest associated with a large number of assets and accounting for those costs as the assets are used. So, entities will just have to use judgment to determine whether interest associated with a particular self-constructed asset would have a material effect and, therefore, need to be capitalized, or simply expensed during that period.

I mentioned repairs and maintenance a moment ago. Another thing that we run into with respect to any type of property, plant, and equipment, including [any] that has been self-constructed, the general guideline for property, plant, and equipment expenditures that are made after acquisition or after construction is completed is that if the expenditures provide additional service potential beyond the initial estimated useful life, then they would be capitalized. If they don't provide additional service potential, then they would be expensed as incurred.

So, how does an expenditure provide additional service potential for an asset? We see it on the next slide. It might be an extension of the useful life of the asset, or it might be an increase in the operating efficiency of the asset that results in either an increase in the quantity of goods or a decrease in future operating costs, or it could be an increase in the quality of the goods or services that are produced by the asset. The bottom line is any expenditures that cause any of those three results should be capitalized, then allocated to future periods through depreciation or amortization or whatever it may be. Again, materiality is going to come into play in terms of the practical application of that approach to repairs and maintenance. The key thing I always say about repairs and maintenance is it doesn't matter what you



call it. It doesn't matter if you call it a repair, a maintenance, a replacement, whatever. The key thing is those three conditions. If it extends the useful life, capitalize it. If it increases the operating efficiency, capitalize it. If it increases the quality of the goods or services produced, capitalize it. If it doesn't do any of those three things, it should be expensed as current-period expense.

If we're going to capitalize, we even have different ways of accomplishing that from a basic journal entry standpoint. On the next slide, you see there's three methods that can be used to record or capitalize these costs. One is called substitution, another is just capitalization of the new cost, and the third way is through reduction of accumulated depreciation. With substitution, the improvement can be recorded as a disposition of the old component and an acquisition of a new component. That can be practical usually only if the original cost and accumulated depreciation of the old piece that we are, in effect, substituting can be separately identified. Of course, capitalization of the new cost, to me, this is the easiest. You just record the cost of the improvement as a debit to the related asset account without removing any original cost or accumulated depreciation. Again, that, to me, seems the most appealing and easiest way to do it. The final way is to reduce accumulated depreciation, so the way you increase an asset's book value is to leave the asset account unaltered but decrease the related accumulated depreciation. The argument for using that method is that a lot of improvements extend the useful life of the asset and are equivalent to a partial recovery of previously recorded depreciation. Of course, this method produces the same book value as simply capitalizing the cost, which I said is my personal favorite, but here the cost and accumulated depreciation amounts are going to differ. Book value will be the same, but the two components of that will differ depending on which approach is used.

So, that's a whole mouthful about self-constructed assets and some issues related to those. I know we want to cover some of those other situations, so I'll pause on that part now and see what we'd like to look at next.

**Ms. Grove Casey**

Well, how about R&D costs? Are any of those capitalizable? Because we get some different types of things there. It's not always expensed.

**Mr. Madray**

The short answer is no, they're not capitalizable, but it's a bit more involved. Topic 730 in the Accounting Standards Codification, ASC 730, gives us a definition of research and development, or R&D, and we see that on this next slide. Research is planned search or critical investigation aimed at discovery of new knowledge, with the hope that such knowledge will be useful in developing a new product or service, or a new process or technique, or in bringing about a significant improvement to an existing product or process.

On the other hand, development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process, whether it's intended for sale or use. That would include conceptual formulation, design and testing of product alternatives, construction of prototypes, operation of pilot plants, that kind of thing.

Back to the guidance in Topic 730, capitalization as a tangible asset would be appropriate for expenditures for things like materials, equipment, and facilities that are acquired or constructed for research and development activities and have alternative future uses. The cost of materials that are consumed in R&D activities and the depreciation of equipment or facilities used in those activities would be expensed as R&D costs. Intangible assets that are acquired for use in R&D activities that have an alternative future use can also be capitalized, keeping in mind that intangible assets that are acquired in a business combination are always capitalizable, whether they have an alternative future use or not.

On the other hand, if materials, equipment, and facilities that are acquired or constructed for R&D activities or acquired intangible assets that are used in R&D don't have any alternative future use (which means they have no separate economic value), they should be expensed as R&D costs when incurred. So, that's why I said the short answer is no, they can't be capitalized. But keep in mind, sometimes, in carrying out that activity we might buy

facilities, equipment and so on, and if it has an alternative future use, generally it can be capitalized and then depreciated going forward.

I mentioned intangible assets as part of that. A related question that often comes up is, what about internally developed intangible assets? Well, we find guidance there in Topic 350, and it says that costs to internally develop, maintain, or restore unidentifiable intangible assets (things like goodwill) that have indeterminate lives or that are inherent in a continuing business and related to the business as a whole would be expensed as incurred unless they are explicitly capitalizable under other U.S. GAAP. The example there would be internally developed software.

So, intangible assets that are acquired either individually or with a group of other assets outside of a business combination would be initially recognized and measured based on their cost, but for internally developed intangible assets, there's nothing to capitalize. Any of that kind of expenditure would be expensed as it's incurred.

Since we're talking about intangible assets, that leads me to patent defense costs. Questions about whether an entity can capitalize costs related to legal work in connection with patent applications. These questions come up from time to time, and the key is, because of the uncertainty associated with the successful development of intellectual property rights, legal costs incurred in connection with a patent application generally are expensed as incurred.

There is some guidance in a non-GAAP source, it's called *AICPA Technical Questions and Answers*, and it does address patent defense costs. According to this particular Q&A, the choice of capitalizing or expensing the legal costs associated with defending a patent depends on the outcome of the lawsuit. In this Q&A, it refers back to SFAC 6 which is where we found the definition of an asset, and in that Concepts Statement, it indicates that the legal and other costs of successfully defending a patent from infringement are "deferred legal costs" only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent. Therefore, the answer is, if the defense of the patent lawsuit is successful, the costs could be capitalized to the extent of an evident increase in the value of the patent. Legal costs that relate to an unsuccessful outcome would be expensed, because your patent is also worthless at that point, apparently.

So, the bottom line: capitalization of patent defense costs will be appropriate only when a successful patent defense is likely to occur, and the value of the patent is expected to increase as a result. Now, as a side note here, in many cases, defending a patent or the legal defense of a patent oftentimes will simply maintain the value of the patent and doesn't necessarily increase the value of the patent. If that's the case, those costs would be expensed, even if it were a successful defense of the patent. So, clearly some judgment involved there, but several areas that I thought were somewhat related and I wanted to touch on those. I know we have a couple of others, so what do we want to look at next?

### **Ms. Grove Casey**

Let's take a look at start-up costs. I think that was next on the list.

### **Mr. Madray**

Sure. Start-up costs are known by various names. Sometimes, we see them referred to as pre-opening costs, pre-operating costs, organization costs, start-up costs. Topic 720, specifically 720-15, deals with start-up costs—that's the term that authoritative GAAP uses—and Topic 720 says that start-up costs would include the activities you see on this next slide. That would include opening a new facility; introducing a new product or service; conducting business in a new territory; conducting business with an entirely new class of customers; initiating a new process in an existing facility; or commencing some new operation. Under this guidance, Topic 720 also treats the costs of organizing a corporation or partnership as start-up costs.

So, all of that is incorporated in the concept of start-up costs, and the easy, short answer here is, under Topic 720, all start-up costs must be expensed as incurred. So, looking at the list on that slide again, any costs associated with opening a new facility, introducing a new product, conducting visits to a new territory, an entirely new class of customers, new process in an existing facility, some new operation, even costs of organizing a corporation or partnership, all of those would be expensed as incurred.

I believe the next thing we had on our list was pre-production costs. That can include things—and again, you’re going to see this in certain industries—things like design and development for molds, dies, tools, and so forth that are used to produce parts and other products. This is common in manufacturing industries where there are specific molds or tools that are required to produce the parts that are specific to a customer’s needs. On this issue, there is some specific guidance in Topic 340, ASC 340, which deals with other assets and deferred costs, and it covers the accounting for pre-production costs related to long-term supply arrangements.

In that guidance, you find that design and development costs that are related to products to be sold should be expensed as incurred, whereas any design and development costs related to molds, dies, or other tools that the supplier will own, those generally would be capitalized unless they relate to some new technology. Costs incurred for new technology that have uncertain future economic benefits should be expensed as incurred. I think if you’ve been listening closely, you see some common threads through these various pieces of guidance. This is another one.

Now, in order to capitalize these pre-production design and development costs, the entity generally would consider whether a long-term supply agreement exists, whether a contractual guarantee or reimbursement for pre-production product design development costs exists, and whether the amount of reimbursement can be objectively measured and verified. In going through all of this, ultimately, judgment obviously is required in determining what types of those costs would be capitalized based on what we just discussed, the existence of that long-term supply arrangement.

As I mentioned earlier, these types of arrangements are very common in some manufacturing industries, like the automotive industry, where the supplier is responsible for acquiring or building the mold, the die, or the tool, but ultimately, it will be reimbursed by the customer—the actual car manufacturer. In these cases, those design and development costs generally will be capitalized by the supplier, even in circumstances where the manufacturer has the ability to take possession of the tool, ultimately.

A bit more common to more folks and more industries would be contract costs. Once again, we have guidance on that in Topic 340, specifically 340-40, which deals with other assets and deferred costs, specifically contracts with customers. This guidance addresses circumstances where certain costs that arise in conjunction with performing under contracts under the scope of ASC 606, our revenue standard, and which of those costs should be capitalized. The costs are divided into two categories. First, the costs to fulfill a contract; the other, costs to obtain a contract.

For costs to fulfill a contract, the guidance in Topic 340 says if there is other guidance in the Codification that applies to the costs incurred to fulfill a contract within the scope of Topic 606, then that other guidance should be applied. On this slide there are some examples where you’ll find some other sources of guidance. Inventory, in Topic 330; pre-production costs related to long-term supply contracts, as we just mentioned; internal use software; property, plant, and equipment; and other cases. In these cases that you see in this table on the slide, if the guidance in any of these cases is applicable to any type of contract fulfillment costs, it has to be applied. The guidance in Topic 340 is only applicable to costs to fulfill a contract where there is no other applicable guidance.

What do we do, then? Costs to fulfill a contract where there’s no other applicable guidance would be capitalized when all the criteria we see on this next slide are met. That includes the costs that are incurred by the entity are directly related to a specific contract or an anticipated contract; the costs incurred by the entity generate or enhance resources that will be used in the future to satisfy its performance obligations (activities giving rise to the costs are not performance obligations in and of themselves, but they do contribute to the satisfaction of performance obligations in the revenue contract); and finally, the costs incurred by the entity are expected to be recovered (in other words, the net cash flows of the contract and expected renewals will cover these costs). If all those conditions are met, then the costs to fulfill the contract would be capitalized. Again, that’s all assuming there is no other guidance (like we saw on the previous table) that would apply because, in those cases, the other guidance would control in those situations.

Now, if we move to the costs to obtain a contract, the incremental costs to obtain a specific contract under the scope of Topic 606 will be those costs that would not have been incurred if the contract was not obtained. That can be something like a sales commission. So, the incremental costs to obtain a contract would be capitalized if the entity does expect to recover those costs (same idea as if the net cash flows of the contract and expected renewals will cover

these costs). But there is a practical expedient here where an entity can choose to expense the incremental costs to obtain a contract if the amortization period for those costs would be one year or less.

So, the costs to obtain a contract under the scope of Topic 606 that are not incremental would be those costs related to obtaining the contract that would have been incurred even if the contract were not obtained. Think of things like travel costs incurred to present a proposal to a customer. These costs would only be capitalized if they are explicitly chargeable to the contract with the customer regardless of whether the entity enters into the contract with the customer. Otherwise, those kinds of costs would be expensed as incurred.

I think the next item on our list was advertising costs. Pretty straightforward on the guidance with advertising costs, this is in Topic 720-35, dealing specifically with advertising costs. Essentially, it says that entities would expense costs either when the entity incurs the costs, or the advertising first takes place. Entities have a choice here. That's an accounting policy choice. So, entities that engage in or incur advertising costs would need to disclose which of those two options they are applying and apply that consistently to all their different types of advertising activities.

In order for an entity to actually capitalize advertising costs as an asset, the only time that occurs is if the entity has demonstrable and reliable evidence of a direct connection between the cost of the advertising and the expected future benefits from the advertising. There are only some very narrow conditions that permit capitalization, and that's typically in some type of direct-response advertising types of costs. But by and large, advertising costs are expensed, again, either when incurred or when the first advertising runs. Again, that's an accounting policy choice that would need to be disclosed.

I believe the next item we have is website development costs. Accounting treatment for costs that are incurred in developing a website depends on the development stage, and there are five development stages. There's a planning stage, a website application and infrastructure development stage, a graphics development stage, a content development stage, and an operating stage. Now, during the planning stage, all costs would be expensed as incurred. In the other four stages, in some cases, costs are expensed, in some cases, they're capitalized, but it depends on specific facts and circumstances.

In the application and development stage, as you see on the next slide, generally, entities will follow the guidance in Topic 350 related to internal-use software to account for costs associated with software used to run a website. But if an entity has a plan or is in the process of creating a plan to offer the software for sale to external third parties, then they follow the guidance provided for in Topic 985, which deals with software to be sold, leased, or marketed. Specifically, in Topic 985, costs of developing software would be expensed as incurred until the entity is able to conclude that it's possible to create the software in a way that achieves the design specifications. [Continuing] in the website application development stage, fees incurred for website hosting would be expensed over the term in which the internet service provider grants that internet access. [Additionally], in general, entities would capitalize costs incurred during this stage where they are acquiring or internally developing software tools. They would, however, expense the costs if the tools are utilized in research and development activities and they have no other future use, or they're produced within the company and part of a trial program or utilized for some particular research and development activity. Then, the final thing, costs incurred to acquire and register the internet domain, those are capitalizable.

During the graphics stage of the website development, obviously, graphics are a key element of the software and accounting for the costs of creating preliminary graphics depends on whether those graphics will be included in software that is to be used internally or sold to external third parties. For the costs of graphics that are related to internal-use software, typically, you follow that guidance in Topic 350. For the costs of graphics related to software that is going to be marketed or sold, we use the guidance in Topic 985, as we just saw on that previous slide.

In the content development stage of the website, the costs are accounted for as you see on this next slide. We expense all costs to enter content into a website as a current-period expense; we capitalize costs incurred for software that is employed to integrate a database into the website; and we expense data conversion costs in the period those costs are incurred. Finally, the costs of operating a website are basically like any other costs of operation, so the costs of operating a website would just be expensed as incurred.

There is some guidance in Topic 720 that provides that costs for registering a website with an internet search engine would qualify as advertising costs and, again, would be expensed as they're incurred, or when that first advertising runs as we talked about [earlier] when we talked about advertising costs. Whew, that's a mouthful. I think I covered all of them, but maybe there's a bit more we want to touch on related to some of these issues.

**Ms. Grove Casey**

Well, the only other thing that I wanted to ask you about, and you mentioned one of those items, was an accounting policy choice. Now, a lot of times, larger entities in particular will have capitalization thresholds, which I think of as an accounting policy choice, because you pick at what level you want to make that, and below it would be expensed, and above that would be capitalized. Is there guidance in U.S. GAAP for that?

**Mr. Madray**

The short answer is no. U.S. GAAP does not contain any provisions that specifically permit the establishment of a capitalization threshold. Of course, materiality always comes into play but, generally, for ease of recordkeeping, most entities will establish some type of capitalization threshold to specify the minimum amount of costs that would need to be incurred before the costs can be capitalized. The assumption there is that in applying that kind of threshold, whether the entity capitalizes and depreciates or simply expenses in the current period, those amounts wouldn't have any material impact on the entity's financial statements. So ultimately, the decision to expense costs below some type of established threshold is simply for administrative convenience.

A key thing to keep in mind here is that that threshold, clearly, should not be material to the financial statements. Management would need to consider amounts and types of costs that are expected to be incurred to evaluate the amount of that particular threshold. [Also], materiality, as is always the case, should be assessed both qualitatively and quantitatively.

You mentioned an accounting policy, but keep in mind that use of a threshold for capitalization purposes is *not* an accounting policy because there's nothing in GAAP that says, "Do this," or "Don't do this," or "State what your policy is." So, it's an administrative policy, I guess, is the best way to say it. So, the key is, changing that capitalization threshold is not a change in accounting policy. It might be increased or decreased from time to time, but it is not a change in accounting policy that would have to be justified as other accounting policy changes would have to be. The key is keeping in mind its relationship to materiality within the financial statements.

Typically, also, if we change the level of the capitalization threshold, we would only apply that prospectively. It wouldn't make much sense to go back and uncapitalize something that had previously been capitalized. So, these things happen, but the bottom line is it is not an accounting policy. It is very, very common, and we just need to think through it carefully in how we apply that threshold to these broader issues of the big capitalization question and those areas that we've covered in our variety of examples here today.

### The Capitalization Question

By J. Russell Madray, CPA, CGMA

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#### Background

U.S. generally accepted accounting principles (U.S. GAAP) require the capitalization of costs when a future benefit for the expenditure exists. For example, if a company purchases a building, the benefits of the building are expected to extend into the future. Therefore, the company would record an asset and depreciate the building over time. In some cases, such as the purchase of equipment, the decision to capitalize is straightforward. However, there are situations in which that decision is not as clear. For example, capitalization questions arise in each of the following:

- Self-constructed assets
- Repairs and maintenance
- Research and development costs
- Internally-developed intangible assets
- Patent defense costs
- Start-up costs
- Pre-production costs
- Contract costs
- Advertising costs
- Website development costs

Each of the situations above are covered below, along with both authoritative and non-authoritative sources of guidance related to the capitalization decisions.

#### The Starting Point—What is an Asset?

While there is specific authoritative guidance that is applicable to certain transactions, the underlying issue is always “does the cost represent an asset or an expense.” The Financial Accounting Standards Board (FASB) defined the term “asset” in Statement of Financial Accounting Concepts (SFAC) 6, *Elements of Financial Statements*, as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Accordingly, an asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

“Expenses,” on the other hand, are defined in SFAC 6 as “outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.”

To summarize, an “asset” represents a probable future benefit, while an “expense” represents a benefit already received. In each of the following situations, this relationship is evident in the conclusions related to capitalization versus expensing.

## Self-Constructed Assets

Property, plant, and equipment (PP&E) is reported at its historical cost which is the amount of cash, or its equivalent, paid to acquire an asset, and is commonly adjusted subsequently for amortization, depreciation, and/or impairment. The guidance for the cost to be capitalized when acquiring long-lived assets is found in FASB *Accounting Standards Codification* (ASC) 360, *Property, Plant, and Equipment*:

[T]he historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.

While ASC 360, does not currently include any specific guidance on cost capitalization for capital projects constructed or acquired for a reporting entity's own use, many of the concepts included in a 2001 proposed Statement of Position from the Financial Reporting Executive Committee of the AICPA (FinREC), *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, reflect current practice regarding the accounting treatment for the capitalization of costs for capital projects. In 2003, the FinREC redeliberated and submitted a proposed Statement of Position to the FASB for approval (referred to herein as the PPE SOP). Although it was not approved for issuance by the FASB, the PPE SOP includes guidance related to the capitalization of costs of an asset constructed or obtained for a reporting entity's own use that is helpful when considering the accounting treatment for such costs.

Identifying and determining which costs should be capitalized is a key focus in the accounting for assets that are acquired or self-constructed. Costs may include labor, materials and supplies, transportation, engineering services, certain overhead costs, insurance, employee benefits, taxes, and interest.

**Observation:** ASC 970, *Real Estate—General*, includes incremental guidance on capitalizing the costs of real estate developed for sale or rental. That guidance explicitly excludes capital projects constructed for a reporting entity's own use. However, in the absence of other authoritative guidance, reporting entities often apply the guidance in ASC 970 by analogy in developing their overall capitalization policies.

Essentially, the cost of acquiring an asset includes the costs necessary to bring it to the condition and location necessary for its intended use. The PPE SOP identified four stages during which costs may be incurred related to long-lived assets: preliminary stage, pre-acquisition stage, construction stage, and in-service stage.

### Preliminary Stage

During the preliminary stage, activities are performed exploring the opportunities for acquisition or construction of PP&E. An entity may conduct feasibility studies and other activities related to asset selection. The entity may incur costs to obtain an option to acquire one or more items of PP&E during this stage. Some examples of other costs that may be incurred during this stage include those related to surveying, zoning, engineering studies, design layouts, traffic studies, and obtaining management's approval to move forward with a particular PP&E acquisition or construction. During the preliminary stage, the project is not considered probable of being constructed. Accordingly, given the high degree of uncertainty about the future economic benefits, costs incurred during this stage are expensed as incurred. The preliminary stage commences at the beginning of a project and lasts until the acquisition or construction of the specific long-lived asset is considered probable.

### Pre-Acquisition Stage

The pre-acquisition stage begins when the construction of specific property, plant, or equipment is probable but prior to the start of construction. The PPE SOP differentiates between costs that are directly identifiable and those that are an allocated or overhead cost. Directly identifiable costs should be capitalized in the pre-acquisition stage whereas allocated and other overhead costs should be expensed as incurred.

Directly identifiable costs include the following:

- Incremental direct costs of PP&E pre-acquisition activities incurred for the specific PP&E in transactions with independent third parties.

- Certain costs directly related to pre-acquisition activities performed by the entity (or by third parties who are not independent of the entity) for the specific PP&E. These costs include payroll and payroll benefit-related costs (e.g., costs of health insurance) for employees who devote time to a PP&E pre-acquisition stage activity, to the extent of time the employees spent directly on that activity and in proportion to the total hours employed (including compensated absences).
- Payments to obtain an option to acquire PP&E. The option should be carried at the lower of cost or fair value. Reductions in the recorded value of an option should be charged to expense. If the fair value less cost to sell of the option subsequently increases, amounts previously charged to expense may not be reinstated to the balance sheet.

General and administrative costs and overhead costs should be charged to expense as incurred, regardless of whether those costs are incurred internally or by a third party. Those costs include all costs (including payroll and payroll benefit-related costs) of support functions, which include executive management, corporate accounting, acquisitions, purchasing, legal, office management and administration, marketing, human resources, and information systems.

Pre-acquisition costs should be reclassified to construction work in progress once construction begins.

**Observation:** If during the pre-acquisition stage the construction or acquisition of the specific long-lived asset is determined to no longer be probable, the capitalized costs related to the project should be assessed for impairment under ASC 360. When evaluating whether the capitalized costs of a project that is no longer probable of being completed are impaired, an entity will need to determine whether the asset will be sold, abandoned, or held (e.g., to potentially be completed and used in the future).

### Construction Stage

The construction stage begins at the time the entity obtains ownership of the PP&E or obtains the right to use the PP&E through an agreement (e.g., a lease). During this stage, costs are incurred to acquire, construct, or install the PP&E. This stage includes costs incurred prior to the long-lived asset being available for its intended use. Examples of activities performed during this stage include planning for construction or installation once ownership, or the right to use, has been acquired; constructing or installing PP&E; and supervising the construction of PP&E. Similar to the pre-acquisition stage, costs incurred during the construction stage that are directly identifiable should be capitalized. Directly identifiable costs include:

- Incremental direct costs of acquiring, constructing, or installing the PP&E incurred in transactions with independent third parties.
- Certain costs directly related to activities performed by the entity (or by third parties who are not independent of the entity) for the construction or installation of the specific PP&E, and costs directly related to preproduction test runs of PP&E that are necessary to get the PP&E ready for its intended use.

**Observation:** Rent, depreciation, and other occupancy costs associated with the physical space occupied by employees are not directly identifiable costs and should be charged to expense as incurred (consistent with the accounting for those types of costs within the pre-acquisition stage).

While directly identifiable costs should be capitalized, other costs should be expensed as incurred. Specifically, overhead costs are not directly related to the construction of the asset and should be expensed as incurred.

### In-Service Stage

The in-service stage of long-lived assets begins when the asset is substantially complete and ready for its intended use. Costs during this stage include:

- Repairs and maintenance of existing components
- Replacement of existing components
- Purchase of additional components



Costs incurred to (a) acquire additional components of PP&E or (b) replace existing components of PP&E should be capitalized. The costs of normal, recurring, or periodic repairs and maintenance activities and all other costs related to PP&E incurred during this stage should be charged to expense as incurred. See the discussion below regarding repairs and maintenance.

### Interest Capitalization

As noted in ASC 835-20, *Interest: Capitalization of Interest*, the objectives of capitalizing interest are to obtain a measure of cost that more closely reflects an entity's total investment in the asset and to charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the period it benefits.

The historical cost of acquiring an asset should include all costs necessary to bring it to the condition and location necessary for its intended use. As a result, the cost incurred in financing expenditures for an asset during a required construction or development period is itself a part of the asset's historical acquisition cost. The cause-and-effect relationship between acquiring an asset and the incurrence of interest costs makes interest cost analogous to a direct cost that is readily and objectively assignable to the acquired asset.

ASC 835-20-15-5 defines "qualifying assets" as follows:

- a. Assets that are constructed or otherwise produced for an entity's own use, including assets constructed or produced for the entity by others for which deposits or progress payments have been made.
- b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., ships or real estate developments).
- c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

Interest cost that theoretically could have been avoided if expenditures for qualifying assets had not been made should be capitalized. The interest to be capitalized is determined by applying a capitalization rate to the weighted-average carrying amount of expenditures for the asset during the period. The amount of interest cost capitalized should not exceed the amount of interest cost incurred by the entity in that period.

ASC 835-30, *Interest: Imputation of Interest*, permits some flexibility in determining the capitalization rate. It may be the rate of a specific new borrowing that can be associated with a qualifying asset, or a rate determined by a weighted-average technique. Generally, the weighted-average technique is viewed as the primary method for determining a capitalization rate since proceeds from a specific borrowing typically are not identifiable to a particular qualifying asset. In identifying the borrowings to be included in the weighted-average carrying amount, the objective is to obtain a reasonable measure of the cost of financing the asset while getting the asset ready for its intended use.

### Interest Capitalization Example

Richards Corp begins construction on a new corporate office building on September 1, 2020. Construction continues without interruption through March 31, 2021. Directly attributable expenditures for the year ended December 31, 2020, are:

- September   \$200,000
- October     \$300,000
- November   \$500,000
- December   \$300,000

Richards Corp has assumed a mid-month convention for the attributable expenditures. Therefore, the weighted average carrying amount of the asset during the period is as follows:

Date	Qualifying expenditures (A)	Capitalization period (B)	Weighted-average qualifying expenditures (A × B)
September	\$200,000	3.5/12	\$58,333
October	\$300,000	2.5/12	\$62,500
November	\$500,000	1.5/12	\$62,500
December	\$300,000	0.5/12	\$12,500
<b>Total</b>	<b>\$1,300,000</b>		<b>\$195,833</b>

Richards Corp has not taken out any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. Richards Corp had a \$1,000,000 loan outstanding with a 3.5% interest rate and a \$2,000,000 loan outstanding with a 5.5% interest rate during the construction period. The loans were not for specific expenditures.

The annualized interest costs on the general borrowings outstanding during the construction period is \$145,000  $[(3.5\% \times \$1,000,000) + (5.5\% \times \$2,000,000)]$ , which results in a weighted-average rate of 4.83%  $(\$145,000/\$3,000,000)$ .

Accordingly, the amount of interest that can be capitalized is \$9,459, calculated as the weighted-average interest rate multiplied by the weighted-average qualifying expenditures amount  $(4.83\% \times \$195,833)$ .

According to ASC 835-20-25-3, the capitalization period begins when the following three conditions are present:

- Expenditures for the asset have been made
- Activities that are necessary to get the asset ready for its intended use are in progress
- Interest cost is being incurred

Interest capitalization will continue as long as those three conditions are present.

**Observation:** The principle objective of ASC 835-20 is to require capitalization of interest on major construction projects when the financial statement effect of capitalization versus current expense recognition is likely to be material. In addition, ASC 835-20 speaks to minimum thresholds that require capitalization, which are common in inventory and PP&E accounting. These thresholds are designed to minimize an entity's burden of capitalizing interest associated with a large number of assets and accounting for those costs as the assets are used. Reporting entities should apply judgment to determine whether the interest associated with self-constructed assets would have a material effect on the financial statements if not capitalized.

### Repairs and Maintenance

The general guideline for accounting for PP&E expenditures made after acquisition is that if the expenditures provide additional service potential beyond the initial estimated useful life, they should be capitalized; if they do not provide

additional service potential, they should be expensed as incurred. Expenditures related to assets can increase future benefits in the following ways:

- An extension of the useful life of the asset
- An increase in the operating efficiency of the asset resulting in either an increase in the quantity of goods or services produced or a decrease in future operating costs
- An increase in the quality of the goods or services produced by the asset

Expenditures that cause any of these results should be capitalized initially, and then expensed in future periods through depreciation, depletion, or amortization. Of course, materiality is an important factor in the practical application of this approach.

There are three methods used to record the cost of improvements:

- Substitution. The improvement can be recorded as both (1) a disposition of the old component and (2) the acquisition of the new component. This approach is conceptually appealing, but it is practical only if the original cost and accumulated depreciation of the old component can be separately identified.
- Capitalization of new cost. Another way to record an improvement is to include the cost of the improvement (net of any consideration received from the disposition of the old component) as a debit to the related asset account, without removing the original cost and accumulated depreciation of the original component. This approach is acceptable only if the book value of the original component has been reduced to an immaterial amount through prior depreciation.
- Reduction of accumulated depreciation. Another way to increase an asset's book value is to leave the asset account unaltered but decrease its related accumulated depreciation. The argument for this method is that many improvements extend the useful life of an asset and are equivalent to a partial recovery of previously recorded depreciation. This approach produces the same book value as the capitalization of cost to the asset account. However, cost and accumulated depreciation amounts will differ under the two methods.

## Research and Development Costs

ASC 730, *Research and Development*, defines “research and development” (R&D) as follows:

Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design and testing of product alternatives, construction of prototypes, and operation of pilot plants.

Capitalization as tangible assets is appropriate for the expenditures for materials, equipment, and facilities that are acquired or constructed for research and development activities and that have alternative future uses. The cost of materials consumed in R&D activities and the depreciation of such equipment or facilities used in those activities should be expensed as R&D costs. Intangible assets acquired for use in R&D activities that have an alternative future use can also be capitalized. Intangible assets acquired in a business combination are capitalizable regardless of whether they have an alternative future use.

If, however, materials, equipment, and facilities acquired or constructed for R&D activities or acquired intangible assets used in R&D have no alternative future use (and, therefore, no separate economic value), they should be expensed as R&D costs when incurred.

### Internally Developed Intangible Assets

According to ASC 350, *Intangibles—Goodwill and Other*, costs to internally develop, maintain, or restore unidentifiable intangible assets (including goodwill) that have indeterminate lives or that are inherent in a continuing business and related to the business as a whole are recognized as expensed as incurred unless explicitly capitalizable under other U.S. GAAP (e.g., internally developed software).

Intangible assets acquired either individually or with a group of other assets outside of a business combination are initially recognized and measured based on their cost to the acquiring entity.

### Patent Defense Costs

Questions about whether an entity may capitalize costs related to legal work in connection with patent applications or litigation sometimes arise. Because of the uncertainty associated with the successful development of intellectual property rights, legal costs incurred in connection with a patent application generally are expensed as incurred.

Paragraph 2260.03 of *AICPA Technical Questions and Answers* provides guidance on patent defense costs. According to the Q&A, the choice of capitalizing or expensing depends on the outcome of the lawsuit. SFAC 6 indicates “. . . the legal and other costs of successfully defending a patent from infringement are ‘deferred legal costs’ only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent.” Therefore, if defense of the patent lawsuit is successful, costs may be capitalized to the extent of an evident increase in the value of the patent. Legal costs which relate to an unsuccessful outcome should be expensed.

Accordingly, capitalization of patent defense costs is appropriate only when a successful patent defense is likely to occur, and the value of the patent is expected to increase as a result.

**Observation:** Often, defense of a patent maintains rather than increases the value of the patent, in which case defense costs should be expensed as incurred.

### Start-Up Costs

Although companies refer to start-up costs using varying terms, including pre-opening costs, pre-operating costs, organization costs, and start-up costs, ASC 720-15, *Other Expenses: Start-Up Costs*, refers to these costs only as start-up costs. Under ASC 720-15, start-up activities include:

- Opening a new facility
- Introducing a new product or service
- Conducting business in a new territory
- Conducting business with an entirely new class of customers or beneficiary
- Initiating a new process in an existing facility
- Commencing some new operation

FASB ASC 720-15 also treats the costs of organizing a corporation or partnership as start-up costs rather than as separate costs.

According to ASC 720-15, a business must expense start-up costs as incurred.

## Pre-Production Costs

In some industries, various pre-production costs are incurred related to the design and development for molds, dies, and other tools that will be used in producing parts under a long-term supply arrangement. This is common in manufacturing industries in which specific molds or tools are required to produce parts that are specific to a customer's needs. Specific guidance exists in ASC 340, *Other Assets and Deferred Costs*, regarding the accounting for pre-production costs related to long-term supply arrangements.

This guidance indicates that design and development costs related to products to be sold should be expensed as incurred, whereas design and development costs related to molds, dies, or other tools that the supplier will own generally should be capitalized, unless they relate to new technology. Costs incurred for new technology that have uncertain future economic benefits should be expensed as incurred.

In order to capitalize pre-production design and development costs, the reporting entity generally should consider whether a long-term supply agreement exists, whether a contractual guarantee of reimbursement for pre-production product design and development costs exists, and whether the amount of reimbursement can be objectively measured and verified.

When evaluating the existence of a contractual guarantee, there should be a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified. In other words, there is a legal obligation to provide reimbursement. Objective measurement and verification of the amount of reimbursement can be difficult to assess and requires judgment in many cases, particularly when reimbursement is built into the price paid for each part purchased. Generally, the amount of reimbursement should be clearly defined in the contract, indicating a dollar threshold to which the company will be reimbursed for pre-production design and development costs. Alternatively, contract terms may specify that the company will be reimbursed at a fixed rate per unit of production. In this case, to record an asset, the contract must specify the number of parts to be produced, the dollar reimbursement per part, and the consequence if production is less than budgeted. Lack of specificity may call into question whether the company can record an asset for such costs. Instances when the amount of reimbursement is not clearly defined or the company has a practice of negotiating a settlement of the reimbursement amount may indicate a lack of a definitive arrangement and, as a result, may mean that pre-production design and development costs should be expensed as incurred.

**Observation:** These types of arrangements are very common in some manufacturing industries, including the automotive industry, in which the supplier is responsible for acquiring or building the mold, die, or tool, but will be reimbursed by the customer. In these cases, the design and development costs generally are capitalized by the supplier in accordance with ASC 340-10-25-3, even in circumstances when the manufacturer has the ability to take possession of the tool.

## Contract Costs

ASC 340-40, *Other Assets and Deferred Costs: Contracts with Customers*, addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606, *Revenue from Contracts with Customers*, should be capitalized. The two categories of costs addressed in FASB ASC 340-40 include: (a) costs to fulfill a contract and (b) costs to obtain a contract.

### Costs to Fulfill a Contract

If there is other guidance in the FASB ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

FASB ASC	Type of Fulfillment Cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts
350-40	Costs of internal-use software
360	Costs related to property, plant, and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased, or marketed

**Observation:** If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

Costs to fulfill a contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or specific anticipated contract
- The costs incurred by the entity generate or enhance resources that will be used in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not performance obligations in and of themselves, but do contribute to the satisfaction of performance obligations)
- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the contract and expected renewals will cover the costs)

If these fulfillment cost capitalization criteria are met, the fulfillment costs must be capitalized.

### Costs to Obtain a Contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission.

The incremental costs to obtain a contract should be capitalized if the entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

The costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

## Advertising Costs

According to ASC 720-35, *Other Expenses: Advertising Costs*, an entity must recognize advertising costs as an expense when either:

- The entity incurs the cost
- The advertising first takes place

An entity's accounting policy must reflect one of these two options and must apply the selected method consistently to similar types of advertising activities.

**Observation:** An entity may pay for advertising after the entity recognizes the revenue from sales that the advertising helped to generate. For example, an entity may agree to a cooperative advertising arrangement and reimburse a reseller's advertising costs. Under this arrangement, the entity recognizes revenue upon sales that result from the advertising. Therefore, when the entity recognizes the revenue, it must accrue the estimated cost of the advertising as an expense and the related obligation as a liability.

An entity may account for promotional materials, such as printed brochures and catalogues, as prepaid supplies. When the entity no longer owns these materials or expects to use them, it must recognize the previously deferred cost as an advertising expense in accordance with FASB 720-35.

In order for an entity to capitalize advertising costs as an asset under the guidance in ASC 340-20, *Other Assets and Deferred Costs: Capitalized Advertising Costs*, the entity must have demonstrable and reliable evidence of a direct connection between the cost of the advertising and the expected future benefits from the advertising. Accordingly, only narrow conditions permit capitalization of direct-response advertising costs.

## Website Development Costs

The accounting treatment for costs incurred by an entity in developing a website depends on the development stage. There are five development stages:

- Planning stage
- Website application and infrastructure development stage
- Graphics development stage
- Content development stage
- Operating stage

During the planning stage, all costs are expensed as incurred. During the later stages of website development, costs are either expensed as incurred or capitalized depending on the facts and circumstances.

The costs incurred during the website application and development stage are accounted for as follows:

- Generally, an entity must follow the guidance in ASC 350-40, *Intangibles—Goodwill and Other: Internal-Use Software*, to account for costs associated with software used to run a website. If, however, an entity currently has a plan (or is in the process of creating one) to offer the software for sale to external third parties, the entity must follow the guidance provided for software to be sold, leased, or marketed in ASC 985-20, *Software: Costs of Software to Be Sold, Leased, or Marketed*. In particular, ASC 985-20 requires that the costs of developing software be expensed as incurred until the entity is able to conclude that it is possible to create the software in a way that achieves the design specifications.
- Fees incurred for website hosting are expensed over the term in which an internet service provider grants internet access. Such fees include specific, recurring payments to an internet service provider in exchange for accommodating the website on its server.

- In general, an entity must capitalize costs incurred during this stage to acquire or internally develop software tools. However, an entity must expense costs if the tools are utilized by the entity in research and development activities and the tools either (1) have no other future use; or (2) are produced within the company and are part of a trial program or are utilized for a particular research and development activity.
- Costs incurred to acquire and register an internet domain are capitalized.

Graphics are an element of software. The accounting for the costs of creating preliminary graphics depends on whether the graphics are for inclusion in software that is to be used internally or sold to external third parties. For the costs of graphics related to internal-use software, an entity must follow the guidance in ASC 350-40. For the costs of graphics related to software marketed to third parties, an entity must use the guidance in ASC 985-20.

If an entity modifies a website after the initial launch, the entity must perform an assessment to determine if the modifications were performed to maintain the website or improve the website.

An entity must account for costs incurred in the content development stage of a website as follows:

- An entity must expense all costs to enter content into a website in the period that the costs are incurred
- An entity must capitalize costs incurred for software employed to integrate a database with a website
- An entity must expense data conversion costs in the period that the costs are incurred

An entity must recognize the costs of operating a website in the same manner as it recognizes costs for any other operations. Costs for operating a website must be expensed as incurred.

ASC 720-35 provides that costs for registering a website with an internet search engine qualify as advertising costs and must be expensed as an entity incurs them.

### Capitalization Thresholds

U.S. GAAP does not contain provisions that permit the establishment of a capitalization threshold. However, for ease of recordkeeping, many entities establish a capitalization threshold to specify the minimum amount of costs that must be incurred before such costs can be capitalized. The assumption in applying such a threshold is that whether the entity capitalizes and depreciates or expenses such amounts immediately, it would not have a material impact on the entity's financial statements. The decision to expense costs below an established threshold is simply for administrative convenience.

It is important that use of such a threshold is not material to the financial statements. Management should consider the amount and types of costs expected to be incurred to evaluate the amount of the threshold. Importantly, materiality should be assessed on both a qualitative and quantitative basis.

Further, use of a threshold is not an accounting policy. As such, a change to the capitalization threshold is not considered a change in accounting policy. Accordingly, before increasing a threshold, management should ensure it would not result in a material effect on the financial statements.

**Observation:** Changes to the capitalization threshold should be applied prospectively. Assets capitalized under a previous threshold should not be adjusted.



## GROUP STUDY MATERIALS

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### **A. Discussion Problems**

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1. Discuss how interest cost should be capitalized for self-constructed assets.
2. Explain the general guideline for accounting for PP&E expenditures (repairs and maintenance) made after acquisition.
3. Describe what are start-up costs and the appropriate accounting for them.
4. Describe the proper accounting for advertising costs.
5. Discuss the development stages of a website.
6. Describe the GAAP requirements for capitalization thresholds.

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**B. Suggested Answers to Discussion Problems**

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1. Interest cost that theoretically could have been avoided if expenditures for qualifying assets had not been made should be capitalized. The interest to be capitalized is determined by applying a capitalization rate to the weighted-average carrying amount of expenditures for the asset during the period. The amount of interest cost capitalized should not exceed the amount of interest cost incurred by the entity in that period.
2. The general guideline for accounting for PP&E expenditures made after acquisition is that if the expenditures provide additional service potential beyond the initial estimated useful life, they should be capitalized; if they do not provide additional service potential, they should be expensed as incurred. Expenditures related to assets can increase future benefits in the following ways:
  - An extension of the useful life of the asset
  - An increase in the operating efficiency of the asset resulting in either an increase in the quantity of goods or services produced or a decrease in future operating costs
  - An increase in the quality of the goods or services produced by the asset

Expenditures that cause any of these results should be capitalized initially, and then expensed in future periods through depreciation, depletion, or amortization.

3. Although companies refer to start-up costs using varying terms, including pre-opening costs, pre-operating costs, organization costs, and start-up costs, ASC 720-15, *Other Expenses: Start-Up Costs*, refers to these costs only as start-up costs. Under ASC 720-15, start-up activities include:
  - Opening a new facility
  - Introducing a new product or service
  - Conducting business in a new territory
  - Conducting business with an entirely new class of customers or beneficiary
  - Initiating a new process in an existing facility
  - Commencing some new operation

FASB ASC 720-15 also treats the costs of organizing a corporation or partnership as start-up costs rather than as separate costs.

According to ASC 720-15, a business must expense start-up costs as incurred.

4. According to ASC 720-35, *Other Expenses: Advertising Costs*, an entity must recognize advertising costs as an expense when either:
  - The entity incurs the cost
  - The advertising first takes place

An entity's accounting policy must reflect one of these two options and must apply the selected method consistently to similar types of advertising activities.

5. The accounting treatment for costs incurred by an entity in developing a website depends on the development stage. There are five development stages:

- Planning stage
- Website application and infrastructure development stage
- Graphics development stage
- Content development stage
- Operating stage

During the planning stage, all costs are expensed as incurred. During the later stages of website development, costs are either expensed as incurred or capitalized depending on the facts and circumstances.

6. U.S. GAAP does not contain provisions that permit the establishment of a capitalization threshold. However, for ease of recordkeeping, many entities establish a capitalization threshold to specify the minimum amount of costs that must be incurred before such costs can be capitalized. The assumption in applying such a threshold is that whether the entity capitalizes and depreciates or expenses such amounts immediately would not have a material impact on the entity's financial statements. The decision to expense costs below an established threshold is simply for administrative convenience.

## PART 2. AUDITING

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### FAQs on Evaluating ECL Estimates

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The FASB issued guidance on measuring credit losses in 2016. The guidance covers a variety of financial assets including loans and long-term receivables. It is management's responsibility to make an evaluation of the potential losses and record the estimated loss. The auditor is then responsible for evaluating the estimate and whether the recorded amount accurately reflects the economic situation of the entity. Recent auditing guidance has been issued to assist auditors in evaluating all types of estimates in the financial statements.

For more on evaluating these estimates, and frequently asked questions about them, let's join Jennifer F. Louis, a CPA with Emergent Solutions Group, LLC, and CPE Network's Debi Grove Casey.

#### **Ms. Grove Casey**

Today we want to talk a little bit about the expected credit loss model and making those estimates. To begin with, what's the general purpose of the new Topic 326 in the FASB codification?

#### **Ms. Louis**

The goal is to relook at how we measure credit losses on a variety of different types of financial instruments. And the likely broadest effect will be on things like loans receivable, but there are also other financial assets out there where there is credit loss exposure that we want to make sure that we're establishing an allowance for.

The allowance for credit loss is a valuation account that will be presented net on the financial statements, and what's interesting is that it is possible that this valuation account can actually be negative in some cases. So, when we say it is deducted from or added to the amortized cost basis of a financial asset, generally it's going to be deducted from, but it can go the other direction underneath this new framework.

#### **Ms. Grove Casey**

So, what were the effective dates for implementing ASC 326?

#### **Ms. Louis**

What is key is that, as we're looking at things, we have the SEC go first, to let them work through issues that would be important. Then, for small reporting companies, public entities that don't meet the definition of SEC filers, and other entities, the changes will be effective for fiscal years beginning after 12/15/2022.

#### **Ms. Grove Casey**

How will this change a reporting entity's system of internal control?

#### **Ms. Louis**

Well, management is always responsible for the preparation and fair presentation of their financial statements. As we think about changing a process—we may have an established process that might've been appropriately designed with controls given the old framework. But now that we have a new approach of thinking about complying with Topic 326, there may be new controls; there may be new inputs [and] new assumptions. We might use different vendors as we're developing our best estimate of that allowance for credit loss. So, it is important that there may be pieces of information that we collect and track that we previously didn't, and we want to make sure that we're adapting our internal controls to cover those aspects of the new process.

#### **Ms. Grove Casey**

What areas of internal control do you think a financial statement auditor will most likely need to focus on during the time of transition to this estimation approach and beyond?

**Ms. Louis**

There need to be internal controls to determine when this expected credit loss model [is] applicable. When does it even apply to my circumstances? Then you have to make choices on—

- What methodology are we going to use?
- What data do we need to capture?
- What assumptions do we need to make?

We need to identify all those things so that we can make sure that we're [not only] using an approach that is consistent with the principles of the applicable financial reporting framework, but also that we're comfortable that the data is relevant, reliable, and available when we need it; that the model seems appropriate for our intended purpose; that the assumptions are reasonable; and that we do have validation checks and balances as we're reaching conclusions about what it is that we should be booking. So, these things that we need to have controls over, we want to make sure that we're covering all those different layers that already exist.

**Ms. Grove Casey**

From a broader perspective, how will the adoption of new accounting policies affect the financial statement audit?

**Ms. Louis**

Well, definitely anything that's new, the auditors are going to have a tendency to indicate that it might be higher risk in the year of transition and adoption. So, there will be a greater focus on it in the stage of implementation, but then, even on a go-forward basis, as we have areas of accounting estimation, depending on the complexity of what I have to do to come up with this allowance, it may continue to be a higher risk area as it relates to [not only] coming up with the estimate itself, but also the disclosures. There may be important disclosures that become critical on an ongoing basis.

The fact of what does the auditor do as they look for risk that there might be material fraud or error in the financial statements or the footnotes. This could definitely have an impact on their decisions and their determinations about where do to get more persuasive evidence to match the risk that I've identified.

**Ms. Grove Casey**

Does the fact that reporting entity management has to exercise significant judgment in relation to making the allowance estimate require more work to be done on the financial statement audit?

**Ms. Louis**

Well, all estimates you're going to look at and say, "Just because it's an estimate, just because it applies judgment, [that] doesn't necessarily make it [a] high risk of material misstatement." So, there can be even places for some of these that my credit loss model might not be that hard to come up with. There might not be a lot of influential factors, depending on the nature of my receivables, for example.

But certainly, it will be explored as the auditors understand the entity and its environment and its controls. They are going to be looking at, where do I believe that I might need to do more work as I'm thinking about how to test this estimate? There can be a variety of procedures that are done to help form those conclusions, and what needs to be done or what combination of things needs to be done is still going to be a matter of professional judgment in the end.

**Ms. Grove Casey**

If the auditor tests management's estimate by developing a point estimate or a range, does the auditor have to use the same assumptions or methods as reporting entity management?

**Ms. Louis**

They may use the same assumptions [or] methods but just really challenge the appropriateness of them, the reasonableness of them. Or I could use totally different methods and assumptions and compare that to see, well, how

does that compare to what management did? It depends on the circumstances. Am I just challenging management's approach, or am I coming up with my own estimate based on my own considerations and seeing how it compares what management decided to do?

It may be that we have differences in what the auditor thinks and what management thinks, so we can try to come up with a difference between the two where we believe it's reasonable and it's not materially misrepresented or misleading in some way. But an estimate is an estimate, right? There's already uncertainty there that's baked in to the whole process.

**Ms. Grove Casey**

Is it plausible that an auditor may simply evaluate subsequent events to see if information confirms or contradicts management's allowance estimate?

**Ms. Louis**

Well, it may be that subsequent events do confirm or contradict something that I assumed was going to happen as I was setting up the estimate. But due to the nature of the allowance for credit loss estimate, just looking at subsequent events in isolation is unlikely to give me sufficient and appropriate evidence just because of the inherent uncertainty and the fact that there is so much subjectivity involved and it may be that subsequent events like it's not a long enough time period to really confirm or contradict things. So yes you can consider what you know right as a subsequent event from the date of the estimate but it rarely in isolation is going to be sufficient and appropriate evidence by itself.

**Ms. Grove Casey**

How does management evaluate whether related disclosures are fairly stated?

**Ms. Louis**

Part of it is going to think about are you explaining things like your accounting policy elections and are you doing it in a sufficient level of detail so that financial statement users can understand. They also need to understand your key decisions, your significant judgments, any major interpretations that are made by the reporting entity as they're trying to clearly communicate the credit risk that exists and how management has assessed the level of that credit risk and how it is that's affected this allowance that's being booked.

**Ms. Grove Casey**

Let's go back to the inherent risk of uncertainty in these estimates and discuss more about what influences management's judgments in making the allowance estimate.

**Ms. Louis**

Well, inherently management has to make judgments about collectability, right, and projected losses. And it is going to be influenced by what we know historically. So my historical information, my historical loss experience is how you might have that described. But I also have to look at that historical information and then say, well, what about current facts and current conditions? Is there something different going on compared to the past that should have me change my assumptions? And then I also have to take into account for the current expected credit loss model, reasonable, supportable forecasts. And so there's judgment in even determining what's the information out there that might affect my current judgments about credit quality as I'm looking at a portfolio of assets. But there does need to be a systematic disciplined, consistently applied approach to try and come up with that estimate.

**Ms. Grove Casey**

When dealing with a large portfolio of amortized cost assets and financing receivables, it seems like a slight variation in assumptions could create a sizable difference when management is identifying that range of potential credit loss. How does that impact the ability to evaluate the reasonableness of the related allowance for credit loss?

**Ms. Louis**

You're right. I mean, it's possible that there may be this range of loss. Given the implicit uncertainty and complexity that ultimately larger losses, large ranges may result, right? A slight change in some assumptions could have a significant effect. And that's part of why you look to see, well, how sensitive is this estimate to slight variations and assumptions?

And the more sensitive it is, the higher risk that estimate is going to be. The less sensitive I am to those assumption changes, the lower risk it's likely to be, which is why we say estimates can be low risk or high risk or somewhere in between. But in some cases, the range might be more than our performance materiality. And so it might be because of the length of a forecast period or the fact that there are significant changes in economic conditions that are influencing my assumptions. The auditor in those cases will want to understand if you have a big range, how did you decide what to book? How did you select the point estimate that you ultimately recorded? Because I can't record a range as a debit or a credit. So how did you decide what to book? And to see is there a way that we can narrow things down to a way that we think it's reasonable, right? And it may be that there is a lot more work that has to be involved as we are trying to feel comfortable that there's not a significant risk of material misstatement in this estimate.

**Ms. Grove Casey**

What types of documentation should reporting entity management maintain related to the allowance for credit loss assessment?

**Ms. Louis**

Well, management needs to be prepared to show the auditors, here's my methodology, here's my assumptions, here's where I'm getting my data from, right? And there needs to be supporting analysis for any judgments that they're making along the way. But it also is important that auditors should ask.

This is the method and what you decided to do. Did you consider any alternatives? And why did you not use one of the alternative approaches compared to the approach that you did decide to use? Because we want to make sure that people aren't making decisions about methods and assumptions with an accounting motivation in mind. I like the outcome of that one. That's why I decided to do that one, right? So that's going to be key is, is why did you pick that methodology over other methodologies? Why did you make that assumption or go to that data source compared to other options that might be out there as an alternative?

**Ms. Grove Casey**

So basically, we need a lot of documentation to support why we picked the one we did.

What if reporting entity management uses a third party to help with developing the assumptions that they used in an estimate? Because we just don't have the time internally sometimes.

**Ms. Louis**

It may be. Sometimes we don't have the time, or we don't have the resources. We may not have the level of knowledge, particularly about reasonable, supportable forecasts that might affect my estimate. So I may engage a third party to assist in the development of the assumptions that we're going to use. And management, though, still needs to understand that you're still responsible for those assumptions.

You're still responsible for having internal controls to make sure that your estimate is reasonable, whether you engage a specialist or not. You're still accountable for the inputs and the outputs relevant to that estimate.

**Ms. Grove Casey**

What are examples of questions that may be asked when evaluating an entity's transition to the new current expected credit loss estimate from what we've previously used, which is incurred loss?

**Ms. Louis**

Right. I think part of it is in the early stages of implementation and transition, even after the first step of implementation, as you're just dealing with this maybe over the course of the next year, where do you maybe have gaps in data? Right. And have you identified any data gaps? How do you plan to resolve it? How is your data captured, stored, extracted and to think about the controls that might need to exist for internal data that we might be using in our estimate, but also controls over external data that I also have to capture and store and use. And so I think that's key--understanding my data, understanding data gaps and understanding the controls over the data.

**Ms. Grove Casey**

So what is the difference between a methodology and a model as it relates to applying the accounting requirements in ASC 326?

**Ms. Louis**

All right, the methodology is just your overall approach. It's the rules, the principles that I'm abiding by. FASB does not require a specific method. No one method is required. Multiple methods are available and even multiple methods might be used to see whether or not I agree with my final estimate. So I may use like a approach such as a discounted cash flow method and at the same time use a probability of default method to see how do the outcomes compare. In some cases, multiple methods might be used. So as we think about the method and we think about the models, the model is a quantitative method system approach that we're going to be applying. And the model needs to figure out how am I capturing the input, the data, the assumptions. How are we processing it to transform that information into an estimate, and how do I make sure that I'm reporting that in a way that's useful business information?

**Ms. Grove Casey**

What are example questions that an auditor may ask related to evaluating a reporting entity's modeling and related assumptions?

**Ms. Louis**

So, in thinking about the assumptions, did you document your key assumptions and the rationale for including those specific assumptions in the model? Have we documented the source of our data and how we made sure it was complete and accurate?

Did we also look to see in thinking about things with our methodologies, our models, our assumptions, in other things that we do as we think about within the entity and different business units, like, are we all kind of consistent in our approach? And if there's inconsistency, why are we seeing that inconsistency? So in the end, there does need to be a focus on making sure that our data, our assumptions, are reasonable and that they also are things that are revisited if facts and circumstances change.

**Ms. Grove Casey**

Does an auditor have any responsibility to explore with reporting entity management whether any contradictory evidence exists which may make their allowance estimate lack reasonableness?

**Ms. Louis**

That's why I mentioned earlier about how we should specifically ask, did you consider any alternative methodologies? Why did you decide that wasn't the proper one? And we also are going to ask them what contradictory information, if any, have you identified? And how was that considered as you were forming your final conclusions? So a lot of it is management's got to be accountable, right? What risks did you identify?

How did you address them as it relates to your process of creating this estimate? What system or model limitations did you identify? How did you compensate for that? We want to understand management's methodology and the application of that methodology and to ask specific questions about things that really could go wrong, where there may be contradictory evidence that makes our assessment less reasonable.



**Ms. Grove Casey**

Let's explore a little bit more about the importance of ensuring the relevance and reliability of data. I know usually with computer systems is garbage in garbage out. Sometimes cleaning or scrubbing our data is really important. How can this be properly assessed that our data is relevant and reliable?

**Ms. Louis**

And what you're going to find is just depending on the nature of the financial instruments that are within the scope of Topic 326 for you. So is it just trade receivables? Do I have notes receivable? Do I have loans receivable? You are going to have to figure out what's relevant based on your specific assets. And so I may have to get information such as prepayment data, if some of my notes or loans receivable can be prepaid. I may need to get information about data about collateral or data about extensions or modifications of loans. So we need to think through what's relevant to our circumstances. And then we can determine, well, how do I get reliable data from our systems?

So to make sure that we have what we need in order to input that information into our given models.

**Ms. Grove Casey**

What does ASC 326 require when measuring expected credit losses amongst a pool of financial assets that have similar risk characteristics?

**Ms. Louis**

Well, first of all, it requires that management can look at things on a collective or pool basis, assuming that there's similar risk characteristics within the pool. And if similar risk characteristics do not exist, then I should assess credit risk, the credit loss, at the individual asset level. So obviously, it's not to our advantage to have things at the asset level, that's going to be a lot more work. So as we look at pooling, what we do have to be careful of, is that management has to be able to document and demonstrate why I've grouped these given assets together. How is it that they have similar risk characteristics as a part of the size or the term or the geographical location sometimes, right? That there's factors that we have to be able to say, it makes sense for these assets to be grouped as a segment of our portfolio. As we have these assets that are all subject to credit loss exposure, here's why I'm grouping these assets together. Then on an ongoing basis, it's also important that you re-challenge your pooling.

It may be that they have similar risk characteristics in one reporting year, and then they don't in the next. So it has to be constantly updated and there should be controls that are focused on that particular issue.

**Ms. Grove Casey**

What's the auditor's responsibility in evaluating management's creation of pools? I know you said that they need to be evaluated regularly. So obviously, if they're evaluating them, then we need to be evaluating their evaluation.

**Ms. Louis**

Exactly. And that's why I said there should be documentation, there should be evidence so that the auditors can say, yes, I think your pool classifications or segmentation is appropriate. Right. And so they need to get comfortable with that. And so you need to be able to provide evidence or information to help support the pooling that you do undertake.

**Ms. Grove Casey**

Well, another key area of uncertainty is the requirement to appropriately adjust historical loss information when establishing that allowance for credit loss. Let's talk a little bit more about that concept and what the auditor's responsibilities are in evaluating this aspect.

**Ms. Louis**

Definitely the historical information can be a starting point and then I need to build in current facts and conditions. I need to think about the reasonable expected forecast or the supportable forecasts. And so the auditor is going to say, I understand that this can be very complex. I understand that there's a lot of subjectivity that might be involved in trying to figure out how these factors, particularly for things that we don't know what's going to definitively happen

with reasonable, supportable forecasts. But yet, I can come up with this, what I believe, is a reasonable, supportable forecast. But there's a lot of judgment in determining what's reasonable, what's supportable. And it's another area where the auditors are going to want evidence and information about what did you factor in and consider in making these adjustments so that the auditors can agree on the appropriateness of your methodology, the nature of the assumptions, and whether or not they do believe that you are doing something that is complete and accurate.

**Ms. Grove Casey**

How does an auditor determine which assumptions are significant to the allowance for credit loss estimates?

**Ms. Louis**

It is going to be based on things that could materially affect the estimate. And that's why it is important to understand how sensitive are we with variation in our assumptions? How susceptible is the application of the process to management bias? Do we have things that are based on observable inputs or unobservable inputs? Those are all things that will affect ultimately the significance of the assumptions and how much evidence do I think I need to gather to get comfortable with those assumptions?

**Ms. Grove Casey**

What information should an auditor gather to evaluate management's adjustments for reasonable and supportable forecasts?

**Ms. Louis**

Well, part of it's going to be on the length of the forecast period, the methodology to consider as well, the forecasts that they're using, the data, the assumptions. Are they consistent with other things that they're doing internally? Is it consistent with what we're seeing other entities apply? So there does need to be a questioning or a challenging as you would any estimate that you might be auditing.

**Ms. Grove Casey**

Can subsequent events impact an auditor's assessment of the reasonableness of an estimate of allowance for credit risk?

**Ms. Louis**

So it is important that if I become aware of something where the outcome would be different than a judgment that I made at the time, I need to gain an understanding of the reasons for the difference, right? And so part of it is going to be, was I making certain assumptions and there was publicly available data, right? That came out that was different from what I thought.

So the forecast though, based on what was available to me at the time, and I did the estimate was reasonable. It was the best data I had available. The fact that publicly available information came out later that might be different. Yes, I need to understand that, but should I go and change my estimate for this new data becomes the question, right? So in general, like the SEC has come out with some, application principles and so we can look towards that to say well what might be prudent. And the SEC has said that if it is asset specific information, so it is factual about this asset specific thing that existed at the balance sheet date and I just found out about it later, I should bring it in. So if it's asset specific. But if we're talking about forecasting assumptions, so we're looking at reasonable, supportable forecasts on, am I done with my estimate or not? So if I get the information before I've completed my estimation process, then I obviously should incorporate it. If I've already finished my estimation process, then I wouldn't pull in the change in assumptions unless I felt as if my process had a weakness or deficiency where I really should have known that this information that came out post the fact is really something that should have been considered upfront. But we do need to have some mechanism of the fact that reasonable supportable forecasts as time passes, you're going to get more information, but we need to turn off the nozzle at some point in making these assessments.

## SUPPLEMENTAL MATERIALS

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### **FAQ for Evaluating the New Expected Credit Loss Model Estimates**

By Jennifer F. Louis, CPA

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#### **Background**

FASB issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU covers a variety of financial assets, with the broadest impact likely to be related to credit losses associated with loans and other long-term receivables.

FASB ASC 326 has the following effective dates:

- For public business entities that meet the definition of an SEC filer, excluding entities eligible to be small reporting companies (SRCs) as defined by the SEC, the changes were effective for fiscal years beginning after Dec. 15, 2019.
- All other entities, the changes are effective for fiscal years beginning after Dec. 15, 2022.

Prior to the effective date of FASB ASC 326, U.S. generally accepted accounting principles (GAAP) required an “incurred loss” methodology for recognizing credit losses that requires loss recognition when it is probable a loss has been incurred. FASB ASC 326-20 requires an entity to measure expected credit losses for financial assets measured at amortized cost and held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Management is required to consider forward-looking information in its determination of an allowance for credit losses (ACL).

For financial assets held at amortized cost, FASB ASC 326-20 eliminates the probable incurred recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses over the contractual term, adjusted for prepayments of these assets. The allowance for credit losses (ACL) is a valuation account that is deducted from, or added to, the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset in the applicable financial reporting framework.

#### **Impact on Reporting Entity Internal Controls**

Management is responsible for the preparation and fair presentation of its financial statements and for the design, implementation, and maintenance of internal control over financial reporting. If the internal control over financial reporting requirements of regulations such as the Sarbanes-Oxley (SOX) Act are applicable, management is responsible for assessing the effectiveness of its internal control relative to financial reporting.

Management should have an established process, including an appropriately designed system of internal controls, to ascertain whether its financial assets are appropriately accounted for in accordance with the applicable financial reporting framework, including FASB ASC 326. This may include processes and controls over inputs and assumptions used in the estimation processes, planned use of vendors, and other considerations.

Management is expected to design, document, and implement policies, procedures, internal controls, systems, and models that result in the development of management’s best estimate of the Allowance for Credit Loss (ACL).

With the adoption of FASB ASC 326 and related accounting policies, a key consideration of the auditor is the effectiveness of internal control over the expected credit loss estimation process and the financial reporting of financial assets. Other elements of internal control implemented by management may be responsive to risks in the following areas:

- Determination of applicability and adoption of new accounting policies
- Determination of the methodologies, assumptions, and data needed to establish the estimate of the ACL.
  - Ensuring relevant, reliable, and available credit risk data.

- Challenging whether model is appropriate for its intended purpose.
- Ensuring inputs and assumptions are appropriate and reasonable.
- Validation and conclusion of the results of the calculation of the ACL.

The implementation of FASB ASC 326 will often require the collection and tracking of information not previously used in the incurred loss modeling. In some cases, this data may not have been previously subjected to internal controls. Management will need a detailed plan to address these challenges and to ensure the availability of complete and accurate data and development of appropriate models. The resources and time needed to effectively adopt the standard may be substantial.

### **Impact on Financial Statement Audits**

The adoption of new accounting policies will affect the auditor's evaluation of whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework.

The auditor is required to assess the risk of material misstatement and design and perform audit procedures based on the assessed risk. During the risk assessment process, an auditor may identify factors that need to be addressed during the audit, including new risks of material misstatement. Therefore, an entity's implementation of an inherently different credit loss model causes an auditor's audit procedures to change and be tailored to address the new or different risks identified.

The auditor is required to conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements. FASB ASC 326 requires management to exercise significant judgment with respect to assumptions, such as portfolio segmentation, the determination of an appropriate historical loss period, adjustments for current asset-specific risks, reasonable and supportable forecasts, and reversion methods.

AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, addresses the auditor's responsibility to evaluate the reasonableness of management's estimate and requires the auditor to undertake one or more of the following audit approaches:

- Determining whether events occurring up to the date of the auditor's report provide audit evidence about the accounting estimate.
- Testing how management made the accounting estimate and the data on which it is based, evaluating whether:
  - The method of measurement used is appropriate in the circumstances.
  - The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.
  - The data on which the estimate is based is sufficiently reliable for the auditor's purposes.
- Testing the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Developing a point estimate or range to evaluate management's point estimate.

In developing an estimate, if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range considers relevant variables and to evaluate any significant differences from management's point estimate. If the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

Due to the subjectivity, complexity, and estimation uncertainty inherent in the ACL estimate, testing management's process to develop the estimate may be the most effective audit approach. Due to the nature of the ACL estimate, an evaluation of subsequent events in isolation likely would not provide sufficient appropriate audit evidence.

The auditor is required to obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. This includes obtaining sufficient appropriate audit evidence about whether management's accounting policies are complete and are in accordance with the applicable accounting requirements. Financial statement disclosures, including accounting policy disclosures should include a sufficient level of detail so that users of the financial statements can identify the key decisions, judgments, and interpretations made by the entity. Complete accounting policies enable mapping to the underlying principles of FASB ASC 326-20. Clear and comprehensive evidencing by the entity is an important element in ensuring the completeness and appropriateness of the accounting policies.

### **Inherent Accounting Uncertainty**

Estimating expected credit losses is inherently subjective and involves management making judgments about collectibility and the estimation of losses. Management's judgments are influenced by historical information, current conditions, and reasonable and supportable forecasts. It is critical that the ACL methodology incorporate management's current judgments about credit quality of the asset portfolio through a systematic, disciplined, and consistently applied approach.

It is possible that management may develop a range of loss given the complexity and uncertainty implicit in an ACL model and the significant level of judgment involved in measuring the ACL. Large ranges may result from only minor differences in assumptions due to the size of the exposures and the sensitivity of the assumption. In some cases, this range may be more than performance materiality due to the level of judgment required because of:

- The number and sensitivity of assumptions (e.g., alternative and contradictory external economic forecasts that are both reasonable and supportable),
- The length of the forecasted period, or
- The amount of an adjustment to the historical loss information for a change in economic conditions may be highly judgmental in some cases.

When the range is more than performance materiality, the auditor likely will want to understand how management:

- Selected the point estimate for the ACL.
- Attempted to generate a point estimate or narrow the range by, for example, varying the assumptions in management's model, using other reasonable assumptions, and comparing the output with that obtained using management's assumptions or using a specialist.

It is not necessary to narrow the range below performance materiality. However, if the range exceeds performance materiality, the range may indicate a higher degree of estimation uncertainty for which the auditor may identify a significant risk of material misstatement.

### **Specific Methodology Implementation Considerations**

Management's methodology for estimating credit losses should be well documented, including assumptions made, with clear explanations of the supporting analysis and rationale for the judgments made. In addition, if alternatives are considered by management, they should also be well documented with clear explanations of the supporting analysis and rationale for the judgments made.

When management engages a third party to assist in the development of the assumptions used in management's estimate of credit losses, those assumptions, become management's assumptions. Management needs to consider

those assumptions in the same manner as management's other assumptions when designing and implementing internal control over the reasonableness of the estimate. When management engages a specialist, management is still responsible for the appropriateness of the specialist's methodology, as well as both inputs and outputs relevant to the estimate.

Implementation questions that may be appropriate to ask about the reporting entity's systems, data, and changes in controls in early implementation of ECL include the following:

1. Have any data gaps (e.g., vintage information, prepayment history) been identified with appropriate plans for resolution?
2. Are new systems or improvements to existing systems needed and what is the status of any system implementation?
3. How is data controlled, stored, and extracted?
4. Does the entity plan to use in its model any external or internal data not previously subject to internal controls and how has management assessed the relevance and reliability of such data?
5. If manual processes are necessary, what controls are in place to evaluate completeness and accuracy of accounting, including any data inputs?
6. Who is responsible for changing, updating, and reviewing processes, controls, and related documentation impacted by the new standard?
7. Do existing control deficiencies, including significant deficiencies or material weaknesses, impact control considerations in implementing the new standard?

### **Modeling and Assumptions**

Management's methodology describes the overall estimation approach for the ACL and includes rules or principles governing the relationship between the variables in the estimate. FASB ASC 326-20 does not require a specific method to determine this estimate. Although multiple methods are available, no one method is required, and multiple methods may be used to arrive at the final estimate. The method(s) used to estimate expected credit losses may vary based on the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity.

Management may use a model in developing the estimate. A model is a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model consists of three components:

1. An information input component, which delivers assumptions and data to the model;
2. A processing component, which transforms inputs into estimates; and
3. A reporting component, which translates the estimates into useful business information.

The following are questions auditors could ask related to the reporting entity's modeling and assumptions:

1. Has management created robust processes to develop the expected credit loss model and model validation controls to verify the model is performing as expected?
2. Has management's risk assessment appropriately considered how assets are pooled and unique risks associated with the asset pools?
3. Has management documented the determination of key assumptions and the rationale for including those assumptions in the model?
4. Does the documentation include the source of the data and the controls relevant to its completeness and accuracy?

5. How do significant modeling methodologies and assumptions used compare to other business units within the entity, to peers, and to competitors?
6. What controls has management put in place to evaluate internal consistency where appropriate or documented reasons for any lack of consistency?
7. Have specialists (either internal or external) been identified to assist with the development of the estimate?
8. What controls are there around the data that was provided to any specialists and the output produced by the specialist?
9. Have model governance processes and controls been put in place to determine the model is fit for purpose, including as facts and circumstances change?

During the auditor's process to understand management's methodology, common questions the auditor may ask management include the following:

1. Why did management select this methodology?
2. What alternative methodologies did management consider and why were they discarded?
3. How did management determine the relevant data (internal and external) and assumptions?
4. What contradictory information (if any) has management identified and how was it considered?
5. What risks did management identify in its process and how were they addressed?
6. What types of information systems did management use?
7. How did management ensure relevance and reliability (completeness and accuracy of internal data) of the data used in the estimate?
8. What system or model limitations were identified and what (if any) adjustments compensate for system or model limitations?
9. What data limitations were identified and what (if any) adjustments compensate for data limitations?
10. How has management ensured that the necessary skills and expertise were available to the entity or if gaps were identified, how did management compensate (e.g., training, hiring, engaging a specialist, engaging a third-party service provider)?

The auditor's understanding of the model includes understanding management's validation process. Among the components of management's validation process is the evaluation of the conceptual soundness of the model. As part of the auditor's evaluation of the conceptual soundness, the auditor obtains an understanding of management's judgments related to the development of the model and how those judgments were applied in the modeling.

### **Relevance and Reliability of Data**

Management should use relevant and reliable data (regardless of its source) within its model. Management's consideration of the reliability of data from its information systems includes an evaluation of the completeness and accuracy of the historical data that resides in the system.

In determining the completeness and accuracy of the data, management may consider the past operating effectiveness of controls over data input and data integrity. For situations in which the data was not previously subject to a control, the control was ineffective, the control was not sufficiently precise for use in the ACL estimate, or the effectiveness of the controls is unknown; management should consider implementing a control to retrospectively evaluate the completeness and accuracy of the historical data (e.g., by agreeing with relevant historical data to original source documents).

Relevant data for calculating the ACL may include the following, among others:

- Amortized asset cost
- Prepayment data
- Asset extension, modification, and renewals
- Asset attributes used to determine portfolio segments
- Asset attributes used to adjust for current asset-specific risk characteristics
- Historical loss information
- Economic data supporting current, reasonable, and supportable forecasts
- Borrower data
- Collateral values

In evaluating the reliability of data used as audit evidence, the auditor considers the nature and the source of the data. When using information produced by the entity such as historical asset data, the auditor tests the completeness and accuracy of information or tests the controls over the completeness and accuracy of that information. Tests of completeness and accuracy may include tests such as comparing data from or to original source documents. For externally sourced information, the auditor may evaluate similar factors as outlined above in management's considerations.

### **Pooling**

FASB ASC 326-20 requires management to measure expected credit losses on a collective (pool) basis when similar risk characteristics exist. When similar risk characteristics do not exist, management should evaluate the asset individually.

FASB ASC 326-20 also requires disclosure of expected losses by portfolio segment for assets. On an ongoing basis, management is required to evaluate whether an asset in a pool continues to exhibit similar risk characteristics as the other assets in the pool. Management's determination of the asset pools, or decision to evaluate an asset on an individual basis, is highly judgmental and should be reflective of management's identification and evaluation of similar risk characteristics.

The determination of asset pools may affect the model chosen by management to estimate expected credit losses and any related qualitative adjustments.

Management may consider the following potential risk characteristics when identifying pools:

- Internal or external (third-party) credit score or credit ratings
- Risk ratings or classification
- Loan purpose
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns



- Reasonable and supportable forecast periods.

The auditor may consider factors that could affect whether management has appropriately and consistently applied the asset segmenting requirements such as the following:

- Completeness and appropriateness of the pool classification of the asset segment
- Appropriateness of the entity's data, classifications, and methods
- Prior periods
- Consideration of alternative risk characteristics
- Relevance and reliability of the entity's data used to segment the portfolio

### **Adjustments to Historical Loss Information**

FASB ASC 326-20 states that an entity should consider adjustments to historical loss information for differences in current asset-specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the prepayment adjusted contractual term of the financial asset or group of financial assets.

ASB ASC 326-20 also requires an entity to consider the need to adjust historical loss information to reflect the extent to which management expects current conditions to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments for current conditions may be qualitative in nature and should reflect changes related to relevant data, such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets.

Qualitative adjustments to historical information are inherently subjective and complex and can result in a high degree of estimation uncertainty. These adjustments should be inherent in a methodology that is subject to appropriate governance and periodic controlled reevaluation.

The information used to support management's subjective adjustments may be publicly available information, information specifically developed for the entity via management's specialist (internal or external), or other relevant and reliable information. Due to the level of judgment being applied by management, management should expect to have adequate documentation supporting management's collection and evaluation of that data to demonstrate its basis for its adjustments. The less objective and more qualitative in nature the adjustment is, the greater the need for robust documentation.

In all cases, it is expected that management will document the relevant factors and related adjustments, especially qualitative adjustments, that it considered and include in the documentation objective evidence to support the amount of adjustment (or why there is no adjustment) and an explanation about why (or why not) an adjustment is necessary.

The auditor is required to determine whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate. This includes whether the assumptions (including qualitative adjustments) used in determining the ACL are consistent with FASB ASC 326.

If the auditor is testing management's process of determining the accounting estimate, the auditor is required to evaluate whether the assumptions used by management are reasonable considering the measurement objectives of the applicable financial reporting framework. Considerations may include the following:

- The appropriateness of the methodology for developing the adjustment to historical data
- The nature of the assumptions (e.g., if the assumptions are supported by quantitative evidence or primarily subjective in nature)
- How management assessed whether the assumptions are relevant and complete and internally consistent

- The completeness and accuracy of the data used to support the assumption
- The nature and extent of management's documentation supporting the assumptions

Identifying those assumptions that are significant to the ACL estimate requires the auditor's professional judgment. The auditor focuses attention on the significant assumptions identified. Generally, significant assumptions cover matters that could materially affect the ACL estimate and may include those that:

- Are sensitive to variation or uncertainty in amount or nature (e.g., assumptions about current asset-specific risk characteristics may be less susceptible to significant variation compared with current conditions).
- Are susceptible to misapplication or bias.
- Involve unobservable data or entity adjustments of observable data.
- Are dependent on the entity's intent and ability to carry out specific courses of action.

### **Adjustments for Reasonable and Supportable Forecasts**

FASB ASC 326-20 requires an entity to adjust historical loss information to reflect the extent to which management expects reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated.

Considerations by the auditor with respect to the nature and extent of management's documentation supporting the adjustments related to the reasonable and supportable forecasts may include the following:

- The length of the forecast period
- Management's forecasting methodology
- How management assessed whether the factors affecting the reasonable and supportable forecasts are relevant and complete
- Whether the reasonable and supportable forecasts are evaluated for internal consistency, such as other forecasts used by the entity
- Whether the reasonable and supportable forecasts methodology is consistently and appropriately applied period over period
- The completeness and accuracy of the data upon which the forecasted losses are based

The auditor's consideration of judgments about the future is based on information available at the time the judgment is made. Subsequent events may result in outcomes that are different from the judgments that were reasonable at the time they were made by management. When this happens, the auditor is required to obtain an understanding of the reasons and evaluate the differences. For example, did management use publicly available forecast data and the forecast was different from actual? In this situation, the forecast may have been reasonable at the time of the estimate based on the best data available.

The Securities and Exchange Commission (SEC) has stated the following with respect to subsequent events:

- Loan-specific information about factual conditions that existed at the balance sheet date ... would be recognized.
- "Information relating to forecasting assumptions used in establishing expected credit losses that are received before the registrant has completed an appropriate estimation process would be permitted to be included in the estimate, unless such information indicates a weakness or a deficiency in the registrant's estimation process, in which case the information would be recognized."
- "Information relating to forecasting assumptions used in establishing expected credit losses that are received after the registrant has completed an appropriate estimation process would not be recognized, unless such information

indicates a weakness or a deficiency in the registrant's estimation process, in which case the information would be recognized."

**Management Bias**

The auditor is required to review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist. Professional skepticism is necessary for the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes evaluating contradictory audit evidence and questioning the reliability of documents, responses to inquiries, and other information obtained from management and audit committees. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained considering the circumstances.

## GROUP STUDY MATERIALS

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### **A. Discussion Problems**

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1. Discuss the effectiveness of internal control over the expected credit loss estimation process under ASC 326.
2. What are example questions that an auditor may ask reporting entity management to better understand the methodology used to estimate the allowance for credit loss?
3. Discuss the auditor's requirement to assess management's bias in estimating the allowance for credit loss.

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**B. Suggested Answers to Discussion Problems**

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1. Management is expected to design, document, and implement policies, procedures, internal controls, systems, and models that result in the development of management's best estimate of the Allowance for Credit Loss (ACL).

With the adoption of FASB ASC 326 and related accounting policies, a key consideration of the auditor is the effectiveness of internal control over the expected credit loss estimation process and the financial reporting of financial assets. Other elements of internal control implemented by management may be responsive to risks in the following areas:

- Determination of applicability and adoption of new accounting policies
- Determination of the methodologies, assumptions, and data needed to establish the estimate of the ACL.
  - Ensuring relevant, reliable, and available credit risk data.
  - Challenging whether a model is appropriate for its intended purpose.
  - Ensuring inputs and assumptions are appropriate and reasonable.
- Validation and conclusion of the results of the calculation of the ACL.

The implementation of FASB ASC 326 will often require the collection and tracking of information not previously used in the incurred loss modeling. In some cases, this data may not have been previously subjected to internal controls. Management will need a detailed plan to address these challenges and to ensure the availability of complete and accurate data and development of appropriate models. The resources and time needed to effectively adopt the standard may be substantial.

2. During the auditor's process to understand management's methodology, common questions the auditor may ask management include the following:
  1. Why did management select this methodology?
  2. What alternative methodologies did management consider and why were they discarded?
  3. How did management determine the relevant data (internal and external) and assumptions?
  4. What contradictory information (if any) has management identified and how was it considered?
  5. What risks did management identify in its process and how were they addressed?
  6. What types of information systems did management use?
  7. How did management ensure relevance and reliability (completeness and accuracy of internal data) of the data used in the estimate?
  8. What system or model limitations were identified and what (if any) adjustments compensate for system or model limitations?
  9. What data limitations were identified and what (if any) adjustments compensate for data limitations?
  10. How has management ensured that the necessary skills and expertise were available to the entity or if gaps were identified, how did management compensate (e.g., training, hiring, engaging a specialist, engaging a third-party service provider)?

3. The auditor is required to review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist. Professional skepticism is necessary for the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes evaluating contradictory audit evidence and questioning the reliability of documents, responses to inquiries, and other information obtained from management and audit committees. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained considering the circumstances.

## GLOSSARY OF KEY TERMS

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**ACL**—Allowance for Credit Loss

**Asset**—Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events

**Construction Stage**—Begin at the time the entity obtains ownership of the asset or obtains the right to use the asset through an agreement like a lease. During that stage, costs that are incurred to acquire, construct, or install the property, plant, and equipment would be capitalized. This stage would include costs that are incurred prior to the asset being available for its intended use.

**Expense**—Outflows or other using up of assets or incurrences of liabilities, or even a combination of both of those, from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations

**In-service Stage**—Begins when the asset is substantially complete and ready for its intended use

**Preliminary Stage**—Commencing at the beginning of a project and lasting until the acquisition or construction of the specific asset is considered probable

**Research and development**—Planned search or critical investigation aimed at discovery of new knowledge, with the hope that such knowledge will be useful in developing a new product or service, or a new process or technique, or in bringing about a significant improvement to an existing product or process.

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**BY SPEAKER**

<b>Speaker</b>	<b>Month</b>	<b>Speaker</b>	<b>Month</b>
Jennifer Louis .....	Jan-Dec	Russ Madray .....	Jan-May, Jul-Dec
Kurt Oestricher.....	Feb-Nov		

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Choose the best response and record your answer in the space provided on the answer sheet.

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1. According to Russ Madray, what is one characteristic of an *asset* under SFAC No. 6?
  - A. Related benefits are realized immediately.
  - B. Multiple entities can obtain access to the related benefits.
  - C. The associated transaction has already occurred.
  - D. The associated expenditure was an outflow to produce goods.
2. According to Russ Madray, can the guidance about capitalization in Topic 970 be applied to capital assets constructed for the reporting entity's own use?
  - A. Yes, the guidance provided in Topic 970 is applicable in this situation.
  - B. Yes, the guidance provided in Topic 970 is applicable if the self-constructed asset is a type of real estate.
  - C. No, self-constructed assets are explicitly excluded from Topic 970, so it should not be consulted.
  - D. While self-constructed assets are excluded from Topic 970, the guidance may apply to entities' overall capitalization policies.
3. According to Russ Madray, which of the following activities takes place during the preliminary stage of acquiring a self-constructed asset?
  - A. Placing the asset into service.
  - B. Repairing an asset.
  - C. Obtaining a lease.
  - D. Doing a feasibility study.
4. According to Russ Madray, what happens when the construction or acquisition of an asset becomes improbable during the pre-acquisition stage?
  - A. Any costs already capitalized must be assessed for impairment.
  - B. The associated asset must be sold or abandoned.
  - C. Any costs already capitalized are now considered administrative.
  - D. The project moves from the pre-acquisition stage back to the preliminary stage.
5. According to Russ Madray, when does the in-service stage begin?
  - A. After construction has begun on the asset.
  - B. Once the asset is substantially complete and ready for use.
  - C. When use of the asset during the course of normal business begins.
  - D. After the asset incurs maintenance or repair expenses.

*Continued on next page*

6. According to Russ Madray, how much of the interest associated with self-constructed assets should be capitalized?
- A. The total amount of interest paid on self-constructed assets should be capitalized by the reporting entity.
  - B. The amount capitalized is based on a capitalization rate applied to the weighted-average carrying amount of associated expenditures.
  - C. Because interest is not part of the historical cost of acquiring an asset, entities cannot capitalize interest related to capital assets, self-constructed or not.
  - D. The total amount of interest related to self-constructed assets is specifically excluded from capitalization by Topic 853.
7. According to Russ Madray, under what circumstances should entities capitalize expenditures for repairs made after the acquisition/construction of any type of property, plant, or equipment is complete?
- A. The repairs provide additional service potential beyond the asset's initial estimated useful life.
  - B. The repairs are incurred for routine maintenance to keep the asset working at current capacity.
  - C. The repairs lower the quality or amount of goods or services produced by the asset.
  - D. The total amount of expenditure for the repairs is considered immaterial.
8. According to Russ Madray, under what circumstances can a reporting entity capitalize costs for research and development (R&D)?
- A. They relate to tangible materials that are consumed during R&D activities.
  - B. They are depreciation costs for equipment or facilities that are used in R&D activities.
  - C. They relate to intangible assets purchased for R&D activities that have an alternative future use.
  - D. The costs for research cannot be capitalized ever.
9. According to Russ Madray, what term does Topic 720 use for expenditures related to activities such as organizing a partnership or corporation, introducing a new product, opening a new facility, introducing a new product, or developing a new class of customers?
- A. Advertising costs.
  - B. Maintenance costs.
  - C. R&D costs.
  - D. Start-up costs.
10. According to Russ Madray, which of the following considerations applies to capitalization thresholds?
- A. Because they are required by U.S. GAAP, entities must treat changing their capitalization thresholds as a change in accounting policy.
  - B. The main advantage of establishing a capitalization threshold is for the administrative convenience of the entity.
  - C. The capitalization threshold can be material to the entity's financial statements if there is documentation to justify that decision.
  - D. When changing its capitalization policy, an entity should apply the new threshold retroactively and restate prior financial statements as needed.

*Continued on next page*

11. According to Jennifer Louis, the allowance for credit loss will be which of the following under Topic 326?
  - A. Presented as a positive amount.
  - B. Unlikely to affect accounts like loans receivable.
  - C. Prepared based on actual amounts, not estimates.
  - D. Presented net on the financial statements.
12. According to Jennifer Louis, who is ultimately responsible for the new information discussed in Topic 326 and how it affects the preparation and fair presentation of an entity's financial statements?
  - A. The reporting entity's management.
  - B. The independent auditor.
  - C. A FASB-appointed governing body.
  - D. Users of the entity's financial statements.
13. According to Jennifer Louis, do subsequent events typically provide enough information for an auditor to confirm or contradict management's allowance estimate?
  - A. Yes, if subsequent events confirm or contradict management's allowance estimate, that is enough evidence for the audit.
  - B. No, subsequent events rarely provide sufficient appropriate audit evidence in isolation due to the inherent uncertainty and subjectivity.
  - C. It depends on how much time has passed between the end of the fiscal year and the beginning of the audit engagement.
  - D. It depends on the accounting policy elections made by the reporting entity and, thus, can vary by audit engagement.
14. According to Jennifer Louis, what is the correct term for an entity's overall approach to applying the requirements of Topic 326?
  - A. Election.
  - B. Methodology.
  - C. Model.
  - D. Principle.
15. According to Jennifer Louis, how does Topic 326 address the pooling of assets when assessing potential credit loss?
  - A. Management is required to pool assets with similar characteristics and look at them collectively.
  - B. Management should evaluate assets individually rather than pool and address them as a group.
  - C. Once assets are pooled, they stay in that group year after year for consistency on the financial statements.
  - D. Documentation is unnecessary because it is typically obvious why assets are pooled together.

## Subscriber Survey

### Evaluation Form

Please take a few minutes to complete this survey related to **CPE Network® A&A Report** and return with your quizzer or group attendance sheet to CeriFi, LLC. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to [CPLgrading@cerifi.com](mailto:CPLgrading@cerifi.com).

How would you rate the topics covered in the December 2023 **CPE Network® A&A Report**? Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
To Capitalize or Not?	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
FAQs on Evaluating ECL Estimates	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

Which segments of the December 2023 issue of **CPE Network® A&A Report** did you like the most, and why?

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Which segments of the December 2023 issue of **CPE Network® A&A Report** did you like the least, and why?

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What would you like to see included or changed in future issues of **CPE Network® A&A Report**?

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How would you rate the effectiveness of the speakers in the December 2023 **CPE Network® A&A Report**? Rate each speaker on a scale of 1–5 (5 highest):

	<b>Overall</b>	<b>Knowledge of Topic</b>	<b>Presentation Skills</b>
Russ Madray	_____	_____	_____
Jennifer Louis	_____	_____	_____

Are you using **CPE Network® A&A Report** for: CPE Credit ☐ Information ☐ Both ☐

\_\_\_\_\_

Were the stated learning objectives met? Yes ☐ No ☐ \_\_\_\_\_

If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ \_\_\_\_\_

Were program materials accurate? Yes ☐ No ☐ \_\_\_\_\_

Were program materials relevant and contribute to the achievement of the learning objectives? Yes ☐ No ☐

\_\_\_\_\_

Were the time allocations for the program appropriate? Yes ☐ No ☐ \_\_\_\_\_

Were the supplemental reading materials satisfactory? Yes ☐ No ☐ \_\_\_\_\_

Were the discussion questions and answers satisfactory? Yes ☐ No ☐ \_\_\_\_\_

Specific Comments: \_\_\_\_\_

\_\_\_\_\_

Name/Company \_\_\_\_\_

Address \_\_\_\_\_

City/State/Zip \_\_\_\_\_

Email \_\_\_\_\_

**Once Again, Thank You...**

**Your Input Can Have a Direct Influence on Future Issues!**

**CPE Network®**

Firm/Company Name: \_\_\_\_\_

Account #:

**Location:**

Program Title: \_\_\_\_\_ Date: \_\_\_\_\_

[illegible]

I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CPE Network® newsletter, and earned the number of hours shown.

Instructor Name: \_\_\_\_\_

Date: \_\_\_\_\_

E-mail address:

License State and Number:

# CPE Network/Webinar Delivery Tracking Report

<b>Course Title</b>	
<b>Course Date:</b>	
<b>Start Time:</b>	
<b>End Time:</b>	
<b>Moderator Name, Credentials, and Signature Attestation of Attendance:</b>	
<b>Delivery Method:</b>	Group Internet Based
<b>Total CPE Credit:</b>	3.0
<b>Instructions:</b>	During the webinar, the moderator must verify student presence a minimum of <u>3 times per CPE hour</u> . This is achieved via polling questions. Sponsors must have a report which documents the responses from each student. The timing of the polling questions should be random and not made known to students prior to delivery of the course. Record the polling question responses below. Refer to the CPL Network User Guide for more instructions. Partial credit will not be issued for students who do not respond to at least 3 polling questions per CPE hour.
<b>Brief Description of Method of Polling</b>	Example: Zoom: During this webinar, moderator asked students to raise their hands 3 times per CPE hour. The instructor then noted the hands that were raised in the columns below.

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# CHECKPOINT LEARNING NETWORK

# CPE NETWORK<sup>®</sup>

# USER GUIDE

REVISED August 29, 2023

## Welcome to CPE Network!

CPE Network programs enable you to deliver training programs to those in your firm in a manageable way. You can choose how you want to deliver the training in a way that suits your firm's needs: in the classroom, virtual, or self-study. You must review and understand the requirements of each of these delivery methods before conducting your training to ensure you meet (and document) all the requirements.

This User Guide has the following sections:

- **“Group Live” Format:** The instructor and all the participants are gathered into a common area, such as a conference room or training room at a location of your choice.
- **“Group Internet Based” Format:** Deliver your training over the internet via Zoom, Teams, Webex, or other application that allows the instructor to present materials that all the participants can view at the same time.
- **“Self-Study” Format:** Each participant can take the self-study version of the CPE Network program on their own computers at a time and place of their convenience. No instructor is required for self-study.
- **Transitioning From DVDs:** For groups playing the video from the online platform, we suggest downloading the video from the Checkpoint Learning player to the desktop before projecting.
- **What Does It Mean to Be a CPE Sponsor?:** Should you decide to vary from any of the requirements in the 3 methods noted above (for example, provide less than 3 full CPE credits, alter subject areas, offer hybrid or variations to the methods described above), Checkpoint Learning Network will not be the sponsor and will not issue certificates. In this scenario, your firm will become the sponsor and must issue its own certificates of completion. This section outlines the sponsor's responsibilities that you must adhere to if you choose not to follow the requirements for the delivery methods.
- **Getting Help:** Refer to this section to get your questions answered.

**IMPORTANT:** This User Guide outlines in detail what is required for each of the 3 formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) Checkpoint Learning Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

**IMPORTANT:** If you vary from the instructions noted above, your firm will become the sponsor of the training event and you will have to create your own certificates of completions for your participants. In this case, you do not need to submit any documentation back to CeriFi, LLC.

If you have any questions on this documentation or requirements, refer to the “Getting Help” section at the end of this User Guide **BEFORE** you conduct your training.

**We are happy that you chose CPE Network for your training solutions.  
Thank you for your business and HAPPY LEARNING!**

### **Copyrighted Materials**

CPE Network program materials are copyrighted and may not be reproduced in another document or manuscript in any form without the permission of the publisher. As a subscriber of the **CPE Network Series**, you may reproduce the necessary number of participant manuals needed to conduct your group study session.

# “Group Live” Format

## CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

**50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours**

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

**\*Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

## Advertising / Promotional Page

**Create a promotion page** (use the template after the executive summary of the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

## Monitoring Attendance

You must monitor individual participant attendance at “group live” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **attendance sheet**. This lists the instructor(s) name and credentials, as well as the first and last name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant arrives late, leaves early, or is a “no show,” the actual hours they attended should be documented on the sign-in sheet and will be reflected on the participant’s CPE certificate.

## **Real Time Instructor During Program Presentation**

“Group live” programs must have a **qualified, real time instructor while the program is being presented**. Program participants must be able to interact with the instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

## **Elements of Engagement**

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

## **Make-Up Sessions**

Individuals who are unable to attend the group study session may use the program materials for self-study either in print or online.

- If the print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his/their CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

## **Awarding CPE Certificates**

The CPE certificate is the participant's record of attendance and is awarded by Checkpoint Learning Network after the "group live" documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

## **Subscriber Survey Evaluation Forms**

**Use the evaluation form.** You must include a means for evaluating quality. At the conclusion of the "group live" session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

## **Retention of Records**

Regardless of whether Checkpoint Learning Network is the sponsor for the "group live" session, it is required that the firm hosting the "group live" session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Group Study Attendance sheets; indicating any late arrivals and/or early departures)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations.



## Finding the Transcript

**Note:** DVDs no longer ship with this product effective 3/1/2023.

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- <https://get.adobe.com/reader/>

The entire transcript is also available as a pdf in the Checkpoint Learning player in the resource toolbox at the top of the screen, or via the link in the email sent to administrators.

## Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group live” session should be sent to Checkpoint Learning Network by the following means:

Email: [CPLgrading@cerifi.com](mailto:CPLgrading@cerifi.com)

**When sending your package to CeriFi, you must include ALL of the following items:**

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Attendance Sheet		Use this form to track attendance during your training session.
Subscriber Survey Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

**Incomplete submissions will be returned to you.**

# “Group Internet Based” Format

## CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

**50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours**

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

**\*Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

## Advertising / Promotional Page

**Create a promotion page** (use the template following the executive summary in the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

## Monitoring Attendance in a Webinar

You must monitor individual participant attendance at “group internet based” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **Webinar Delivery Tracking Report**. This form lists the moderator(s) name and credentials, as well as the first and last name of each participant attending the seminar. During a webinar you must set up a monitoring mechanism (or polling mechanism) to periodically check the participants’ engagement throughout the delivery of the program.

In order for CPE credit to be granted, you must confirm the presence of each participant **3 times per CPE hour and the participant must reply to the polling question**. Participants that respond to less than 3 polling questions in a CPE hour will not be granted CPE credit. For example, if a participant only replies to 2 of the 3 polling questions in the first CPE hour, credit for the first CPE hour will not be granted. (Refer to the Webinar Delivery Tracking Report for examples.)

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and ask that participants confirm their attendance by using the “raise hands” feature. Once the participants raise their hands, the moderator records the participants who have their hands up in the **webinar delivery tracking report** by putting a YES in the webinar delivery tracking report. After documenting in the spreadsheet, the instructor (or moderator) drops everyone’s hands and continues the training.
2. You are using **Teams** for your webinar. The moderator will pause approximately every 15 minutes and ask that participants confirm their attendance by typing “Present” into the Teams chat box. The moderator records the participants who have entered “Present” into the chat box into the **webinar delivery tracking report**. After documenting in the spreadsheet, the instructor (or moderator) continues the training.
3. If you are using an application that has a way to automatically send out polling questions to the participants, you can use that application/mechanism. However, following the event, you should create a **webinar delivery tracking report** from your app’s report.

#### **Additional Notes on Monitoring Mechanisms:**

1. The monitoring mechanism does not have to be “content specific.” Rather, the intention is to ensure that the remote participants are present and paying attention to the training.
2. You should only give a minute or so for each participant to reply to the prompt. If, after a minute, a participant does not reply to the prompt, you should put a NO in the webinar delivery tracking report.
3. While this process may seem unwieldy at first, it is a required element that sponsors must adhere to. And after some practice, it should not cause any significant disruption to the training session.
4. **You must include the Webinar Delivery Tracking report with your course submission if you are requesting certificates of completion for a “group internet based” delivery format.**

#### **Real Time Moderator During Program Presentation**

“Group internet based” programs must have a **qualified, real time moderator while the program is being presented**. Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers

during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

### **Make-Up Sessions**

Individuals who are unable to attend the “group internet based” session may use the program materials for self-study either in print or online.

- If print materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

### **Awarding CPE Certificates**

The CPE certificate is the participant’s record of attendance and is awarded by Checkpoint Learning Network after the “group internet based” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who may not have answered the required amount of polling questions.

### **Subscriber Survey Evaluation Forms**

**Use the evaluation form.** You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

## **Retention of Records**

Regardless of whether Checkpoint Learning Network is the sponsor for the “group internet based” session, it is required that the firm hosting the session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Webinar Delivery Tracking Report)
- Copy of the program materials
- Timed agenda with topics covered
- Date and location (which would be “virtual”) of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations

## **Finding the Transcript**

**Note: DVDs are no longer shipped effective 3/1/2023**

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. It should look something like the screenshot below. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- <https://get.adobe.com/reader/>

**Alternatively, for those without a DVD drive, the email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.**

## Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group internet based” session should be sent to Checkpoint Learning Network by the following means:

Email: [CPLgrading@CeriFi.com](mailto:CPLgrading@CeriFi.com)

**When sending your package to CeriFi, you must include ALL the following items:**

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Webinar Delivery Tracking Report		Use this form to track the attendance (i.e., polling questions) during your training webinar.
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

**Incomplete submissions will be returned to you.**

# “Self-Study” Format

If you are unable to attend the live group study session, we offer two options for you to complete your Network Report program.

## Self-Study—Print

Follow these simple steps to use the printed transcript and video:

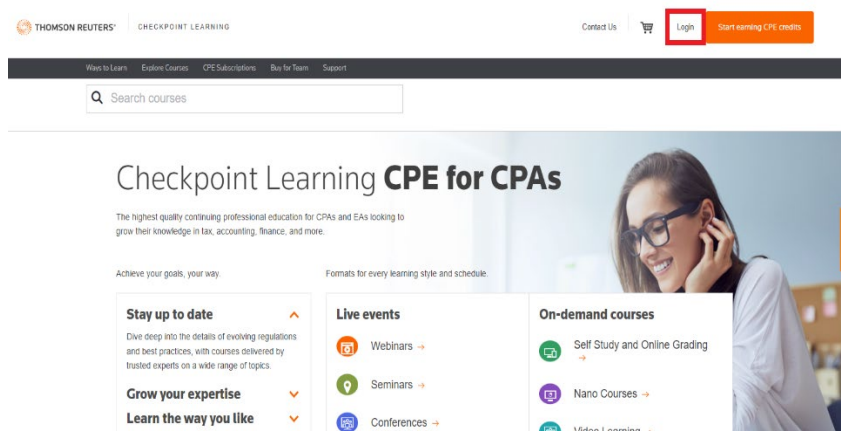
- Watch the video.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
- E-mail your completed quizzer and survey to:

**CPLgrading@cerifi.com**

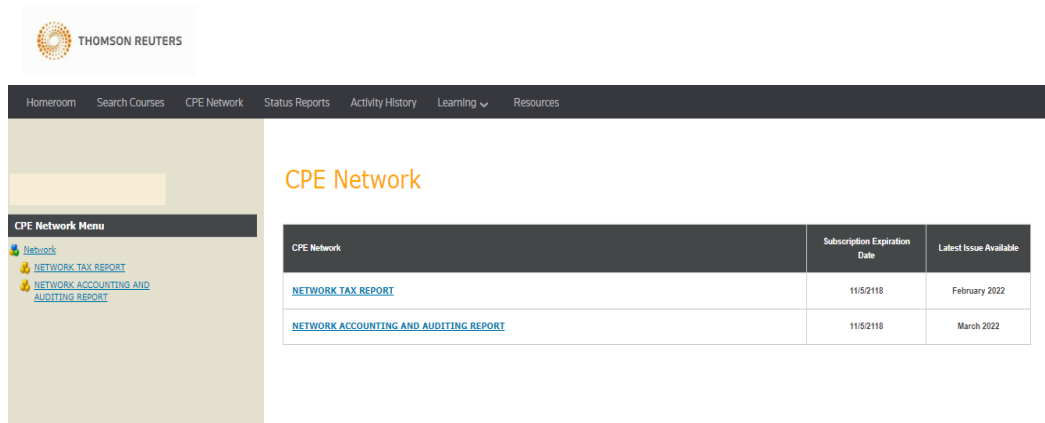
## Self-Study—Online

Follow these simple steps to use the online program:

- Go to [www.checkpointlearning.thomsonreuters.com](http://www.checkpointlearning.thomsonreuters.com).
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Login or Register”).

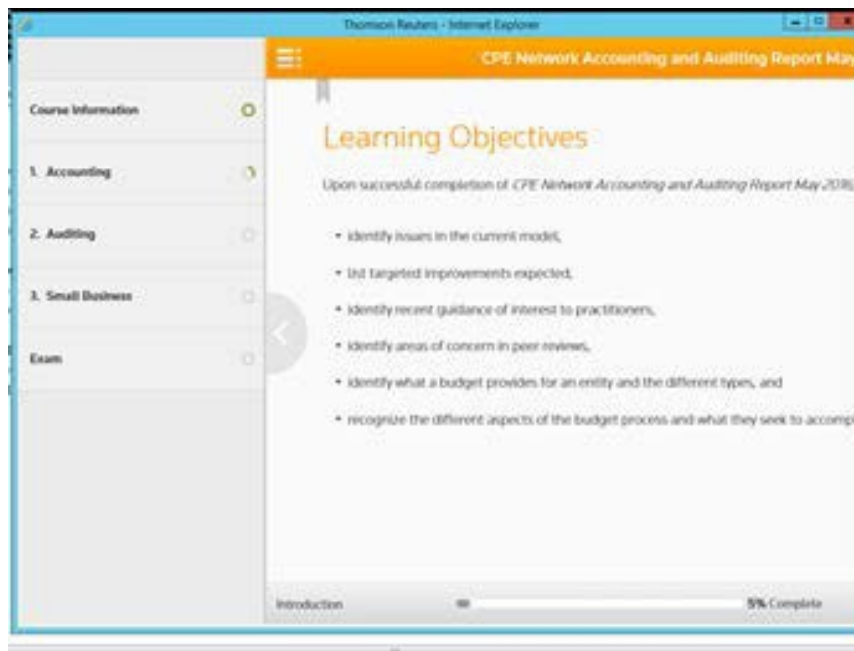


- In the **CPE Network** tab, select the desired Network Report and then the appropriate edition.



CPE Network	Subscription Expiration Date	Latest Issue Available
<a href="#">NETWORK TAX REPORT</a>	11/5/2118	February 2022
<a href="#">NETWORK ACCOUNTING AND AUDITING REPORT</a>	11/5/2118	March 2022

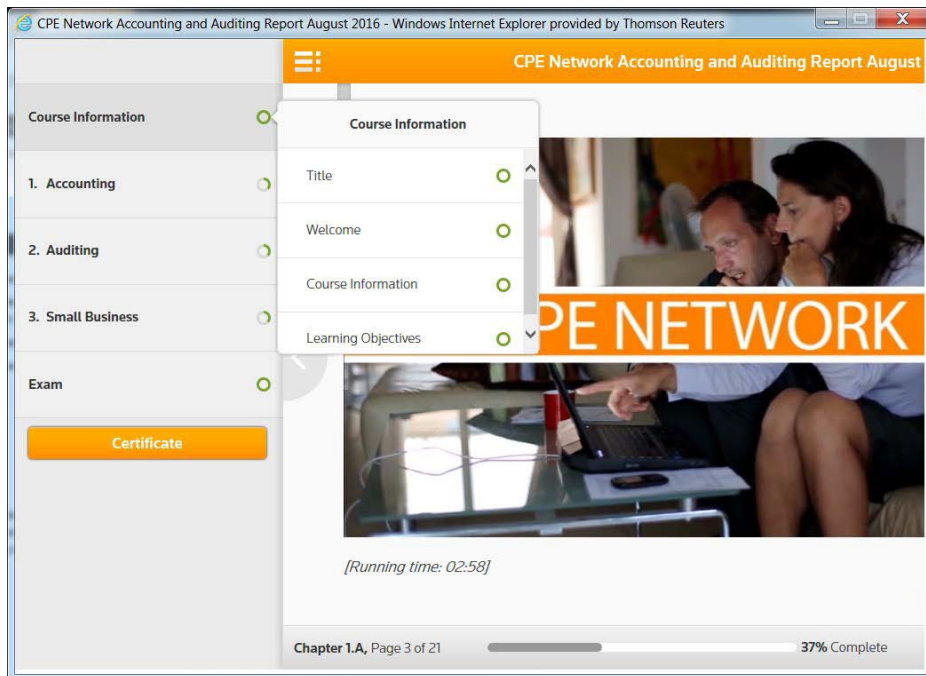
The Chapter Menu is in the gray bar at the left of your screen:



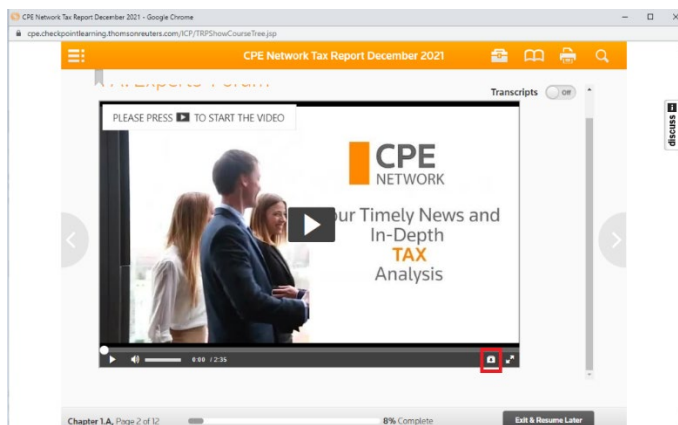
Click down to access the dropdown menu and move between the program Chapters.

- **Course Information** is the course Overview, including information about the authors and the program learning objectives





- **Each Chapter is self-contained.** Each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This streamlined approach allows administrators and users to more easily access the related materials.



Video segments may be downloaded from the CPL player by clicking on the download button. Tip: you may need to scroll down to see the download button.

Thomson Reuters - Internet Explorer

CPE Network Accounting and Auditing Report May 2016

Transcripts ☒

## Chapter 1 Liabilities and Equity: Another Look at the Model

Both the FASB and the AICPA have targeted improvements to the guidance related to liabilities and equity instruments. The current debt-equity model in U.S. GAAP is very complex, making it difficult for both preparers and accountants to implement.

For more on the targeted improvements in this area, let's join Paul Munter, professor in practice for the University of Colorado at Boulder, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today, we want to talk a little bit

Please note that the transcript [Liabilities and Equity Transcripts](#) can also be found as a link and in the Tools section.

Chapter 1A, Page 4 of 21 8% Complete [Exit & Resume Later](#)

Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.

D:\xml\production\working\U6015494\N... Network Accounting and Auditing Report May 2016

Transcripts ☒

## Chapter 1 Liabilities and Equity: Another Look at the Model

Both the FASB and the AICPA have targeted improvements to the guidance related to liabilities and equity instruments. The current debt-equity model in U.S. GAAP is very complex, making it difficult for both preparers and accountants to implement.

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Chapter 1A, Page 4 of 21 8% Complete [Exit & Resume Later](#)

**CHAPTER 1A: ACCOUNTING**

**Liabilities and Equity: Another Look at the Model**

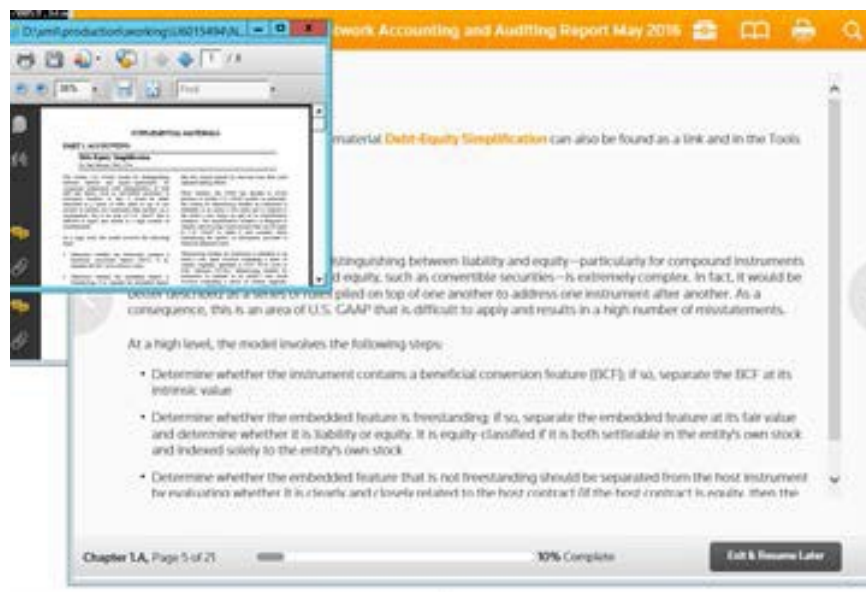
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Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.



Continuing to click the arrow to the right side of the screen will bring the user to the Discussion problems related to the segment.

The Suggested Answers to the Discussion Problems follow the Discussion Problems.

The screenshot displays a web-based interface for a CPE (Continuing Professional Education) report. The header bar is orange and contains the text "CPE Network Accounting and Auditing Report July 2016" along with several icons: a hamburger menu, a calendar, a book, a printer, and a search icon. Below the header, the main content area is titled "Suggested Answers to Discussion Problems". It contains three numbered items:

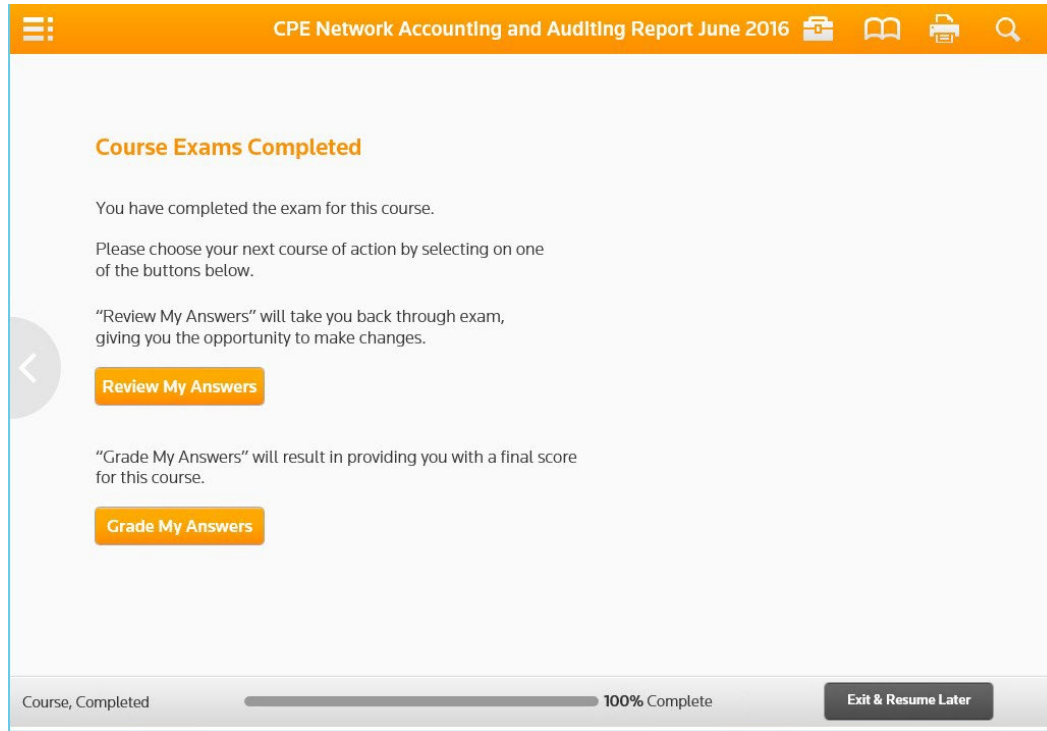
1. ASC 320 requires that, at acquisition, an enterprise classify debt and marketable equity securities into one of three categories:
  - Held-to-maturity
  - Trading
  - Available-for-sale

An entity decides how to classify securities based on its intended holding period for each individual security, using the framework in ASC 320. In establishing its intent, an entity should consider relevant trends and experience, such as previous sales and transfers of securities. Classification decisions should be made at acquisition and, preferably, formally documented. It is not appropriate to use "hindsight" to classify securities transactions, perhaps by considering changes in value after acquisition.
2. The trading securities category includes securities that are bought and held principally for the purpose of selling them in the short term. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. "Short-term," in this context, is intended to be measured in hours and days, rather than in months or years, according to ASC 320. However, an entity is not precluded from classifying as trading a security it plans to hold for a longer period, as long as that designation occurs at acquisition.
3. Impairment is recognized in earnings when a decline in value has occurred that is deemed to be other than temporary, and the current fair value becomes the new cost basis for the security. An investment is considered to be impaired if the fair value of the investment is less than its cost basis. Cost includes adjustments made for

At the bottom of the page, there is a footer bar. On the left, it says "Chapter 3.A, Page 20 of 20". In the center, there is a progress bar that is filled to the right and labeled "100% Complete". On the right, there is a button labeled "Exit & Resume Later".

The **Exam** is accessed by clicking the last gray bar on the menu at the left of the screen or clicking through to it. Click the orange button to begin.

When you have completed the quizzer, click the button labeled **Grade or the Review button**.



- Click the button labeled **Certificate** to print your CPE certificate.
- The final quizzer grade is displayed and you may view the graded answers by clicking the button labeled **view graded answer**.

### Additional Features Search

Checkpoint Learning offers powerful search options. Click the **magnifying glass** at the upper right of the screen to begin your search. Enter your choice in the **Search For:** box.

**Search Results** are displayed with the number of hits.

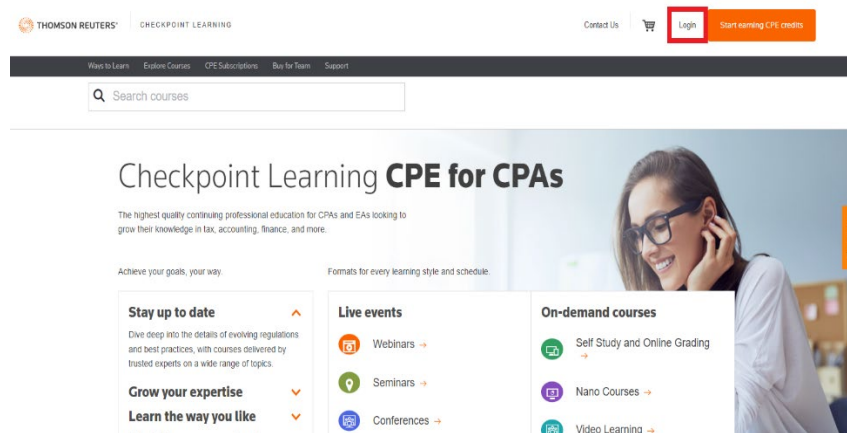
### Print

To display the print menu, click the printer icon in the upper bar of your screen. You can print the entire course, the transcript, the glossary, all resources, or selected portions of the course. Click your choice and click the orange **Print**.

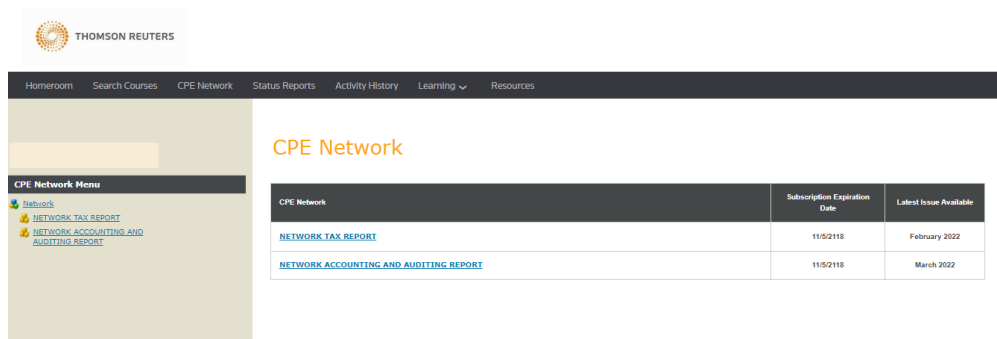
# Transitioning From DVDs

Follow these simple steps to access the video and pdf for download from the online platform:

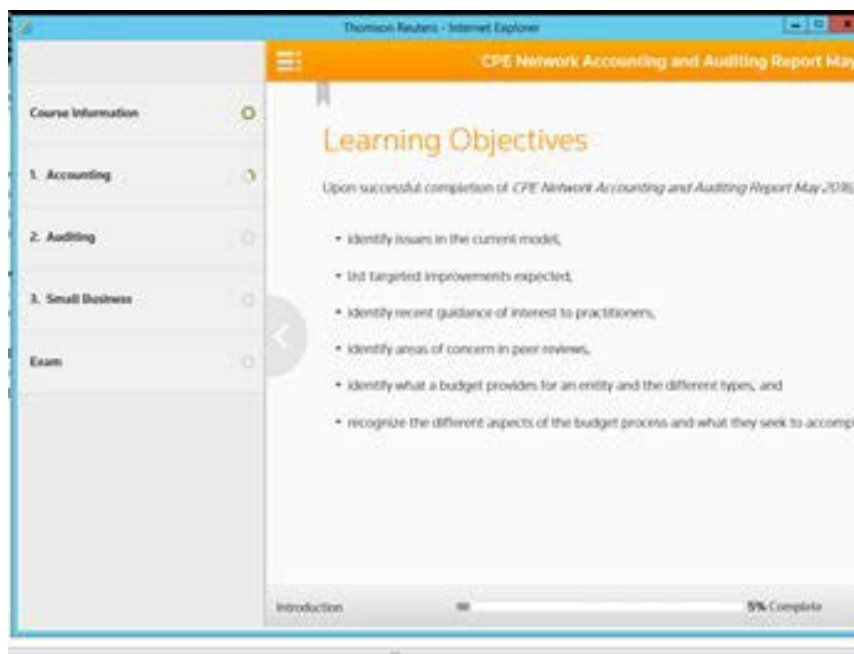
- Go to [www.checkpointlearning.thomsonreuters.com](http://www.checkpointlearning.thomsonreuters.com) .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Login").



- In the CPE **Network** tab, select the desired Network Report by clicking on the title, then select the appropriate edition.



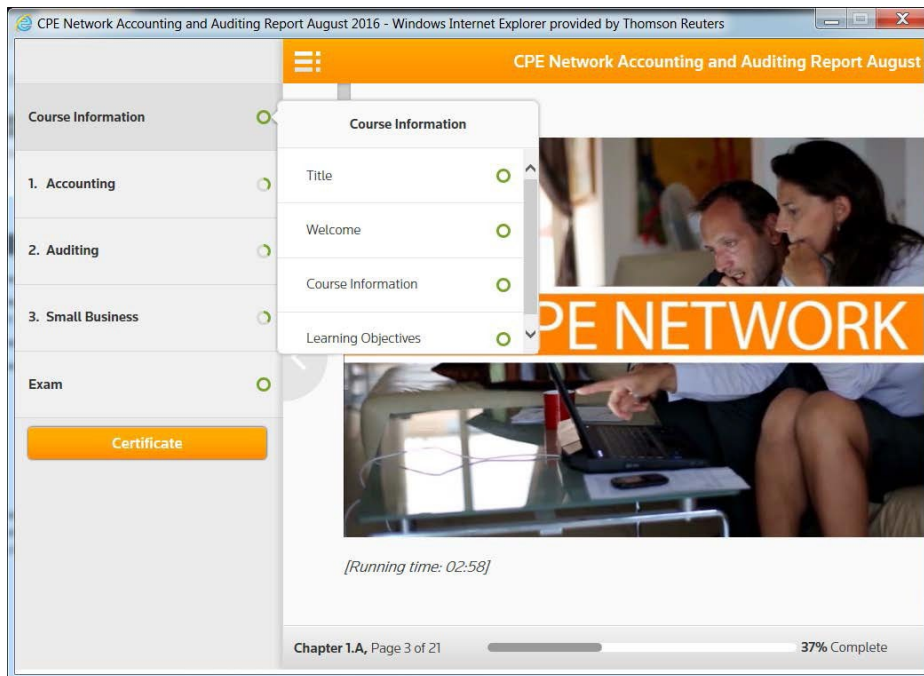
The Chapter Menu is in the gray bar at the left of your screen:



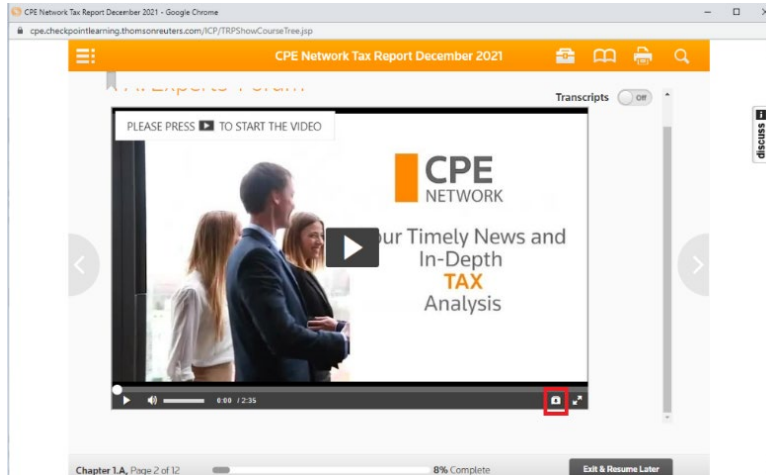
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- **Course Information** is the course Overview, including information about the authors and the program learning objectives





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Video segments may be downloaded from the CPL player by clicking on the download button noted above. You may need to use the scroll bar to the right of the video to see the download button. **Tip: You may need to use the scroll bar to the right of the video to see the download button.**

PDFs may be downloaded from either the course toolbox in the upper right corner of the Checkpoint Learning screen or from the email sent to administrators with each release.



# What Does It Mean to Be a CPE Sponsor?

If your organization chooses to vary from the instructions outlined in this User Guide, your firm will become the CPE Sponsor for this monthly series. The sponsor rules and requirements noted below are only highlights and reflect those of NASBA, the national body that sets guidance for development, presentation, and documentation for CPE programs. **For any specific questions about state sponsor requirements, please contact your state board. They are the final authority regarding CPE Sponsor requirements.** Generally, the following responsibilities are required of the sponsor:

- Arrange for a location for the presentation
- Advertise the course to your anticipated participants and disclose significant features of the program in advance
- Set the start time
- Establish participant sign-in procedures
- Coordinate audio-visual requirements with the facilitator
- Arrange appropriate breaks
- Have a real-time instructor during program presentation
- Ensure that the instructor delivers and documents elements of engagement
- Monitor participant attendance (make notations of late arrivals, early departures, and “no shows”)
- Solicit course evaluations from participants
- Award CPE credit and issue certificates of completion
- Retain records for five years

The following information includes instructions and generic forms to assist you in fulfilling your responsibilities as program sponsor.

## CPE Sponsor Requirements

### Determining CPE Credit Increments

Sponsored seminars are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned. Sponsors must monitor the program length and the participants' attendance in order to award the appropriate number of CPE credits.

## **Program Presentation**

CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. CPE program sponsors must make the following information available in advance:

- Learning objectives.
- Instructional delivery methods.
- Recommended CPE credit and recommended field of study.
- Prerequisites.
- Program level.
- Advance preparation.
- Program description.
- Course registration and, where applicable, attendance requirements.
- Refund policy for courses sold for a fee/cancellation policy.
- Complaint resolution policy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits).

## **Disclose Significant Features of Program in Advance**

For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (e.g., through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with non-educational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration and attendance policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

## **Monitor Attendance**

While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must maintain a process to monitor individual attendance at group programs to assign the correct number of CPE credits. A participant's self-certification of attendance alone is not sufficient. The sign-in sheet should list the names of each instructor and her/his credentials, as well as the name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant leaves early, the hours they attended should be documented on the sign-in sheet and on the participant's CPE certificate.

### **Real Time Instructor During Program Presentation**

“Group live” programs must have a qualified, real time instructor while the program is being presented. Program participants must be able to interact with the real time instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

### **Elements of Engagement**

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

### **Awarding CPE Certificates**

The CPE certificate is the participant’s record of attendance and is awarded at the conclusion of the seminar. It should reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early. Attached is a sample *Certificate of Attendance* you may use for your convenience.

CFP credit is available if the firm registers with the CFP board as a sponsor and meets the CFP board requirements. IRS credit is available only if the firm registers with the IRS as a sponsor and satisfies their requirements.

### **Seminar Quality Evaluations for Firm Sponsor**

NASBA requires the seminar to include a means for evaluating quality. At the seminar conclusion, evaluations should be solicited from participants and retained by the sponsor for five years. The following statements are required on the evaluation and are used to determine whether:

1. Stated learning objectives were met.
2. Prerequisite requirements were appropriate.
3. Program materials were accurate.
4. Program materials were relevant and contributed to the achievement of the learning objectives.
5. Time allotted to the learning activity was appropriate.
6. Individual instructors were effective.
7. Facilities and/or technological equipment were appropriate.
8. Handout or advance preparation materials were satisfactory.
9. Audio and video materials were effective.

You may use the enclosed preprinted evaluation forms for your convenience.

### **Retention of Records**

The seminar sponsor is required to retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (the original sign-in sheets, now in an editable, electronic signable format)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name(s) and credentials
- Results of program evaluations

# Appendix: Forms

Here are the forms noted above and how to get access to them.

<b>Delivery Method</b>	<b>Form Name</b>	<b>Location</b>	<b>Notes</b>
"Group Live" / "Group Internet Based"	Advertising / Promotional Page	Transcript	Complete this form and circulate to your audience before the training event.
"Group Live"	Attendance Sheet	Transcript	Use this form to track attendance during your training session.
"Group Internet Based"	Webinar Delivery Tracking Report	Transcript	Use this form to track the 'polling questions' which are required to monitor attendance during your webinar.
"Group Live" / "Group Internet Based"	Evaluation Form	Transcript	Circulate the evaluation form at the end of your training session so that participants can review and comment on the training.
Self Study	CPE Quizzer Answer Sheet	Transcript	Use this form to record your answers to the quiz.

# Getting Help

Should you need support or assistance with your account, please see below:

Support Group	Phone Number	Email Address	Typical Issues/Questions
Technical Support	844.245.5970	<a href="mailto:Cplsupport@cerifi.com">Cplsupport@cerifi.com</a>	<ul style="list-style-type: none"><li>• Browser-based</li><li>• Certificate discrepancies</li><li>• Accessing courses</li><li>• Migration questions</li><li>• Feed issues</li></ul>
Product Support	844.245.5970	<a href="mailto:Cplsupport@cerifi.com">Cplsupport@cerifi.com</a>	<ul style="list-style-type: none"><li>• Functionality (how to use, where to find)</li><li>• Content questions</li><li>• Login Assistance</li></ul>
Customer Support	844.245.5970	<a href="mailto:Cplsupport@cerifi.com">Cplsupport@cerifi.com</a>	<ul style="list-style-type: none"><li>• Billing</li><li>• Existing orders</li><li>• Cancellations</li><li>• Webinars</li><li>• Certificates</li></ul>