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CPE NETWORK

ACCOUNTING & AUDITING REPORT

MARCH 2022

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Note: Beginning with the March 2023 edition of the Network programs DVDs will no longer be shipped by Thomson Reuters. Videos will be available for download or streaming only. For customers wishing to adopt an online only format sooner, please contact your customer representative.

NOTE: During the current COVID-19 crisis, direct person to person contact can be reduced by forwarding this to participants and reminding others that the video is also available online through the CPL player. Additionally, video/discussion/Q&A may be shared via Teams, Zoom, or other conferencing-type software. Participants may submit the quiz for self-study credit, or Group Internet Based credit (similar to a webinar) is now available. Consult the user guide at the end of the newsletter for instructions on how to earn credit in this manner.

Topics for future editions may include:

- Personal Financial Statements
- SAS 145
- Analytical Procedures in Reviews



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EXECUTIVE SUMMARY

PART 1. ACCOUNTING

Special Purpose Frameworks3

Kurt Oestrieher, CPA, reviews the special purpose frameworks frequently used in preparing financial statements. [*Running time: 34:40*]

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

- Identify GAAP standard setters
- List examples of different bases and what entities use them in which service levels
- Identify the considerations in choosing an accounting framework
- Identify the guidance for disclosures if a framework does not have them

PART 2. AUDITING

Independence and Ethics Interpretations21

Jennifer Louis, CPA considers recent independence and ethics interpretations issued by the Professional Ethics Executive Committee. [*Running time: 32:40*]

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

- Identify the senior committee of the AICPA charged with interpreting and enforcing the Code of Conduct
- Identify the focus and effective dates of recent ethics interpretations
- Identify the focus of the information systems ethics interpretation

PART 3. SMALL BUSINESS

Communicating Internal Control Deficiencies..... 47

Kurt Oestrieher, CPA, discusses the different levels of control deficiencies and when communications to those charged with governance should occur. [*Running time: 26:40*]

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

- Identify the steps in determining a control deficiency
- Identify types of control deficiencies
- Determine steps to evaluate the level of deficiency and when to communicate deficiencies
- Define a material weakness

ABOUT THE SPEAKERS

Kurt Oestrieher, CPA is a CPA and partner with the accounting firm of Oestrieher and Company in Alexandria, Louisiana. He is in charge of accounting and auditing services, and is also involved in litigation support and small business consulting engagements. In addition to his client responsibilities, Kurt has served as a discussion leader for numerous accounting and auditing courses. He has served on the AICPA Accounting and Review Services Committee and is currently serving a three-year term on the AICPA Council.

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

Special Purpose Frameworks

While US GAAP is a commonly used accounting framework, it's not the only acceptable one for entities to use in preparing financial statements. Other GAAP frameworks include IFRS and IFRS for SMEs, but far more common are the tax basis and modified cash basis. Interestingly, the discussion related to other accounting frameworks takes place mostly in the auditing literature and not the accounting guidance.

For a closer look at special accounting frameworks, let's join Kurt Oestrieher, CPA and a partner with Oestrieher and Company in Alexandria, Louisiana, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk about special purpose frameworks. Now U.S. GAAP is used by a lot of entities, but there are probably more entities using special purpose frameworks because it's probably the tax framework, although there's a variety of others out there. Let's talk about those special purpose frameworks, because it used to be that it was in the SASs. And that's how we knew whether or what framework... we were going to be auditing or reviewing or whatever under. But it's really the accounting framework and that's supposed to be determined by management. So let's talk about what kind of options they have.

Mr. Oestrieher

Yes. It's interesting. The vocabulary has actually changed on this. It used to be GAAP or tax that people thought, those are the only two options. If it was not GAAP, it was referred to as OCBOA, other comprehensive basis of accounting. And in fact, ...they listed the special purpose frameworks so that the terminology has gone from OCBOA to special purpose framework, but the auditing standards still acknowledge that because they said these are commonly referred to as other comprehensive bases of accounting. So you're not incorrect when you say that, but the more proper terminology, the vocabulary, is these special purpose frameworks, which means it is a framework other than a general purpose framework. Under our vocabulary general purpose frameworks are considered GAAP, which is generally accepted accounting principles, which interestingly in the United States under AICPA standards can be either United States GAAP or international financial reporting standards because they have designated the standard setters that are under the FAF (Financial Accounting

Foundation), which is the FASB, GASB, and FASAB and in 2008, when it was anticipated that public companies were going to start using international financial reporting standards, the AICPA Council also designated the IASB as a GAAP standard setter and they did a five-year renewal. Even though public companies never went there, they still recognize them. So I have seen and heard and talked; I know it's rare that people use international financial reporting standards. That is not a special purpose framework. Fortunately, a CPA I can't remember what state that person was from had listened to one of my courses and said, Hey, look, I had to do IFRS statements because the entity was purchased by a company that reports under that. Can you just look over my compilation report, and they had referenced it. There's a special paragraph in a compilation when you have a special purpose framework where you identify the framework and they identified IFRS as a special purpose framework. Nope, sorry that is GAAP. And he's like, how can that be United States GAAP?

I said, it's not United States GAAP; it's GAAP in the United States, which makes it even more confusing. So understand that the literature talks about these general purpose frameworks and that is where you have United States GAAP, IFRS and IFRS for SMEs. So here are these frameworks, which think of it as this, it is a set of rules an entity is going to use in order to prepare and issue their financial statements. And for those of you that like sports, if you are watching basketball, you have to know, are they using high school rules, which have different timing, college rules, NBA rules, or international rules. International rules have a different trapezoid foul lane. It's like, wait, but it's all the same game. And, like in international basketball, you don't need to have the official, if there's a turnover, you can just grab the ball and chunk it in like you do in soccer.

So is it the same game? Yes. There's little tweaks in the rules if you will. But in these frameworks, you're going to see there could be vast differences, but you have to know the rules by which you're playing before you can even start to prepare the financial statements for an entity. And then later on, we're going to talk about audit, review, compilation, which all require reporting. And then the engagement letters you have to know where you are. So let's go through these frameworks that are considered to be special purpose frameworks. And they're defined in both the audit standards and in the compilation and review standards. And when I was looking at it, I thought they'd be a hundred percent identical but there's actually slightly tweaking of the words. It doesn't matter that they're all the same, so let's talk about cash basis first. And when you look at cash basis, and let's be clear on this, there is no cash basis accounting standards board.

None that I know of, maybe someone has created one and they have some website and they're charging people \$9 a year to subscribe to it. I don't know, but there's no authoritative cash basis standard setting board. So it is really just these definitions that we have within auditing and comp and review standards that tell us what governs the cash basis. And it starts with the cash basis saying, you're using cash, receipts and disbursements. So we have probably all used this at one point and not realized it. And it was when you were elected treasurer of your kids' soccer association and people found out you are a CPA and go, oh, well, Kurt keep the books again. They don't know what that means, but what they're trying to convey is, we want you to come here to every meeting. And if at the last meeting, our cash balance was \$3,472.62, we want you to tell us everything that got deposited into that account, everything that was written out of that account and what is our reconciled cash balance at this meeting.

So, first of all, your time period that you might be reporting isn't your normal month or quarter it's from March 12, 2021 to July 17, 2021, which again, you can do that and you just have the cash receipts and cash disbursements, and you don't care if it was borrowed money. You don't care if y'all used \$2,000 to put up a scoreboard. You're not going to capitalize that as a fixed asset. I mean, pure cash basis is exactly what that means. But now we get to the modifications of the cash basis, where the standards say, you can have modifications if there is clear and substantial support for those modifications. Well, what is clear and substantial? I think substantial is actually the first word

they use. I think some of the more common ones that you're going to see out there as far as clear and substantial [sup]port is going to be what I just mentioned, the fixed assets.

Instead of showing everything that is spent on a capital expenditure as an expense, things like scoreboards, or even maybe larger vehicles and things like that, you're going to set up and capitalize – now do not confuse this basis of accounting with an income tax basis where the taxpayer happens to be on the cash basis. Okay, we're talking about an entity here, regardless of what they may do on their tax return for financial reporting purposes. They're going to say, you know what? These fixed assets we're going to capitalize. So you're probably not going to be using a tax depreciation method. You might be using a GAAP depreciation method. By the way, you are not required to depreciate it just because you set it up. When I say it's the wild, wild, wild west, that's what I mean.

You just say, Hey look, it's over there. We're not going to include depreciation expense. It just tells people that over the years we spent \$14,000 on scoreboards or other things that, you know, if our policy was a thousand dollars, that's what we've done there. There's no requirement to depreciate it. If you depreciate it, good for you because there's no one that says you can do it. There's no one that says you can't do it. I can just tell you it's very common that you don't. Because again, if you're especially that example of the soccer thing, they don't even understand the concepts of depreciation. So that, that's why you, you're generally not going to see it. The second most common modification I believe is when you borrow money, you don't show that it's a revenue. You actually put it on the balance sheet as debt owed to someone because you're going to have to pay that back again.

I've seen it handled both ways. I've seen borrowed money and then – because this is the way the board would want to see it on a soccer association – in the expense, they say note payments, which includes both the principal and the interest. Because again, all they're caring about is, how it's just cash. How much money came in, how much money came out. But, if it's more of a business-oriented entity that needs these financials, that's when it's more common that you would see that note payable set up. And again, I know on your tax return, you're not going to pick it up as income I've had people. Well, if you showed it on your financials as income, do you have to show it on your tax return? No.

When I talk about how you file your taxes, it is just as relevant to the cash basis of accounting as, I'm trying to think of the most irrelevant, possible thing that I can, that the weather is to a football game played in the Superdome, it just isn't going to impact it. Not even a little bit, unless the power goes out, but they have their own generator so there's a backup plan there. I mean, it is irrelevant, but people want to conflate the two somehow. Now when you start getting into some modifications I believe there's support, some people would say there's substantial support, but I have no problem with them. If it is, let's say cash basis for a medical practice. For whatever reason, they don't want to be tax basis. They want to be cash basis and they pay \$120,000 malpractice premium in one month, but it's good for a whole year. Can I just set that up as prepaid and do \$10,000 a month. You can. Again, because I believe there's support for that because I've seen it happen before and there there's no authoritative area that I can send to you to say, yeah, this is how we're going to do it. But I believe there's support.

What about things like on a pure cash basis, if you have a payroll and your payroll is on the last day of the month, but your payroll tax deposit is made on the second or third day, but you cut off at the end of the month, your gross payroll is actually going to show the net payroll checks, right? Cause you will not have accrued the employee withholding portion. So I think that's appropriate to show, well this is the employee withholding. Now you may not want to accrue the employer portion. That's fine. And again, this but Kurt, you have to do both. No, you get to pick and choose. But I ...certainly think showing the portion you've withheld from employees is very appropriate and accruing the employer portion probably has less substantial support, but I've seen it done. So I call those the spontaneous liabilities that come about because of other cash transactions.

What about sales tax payable? In other words, if I'm collecting sales taxes for customers, I'm typically going to debit cash. And instead of showing that it's all revenue and then the next month when I pay the sales tax, I'm going to show the liability. Those are the spontaneous things. I think when you get into areas where we can clearly say, there's not substantial support, that's where you're trying to start now. Well, you know what? I think I really want to recognize revenues when we bill them rather than when we collect it. That's where I think I cannot find substantial support for accruing payables. Those are the type things where

you jump a line. And I wish I could tell you exactly where you crossed that line, I can't because no one has drawn that line anywhere. You have to use your judgment, but that is what we see for a cash basis. And it's not only those little smaller volunteer organizations that you may be in. A lot of your nonprofit organizations while they could use what's on their Form 990 for tax purposes, GAAP can be very complex. You remember the revenue recognition rules apply to nonprofits. So a lot of nonprofits actually use the cash basis rather than the tax basis. And again, and this is not just the small soccer team, this can be large nonprofits. I've got a nonprofit school, they want cash basis, and so we use cash basis for them. So that is the discussion of the cash basis of accounting.

Ms. Grove Casey

So let's talk a little bit about the tax basis because it is the most common one, I think, that's used out there outside of GAAP.

Mr. Oestrieher

Right? And, because of that, there's less let's call it confusion, complexity, or whatever. When you look at the definition of the tax basis of accounting the standards say, the basis of accounting the entity uses in order to, it's interesting they use the term file, file its tax return for the period covered by the financial statements. Notice that they don't say prepare, because I guess you can prepare anything you want to, they wanted to make sure whatever, whatever you sign and send to the government, that's it. But interestingly, there's some states that actually have lots of substantially different rules than federal tax code. So I I'm kind of surprised they don't actually just for commonality say federal. So technically there's nothing that keeps an entity from saying, Hey look, I would rather I'm in Connecticut and they have to measure things differently and we're not allowed accelerated depreciation and we have to do certain things.

I just think if you use that in your disclosure or in your we'll talk about that later on, you'd actually refer to Connecticut department of or whatever they have a code, whatever that state might have. And in Louisiana, it'd be in accordance with the revised statutes in the state of Louisiana. So I haven't seen that often. I've had that question asked before, can I use my state taxes? And because of the way it said, the entity used to file its tax return. It does not specify federal tax return. I believe that absolutely various state tax returns are in

play, but I do believe that should be disclosed. I believe there is a reasonable assumption out there that people are assuming that you're talking about the federal tax code. So when you're talking about the tax basis, any basis of framework has really three major areas we have to worry about. How do you measure things? What do you measure and how do you measure it? How do you present it? And what are the required disclosures? Well, our friends up in Washington, DC, you know, there's wonderful members of Congress. And I'm saying that somewhat sarcastically. It's always hard to talk about politics and you really shouldn't, but one of the things that I've found when people aren't mad at each other kind of, no one really likes what's going on up there.... Everyone likes your representative or your Senator, but everybody else up there is crazy. And so we all see the dysfunction up there. Could you imagine if someone in Congress said, wait a second. And there's a realization that so many small businesses out there use our tax code to present financials.

Let's write a section of the tax code that tells them how we want them to present it and what disclosures we want to be.... All they do is write the code to say, this is what a revenue is. This is what an expense is. So you have the measurement items covered, but there are no disclosure and no presentation. And so this traces all the way back to SAS 62, that basically states that if you're using a framework that doesn't tell you how to disclose or present items, then you default to U.S. GAAP. So really when you're talking about tax bases, it is a conglomeration if you will of you're using GAAP presentation and GAAP disclosure, but you're using the tax code for measurement. And this is why it's so easy because whatever appears on the tax return is what is going to be measured and presented on the financial statements.

Now, an interesting little caveat here that that came up many, many years ago and I've researched it, and I'll tell you my conclusion, the biggest drawback to the tax basis is of course, all the excess depreciation that we take, which is wonderful. It keeps our tax bill down. But if we are a small business and we're taking an extra \$400,000 or \$500,000 a year of depreciation over a four or five year period, and I know you would've gotten some normal depreciation there, you might have what, \$1 to \$1.6 million in excess depreciation. And what has that done? It has reduced your assets and reduced your equity. So what happens to your leverage ratios? They suck. Okay. So a bank just has somebody and they run some ratios and go, wait, I can't loan you money

anymore. I have to call your loan. Your leverage ratios are out of whack and you go, no, that's just all that depreciation.

And what I've learned is banks really don't understand the differences between frameworks. So the fix people thought was, well, now I got to go to U.S. GAAP or some other framework possibly. Oh, actually there are two fixes—one, just measure depreciation on your tax financials using U.S. GAAP principles, come up with your estimated life and remember salvage value. No one ever really does that anymore, but come up with the GAAP method. And then if you're compiling, reviewing, or auditing, you would just modify your report for that departure from the tax basis. Because you say, Hey, I'm not using tax for this. I'm using straight line GAAP. And again, at this point, the banks probably don't care. So that's solution number one, Solution number two is even more interesting. Remember within the tax code, there are multiple different ways to record depreciation. You can use MACRS 200%.

Ms. Grove Casey

There's quite a few.

Mr. Oestrieher

There's ADS 150, you got straight line, you got all the accelerated. And because it doesn't say methods, it says basis of accounting, basis of the tax code within the tax code, there are multiple methods for depreciation. So I present to you, woman of the jury, since I don't have ladies and gentlemen, the lady of the jury that, can I for my tax return take all the accelerated depreciation I want, but then on the financial statements, use a tax like straight line ADS and assign all the proper class lives? I think I can, and I have no departure for the framework, because it doesn't say you have to use the exact same numbers. Now I believe that is widely believed. And people said, whatever numbers on the tax return have to go there. But because the definition says basis, I believe you've got an, I don't want to call it an out, but I believe you have very appropriate reporting there, which quite frankly, more accurately reflects economic reality, which actually makes the financial statements more useful. And isn't that what we're trying to get to, right?

Ms. Grove Casey

Well, yes. And they, I suspect that they would do it from a cost perspective on the part of the accountant, or whoever is doing the preparation of statements.

Mr. Oestrieher

Right. And isn't

Ms. Grove Casey

The whole point of using the tax basis is that you've already got the numbers and you don't have to go through the calculations.

Mr. Oestrieher

Correct. ...I only recommend looking at that if a bank or bonding company is saying, wait a second, you're blowing through these ratios. I tried to explain to the banker, yes, but this is tax basis because they will adjust the income statement for EBITDA. They go, okay, we're looking at EBITDA so that isn't an issue, they don't understand the impact on the balance sheet. So I just recommend that if there's now pushback, because again, there's so many advantages to the tax basis, but the limitation is, remember our goal is to get net income as low as possible to pay as little taxes as possible. Now I've got some friends who love paying taxes or at least they try to tell me they do until you know, they like other people to pay more taxes, not them.

So yeah. It's like, oh no, no we, we don't need [to pay more]. Those rich people don't need tax breaks, but give me every one I can get, because I don't consider myself a rich person. So yeah, everyone trying, I don't care what your political beliefs are. I very rarely found someone that wants to voluntarily say, I don't want to take advantage of that tax deduction. I want to write a check for 40,000 more to the IRS because I know the government's going to spend it. I've yet for anyone to tell me that. So understanding that goal, remember tax basis goal is to get tax and net income as low as possible. So those are just some alternatives if that becomes problematic for you because external users are using the financials, that's when you might want to look at it. The other issue that we have on tax basis that comes up quite often is people say, well, Kurt does my net income on my income tax basis income statement have to agree exactly with taxable income? No, because you're going to have M-1 items or the question is, do I have to have a line item on my tax basis that equates to that. And then all my M-1 items, nondeductible non-taxable have to be another income and expense. You can do it that way. You're not required to do it. Trust me. There's no requirement anywhere from a presentation standpoint that says you have to do that. In fact, that'd be extraordinarily difficult on a passthrough

because what you have ordinary income rental income dividend, other 12, 14 different categories of income. And then you have nondeductible items in a different place. So you're not required to do that, but if you want to format it that way, that is fine. So that is, that is what we have with the tax basis of accounting.

Ms. Grove Casey

Well, let's take a look at regulatory basis. You mentioned it. There are very few areas that require the regulatory basis.

Mr. Oestrieher

We can spend about 30 seconds, if I spend more than that cut me off. It is a basis of accounting that a regulator requires. So you just follow whatever the rules the regulator has, but you have to be subject to the regulatory oversight of that regulatory body to use it. So if I decide, Ooh, the Iowa corn administration, farm administration bureau, I love their rules. Well, if I'm not subject to their jurisdiction, I cannot do that. So insurance is the most common one that you see there.

Ms. Grove Casey

That's the one I was thinking of. So let's talk about the contractual basis, right? So that's again, probably insurance as much as anything.

Mr. Oestrieher

Even rarer than a regulatory, it has to be in compliance. So you have a contract agreement that the entity, reporting entity is a third party too, but it has to be more than at least one or more third party. So I cannot go enter into a contract with my client, say, these are the rules that I want. It has to be enforceable by a third party. So a lot of times this will be a partnership. I haven't seen in insurance. I see those more in regulatory. These are more contractual agreements between third parties as to how things are going to be paid or how things are going to be settled. Again, I can tell you in 35 years of practice and we have a decent size firm, I'm not a sole practitioner, but we're not a gigantic or large firm either. I've never done regulatory or contractual, but just understand that if you are looking at a piece of paper that's written by somebody else that your client is subject to, is it regulatory or contractual? That's when you're in that basis. If you're not looking at a written document that's enforceable, you can never be in regulatory or contractual basis.

Ms. Grove Casey

Let's talk about our other alternatives. So we had mentioned FRF for SMEs, I think is primarily the one that falls under that other basis that entities might be using, but, maybe there is something else.

Mr. Oestrieher

Well, they had to have a catchall. And, and because again, when you're talking about special purpose framework, like if I wanted to, I could write Kurt's accounting framework. I've thought about it, trust me, and I could put it on the web. I doubt anyone would use it, but maybe I should do that one day and it will become widely used, but that really couldn't be considered another basis because it says, is it a basis of accounting that uses a definite set of logical reasonable criteria that is applied to all material items appearing in the financial statements. So first of all, I don't know if I'd go through that much work to do it, but we really didn't have anything that met that criteria until the AICPA wrote their financial reporting framework for small to medium enterprises back in 2013/14, it was over that two year period. And you can get it off the AICPA website, it's about 210 pages long. Quite frankly, what's contained in the framework is what a lot of entities issue, what I call Frankenstein financial statements, because they really weren't quite sure if they were GAAP on tax. Like I have seen allegedly income tax basis financial statements that used U.S. GAAP depreciation and allowance for doubtful accounts. Okay. Those are GAAP issues, not tax issues. I've had alleged GAAP – based financial statements that had marketable securities at cost, which is a tax concept or didn't record an allowance for doubtful accounts or had GAAP depreciation. Those are those Frankenstein things. What FRF does is it gives you, first of all, it doesn't have the new rev rec standard. It doesn't have the new lease standard. It has pretty much the accounting principles you learned in the 1980s.

If you're my age what you learned in accounting principles one and two class. It also is flexible enough that it, believe it or not, does have accounting for hedges and some of the more complex transactions that you may have, but it is what we would think of as reasonable accrual financial statements for small businesses, without a lot of the complexities that are in U.S. GAAP that are necessitated because of the, a wide range of companies that use United States GAAP. Quite frankly, I'm surprised this framework has not gotten more traction. I think it is a wonderful basis for small

businesses with the limitations of the tax basis, such as the depreciation, especially if you are a cash basis taxpayer. Now you're not accruing receivables. You're not seeing all that. That's where there's a big limitation. So I need accrual basis financial statements. I have to understand the economic reality of what's happening with my entity, but U.S. GAAP is just too complex. I don't want to record deferred taxes. I don't want to implement the new rev rec standard. I don't want to implement leases. I do not want to worry about hedging transactions, a credit on my interest rate swaps and all those complexities that we have. I just want to amortize my Goodwill. I don't want to do the testing, which I know there's some PCC alternatives there, but I just don't want to do all that folks. This is the basis for you. And people have said, I don't want to learn a whole new framework. You don't have to learn anything new. It's 200 pages. U.S. GAAP is 20,000 pages. You get to forget 19,800 pages of stuff!

So, I urge you to try that. Again, you're never going to have a client walk in your office and say, you know, give me one of those FRF for SMEs. You know, I really want that and add fries to it, but no, we have to educate ourselves. I don't think you're going to get a lot of existing clients to convert, but I strongly urge practitioners. We are here to provide services and information to our clients, with the ever-changing world of GAAP, and again, lease and current expected credit loss coming up, right? If you are doing GAAP-basis statements right now, and you have seven GAAP departures in your compilation report, that's a candidate for an entity to convert to this. But as you pick up new clients that are newly beginning entities folks, this is where you're going to want to be.

If they need financial statements more than just for tax planning, this is where you want to go. You really only want to use United States GAAP if a bank regulatory bonding company says, no, I want U.S. GAAP statements. There's all the tools you need at the AICPA website. It's the framework itself. There's sample reports, sample engagement letters. Folks, you will find that this is the easiest framework out there and provides the best information for your client. I get no royalties on this. It's not, this is just Kurt Oestrieher saying, wow, this is where I direct my clients that need accrual basis financial statements that reflect economic reality and are not required to use U.S. GAAP. Trust me, this is where you want to be. This will give you the results you're looking for with the cost-benefit. You had mentioned that a couple of times earlier, and that's that,

that's really what you're looking for in these frameworks by finding the appropriate framework for the amount of money you're going to spend.

Ms. Grove Casey

Okay. So, you know, we can do accounting framework it's almost a separate decision, really, because number one, it's supposed to be made by management, but then we, the practitioners can do audit, reviews, or compilations. We can provide any of those services regardless of the framework. Yep. So let's talk about what the guide, the audit guidance said, because that's where the other comprehensive basis of accounting used to be was in the SASs.

Mr. Oestrieher

Right. That's where so you're going to want to read AU-C 800 special considerations and there's lots of things, but within there it's audits for financial statements and very straightforward. First of all, that's where they define them and that's where it says, yes, you can do that. People believe that audits have to be GAAP no, it's there. So evaluate whether or not the basis is appropriate. Why are they using the basis? Again, it'd be inappropriate. If the third party requested the audit under United States GAAP, you have to have that basis described in the engagement letter. So again, you want to make sure that if you're doing this, you're not using some boiler-plate language, make sure everywhere your engagement letter had said U.S. GAAP, that you switch it over to whatever basis you are tax basis or all those. You have to add an emphasis paragraph in the report.

Now, remember you're going to have full disclosures on all these, because if it's an audit, you're not allowed to say you're omitting disclosures. So that basis of accounting is going to be described in the footnotes. So you're going to emphasize that's an emphasis of a matter. So you'll say as referred to in note A, summary of significant accounting policies, the entity uses either the income tax basis or whatever it is. You have to affirmatively state that, that it's not a basis in accordance with generally accepted accounting principles in the United States of America, and then you have to describe the major differences between them, which by the way, a year from now, that is going to be leases for a lot of people. Lease accounting. Rev may not even be, if it's retail store, I think rev wouldn't be that much different, but for some entities that recognize revenue over time, rev rec may be a difference.

Depreciation could be a difference, handling of intangible assets, recording of certain liabilities, such as asset retirement obligations, pension accounting could be different. So that's all the differences that you could potentially have there. And then you have to be aware of that basis of accounting, because now when you're getting audit evidence, your criteria is not determining if it is in accordance with GAAP, it is, is it in accordance with whatever the basis of accounting is? That should be kind of obvious, but they went ahead and put that in there. That, that's how you evaluate. And so, if the departures are significant enough, then again, you can have a qualified or an adverse opinion. You can't say, well, you can have whatever differences you want, because this isn't GAAP basis. You still put the reader on alert, Hey, these are in accordance with whatever basis, and if there are departures from that basis, you must modify your opinion.

Ms. Grove Casey

Well, as I mentioned, you can have not just audits, right? But regardless of the framework, you can have reviews or compilations as well. So let's talk about what the SSARS guidance requires.

Mr. Oestrieher

First of all, I think that's where you're going to see more special purpose frameworks. While they're out there in audits, quite frankly, I know of an entity that has over a billion dollars in revenue, it's privately held and they use income tax basis. So absolutely you can have it in audit. I think most of your reviews even are going to be GAAP basis. It's really in the compilation world where you see these frameworks, your compilation report just as you did in an audit report, you'll always have a second paragraph that tells you what the framework is and the basis of accounting. Now, if you actually have a full disclosure compilation, it will be in the notes. So you'd modify that paragraph and say, as referred to in note X. So you add an emphasis paragraph. So the reporting's a little bit different if you have full disclosures versus no disclosure.

So make sure you get that paragraph in there. Then also in your report, just make sure that everywhere that you used to refer to United States GAAP, you're referring to whatever framework it might be. And the other thing is there's a discussion of account titles. You're prohibited from using account titles that are indicative of GAAP. So I can't just use the term balance sheet. So for income tax basis, since that's the most common one, and I can

either say statement of assets and liabilities and equity income tax basis, I can even say balance sheet income tax basis. I just can't say balance sheet. So make sure your account titles are appropriate and make sure that your report reflects whatever those account titles are. And then, the last issue that we really have to think about is, remember, you still have to alert the reader if substantially all disclosures are omitted, but the wording's a little bit different.

If it's U.S. GAAP, it says, all right management has elected to omit substantially all the disclosures required by generally accepted accounting principles, if it's tax basis or cash or any of the special purpose framework, you say management has elected to omit substantially all the disclosures ordinarily included, because I can't go to any authoritative source that says it's required again. And, this goes all the way back to SAS 62, that says you will ordinarily include those items, but like the statement of cash flows is not a disclosure. You don't have to worry about the statement of cash flows on income tax or cash. You can say I've omitted the disclosures and cash flows ordinarily included. Because you could say I would've ordinarily included it, but you don't even have to mention things like the statement of cash flows, because that's not required anywhere. Of course in the tax code or any of the special purpose frameworks right now, if you using FRF for SMEs, they actually do require disclosure. So then you would say required by the FRF for SMEs. So that's why you have to understand what framework you're in. So it, it is again permissible for all, but understanding there are modifications to the report and modifications to the engagement letter that are going to be dictated by the framework that you have selected.

Ms. Grove Casey

Did you want to say anything about the review report and how that's different from what we're doing with a compilation report?

Mr. Oestriecher

It's going to be similar to what we have in the audit and the review report. Again, you're never going to be omitting disclosure. So you will always refer to the note, right? So you're going to always have the notes in a review. So whatever note A or note B, you'll say as just an added emphasis of a matter paragraph, it's after your accountant's conclusion paragraph that will refer to it, but you have to refer in all these reports, no matter what type of level of service you have to direct the

reader or inform them, that it is a special purpose framework. And that's all because there is still the underlying assumption, which I think is appropriate, that when anyone's looking at a set of financial statements, they assume it's U.S. GAAP until you tell them otherwise. That's why we have these warning labels if you will on them.

Special Purpose Frameworks

by Kurt Oestrieher, CPA

Introduction

Entities that issue financial statements in the United States have a long history of defaulting to United States GAAP for their financial reporting framework. This is due to regulatory and banking requirements, as well as tradition. However, GAAP has grown increasingly complex over the years, and the Financial Accounting Federation has resisted the move to a “Big GAAP/Little GAAP” approach to setting standards. While the Private Company Council (PCC) has made strides in eliminating some of the more onerous accounting requirements for non-public companies, there is still the question of a cost/benefit to the use of United States GAAP for many small companies.

Special Purpose Frameworks (formerly known as Other Comprehensive Basis of Accounting – OCBOA) are defined in various AICPA Standards and are a viable alternative to United States GAAP for many small companies. This segment will provide an overview of the Special Purpose Frameworks and discuss the applicability in audit, review, compilation, and preparation engagements.

Definition

The definition of a Special Purpose Framework in AR-C 60 is

“A financial reporting framework other than GAAP that is one of the following bases of accounting:

- *Cash basis*
- *Tax basis*
- *Regulatory basis*
- *Contractual basis*
- *Other basis*

The cash basis, tax basis, regulatory basis, and other basis of accounting are commonly referred to as other comprehensive basis of accounting.”

Any framework, or set of accounting rules, that do not meet this definition or the definition of a general purpose framework, cannot have AICPA audit, review, compilation, or preparation applied to those financial statements.

Cash Basis

Cash basis is defined as *“A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets)”*.

In its purest form, a cash basis balance sheet will have only cash and equity and those two accounts would be equal. All deposits of cash are considered revenue and all disbursements of cash are considered expenses. Net income will be equal to the change in cash during the reporting period. This method is sometimes used for very small non-for-profit entities such as a soccer club or church group where the stakeholders are mostly concerned about cash flows and want an accounting framework that is simple to implement and understand.

When an entity includes modifications that have substantial support, which is allowed in the definition, it will sometimes refer to the financial reporting framework as “Modified Cash Basis” instead of “Cash Basis”. These entities will have balance sheet accounts other than cash, and these accounts represent the modifications. The most common modifications are:

- Capitalization of fixed assets
- Recognition of loans as a liability instead of income (and resulting repayments as an expense)
- Presenting owner distributions as a reduction of equity instead of an expense
- Recognition of payroll withholding as a liability when the withheld taxes have not yet been remitted to the taxing authority at the balance sheet date.

Other modifications that may not be as common, but have support are:

- Recognition of prepaid insurance so that monthly financial statements are not distorted by a large annual premium.
- Recognition of marketable equity and debt securities as an asset

It is important to understand that for the cash basis of accounting, there is no authorized or recognized standard setting body. The term “generally accepted” does not apply. The only recognized guidance is the definition that is contained in AICPA standards. Therefore it is up to the judgement of the CPA as to when an entity may have included modifications that do not have substantial support. It is the opinion of the author that accruing elements such as receivables, payables, and other accruals, do not have substantial support. As long as one side of the transaction contains either a debit or a credit to cash, a strong argument can be made that substantial support exists. The one exception to this general rule is the recording of depreciation if an entity capitalizes assets as a modification of the cash basis.

Tax Basis

Tax basis is defined as “*a basis of accounting that the entity uses to file its tax return for the period covered by the financial statements*”. The definition does not specify which tax return, and many entities in the United States file both a federal and a state tax return. It is the opinion of the author that the intent of the definition in the standards is that the entity would use the guidance in the federal tax code used when filing its federal tax return. However, because this is not specifically stated in the definition, there is nothing that prohibits an entity from using the rules in preparing a state tax return that the entity is required to file. If an entity chooses to use a state tax return as the basis, the author recommends that this fact be disclosed. For purposes of this discussion, we will assume that the federal tax code is used by the entity.

Entities that are required to file an 1120, 1120S, and a 1065, can find the guidance on what is recognized on the income statement and balance sheet in the instructions to the respective forms. The forms and instructions are used by the IRS to encapsulate the intent of the federal tax code. However, there is nothing implicit in the definition of the tax basis that requires an entity to use the exact order and format of the income statement and balance sheet that are on the tax form. Most entities use the tax code to determine how to **measure** the assets, liabilities, equity, revenues, and expenses of an entity. Because the tax code does not provide guidance for presentation and measurement of financial statement elements, a reporting entity should use the guidance in United States GAAP to determine how to present the financial statements and what disclosures are appropriate.

A special situation exists when an entity is an LLC that is considered a disregarded entity. In most cases, the income and expenses of the entity will be reported on the schedule C or E of a 1040, and no balance sheet reporting is required. It is the opinion of the author that such an entity is permitted to, and should, present a balance sheet when using the tax basis of accounting.

Regulatory Basis

Regulatory basis is defined as *A basis of accounting that the entity uses to comply with the requirements of financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance department).*

A key takeaway from the definition is that any entity that is not subject to a regulatory body is not permitted to use the regulatory basis. Because of this limitation, it is rare to see the regulatory basis of accounting for any use other than regulatory filings.

Contractual Basis

Contractual basis is defined as “*A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant*”.

Financial statements prepared under the contractual basis are often used to present the elements of a partnership agreement for bonus purposes, or calculating post purchase obligations under the terms of a buyout. Because most contracts only address measurement issues, an entity should use presentation and disclosure requirements prescribed by United States GAAP when issuing financial statements under the contractual basis.

Other Basis

Other basis is defined as “*A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements, for example, the AICPA’s Financial Reporting Framework for Small- and Medium-Sized Entities.*”

While the definition uses the AICPA FRF for SMEs as an example in the definition, this is the only framework that the author is aware of that meets the other elements of the definition. While both IFRS and IFRS for SMEs

use a definite set of logical, reasonable criteria, those frameworks are considered general purpose frameworks, therefore they are not considered to be special purpose frameworks.

The AICPA FRF for SMEs was developed in 2013 in response to the position of the Financial Accounting Federation that a separate set of accounting standards should not be developed for non-public entities. In order to fill a perceived demand for such a set of standards, the AICPA convened a task force to develop a set of standards that while providing useful financial information, would not subject non-public companies to any undue costs or expertise associated with the financial statements. The framework appears to have met those goals, however it has not been widely adopted.

The framework is available for download at aicpa.org, along with implementation guidance and sample audit, review, and compilation reports. The AICPA had originally intended to update the framework every three years, but it has not been updated since the issuance of the original version.

Any entity that believes that United States GAAP has become to complex or costly, yet also believes the limitations of the cash and tax basis do not provide suitable financial reporting, should seriously consider this framework. As companies are required to implement the lease standard and CECL, it is the opinion of the author that a migration away from United States GAAP will continue, and that FRF for SMEs is the most effective and efficient option for these companies.

Audit Guidance

A CPA should follow the guidance in AU-C 800 when management uses a special purpose framework for financial reporting. In addition to all other required audit procedures, the auditor should:

- Evaluate whether the financial reporting framework is appropriate in the circumstances
- Describe the basis of accounting in the engagement letter
- Add an emphasis-of-matter paragraph in the audit report that refers to the disclosure of the special purpose framework

- Evaluate departures from the framework when forming an opinion on the financial statement.

While not specifically stated in AU-C 800, the accountant should consider the framework when evaluating inherent risk during audit planning. While a special purpose framework is typically less complex than United States GAAP, the experience of management with the special purpose framework should be considered.

While no statistical data is available, it is likely that the tax basis is the most common special purpose framework adopted by management. Therefore, the use of a tax specialist in the firm would likely be appropriate in performing and evaluating audit procedures.

SSARS Guidance

SSARS allows for review, compilations, and preparations for any of the special purpose frameworks. The financial statements titles for any set of financial statements that use a special purpose framework should be indicative of the framework and not imply that the financial statements are prepared in accordance with United States GAAP. There is no specific title that is mandated for any of the frameworks, but commonly used titles include:

- Balance Sheet – Income Tax Basis
- Income Statement – Income Tax Basis
- Statement of Assets, Liabilities, and Equity – Income Tax Basis
- Statement of Revenues and Expenses – Income Tax Basis
- Statement of Assets and Capital – Cash Basis
- Statement of Cash Receipts and Disbursements
- Balance Sheet – Modified Cash Basis
- Income Statement – Modified Cash Basis

An entity is not limited to the examples above. As long as the titles properly reflect the basis used, the financial statements would be appropriate.

A common misconception is that only GAAP departures are required to be evaluated in SSARS engagements. Just as an entity can have a departure from United States GAAP, an entity can have a departure from a special purpose framework. Such departures are not common, but if encountered, would require disclosure in a preparation engagement, and modification of the compilation or review report in accordance with the standards.

Preparation Engagements

AR-C 70 does not require a report for prepared financial statements, however AR-C 70.15 requires the accountant to include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements. Because management omits disclosures on most preparation engagements, the accountant should ensure that management includes the description on the face of the financial statements. This is usually accomplished by including the framework in the title of the financial statements, such as Balance Sheet – FRF for SMEs.

Compilation Engagements

In addition to evaluating any departures from the special purpose framework, an accountant should modify the compilation report to include a separate paragraph that

- Indicates that the financial statements are prepared in accordance with a special purpose framework
- Refers to the note to the financial statements that describes the framework, if applicable, and
- States that the special purpose framework is a basis of accounting other than United States GAAP

The following is an example of such a paragraph when the income tax basis of accounting is used.

The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

If the financial statements are prepared in accordance with the contractual basis of accounting, the separate paragraph should also state that, as a result, the financial statements may not be suitable for another purpose.

Review Engagements

An accountant performing a review of financial statements prepared in accordance with a special purpose framework should align the inquiries and analytical procedures to focus on departures from the special purpose framework, and also determine that the special purpose framework is appropriate in the circumstances.

Management is not allowed to omit substantially all disclosures in a review engagement, therefore, the accountant should determine that the summary of significant accounting policies properly discloses the framework, and significant differences with United States GAAP.

The review report should include an emphasis-of-matter paragraph, under an appropriate heading, that:

- Indicates that the financial statements are prepared in accordance with the applicable special purpose framework
- Refers to the note to the financial statements that describes the framework, and
- States that the special purpose framework is a basis of accounting other than United States GAAP.

If the financial statements are prepared in accordance with the contractual basis of accounting, the review report should include an other-matter paragraph that restricts the use of the review report.

Summary

Entities that present financial statements have many options available other than United States GAAP. Management should determine what is the most appropriate framework considering the needs of all stakeholders and the cost/benefit of the different frameworks. AICPA standards for audit, review, compilation, and preparation engagements provide the necessary flexibility so that all levels of service can be provided, regardless of the framework selected by management.

Special Purpose Frameworks

- Non-GAAP Frameworks
 - Cash Basis
 - Tax Basis
 - Regulatory Basis
 - Contractual Basis
 - Other Basis



Cash Basis

A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support

Tax Basis

A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements

Regulatory Basis

A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).

Contractual Basis

A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.

Other Basis

A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

Audit Guidance

AU-C 800 Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

- Must evaluate whether or not the basis is appropriate
- Must describe the basis in the engagement letter
- Must add an emphasis matter paragraph to refer to the basis of accounting
- Must evaluate departures from the basis when forming an opinion

SSARS Guidance



Special Purpose frameworks are defined in AR -C 60



Allowed for all types of SSARS Engagements



Compilation report must refer to the basis

Must state the basis is not US GAAP
Refer to the footnotes if included



Review report must refer to the basis

Must refer to the footnotes
Evaluate for departures from the basis of accounting

GROUP STUDY MATERIALS

A. Discussion Problems

1. Describe the cash basis of accounting.
2. Describe the tax basis of accounting.
3. Describe the type of modifications to the review report when a special purpose framework is used instead of U.S. GAAP.

B. Suggested Answers to Discussion Problems

1. Cash basis is defined as “A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets”).

In its purest form, a cash basis balance sheet will have only cash and equity and those two accounts would be equal. All deposits of cash are considered revenue and all disbursements of cash are considered expenses. Net income will be equal to the change in cash during the reporting period. This method is sometimes used for very small non-for-profit entities such as a soccer club or church group where the stakeholders are mostly concerned about cash flows and want an accounting framework that is simple to implement and understand.

2. Tax basis is defined as “a basis of accounting that the entity uses to file its tax return for the period covered by the financial statements”. The definition does not specify which tax return, and many entities in the United States file both a federal and a state tax return. If an entity chooses to use a state tax return as the basis, the author recommends that this fact be disclosed.

Entities that are required to file an 1120, 1120S, and a 1065, can find the guidance on what is recognized on the income statement and balance sheet in the instructions to the respective forms. The forms and instructions are used by the IRS to encapsulate the intent of the federal tax code. However, there is nothing implicit in the definition of the tax basis that requires an entity to use the exact order and format of the income statement and balance sheet that are on the tax form. Most entities use the tax code to determine how to measure the assets, liabilities, equity, revenues, and expenses of an entity. Because the tax code does not provide guidance for presentation and measurement of financial statement elements, a reporting entity should use the guidance in United States GAAP to determine how to present the financial statements and what disclosures are appropriate.

3. An accountant performing a review of financial statements prepared in accordance with a special purpose framework should align the inquiries and

analytical procedures to focus on departures from the special purpose framework, and also determine that the special purpose framework is appropriate in the circumstances.

Management is not allowed to omit substantially all disclosures in a review engagement, therefore, the accountant should determine that the summary of significant accounting policies properly discloses the framework, and significant differences with United States GAAP.

The review report should include an emphasis-of-matter paragraph, under an appropriate heading, that:

- Indicates that the financial statements are prepared in accordance with the applicable special purpose framework
- Refers to the note to the financial statements that describes the framework, and
- States that the special purpose framework is a basis of accounting other than United States GAAP.

If the financial statements are prepared in accordance with the contractual basis of accounting, the review report should include an other-matter paragraph that restricts the use of the review report.

PART 2. AUDITING

Independence and Ethics Interpretations

Independence is one of the key aspects to any audit of the financial statements. Along with integrity, confidentiality, and several other ethical requirements, independence helps ensure that auditors keep the public's interest at heart. The ethics principles followed by external auditors are found in the AICPA's Code of Professional Conduct. The Professional Ethics Executive Committee of the AICPA is responsible for interpreting and enforcing the Code and issuing new guidance when needed.

For more on recent guidance in this area, let's join Jennifer F. Louis, a CPA with Emergent Solutions Group, LLC, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk a little bit about recent ethics and independence guidance that we've been seeing to begin with, who interprets and enforces the AICPA code of professional conduct.

Ms. Louis

There is a senior committee of the AICPA that's called the professional ethics executive committee. The PEEC is charged with interpreting and enforcing the AICPA's Code of Professional Conduct. They create new rulings, interpretations, but they also help with monitoring for those rules and making revisions as deemed necessary. And ultimately through the AICPA Journal of Accountancy is where a lot of these interpretations and guidance are communicated and provide notice to the various members of the AICPA.

Ms. Grove Casey

Well, there were several interpretations where original, effective dates were deferred a year due to the pandemic and ethics wasn't the only area where that occurred. So one of those was related to information systems services. What is the effective date and what does it relate to?

Ms. Louis

Information system services that interpretation is now effective beginning January 1, 2022, but early implementation was permitted. The main goal around this interpretation was to differentiate that there are financial information systems, and then there's those that aren't related to financial information systems. A financial information system is aggregating source documents that's underlying the financial statements or generating information that is either significant to either

the financial statements or the financial statement process itself as a whole. It's not limited to applications like the general ledger and other obvious things that would be part of accounting systems, but could be a wide variety of things like inventory control, production, scheduling, order placing, points of sale. Those could still be a part of your financial information system and it provides guidance on determining whether or not certain systems or certain nonattest services related to these financial information systems, ultimately, could be an issue as it relates to independence.

Ms. Grove Casey

Well, what are some of the key clarifications related to what information systems services a member may, and may not perform in order to retain independence?

Ms. Louis

Well, first of all, a member does have to always make sure that they're in compliance with the general requirements of when I'm doing attest and non-attest things that there's inherently going to be some sort of self-review threat or management participation threat that needs to be managed. Then that ultimately includes threats that could exist that are more broadly even related to nonfinancial information systems, as you're looking at not functioning like management and making management decisions and those types of matters. But then also we would have where threats would be even more precise and harder to safeguard as it relates to me designing or implementing or developing a financial information system for an attest client. In both cases, you want to make sure that you're in compliance with the general requirements as I'm providing attest and nonattest services, but ultimately

there's going to be more specific guidance about how could I safeguard these given threats to an acceptable level when I am working with designing, developing, or implementing some sort of financial information system, or even related to an off the shelf accounting solution where I'm not designing, developing building an interface, but yet there's still services that I'm providing to assist the client with configuring this off the shelf solution.

Ms. Grove Casey

Well, what else does this recent interpretation accomplish?

Ms. Louis

So a large part of it is to really focus on customized off the shelf software, what they call C-O-T-S or COTS that regardless of the complexity and scale of this off the shelf solution, it does try to provide useful definitions to help members focus on the nature of the specific information system, activities and services, and to help provide more clarity for these customized off the shelf solutions – what is a financial information system and what is not.

Ms. Grove Casey

Well, let's talk a little bit more about the customized off the shelf software, or COTS is the acronym that you frequently see associated with that.

Ms. Louis

It's a commercially available software product it's designed, developed, distributed maintained by a third party, like a software vendor. It can be a relatively simple program we can ultimately just load on my computer and run. It could be a large complex enterprise system that you might get from somebody like Oracle or Salesforce. The main point of these COTS is ultimately that unless the member's firm is the software vendor, it's not software designed and developed by the member. It doesn't matter how complex the software may be, whether it's simple or not to run, ultimately, is there a third party that's designing, developing and implementing the system? Even though the auditor or the attest provider may be assisting management with deploying the COTS, I'm not actually the one that's considered to be the one that's designing, developing, and implementing the actual software itself.

Ms. Grove Casey

Well, what are some of the other definitions that are important to properly applying this recent interpretation?

Ms. Louis

So there is a lot of things like, what does it mean when I am designing something, designing an information system or a SIM or a single program I'm determining how it will function, how it will process data, how it will produce results and including things like reports and other types of documents like sales orders. So what am I doing when I'm designing a system, which is different than ultimately developing. Developing is where I'm actually writing and testing the software code. So usually I have a specific design and now we need to develop it, configuring a COTS. The customized off the shelf software solution requires a user to understand and decide ultimately what will be displayed, what data options to pick. You could have a member of the AICPA that is a software implementation consultant who just assists the client in understanding the various configuration options and the implications of your choices, and then helps them make decisions, right?

If I'm limited solely to configuration, then I'm not designing or developing the COTS. And so that, as I said, is one of the key things that they wanted to provide very specific terms around things, but then even as I have a COTS, I could be customizing it, meaning that I'm enhancing or modifying the software to add new features, new functionality, then I'm going beyond what the third party provided. And so now, as I customize a COTS, I may be now going through design and development of new code that now creates a new level of concern about independence. I also could just be creating an interface between two or more systems that might exist so that they can pass data between each other and building an interface involve design and development, right? Unless the interface was purely affected by a third-party ready-made solution that does exist out there, where there really was no additional design and development. So the key thing that I want to talk about is that there is the difference between what is design and development creates the independence threat that may not be able to be safeguarded, whereas simply helping them configure a software solution that's off the shelf while that is a non-attest service, where I have to meet my general overarching requirements. It's not going to be as difficult for me to

safeguard a configuration project as opposed to a design development, customization and creating an interface type solution.

Ms. Grove Casey

Well, let's talk about an example of an information system service that cannot be performed without impairing independence to help people understand a little bit more.

Ms. Louis

So as we think about things that would not be able to be safeguarded to an acceptable level that ultimately involves the client is outsourcing to me the member in an ongoing function or process monitoring, supporting, maintaining certain systems, right? So ultimately the ongoing function or process now becomes where the member is assuming a management responsibility. So even if there's somebody with suitable skills, knowledge, and experience in client management, that's overseeing my work, that ongoing expectation they would say would be an independence impairing issue. On the other hand, if I do separate and distinct engagements, that aren't an ongoing, continuing service that may be permissible. So if I'm engaged to analyze the client's network and provide certain observations and recommendations in a distinct way, it's not an ongoing function or process where I'm assuming management responsibilities, and that may be acceptable. So we do need to think about that concept as we're trying to determine what's acceptable as relates to these information system supports.

Ms. Grove Casey

Well, another delayed interpretation was related to leases. Now let's talk about what the purpose of this interpretation was, and what was the effective date?

Ms. Louis

So ultimately, the effective date is going to be for fiscal years, beginning after 12/15/2020. And it relates to when a covered member enters into, or actually already has a lease with an attest client. They would say that you have threats with self-interest, with familiarity, undue influence to be able to comply with these independence rules.

Ms. Grove Casey

Well, does this interpretation apply to every covered member?

Ms. Louis

It is going to apply to, obviously, a covered member being somebody that's a part of the attest engagement team, it's the firm itself, but it's also an individual that is in a position to influence the engagement team. So, as we look at any of those members that are covered, any of those groups, if they're entering into a lease or renegotiating terms of an existing lease with an attest client during the period of professional engagement, then it may be that my threats would not be at an acceptable level and could not be reduced to an acceptable level if I'm entering into or renegotiating terms of an existing lease with an attest client. So that is going to be the key.

Now it could be that if we already had an existing lease, not renegotiating terms in a lease, but I just already had a lease, then there may be safeguards that could be put into place as you looked at the pre-existing terms and conditions of the lease.

Ms. Grove Casey

Well, are there any criteria that have to be met in order for a leasing arrangement to automatically be an impairment issue?

Ms. Louis

There needs to be safeguards that have to be met at the time of entering into or renegotiating the lease. So it could be that the lease is on market terms. It was done at arms-length conditions, but also the lease is not material to any of the parties to the lease. And all the parties that are involved, both the attest client, as well as the covered member, once the covered member enters into, or renegotiates the lease, then you also are going to have an issue if your lease amounts are not paid in accordance with the terms and provisions of the lease, including any due dates and available grace periods that might exist.

Ms. Grove Casey

Well, what if a covered member is already a part of a leasing arrangement with a party who may become a new attest client?

Ms. Louis

So if you're previously identified as having a lease that was entered into or we negotiate prior to the period of professional engagement, prior to me becoming a covered member prior to, you know a counterparty

becoming an attest client or an affiliate at that point, you are going to have circumstances where I am going to think about, are we entering into, or re negotiating the lease, and ultimately, due to the change in circumstances after the lease has already entered into, does that now become material to the party, to the lease, to any party of the lease? And so, yes, we still need to monitor to say what happens with changing circumstances once we have a pre-existing type of lease.

Ms. Grove Casey

Well, what factors should be considered when evaluating the significance of threats related to leases?

Ms. Louis

There's going to be a wide variety of things. We already mentioned materiality of the lease itself to end the party. But also to think about the duration of the lease term, the role that the covered member is playing to the attest client, the extent that this lease will be subject to the actual attest procedures or financial statement disclosures? It ultimately is going to be based on a variety of factors that, in essence, makes this lease scalable on a relative spectrum of inherent risk.

Ms. Grove Casey

Well, the third interpretation that was delayed related to state and local government client affiliates. What is that current effective date, and what does the interpretation generally relate to?

Ms. Louis

This one is effective for years beginning after 12/15/2021. And it applies to all state and local government entities that are financial statement attest clients. It ultimately is trying to clarify certain terminology that is used in this environment because of the fact that we have certain independence interpretations that use the word officer, director, owner. Obviously, when you deal with a state and local government environment, it, how do I take those concepts and apply them using the language and the circumstances that exist in this environment? It's not related to a business.

Ms. Grove Casey

Well, let's switch to talk about some recently finalized interpretations. And one of them is related to responding to records requests. We talked briefly at another point in time related to a pandemic related

remote requests, which may or may not be more or less expedient because they may have fewer staff who are able to comply, but they may have more or less than they have in the past because of people either being in the office or not being in the office. So what's the effective date and what types of records and documents are covered under this guidance?

Ms. Louis

It's effective July 31, 2021, and it does affect client-provided records that are the accounting or the records either electronic or hard copy reproductions, belonging to the client that were provided to the member by or on behalf of the client. And so there needs to be that the client upon initial request that they need to be returned to the client. Even if the client does not pay the member for the time and expense to retrieve and copy the records now if it's a repeat request, like I already gave it to you once and they're asking for it again, that's different. But as far as initial requests, we are going to be required to give client provided records back to the client, which is going to be different than a member prepared record.

I wasn't specifically engaged to prepare and, and ultimately it's not something that ultimately the client could have it be otherwise available to them, but we do need to think about even with member prepared records while we're not specifically engaged by it, it might be that my client's financial information is incomplete without it, like if, I give them a journal entry to book or computations around their depreciation expense, their supporting schedules and documents that ultimately would be different than the client provided records. It's a member prepared record, which is different than the work product, the deliverable like a tax return that I'm engaged to do, which is different and distinct than my working papers, which are things like my audit programs and my sampling forms and other things like that that reflect the testing and other work that was done.

Ms. Grove Casey

And this interpretation includes discussion of requests made by a beneficiary. So let's talk about who is a beneficiary and what are the general obligations of the member there?

Ms. Louis

A beneficiary is a person or an entity where the engaging entity has requested the member or the service provider to perform professional services. So

the engaging party and the beneficiary of my services could be different. And that's where they started having, what's my obligations if it's not the engaging party, but there's a beneficiary that I'm helping, then I'm performing certain services on? And if I am performing services with respect to the beneficiary, then I need to make sure that as I think about the client provided records, I have to make those records available to the person or entity that provided the records to the member or to an individual designated as being representative right of that group. And so did I satisfy that? I gave it back to them as far as these client provided records. And, that would also be clarification's that they needed to have, as we looked at the other requirements of making records and work products available, as it relates to member-prepared records and member work products, as I might be engaged to perform certain tax services, say for the benefit of the executives of a company, right? Ultimately, if I make the tax records available to the executives, even though the company is who hired me, I complied with making my work product available.

Ms. Grove Casey

Well, let's talk exactly about what exactly make records available, means.

Ms. Louis

Well, so they do talk about how you have to make certain records available. It means that I provided the records in any format that's usable and accessible, right? Regardless of the format that I received them when I make them available back to the client or the beneficiary of the service, whether it's electronic or otherwise it's in a usable and accessible form.

Ms. Grove Casey

Well, what if the member is engaged to perform professional services with respect to another entity that does not meet the definition of a beneficiary?

Ms. Louis

All right. So if they don't meet the definition of being a beneficiary of the professional services, absent, having an agreement that says otherwise, I would be in compliance with the requirement related to like my work product. If I made the work product available to the engaging party or a designated representative, like I don't have to provide it to the other entity that is not deemed to be a beneficiary. So for example, if I'm

engaged to value the assets of another company for possible acquisition, ultimately, if I made that valuation report available to the engaging entity, I met my requirements.

Ms. Grove Casey

Can a member and a client or beneficiary agree on terms different than what is laid out in this agreement?

Ms. Louis

Absolutely. We can agree on things that are beyond the minimum requirements of this interpretation. And obviously, if you come to an agreement that's different, you need to make sure that you're performing in accordance with that agreement.

Ms. Grove Casey

So generally, how must a member respond to a request for member-prepared records or a member's work products that are in the member's custody or control, as well as the working papers that have not previously been made available to the client or beneficiary?

Ms. Louis

So ultimately the member should make available member prepared records related to a completed and issued work product, but I am allowed to withhold such records if fees due to me for that specific work product are not paid. Right? So as we think about member-prepared records related to a completed and issued work product. But when I have cases where I have a member work product that itself, so that's the member prepared records, the actual member work product may be withheld if fees are due for the specific work product or the work product is incomplete or there's outstanding issues like I have outstanding audit issues. And so, to comply with my professional standards, I'm withholding this information, or it could be because of some sort of threatened or outstanding litigation that exists. We do have guidelines around member-prepared records related to a completed and issued work product, which is different than the members work product, where there are certain cases where I can withhold it for these given reasons. And then, the working papers are the member's property, and I'm not required to make that information available unless there's some sort of federal or state statute or regulation or contractual agreement that proposes a different requirement on me.

Ms. Grove Casey

Well, I know that attorneys charge for everything under the sun especially if you get the detailed billing, but can a member charge a fee to respond to a records request?

Ms. Louis

You can charge a reasonable fee for the time and expense incurred for you to retrieve, copy, ship these different records. But you have to remember that client-provided records cannot be withheld because they didn't pay that fee. Now subsequent requests, I can withhold the information, but initial request for client provided records may not be withheld for non-payment of fees, but I could withhold that information if it is one of those other aspects – member prepared records, member work product, right? Those can be withheld in appropriate circumstances.

Ms. Grove Casey

Well, are there any specified time limits for compliance?

Ms. Louis

Well, obviously they want you to return or make the records available in a usable accessible way. As soon as practicable, but absent, given circumstances, no later than 45 days after the request is made is what they've stipulated related to what would be a reasonable timeframe?

Ms. Grove Casey

Are there any other interpretations that had 2021 effective dates?

Ms. Louis

There is. Effective November 30, 2021, there was an interpretation related to staff augmentation arrangements. There also was an interpretation related to client affiliates, which gives an exception to the rule when making independence determinations, as we deal about the affiliate of a client, like loans or subsequent employment with an affiliate of the client. And then thirdly, there is another one that's related to agreed-upon-procedures engagements that you might be performing in accordance with the SSAES that prohibits independence, impairing non-attest services from being performed, as it relates to the subject matter of the agreed upon procedure or AUP type engagement. And then lastly, there's one related to just the scope and applicability of non-attest services.

Ms. Grove Casey

Oh, let's talk a little bit about staff augmentation arrangement. I worked for a firm one time and we were a small local firm. But we won the county audit, and so we had partnered with a much larger firm to go about conducting the audit because we didn't have enough staff on our own. Is that a staff augmentation arrangement?

Ms. Louis

Yes, it's lending firm personnel, but in this case, when they talk about staff augmentation, they're worried about lending firm personnel to an attest client. So now the attest client is responsible for the direction and supervision of activities performed by the augmented staff. You are correct. There are other cases where between firms we're sharing staff that we're outsourcing some responsibilities, but what they're really looking at in the arrangements is where the firm is actually billing an attest client for activities performed by this automated staff, in the end. Where is it that we can do this in a way that doesn't impair independence, and when is it that it is going to impair independence. It is ultimately that you have obvious threats with familiarity, management participation, self-review, advocacy, and there are certain safeguards that have to be in place in order for your threats to be at an acceptable level.

And there was a listing of what these safeguards are and part of them are going to be the fact that this augmented staff arrangement is not expected to be recurring. Like it's not like an ongoing thing that you're doing. It's related to a specific unexpected situation that would create a significant hardship for the attest client to make another arrangement. And this is something that's done for a short period of time, a rebuttable assumption being, not exceeding 30 days, but also the augmented staff don't participate in, are in a position to influence an attest engagement covering the period where they were there augmenting certain activities. The augmented staff performs activities that would not be expressly prohibited, otherwise. So it's temporary; it's not otherwise prohibited; it's for a short period of time, right? And you're having those general overarching requirements that somebody with suitable skills, knowledge, experiences is overseeing the augmented staff. It is recognizing that particularly during the pandemic that sometimes the CPA firms had to step up and help their clients.

Ms. Grove Casey

Well, what is a member's responsibility for identifying and gathering the necessary information related to those client affiliates?

compliance with the law or regulation or suspected noncompliance of a law or regulation and who is it that I need to be having conversations with around that particular issue?

Ms. Louis

Well, when you have the client affiliate, you have to expend your best efforts to get necessary information to enable us to determine whether or not there's threats to independence. And if we do identify a client affiliate, to discuss the matter with the governance of my client, right? If I have an issue with one of their affiliates, how does that affect my ability to provide the services to you? And we should document those conversations and, and ultimately, take reasonable efforts to obtain necessary information to identify our independence issues with these client affiliates.

Ms. Grove Casey

Oh, lastly, can you give us an idea of what's on the horizon with exposure drafts from PEEC?

Ms. Louis

Yes, there's a variety of topics that are out there for them to still address. One of them is going to be to look at the definition of what is a loan. As we try to determine independence issues that might come from that, they also are doing something where they're going to interpret how independence could be affected when a member assists an attest client with implementing a new or even an existing accounting standard. There will be an interpretation related to unpaid fees. As we're thinking about that, we already talked a little bit about when could you withhold records because of unpaid fees, but in essence, the fact that fees might be unpaid, does that create an automatic independence impairment type issue underneath the principle-based approach? Or could there be certain safeguards that could be in place to bring that threat down to an acceptable level, given the access, the significance of the fees, how long they'd been outstanding, the likelihood they're going to get paid, the effect it's actually having on the auditor's independence. That's an area that also is going to be pursued.

Then the final one that I think it merits just knowing that there is a project ongoing relates to responding to noncompliance with laws and regulations, where ultimately, is there a specific guidance for when members encounter where the client is in non-

Recent Ethics and Independence Guidance Activity

by Jennifer F. Louis, CPA

Background

The Professional Ethics Executive Committee is a senior committee of the AICPA charged with interpreting and enforcing the AICPA Code of Professional Conduct and for promulgating new interpretations and rulings, and for monitoring those rules and making revisions as needed.

Ethics interpretations and other guidance are promulgated by the executive committee of the Professional Ethics Division to provide guidelines about the scope and application of the rules but are not intended to limit such scope or application. Publication in the Journal of Accountancy constitutes notice to members.

Recent Guidance with Delayed Effective Dates

PEEC extended the effective dates of the following interpretations to the AICPA *Code of Professional Conduct* by one year:

- The “Information Systems Services” interpretation (ET §1.295.145), which is now effective on Jan. 1, 2022, with early implementation permitted.
- The “State and Local Government Client Affiliates” interpretation (ET §1.224.020), which is now effective for years beginning after Dec. 15, 2021.
- The “Leases” interpretation (ET §1.260.040), which is now effective for fiscal years beginning after Dec. 15, 2020, with early implementation permitted.

Information Systems Services

The revised interpretation differentiates between two general classes of information systems: financial information systems (FISs) and systems that are unrelated to an FIS (that is, non-FIS). A FIS aggregates source data underlying the financial statements or generates information that is significant to either the financial statements or financial processes as a whole. A FIS is not limited to applications such as the general

ledger and other obvious accounting systems, but includes a wide array of systems that create transactions with cost or revenue implications, such as inventory control, supply chain, production scheduling, order placing, points of sale, and many others.

The revised interpretation provides guidance on determining whether certain systems or nonattest services are related to a FIS, such as systems that may include controls or output that may be subject to attest procedures or are part of the client's systems of internal control over financial reporting.

1. As long as the member is in compliance with the general requirements of the provision of nonattest services, threats would be at an acceptable level if the member performs design, development, and, more broadly, implementation services related to a non-FIS for an attest client.
2. Threats to a member's independence would not be at an acceptable level and could not be reduced to an acceptable level if the member designs or develops a FIS for an attest client.
3. As long as the member is in compliance with the general requirements for the provision of nonattest services, threats to a member's independence would be at an acceptable level if a member performs implementation services related to a FIS COTS software solution where the services do not involve design, development, customizations, the building of interfaces, or the creation of data translation programs. The services may include the member assisting the client with understanding and effecting configuration options for the FIS COTS software solution, as long as the client makes all decisions with respect to selecting those options.

In addition to clarifying that "all COTS software solutions are COTS," regardless of complexity and scale, the revised interpretation provides useful definitions that enable members to focus on the nature of certain specific information systems activities and services. The revised interpretation also provides more guidance on defining what constitutes an FIS and what does not.

Though there may be differing views about the intended scope or nuances of some common information systems terms (such as install, design, configure, develop, etc.) information technology (IT) practitioners and consultants who provide information systems services to clients have a general, common understanding of the meaning of such terms.

Customized Off-the-Shelf Software (COTS) is generally understood to be commercially available software products that are designed, developed, distributed, and maintained by a third party—usually a software vendor. COTS software could be relatively simple programs that can be purchased from a retailer and only require loading onto a computer before they are ready to run, or they could be large, complex enterprise systems offered by vendors such as Oracle, Salesforce, SAP, and many others. The main point of COTS software for the purposes of the revised interpretation is that such software—unless the member's firm is the software vendor that designs, develops, and implements the software—is not software designed and developed by a member, no matter how complex the software may be.

Designing an information system, or a single program, means determining how it will function, process data, and produce results, such as reports and a variety of transmittal documents (for example, sales orders). *Develop* means writing and testing software code, often by following a specified design.

Configuring a COTS software solution requires a user to understand and decide which processing, display, and data options to select. A COTS software implementation consultant, who may be a member, typically assists the client in understanding the various configuration options and the implications of various choices, and then makes the selections within the system based on the client's decisions. If limited solely to configuration activities, no matter how complex the COTS software solution, a member would not be engaging in design or development.

To *customize* a system, specifically a COTS software solution, means to enhance or modify the software by adding new features and functions, or altering existing features and functions that allow the solution to go beyond what the third-party vendor provides, generally through design and development of new or modified code.

Creating an interface between two or more systems means enabling the systems to pass data from one system to the other. The building of interfaces involves design and development activities, unless the interface is effected through a third-party vendor's ready-made software solution, such as an application programming interface (API), and no additional design and development activities are required to tailor or customize the API to make it work.

Data translation, sometimes referred to by IT professionals as *data conversion* means changing the format of data from one system so it is compatible with the data format in another system. Data translation is typically required to populate a new COTS software solution with data from a client's legacy system(s). Data translation may also be required in creating interfaces. Data translation programs, unless effected through a third-party vendor's ready-made software solution without any modifications, require design and development activities in order to work.

A COTS software solution is *installed* by performing an initial load of the software onto a client's designated hosting site that may be a client's own or a third party's servers. In the case of cloud-based COTS solutions, this may involve establishing a new tenant in the third-party vendor's hosting environment. Installing a COTS software solution does not involve design or development activities.

Implementing a COTS software solution can mean a range or subset of activities, from installation, configuring, design, development, and data translation through cutover to production where the system is available for the client to use regularly.

Threats to a member's independence cannot be brought to acceptable levels for services that involve a client outsourcing to the member an ongoing function or process (such as systems monitoring, support, or maintenance), as such services represent the member assuming a management responsibility, even if an individual with suitable skill, knowledge, and/or experience from client management is overseeing the services.

On the other hand, certain services that may represent separate and distinct engagements, and are not ongoing or continuous services, may be permissible. For example, being engaged by a client to analyze the client's network and provide observations or recommendations for the client's consideration.

Leases

When a covered member enters into or has a lease with an attest client, the self-interest, familiarity, and undue influence threats to the covered member's compliance with the "Independence Rule" [1.200.001] may exist.

If a covered member who is:

- a. An individual on the attest engagement team,
- b. An individual in a position to influence the attest engagement, or
- c. the firm

Enters into a lease or renegotiates terms of an existing lease with an attest client during the period of the professional engagement, threats would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards.

The covered member should evaluate the significance of any threats to determine whether the threats for existing leases are at an acceptable level. If threats are not at an acceptable level, apply safeguards to eliminate or reduce the threats to an acceptable level.

Independence would be impaired, unless all the following safeguards are met at the time of entering into or renegotiating the lease:

- The lease is on market terms and established at arm's length.
- The lease is not material to any of the parties to the lease – considering all leases between the covered member and the attest client in the aggregate.

Once the covered member enters into or renegotiates the lease, independence would be impaired if the lease amounts are not paid in accordance with the lease terms or provisions by the due date or within any available grace periods during the period of the professional engagement.

A covered member previously identified above may have a lease with an attest client that was either:

- a. Entered into or renegotiated prior to the
 - period of the professional engagement,
 - member becoming a covered member, or

- counterparty becoming an attest client or an affiliate of a financial statement attest client, or

- b. Entered into or renegotiated during the period of the professional engagement, but due to a change in circumstances after the lease is entered into or renegotiated, the lease becomes material to any party to the lease during the period of the professional engagement.

The significance of the threats will depend on factors such as the following:

- The role of the covered member on the attest engagement or with the firm
- The materiality of the lease to the covered member or the attest client during the period of the professional engagement
- Whether multiple leases exist with the attest client and, if so, the aggregate materiality of those leases to the covered member or the attest client
- The extent to which the lease will be subject to attest procedures or financial statement disclosures
- The duration of the lease term
- Whether the lease is on market terms or established at arm's length

Interpretation State and Local Government Client Affiliates

This interpretation applies to state and local government entities that are financial statement attest clients. When an interpretation of the "Independence Rule" [1.200.001] is applied in a state or local government environment and the interpretation uses terminology that is not applicable in this environment, the member should use professional judgment to determine if there is an equivalent term. For example, certain interpretations use the phrase "officer, director, or owner of the attest client." In some state or local government environments, it may be necessary for the member to extend these interpretations to officials of the financial statement attest client when the official has governance responsibilities or control over financial reporting.

Recent Finalized Changes in Official Releases

Effective July 31, 2021 – Revised “Records Requests” interpretation (ET sec. 1.400.200) under the “Acts Discreditable Rule” (ET sec. 1.400.001)

The following terms are defined for use with this interpretation:

- a. A *client* includes current and former clients.
- b. A *member* means the member or the member’s firm.
- c. *Client-provided records* are accounting or other records, including hardcopy and electronic reproductions of such records, belonging to the client that were provided to the member by, or on behalf of, the client.
- d. *Member-prepared records* are accounting or other records that the member was not specifically engaged to prepare and that are not in the client’s books and records or are otherwise not available to the client, thus rendering the client’s financial information incomplete. Examples include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) and supporting schedules and documents that the member proposed or prepared as part of an engagement (for example, an audit).
- e. *Member’s work products* are the deliverables set forth in the terms of the engagement, such as tax returns.
- f. *Working papers* are all other items prepared solely for purposes of the engagement and include items prepared by the i. member, such as audit programs, analytical review schedules, and statistical sampling results and analyses. ii. client at the request of the member and reflecting testing or other work done by the member.
- g. *Make records available* means to provide the records in any format that is usable and accessible, whether electronic or otherwise, regardless of the format in which they were received.
- h. *Beneficiary* is a person or entity for which the engaging entity has requested the member to perform professional services.

When a member is engaged to perform professional services with respect to a beneficiary, the member will be considered in compliance with the requirements of client-provided records if the member makes these records available to the person or entity that provided the records to the member or to the individual designated or held out as the entity’s or individual’s representative.

The member will be considered in compliance with the requirements related to member-prepared records and a member’s work products if the member makes such records and work products available to the beneficiary or to the individual designated or held out as the beneficiary’s representative. For example, if a company engages a member to perform personal tax services for the benefit of its executives, the member would be in compliance if the member made the tax returns available to the executives.

When an engaging entity engages a member to perform professional services with respect to another entity that is not the beneficiary of the professional services, absent an agreement stating otherwise, the member would be in compliance related to a member’s work products if the member made such work products available to the engaging entity or to the individual designated or held out as the engaging entity’s representative. For example, if a company engaged a member to value the assets of another company for a possible acquisition, absent an agreement stating otherwise the member would be in compliance if the member made the valuation report available only to the engaging entity.

When an initial request for client-provided records is received, the member should make those records in the member’s custody or control available to the person or entity that provided the records to the member. The member may charge a reasonable fee for the time and expense incurred to retrieve, copy, and ship such records. However, the client-provided records may not be withheld for nonpayment of such fees.

A member and the client or beneficiary may agree to terms other than those stated in this interpretation. When this occurs, the member should respond in accordance with such agreement. Otherwise, a member should respond to a request for member-prepared records or a member’s work products that are in the member’s custody or control and that have not

previously been made available to the client, or, if applicable, to the beneficiary as follows:

- a. The member should make available member-prepared records relating to a completed and issued work product; to the client, except that however, such records may be withheld if fees are due to the member for that specific work product.
- b. Member's work products should be provided or made available; however, such work products may be withheld if:
 - Fees are due to the member for the specific work product;
 - The work product is incomplete;
 - For purposes of complying with professional standards (for example, withholding an audit report with outstanding audit issues); or
 - Threatened or outstanding litigation exists concerning the engagement or the member's work.

Once a member has complied, the member is under no ethical obligation to:

- Comply with any subsequent requests to again provide make records or copies of records available. However, if after complying with a request a loss of records due to a natural disaster or an act of war is experienced, the member should, when practicable, comply with an additional request to make such records available.
- Retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.
- Make the records available to any other associated party, such as the general partner, majority shareholder, or spouse.

Working papers are the member's property, and the member is not required to make such information available. However, state and federal statutes and regulations and contractual agreements may impose additional requirements on the member.

In fulfilling a request for the member's copy of client-provided records that was previously made available to the client or a party, member-prepared records, or a member's work products, the member may:

- a. Charge a reasonable fee for the time and expense incurred to retrieve, and copy, and ship such records and require payment before the member makes the records available.
- b. Make the requested records available in any usable and accessible format. However, the member is not required to convert records that are not in electronic format to electronic format. If the records are requested in a specific format and the records are available in such format within the member's custody and control, the client's request should be honored. In addition, the member is not required to make formulas available, unless the member was engaged to make such formulas available as part of a completed work product or the formulas were used to create member-prepared records without which the client's financial information would be incomplete.
- c. Make and retain copies of any records that the member already made available.

When a member is required to return or make records available, the member should comply as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made.

The fact that the statutes of the state in which the member practices grant the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation.

November 2021 – New Interpretation and Related Revisions Staff Augmentation Arrangements

Effective November 30, 2021, the Professional Ethics Executive Committee (PEEC) adopted a new interpretation under the "Independence Rule" (ET sec. 1.200.001): "Staff Augmentation Arrangements" (ET sec. 1.275.007).

PEEC also adopted these revised independence interpretations:

- "Client Affiliates" (ET sec. 1.224.010)

- “Agreed-Upon Procedure Engagements Performed in Accordance With SSAEs” (ET sec. 1.297.020)
- “Scope and Applicability of Nonattest Services (ET sec. 1.295.010)

Staff Augmentation Arrangements involve lending firm personnel (augmented staff) to an attest client whereby the attest client is responsible for the direction and supervision of the activities performed by the augmented staff. Under such arrangements, the firm bills the attest client for the activities performed by the augmented staff but does not direct or supervise the actual performance of the activities.

If a partner or professional employee of the member’s firm serves as augmented staff for an attest client, familiarity, management participation, advocacy, or self-review threats may exist. Threats would not be at an acceptable level and independence would be impaired unless all the following safeguards are met:

- a. The staff augmentation arrangement is being performed due to an unexpected situation that would create a significant hardship for the attest client to make other arrangements.
- b. The augmented staff arrangement is not expected to reoccur.
- c. The augmented staff arrangement is performed for only a short period of time. There is a rebuttable presumption that a short period of time would not exceed 30 days.
- d. The augmented staff neither participates in, nor is in a position to influence, an attest engagement covering any period that includes the staff augmentation arrangement.
- e. The augmented staff performs only activities that would not be prohibited otherwise.
- f. The member is satisfied that management of the attest client designates an individual or individuals who possess suitable skill, knowledge, and experience, preferably within senior management, to be responsible for
 - Determining the nature and scope of the activities to be provided by the augmented staff;
 - Supervising and overseeing the activities performed by the augmented staff; and

- Evaluating the adequacy of the activities performed by the augmented staff and the findings resulting from the activities.

Client Affiliates – When a client is a financial statement attest client, members should apply the “Independence Rule” [1.200.001] and related interpretations applicable to the financial statement attest client to their affiliates, except in the following situations:

- a. A covered member may have a loan to or from an individual who is an officer, a director, or a 10 percent or more owner of an affiliate of a financial statement attest client during the period of the professional engagement unless the covered member knows or has reason to believe that the individual is in such a position with the affiliate. If the covered member knows or has reason to believe that the individual is an officer, a director, or a 10 percent or more owner of the affiliate, the covered member should evaluate the effect that the relationship would have on the covered member’s independence by applying the “Conceptual Framework for Independence” [1.210.010].
- b. A member or the member’s firm may provide prohibited nonattest services to entities described under the definition of affiliate during the period of the professional engagement or during the period covered by the financial statements, provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level.
- c. A firm will only have to apply the “Subsequent Employment or Association With an Attest Client” interpretation if the former employee, by virtue of his or her employment at an entity defined as an affiliate, is in a key position with respect to the financial statement attest client. Individuals in a position to influence the attest engagement and on the attest engagement team who are considering employment with an affiliate of a financial statement attest client will still need to report consideration of employment to an appropriate

person in the firm and remove themselves from the financial statement attest engagement, even if the position with the affiliate is not a key position.

- d. A covered member's immediate family members and close relatives may be employed in a key position at an entity described as an affiliate during the period of the professional engagement or during the period covered by the financial statements, provided they are not in a key position with respect to the financial statement attest client.
- e. A covered member who is an individual on the attest engagement team, an individual in a position to influence the attest engagement, or the firm may have a lease that does not meet the requirements of the "Leases" interpretation [1.260.040] under the "Independence Rule" with an entity described as an affiliate during the period of the professional engagement. The covered member should use the "Conceptual Framework for Independence" to evaluate whether any threats created by the lease are at an acceptable level.
- f. A member or member's firm may enter into a staff augmentation arrangement with entities described as an affiliate during the period of the professional engagement or during the period covered by the financial statements. The member should use the "Conceptual Framework for Independence" to evaluate whether any threats created by the staff augmentation arrangement are at an acceptable level.

A member must expend best efforts to obtain the information necessary to identify the affiliates of a financial statement attest client. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, threats would be at an acceptable level and independence would not be impaired if the member

- a. Discusses the matter, including the potential impact on independence, with those charged with governance;
- b. Documents the results of that discussion and the efforts taken to obtain the information; and
- c. Obtains written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the affiliates of the financial statement attest client.

This interpretation does not apply to a financial statement attest client that is covered by the "Entities Included in State and Local Government Financial Statements" interpretation [1.224.020] of the "Independence Rule" [1.200.001].

Acquisitions and Other Business Combinations That Involve a Financial Statement Attest Client – The exception below would apply when:

- (1) A financial statement attest client is acquired during the period of the professional engagement by either a nonclient or a nonattest client (acquirer),
- (2) The attest engagement covers only periods prior to the acquisition, and
- (3) The member or member's firm will not continue to provide financial statement attest services to the acquirer.

Independence will not be considered impaired with respect to the financial statement attest client because a member or member's firm has an interest in or relationship with the acquirer that may otherwise impair independence as a result of the requirements of this interpretation or the definition of "attest client" (as it relates to the entity or person that engages the member or member's firm to perform the attest engagement).

Regardless, a member should give consideration to the requirements of the "Conflicts of Interest" subtopic [1.110], with regard to any relationships that the member knows or has reason to believe exist with the acquirer, the financial statement attest client, or the firm.

Agreed-Upon Procedure Engagements Performed in Accordance With SSAEs – When performing agreed-upon procedures (AUP) engagements in accordance with the SSAEs, the application of the "Independence Rule" [1.200.001] is modified, as described in the "Application of the Independence Rule to Engagements Performed in Accordance With Statements on Standards for Attestation Engagements" interpretation [1.297.010].

When providing nonattest services that would otherwise impair independence under the interpretations of the "Nonattest Services" subtopic [1.295], threats would be at an acceptable level and independence would not be impaired, provided that the nonattest services do not relate to the specific subject matter of the SSAE engagement.

Threats would be at an acceptable level and independence would also not be impaired if the “General Requirements for Performing Nonattest Services” interpretation [1.295.040] were not applied when providing the nonattest services, provided that the nonattest services do not relate to the specific subject matter of the AUP engagement.

When a member or member’s firm enters into a staff augmentation arrangement, threats would be at an acceptable level and independence would not be impaired provided that the services performed by the augmented staff are unrelated to the specific subject matter of the AUP engagement.

In addition, when performing an AUP engagement under the SSAEs, threats would be at an acceptable level and independence would not be impaired, if the following covered members and their immediate families are independent of the responsible party(ies):

- Individuals participating on the AUP engagement team
- Individuals who directly supervise or manage the AUP engagement partner or partner equivalent
- Individuals who consult with the attest engagement team regarding technical or industry-related issues specific to the AUP engagement

Furthermore, independence would be impaired if the firm had a material financial relationship with the responsible party(ies) that was covered by any of the following interpretations of the “Independence Rule”: a. Paragraphs .01–.02 of “Overview of Financial Interests” [1.240.010] b. “Trustee or Executor” [1.245.010] c. “Joint Closely Held Investments” [1.265.020] d. “Loans” [1.260.010]

Exposure Drafts

October 2021 Exposure draft: Proposed revised interpretations and definition Loans, acquisitions, and other transactions

As part of convergence efforts, the Professional Ethics Executive Committee (PEEC) is exposing for comment revisions to one definition and four independence interpretations:

- Definition of “beneficially owned” (ET sec. 0.400.06)
- “Loans” interpretation (ET sec. 1.260.010)

- “Loans and Leases With Lending Institutions” interpretation (ET sec. 1.260.020)
- “Immediate Family Members” interpretation (ET sec. 1.270.010)
- “Client Affiliates” interpretation (ET sec. 1.224.010)

September 2021 – Exposure draft: Accounting Standards Implementation Services

Given the increased complexity of accounting standards, PEEC is exposing a new interpretation that provides guidance on how independence could be affected when a member assists an attest client with implementing new or existing accounting standards.

The key elements to keep in mind when providing these nonattest services are as follows:

- Do not perform any management responsibilities.
- Ensure that the individual at the attest client who is overseeing your service is not only able to oversee the service but is also capable of making all significant judgments and decisions. This individual needs to be able to evaluate and accept responsibly for the results of your service.

September 2021 – Exposure draft: Proposed revised interpretation, Unpaid Fees

The Professional Ethics Executive Committee (PEEC) has exposed for comment a revision to the “Unpaid Fees” interpretation. PEEC undertook this project to:

- review the “Unpaid Fees” interpretation to develop a principles-based framework for members to determine when unpaid fees impair independence.
- converge with other standard setters such as the IESBA and SEC.
- determine whether the current bright-line one-year approach continues to be appropriate, especially given the COVID-19 pandemic.

PEEC is proposing revisions to:

- Remove the reference to an advocacy threat because it is not applicable to unpaid fees.

- Provide a principles-based framework to evaluate when unpaid fees may impair independence.
- Provide factors to consider when evaluating whether threats to independence are at an acceptable level under the principles-based framework.
- Provide examples of safeguards to eliminate the threat to independence or reduce it to an acceptable level.

The proposed factors used to determine the level of threats are

- The significance of the fees to the covered member;
- How long the fees have been outstanding;
- The likelihood that the fees will be paid; and
- The potential effects the situation will have on the auditor's objectivity and appearance of the auditor's ability to maintain independence.

Under the framework, threats are considered at an acceptable level when the unpaid fees are clearly insignificant and relate to services provided less than one year prior to the date of the current attest report. If, however, one or both of the criteria is not met, threats may not be at an acceptable level and the member may need to implement safeguards to continue with the engagement. The proposed interpretation provides examples of possible safeguards.

February 2021 – Proposed interpretations and definition Responding to Noncompliance With Laws and Regulations

The Professional Ethics Executive Committee (PEEC) has re-exposed for comment two new interpretations from 2017, each entitled “Responding to Noncompliance With Laws and Regulations.”

In developing the proposed interpretations, PEEC considered the International Ethics Standards Board for Accountants' (IESBA's) new ethics standards, sections 260 and 360, each entitled Responding to Non-Compliance with Laws and Regulations. PEEC believes that though many of the proposed requirements were already consistent with those of the IESBA Code of Ethics for Professional Accountants

(IESBA code), certain modifications are necessary to enhance the clarity of the proposed interpretations and make them relevant to AICPA members in the United States.

The AICPA code does not currently provide specific guidance for members who encounter noncompliance with laws or regulations (NOCLAR) or suspected NOCLAR. The general objective of members who encounter a NOCLAR is to alert the appropriate parties to enable a client's or employing organization's management and those charged with governance to rectify the NOCLAR, mitigate the effects of the NOCLAR, or deter the commission of the NOCLAR.

Though the proposed interpretations require a member to obtain an understanding of the matter when a NOCLAR is discovered, the member is only expected to have a level of knowledge and understanding of laws and regulations necessary for the professional service for which the member was engaged or was employed to perform. In addition, for members performing audit services for a client, the proposed guidance imposes ethical requirements that are separate from any audit or other applicable standards. The proposals are not intended to modify or interpret AU-C section 250, Consideration of Laws and Regulations in an Audit of Financial Statements.

INFORMATION SYSTEMS SERVICES

ET \$1.295.145

Effective January 1, 2022



CUSTOMIZED OFF THE SHELF (COTS)

- Designing
- Developing
- Implementing
- Look for independence implications when assisting clients

LEASES

- Lease with attest client
- Self-interest, familiarity, and undue influence threats
- ET §1.200.001
- Effective for FY beginning after 12.15.2020



S&L GOVERNMENT CLIENT AFFILIATES

- ET §1.200.001
- Terminology similarities for responsibilities
- Effective for years beginning after 12.15.2021



RECORDS REQUESTS

- Effective 7.31.2021
- Acts Discreditable
- ET §1.400.200



OTHER INTERPRETATIONS EFFECTIVE IN 2021

- Staff augmentation
- Staff affiliates
- AUP Engagements
- Scope and applicability of nonattest services

POTENTIAL GUIDANCE

- Definitions of loans, acquisitions, etc.
- Accounting standards implementation
- Unpaid fees
- NOCLAR



GROUP STUDY MATERIALS

A. Discussion Problems

1. Briefly discuss the new ethics interpretation related to information systems services.
2. Discuss the four different types of records or other documents that were the subject of the new interpretation on responding to records requests.
3. Discuss what is meant by staff augmentation arrangements.

B. Suggested Answers to Discussion Problems

1. The revised interpretation differentiates between two general classes of information systems: financial information systems (FISs) and systems that are unrelated to an FIS (that is, non-FIS). A FIS aggregates source data underlying the financial statements or generates information that is significant to either the financial statements or financial processes as a whole. A FIS is not limited to applications such as the general ledger and other obvious accounting systems, but includes a wide array of systems that create transactions with cost or revenue implications, such as inventory control, supply chain, production scheduling, order placing, points of sale, and many others.

The revised interpretation provides guidance on determining whether certain systems or nonattest services are related to a FIS, such as systems that may include controls or output that may be subject to attest procedures or are part of the client's systems of internal control over financial reporting.

As long as the member is in compliance with the general requirements of the provision of nonattest services, threats would be at an acceptable level if the member performs design, development, and, more broadly, implementation services related to a non-FIS for an attest client.

Threats to a member's independence would not be at an acceptable level and could not be reduced to an acceptable level if the member designs or develops a FIS for an attest client.

As long as the member is in compliance with the general requirements for the provision of nonattest services, threats to a member's independence would be at an acceptable level if a member performs implementation services related to a FIS COTS software solution where the services do not involve design, development, customizations, the building of interfaces, or the creation of data translation programs. The services may include the member assisting the client with understanding and effecting configuration options for the FIS COTS software solution, as long as the client makes all decisions with respect to selecting those options.

2. *Client-provided records* are accounting or other records, including hardcopy and electronic reproductions of such records, belonging to the client that were provided to the member by, or on behalf of, the client.

Member-prepared records are accounting or other records that the member was not specifically engaged to prepare and that are not in the client's books and records or are otherwise not available to the client, thus rendering the client's financial information incomplete. Examples include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) and supporting schedules and documents that the member proposed or prepared as part of an engagement (for example, an audit).

Member's work products are the deliverables set forth in the terms of the engagement, such as tax returns.

Working papers are all other items prepared solely for purposes of the engagement and include items prepared by the i. member, such as audit programs, analytical review schedules, and statistical sampling results and analyses. ii. client at the request of the member and reflecting testing or other work done by the member.

3. Staff Augmentation Arrangements involve lending firm personnel (augmented staff) to an attest client whereby the attest client is responsible for the direction and supervision of the activities performed by the augmented staff. Under such arrangements, the firm bills the attest client for the activities performed by the augmented staff but does not direct or supervise the actual performance of the activities.

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- The augmented staff arrangement is not expected to reoccur.
- The augmented staff arrangement is performed for only a short period of time. There is a rebuttable presumption that a short period of time would not exceed 30 days.
- The augmented staff neither participates in, nor is in a position to influence, an attest engagement covering any period that includes the staff augmentation arrangement.
- The augmented staff performs only activities that would not be prohibited otherwise.
- The member is satisfied that management of the attest client designates an individual or individuals who possess suitable skill, knowledge, and experience, preferably within senior management, to be responsible for
- Determining the nature and scope of the activities to be provided by the augmented staff;
- Supervising and overseeing the activities performed by the augmented staff; and
- Evaluating the adequacy of the activities performed by the augmented staff and the findings resulting from the activities.

PART 3. SMALL BUSINESS

Communicating Internal Control Deficiencies

Part of conducting an audit is gaining an understanding of an entity's system of internal controls. When there are deficiencies in those controls, they may rise to the level where the auditor must communicate them to others.

For a closer look at internal control deficiencies and what needs to be communicated, let's join Kurt Oestrieher, CPA and a partner with Oestrieher and Company in Alexandria, Louisiana, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk a little bit about communicating internal control deficiencies, and what that means for the auditor. Now, even if you are conducting an engagement with a small entity, you have to make the determination whether or not you're going to rely on internal controls because, in theory, everybody's got some kind of internal controls, even if it's just, the owner's overseeing what else is going on. So to begin with, why don't you give us a little bit of a background or an overview on where the authoritative guidance is related to any internal control deficiencies we have, and what kinds of things we might need to be doing there in accordance with GAAS?

Mr. Oestrieher

Well, when you're conducting an audit in accordance with generally accepted auditing standards, now, certainly there are GAGAS, the *yellow book* rules, and for public companies, PCAOB, there are a lot of standards out there that you could potentially have to comply with. We're going to focus just on the AICPA, generally accepted auditing standards. And as you alluded to, this is an often overlooked aspect of auditing. So often in a small business audit we understand we're not going to rely on internal controls, but we understand there's a certain amount of work we have to do to obtain an understanding of internal controls. In the back of our mind, we're going well, we don't have to rely on control. So let's just get through all these checklists from our third-party practice aid provider and do the work and do the walkthroughs. Let's hurry up and get that done to make our peer reviewer happy, to comply with standards. And then let's move forward with our audit without relying on internal controls. Well, even if that's your approach, AU-C 265 still applies. And what that standard says – I always look at it as a two-prong standard – it requires

you to evaluate any control deficiencies that were identified during the audit. And then after that evaluation, if any of those control deficiencies rise to the level of a material weakness or a significant deficiency, then there are communication requirements. So that's the basic starting point on AU-C 265. So the next logical question is, well, how can I become aware of control deficiencies if I am not going to test internal controls? The answer is very simple because a control deficiency can either be a design issue or an operational issue.

So to understand that you actually have to understand and have a very thorough knowledge of the definition of a control deficiency in AU-C 265 and the definition on kind of go verbatim here, the highlight, the relevant points, a deficiency in internal control over financial reporting. So that's the first thing you have to understand. You may stumble upon an internal control on a compliance issue that has nothing to do with internal controls and why that may be relevant in a governmental audit is completely irrelevant here in a GAAS audit because it's internal controls over financial reporting. That's the first thing. So a deficiency in internal control over financial reporting exists when the design or the operation of a control does not allow management or employees or other people in the business, in the normal course of performing their assigned duties to prevent, detect or correct misstatements on a timely basis.

So when we put all that together, we're talking about design or operation in most small business audits, you really should not become aware of operational deficiencies because you're not testing the controls. You would literally have to stumble over that when you're maybe doing cash disbursements testing and you happen to notice that no one is approving invoices. And you remember in your discussion in obtaining an

understanding of internal controls, that there should be approvals of purchase orders or some other document requests or documented tasks. And you just happen to notice it, again, you should not be testing for it if you're not relying on internal controls, but you may happen to notice it. That's an operational, so small business audits, it can happen, but not that often that you're going to find operational ones. It's the design that you're going to become aware of and just as it holds true in a small business audit that you're not going to test internal controls, it also holds true in a small business audit that when you are obtaining an understanding of internal control over financial reporting, it is highly likely that you are going to come across a lot of design deficiencies. In other words, either improperly designed controls or controls that should be in place that just don't exist and based on your knowledge. You're like, Wow! you don't reconcile bank accounts, or Wow! you leave your checkbooks unlocked, or things like that.

Ms. Grove Casey

Well, do you want to talk a little bit about what the requirements are when it comes to communicating internal control deficiencies?

Mr. Oestrieher

Okay. So once you identify those controls, so we just went over the definition, and then this is something that within our firm, we did the evaluation process because you have to evaluate before you determine what you're going to communicate. So as soon as we come across a control deficiency that meets that definition, that I just provided some people use an internally generated form. Some people use third party practice aids, but stop and write a memo, whatever you do to document, I have found this control deficiency, and hopefully you have a very organized workpaper index system, so that at the end of the audit, when it says evaluate control deficiencies identified, that's when you go back and you go, okay, here are the 8, 9, 10, 11, whatever control deficiencies you've identified. One of the absolute most common gotcha moments in whether it's peer review, litigation, or regulator looking at your audit documentation, whatever it might be is when an auditor states in their audit programs that they are not going to rely on a client's internal control over financial reporting due to poor design of internal controls or non-existence of internal controls. So you are stating right there, Hey, trust me any of those would meet that definition of a control deficiency we just did, and then

later on in the audit, when you get to your concluding steps, when you're overbudget and you're rushing to get the audit out, and you're just filling out checklist, and it gets to that step that says, evaluate control deficiencies identified during the audit and you put non-applicable, you just contradicted yourself and that's a problem. So that's the first step is understanding that it is highly likely that you have, in fact, identified design deficiencies, and probably not operational but design. So now that you've identified these, and again, you have them in your safe space for, you know, a place for safe keeping until you get to that last part of the audit program. The next thing that we do is group similar control deficiencies.

In other words, there, if I identify 12 deficiencies in internal control, many of them may be very, very similar, such as maybe it's lack of approval of accounts payable. And also lack of approval of payroll is still a lack of approval. You don't have a written policy that certain things get approved and either one of those could impact financial reporting in the same manner in that you have inaccuracies hitting either an expense account or in the case of payroll, salary. So we would not treat those as a separate control. We would treat those as a similar control, so that that's the first step is linking them together or grouping the similar control deficiencies. The next thing that you do is you have to evaluate and the evaluation, is, does this control deficiency rise to the level of either a material weakness or significant deficiency? Now to rank them in order a material weakness is the most significant, a significant deficiency is like, okay, we got to know about it, but it's not as harsh. Let's say that. And then a control deficiency is, well, it's just a plain old control deficiency. And it just stayed a control deficiency. It is neither a material weakness or a significant deficiency. So we don't have to communicate it.

So the way most of us think logically we say, we're starting down here at control deficiency. Well, let's see if it's a significant deficiency. And then let's see if it's a material weakness, but that's the wrong way to attack this. The way to do it first is to evaluate whether or not it is a material weakness and then if it is not a material weakness, then you need to evaluate whether or not it is a significant deficiency. And to make that, and this is what I find so interesting that when people tend to about auditors evaluated, they have this internal scale. It's kind of like when we rank our football team's performance, that's halfway, can we say, do they make an A, B, C, D, or E and an F?

And we go, oh, they look like a C. So that must be a significant deficiency or a D and F is a material weaknesses. It's not that kind of a grading scale. It is, there are definitions for both material weaknesses and significant deficiencies. And if you do not know those definitions and have studied them thoroughly and understand the meanings with them, you quite frankly, just cannot properly determine whether something is a material weakness or a significant deficiency. So the next definition we want to look at, and by the way, there's a theme here. If you don't know the three definitions of a control deficiency, a material weakness or significant deficiency, then this is an area you might struggle with. And peer review has told us that yes, many people struggle in this area.

So these definitions are important. A material weakness is a deficiency or a combination of deficiencies. So again, that's why I said, you can lump some of them together they're the same or impact the financial statements in the same manner. So a deficiency or a combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected in a timely basis.

So there's three important thresholds. There we have a likelihood threshold, reasonable possibility, then a materiality threshold, meaning material, in other words the impact of that. And then we talk about, will it be prevented or detected and corrected in a timely basis, which tells us that there's actually two types of internal controls. There are some internal controls in place that are put in place to prevent errors or regularities. And by the way, an error is a mistake and an irregularity is what we think of as fraud. So we want to prevent them from entering the general ledger anyway. So a transaction is about to be processed and some internal control indicates, oh, you don't have an account coding, or it's the wrong amount, or it doesn't match up. So everything is fixed before the transaction is entered into the general ledger. That is a preventative internal control. But then we know that because humans are involved that mistakes can happen and sometimes internal controls will fail. So now we also have procedures that would detect and correct in a timely manner.

And I've taught this topic on courses around the country. I've had people say, well, Kurt it's okay. Because we know there are certain areas that the client is going to need our help with it. Okay. So yeah, they

let it fall through the cracks because they know we're going to fix these items. Well, folks, you just made your CPA firm part of the internal control as the entity that is going to detect and correct. Congratulations! Your independence is impaired. This when, when we talk about internal controls, it means internal to the organization. All of these things should be prevented or fixed before they get to the auditor, which by the way, brings up a really good point. If you have material adjustments that you're proposing to your client, you're going to have a material weakness because they either did not prevent the material error from occurring, or they did not detect and correct it in a timely manner, because by the time the trial balance got to you, there was a material misstatement in the financial statements. So that's a really big clue out there that if you are proposing material adjustments to your client, and yet you are not issuing this report because you said, no, there are no material weaknesses or significant deficiencies. There's an imbalance somewhere. There's something that just doesn't add up when you look at these definitions. So when you are evaluating, now that we have a really good discussion of what is a material weakness. Now we have to say, okay, what is this internal control? Okay. What area of the financial statements is this control designed to either prevent or detect and correct material misstatements? If it's prepaid insurance, okay, maybe not going to be as big of an item, but if it relates to purchasing inventory or an accounts receivable or a major revenue, one of those accounts, then it is more likely that it is going to be a material misstatement. And that's where your judgment comes into play. And I wish I could give you a list or the Auditing Standards Board could write a list that said, okay, these types of control deficiencies would always be a material misstatement and these would not. Such a list can't exist simply because it is all about the entity itself, the type of industry they're in type of accounting pronouncements, that they are now implementing. If it's a new implementation, it's going to be a higher risk. All those things come into play on the magnitude of the misstatement, as far as the likelihood where they use the term reasonable possibility. This is where it gets fun. That they go back to the FASB guidance on contingencies. And they, they use the terms remote, reasonably possible, and probable, and the auditing standard actually references that it is old FASB 5, I believe is where we first heard that language. And so they say, use the term reasonable possibility in the same context, as you would evaluating the impact of... a contingency.

So now what does reasonably possible mean? How likely is that on a scale it has to be between zero and a hundred percent. I can tell you that the way I've always interpreted this. So some linear accountants want to say, okay, between zero and one-third is remote, one third and two thirds is reasonably possible, and two thirds to a hundred percent is probable. I don't look at it that way. The way I've always looked at it. If I flip a coin, it is probably going to be heads 50 times out of a hundred and probably be tails 50 times out of a hundred. I learned that when I was still awake during the statistics class back in college, was what probability. So I've always put probable at more than 50%. Now, other people would say probable is more like 90%, like it has to almost assuredly happen. That's just not the way I interpreted it. By the way, both schools of thought are okay. There's no definition, no special percentage, just the way I consider it. So I think if I think it is more likely than not, 50:50, I think it's probable, reasonably possible is my default, remote is something that I would put at less than 10% or even less than 5%. You know, in this COVID era, some people will put 1% as remote, cause they say, you know what? You know, even if I get it, there's a remote chance that I could be negatively impacted. So in this COVID era, some people put 1% as remote. Whereas if they put it reasonably possible at 1%, then they go, I'm going to take extra measures. I'm going to take CDC guidance and go beyond that. And, and we've seen different people react in different ways.

So but when you're trying to quantify percentages for, unfortunately for the first time in a long time, we've had something that's impacting almost everybody where they're making assessments as to how they do it. I know that... if you want to put remote at 5%, I live in a small town, maybe about 20 flights, leave here a day. If every day one flight crashed, 19 made it out safely, but we have some wind shear and one flight crashed, I wouldn't say, oh, there's a remote chance my plane will crash today. I think I would go to a different airport. Okay. And that's a 5%. Sometimes you have to put things in context that way. So I put remote pretty low. So reasonably possible is something that is a pretty wide range, less than 50%, but more than maybe two or 3%. That's the way I think of it. And when, in doubt, I say, well, it's reasonably possible. So remote has to be way out there. So, and again, at least reasonably possible. So therefore, anything, any control deficiency where it's reasonably possible or probable, which now I'm talking about maybe 97, 98% of the spectrum, the way I think of it, then it's at least reasonably possible that a

departure would exist. That's the first threshold, if I believe that it's at least reasonably possible that a departure can occur and not be prevented or detected, then I look at the materiality, the magnitude. And if I believe it could be material to the financial statements, and then this is where again, I use my judgment. I don't run back to my planning materiality and say, oh, well, the misstatement would be 83,000 and my planning materiality was 105,000 I'm okay. You evaluate it in the same manner that you would a misstatement. In other words, it is the nature of the control. What are the elements of the financial statements that are impacted? How key are those elements to the users of the financial statements, then it's more likely the more accounts it affects. So, things like not having proper authorization, disbursements, well, that's going to impact almost everything that hits the expense side of your financial statements. So it's much more likely that it could be a material misstatement because it's not going to be one item that's missed. It could be multiple items that are missed because of the lack of the control or the nature of the control. So that evaluation is very important. So what you want to see in your audit documentation to comply with AU-C 265 is an identification of all our, if you will, documentation of all control deficiencies identified, lumping them together, and then perform this first test where you look at the magnitude and the likelihood. And if you're not addressing magnitude and likelihood and using terms like at least reasonably possible and material, then you're not using the proper guidelines within the definition to evaluate that.

That's what so often is key when I'm consulting with other firms and looking at it, they just go, oh, well, we just think, because it's payable that it is probably really bad. Well, nowhere in the definition of material weakness, do they say really bad? It is likelihood, magnitude. So if you determine that this control deficiency or combination of them rises to the level of material weakness, then you stop and you have material weaknesses that you will communicate if it does not meet both of those thresholds.

Now you look to see if it's a significant deficiency. And the definition of a significant deficiency is a control deficiency that will not warrant the attention to those charged with governance. In other words, it's not reasonably likely or reasonably possible that a material misstatement will occur because of this design or control deficiency, but it is still something management would want to worry about because is it a very sensitive area like cash? Is it an area that is a combination of both

financial reporting and compliance, like payroll taxes and payroll taxes aren't being paid timely, but the liability is being recorded. Well, that's not a financial statement departure. Then you could have an unrecorded liability because of penalties, obviously, but even if that unreported penalty for liabilities or recorded liabilities for penalties is not material, I think in most cases, those charged with governance would want to know if there's a lack of payroll tax compliance, a lack of control over payroll tax compliance.

So those are the things that typically wind up as a significant deficiency when we are performing audits and our clients are doing their own payroll. Of course, if you're outsourcing that's when it's pretty nice and you don't have to worry about it, but you still have internal control over, are the proper payroll amounts withheld, and some issues like that, that may come up. Those almost always are just control deficiencies because in our judgment, they're just not going to rise to that level of a material weakness sort of significant deficiencies. So that is the evaluation process that needs to be well-documented in order to show compliance with AU-C 265. You can't just put non-applicable and nope, we didn't find any as a note in your audit documentation, in your audit programs.

Ms. Grove Casey

Well, did you want to talk a little bit about what it is that we're required to communicate and how we go about communication of those?

Mr. Oestrieher

Yes, AU-C 265 is very, very clear. The communication needs to be in writing and AU-C 265 actually provides guidelines as to what needs to be in writing. There are AICPA guides, there's actual sample communications in the appendices to the auditing standards. And like I said, third party practice aids are out there. So it's pretty easy to find templates out there that have all the elements of the required communication. It has to be in writing and it has to be made to those charged with governance. Now for a small business, typically those charged with governance and management are one and the same, the shareholders, the stakeholders, they elect themselves as the board. And then they also, then that board elects them as the CEO and CFO and chief operating officer of the company.

But when you have a nonprofit or maybe an

organization that is a small organization, but does in fact have an active board, maybe the bank had decided, Hey, we need a couple of board seats because of the large exposure to loans, and that does happen in small businesses, then you've got to make sure that, Hey, we're giving this communication to those charged with governance, as well as those in management. Within that communication, you're going to define what is a control deficiency. So that definition will be in there. You will have a definition of material weakness. Now the standards say that you will have a definition of a significant deficiency when relevant, and in my opinion, when relevant means that you're actually reporting a significant deficiency. If you are not communicating a significant deficiency, in other words, everything that you have evaluated, you believe to be a material weakness, then in my opinion, you do not have to put in the definition of a significant deficiency. I can tell you that there is a guide out there that's published by the AICPA that actually had the definition of a significant deficiency, even when none are communicated. I happen to believe that that guide is incorrect because of that whole, when relevant, issue.

If you look at the sample, actually within AU-C 265 in their sample communications, they actually have the definition of significant deficiencies in italics. It says include only when relevant. Again, to me, I mean, that's very restrictive when you are communicating that significant deficiency. Again, it doesn't make sense to put a definition of a significant deficiency in there when you're not reporting one. Once you have the restrictive language, and that you're saying that, Hey, we're not providing an opinion on internal controls the procedures that we performed in planning the audit are not designed, so we may not have identified all control deficiencies. So you have to kind of give that disclaimer, language in there, but then once you have all that language in there for each of the material weaknesses, and significant deficiencies, by the significant deficiency an explanation of the potential effects on the financial statement some auditors like to kind of use the same, yellow book type format, where if you're doing an audit in accordance with GAGAS where they look at the criteria, the effect, the cause, however it's appropriate to communicate. So that management understands these deficiencies and the impact those deficiencies can have on the financial statements, then you have properly communicated them. And by the way, when you are writing this, if you find that the compliance issue, then that's when you really have to go back and think, okay, I've identified a

control deficiency on compliance or on financial reporting.

It gets back to that thing that we first said, many different objectives for internal controls. We were only concerned about those that will have an impact on the financial statement, material weaknesses. The definition is the magnitude – is that a material misstatement on the financial statements? And once you're writing this communication, if you can't clearly communicate or identify which elements of the financial statements could be impacted, then go back. This has happened in our firm where we look at something and we were thinking, oh, this is a control deficiency, but we want you to really try to articulate it and write it out. And you're like, yes, there really is no area of the financial statements that this impacts. And then we re-word all of our language and we say, oh, you know, in our audit documentation, we just don't pull it out and document why we believe that this is no longer an internal control over financial reporting.

And once you have that communication ready, of course you proofread and all, you have to communicate it within 60 days after the report release date. In most cases it is being released the same day as the audit. I've never had a situation where we did not release that within 60 days. And then one final thought, if you have these control deficiencies and none of them become material weaknesses or significant deficiencies, there's nothing that precludes you from just communicating those control deficiencies to management. Often that's done in a management letter but you're not required to communicate things that just stay down at that level of a control deficiency.

Ms. Grove Casey

So Kurt timely reporting is always an important thing.

Mr. Oestriecher

That's what we've always found, that when we give the audit report, we want to go ahead and give all those communications, and also we want to go ahead and bill the client. Generally, it's going to take time to put all this together, so it's really the 60-day rule is there, but I always believe that it's best to do it all at the same time.

Communicating Internal Control Deficiencies

by Kurt Oestrieher, CPA

Introduction

The AICPA Auditing Standards Board issued SAS 112 in 2007, which was later updated and amended with SAS 115, then eventually re-codified as AU-C 265 when the clarity standards were adopted by the Auditing Standards Board. The required communications, which began with SAS 112, was one of the first steps in bringing back many required communications with those charged with governance and management. Let's focus on both the requirements to discover internal control deficiencies and the communications.

Requirements

Procedures performed by the Auditor

AU-C 265 does not require the auditor to perform any additional procedures beyond those embodied in AU-C 315 Understanding the Entity and Its Environment, Including the Entity's Internal Control. AU-C 265 requires that any time an auditor **becomes aware** of a deficiency in internal control, the auditor is required to evaluate the deficiency in internal control. If the auditor concludes that a deficiency in internal control is either a **material weakness** or a **significant deficiency**, then the auditor is required to make certain communications to those charged with governance and management.

Relationship of the Auditor and Management

The auditor performs his or her audit procedures independent of management. It is management's responsibility to design, implement, and monitor internal controls, and the auditor's responsibility to gain an understanding of all five elements of internal control, including monitoring. In no way is it intended that these required audit procedures cause an independent CPA to become part of the internal control system of the client. Care should be taken to ensure that notations in the audit documentation do not imply that audit procedures performed by the CPA are considered to be a substitute of either the monitoring or information and communication elements of the entity's internal control.

Definition of a control deficiency

Because the standards require an entity to evaluate control deficiencies identified in an audit, it is important that the auditor understand how a control deficiency is defined in AU-C 256.

Deficiency in internal control – A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

In order to gain a full understanding of the requirements, a further discussion of the following concepts within the definition are necessary.

Design or Operation

This element of the definition makes it clear that deficiencies in internal control are not only operational deficiencies, but also include a deficiency of control by either poor design, or omission of a control. The second half of the definition further explains what the standards imply when discussing design or operational issues.

A deficiency in *design* exists when

- a. A control necessary to meet the control objective is missing
- b. An existing control is not properly designed so that even if the control were operating as designed, the control objective would not be met.

A deficiency in **operation** exists when a properly designed control does not:

- a. Operate as designed
- b. The person performing the control does not possess the necessary authority or competence to perform the control correctly.

Management or employees

This element of the definition limits the responsibility of the operation of controls to management or employees. While not specified, if management outsources components of internal control to contractors, these contractors would fit within this definition.

Normal course of assigned functions

Management or employees may occasionally stumble onto issues that would alert the entity to potential misstatements in the financial statements. The definition of deficiency in internal control makes it clear that if the design of a control will not alert management to potential misstatements in the normal course of business, a deficiency exists.

Prevent

The best possible course of action is to design controls so that all material misstatements are prevented from occurring. This is typically the first objective addressed when designing internal controls. However, because of the cost/benefit relationship, not all misstatements can be prevented.

Detect and correct

Because it is typically not cost effective to design internal controls to prevent every possible material misstatement from occurring, the internal control activities of a company will typically include detection controls. A key element of this portion of the definition is that misstatements that are detected must also be corrected.

Timely basis

While not specifically defined, it is obvious that “timely basis” means before the financial statements are either issued by management, or presented to a third party for

audit. Because the auditor is not “management or employees”, they cannot be part of the internal control structure of the entity. If financial statements are considered “complete” by management, and a misstatement is present, the internal controls in place did not detect and correct the misstatement in a timely manner.

Based on the understanding of the definition, it is most likely that the auditor will become aware of a control deficiency during two phases of the audit: (1) when obtaining an understanding of the internal controls related to financial reporting and (2) testing of such controls, if the auditor intends to rely on the controls.

It is common in small business audits to assess control risk at maximum, thus eliminating the need to test controls. Because this testing focuses on the operation of internal controls, it is rare that operating deficiencies are identified for the simple fact that the auditor has not performed any procedures to determine if the controls are operating properly.

However, because audit standards require the auditor to obtain an understanding of internal controls, design deficiencies are often identified by the auditor, with the most typical design deficiency being the absence of some controls, such as segregation of duties. It is possible the auditor may also determine operating deficiencies during this phase of the audit when the auditor is performing the required “walk-through” procedures.

Evaluation of Control Deficiencies

AU-C 265 requires that the auditor evaluate identified control deficiencies to determine whether or not those control deficiencies are considered material weaknesses or significant deficiencies. If the auditor determines that material weakness or significant deficiencies exist, those deficiencies are required to be communicated to those charged with governance and management. The following chapter discusses this communication.

The evaluation process should be performed near the conclusion of the audit and consists of the following steps:

- Consolidate all identified control deficiencies into categories that are homogenous

- Evaluate aggregated control deficiencies to determine if it is a material weakness
- For control deficiencies that are not deemed material weaknesses, evaluate to determine if they are a significant deficiency
- Document the assessment

Step 1 – Consolidate identified control deficiencies

During the course of an audit, many control deficiencies may be identified that are similar in nature. These control deficiencies may be treated as one deficiency during the evaluation process. Examples of these types of deficiencies are:

- Lack of segregation of duties
- Reconciliations not performed in a timely manner
- Lack of proper approval of transactions
- Pre-numbered documents not used when required

Step 2 – Evaluate to determine if a control deficiency is a material weakness

In order to perform this procedure, an auditor must understand the two qualities that are required in order for a control deficiency to be considered a material weakness. These two qualities are in the definition of a material weakness, and two tests are extrapolated from this definition. The first test is a likelihood test, and the second test is a magnitude test.

Likelihood Test

The definition of a material weakness contains the following phrase: “such that there is at least a reasonable possibility”. This phrase is the basis of the likelihood test. In applying this test, SAS 112 first referred the auditor to legacy accounting standards SFAS 5, Accounting for Contingencies. This standard described “reasonable possibility” as being between remote and probable. While no exact percentage is provided in the standard in general practice, many auditors apply a percentage range of 10% – 50% as reasonably possible. If the auditor that is evaluating a control deficiency uses this range, the auditor will assess whether or not the possibility of a control deficiency not preventing, or detecting and correcting a

misstatement is greater than 10%. If the auditor believes the likelihood is greater than 10%, the likelihood test is met. If the auditor believes the probability is less than 10%, the control deficiency is not considered to be a material weakness, however the control deficiency must be further evaluated to determine if it is a significant deficiency in step 3.

Magnitude test

If the auditor assesses the likelihood of a misstatement is at least reasonably possible, the magnitude test must be performed. In performing this test, the auditor must determine if the misstatement that was not prevented, or detected and corrected, would be material to the financial statements. Auditor judgment is extremely important in this test, and many factors will influence this decision. AU-C 265.A6 provides the following guidelines in assisting the auditor:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.

If the auditor believes the magnitude of the potential misstatement is material, the magnitude test is met, and the control deficiency is considered a material weakness. If the magnitude test is not met, the auditor must evaluate whether or not the control deficiency is a significant deficiency.

Prudent Official Test

When an auditor determines that a control deficiency, or a combination of control deficiencies, is not a material weakness or significant deficiency, the auditor should then consider whether prudent officials, having knowledge of the same set of facts and circumstances, would reach the same conclusion. If the auditor believes that a prudent official would reach the same conclusion, then the control deficiency is not considered a material weakness.

Step 3 – Determination of a Significant Deficiency

When an auditor concludes that a deficiency, or combination of deficiencies, is not a material weakness, the auditor must determine whether or not the deficiency, or combination of deficiencies, merits attention by those charged with governance. If that auditor concludes that attention is merited, the

deficiency or deficiencies are considered significant deficiencies, and must be communicated to those charged with governance.

This determination is solely based on the judgment of the auditor. Many factors may influence the decision, including the following:

- Structure of governance within the entity
- Prior experience with the client
- Nature of the control deficiency
- Regulatory or legal requirements
- Potential litigation

The process of determining whether or not a control deficiency merits attention by those charged with governance has led to discrepancies in the types of deficiencies reported, especially in the governmental realm. Because of this issue, many practitioners have stated a preference for the Auditing Standards Board to provide an absolute list where common control deficiencies are defined by the standards as either a material weakness or a significant deficiency. Not only has the Board decided that this is not appropriate, they have “watered down” language that had been contained in SAS 112 that had implied certain control deficiencies were classified as either material weaknesses or significant deficiencies within the standard.

Step 4 – Document the Assessment

AU-C 265 requires that audit documentation provide evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements. While AU-C 265 is silent on specific documentation requirements, most firms use either PPC or other third-party forms and checklists to guide the documentation process. The documentation is actually a two-step process: (1) documenting the control deficiency, and (2) documenting the evaluation of the control deficiency or combination of control deficiencies.

Documentation of control deficiencies identified

Because control deficiencies can be identified at any time during the audit, this is an on-going process. Most firms have a standard form that requires the auditor that identifies the control deficiency to document the following:

- Description of the deficiency
- Type of deficiency (design or operational)

- Accounts or items affected
- Audit procedures that were being performed when the control deficiency was discovered

The aforementioned information will be useful in the evaluation process, which is usually one of the concluding steps in the audit.

Documentation of the evaluation of control deficiencies

Standardized forms have been used by most firms to document the evaluation of control deficiencies. Whatever documentation process is chosen by the auditor, the evaluation should include the auditor conclusions on magnitude, likelihood, and the reasons why the control deficiency would warrant the attention of those charged with governance.

Communication of Significant Deficiencies and Material Weaknesses

Communication Requirements

AU-C 265 requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. This includes significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated, and those that were remediated during the audit.

While not specifically defined in AU-C 265, those charged with governance and management were previously defined in SAS 115 as follows:

- *Management* – Means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.
- *Those charged with governance* – Means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process.

In many smaller entities, those charged with governance and management may be the same person or persons. In this case, one communication to that party will be adequate to comply with this standard.

Content of Communication

The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include the following:

- Include the definition of the term *material weakness* and, where relevant, the definition of the term *significant deficiency*.
- A description of the significant deficiencies and material weaknesses and an explanation of their potential effects
- Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following:
 - The purpose of the audit was for the auditor to express an opinion on the financial statements.
 - The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the internal control.
 - The auditor is not expressing an opinion on the effectiveness of internal control.
 - The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

An appropriate alert, in accordance with section AU-C 905 *Alert that restricts the Use of the Auditor's Written Communication*

Timing of Communication

AU-C 265 requires that the communication be made no later than 60 days following the report release date. Common practice is to provide the communication very near or on the report date. For practical purposes,

governmental entities will be provided with the communication in conjunction with the issuance of the financial statements in order to comply with yellow book requirements.

Nothing precludes an auditor from orally communicating material weaknesses or significant deficiencies to management or those charged with governance during the course of the audit. However, the oral communication will not suffice as the only communication, and the written communication is still required.

Summary

In order to comply with AU-C 265, and auditor must have sufficient understanding of the relevant definitions of a control deficiency, material weakness, and significant deficiency. The audit team should be alert at all times during the audit of potential control deficiencies and properly document the deficiencies for further evaluation. The final step is drafting the appropriate communication and delivering in a timely manner to management and/or those charged with governance.

Overview

Authoritative Guidance is
AU-C 265

Applies to all audits in
accordance with GAAS

Be aware of other potential
applicable standards –
GAGAS (Yellow Book)

www.audicopas.com [318] 448

-3556

Requirements

Auditor must
evaluate
identified
control
deficiencies

No requirement to look for control
deficiencies

Will become aware of control deficiencies
when performing planning and further
audit procedures

Auditor must
communicate

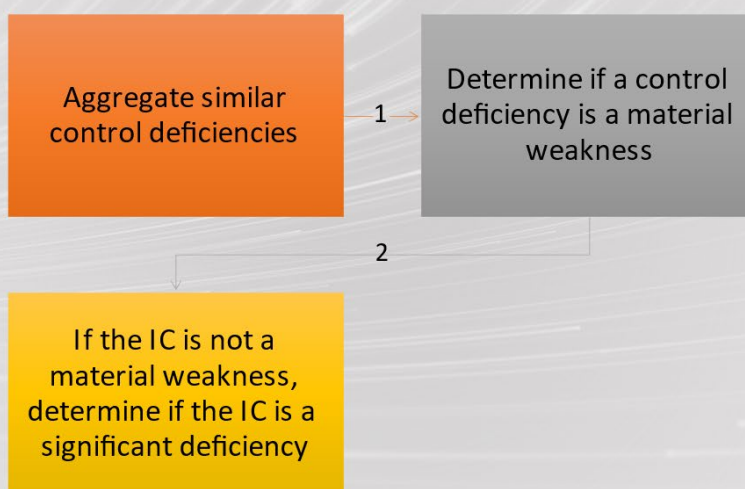
Material weaknesses

Significant deficiencies

Deficiency in Internal Control

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Evaluating



Material Weakness

A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

FASB 5
Contingencies

Remote

Reasonably Possible

Probable

A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Significant Deficiency

Communication

- Must be in writing
- Made to those charged with governance
- Must also communicate to management at an appropriate level of responsibility
- Must define
 - Control deficiency
 - Material weakness
 - Significant deficiency (when relevant)

Communication

- A description of significant deficiencies and material weaknesses and an explanation of the potential effects
- The purpose of the audit was to express an opinion on the financial statements
- No opinion on internal controls
- Not designed to identify all internal controls
- Report must be restricted
- Must be communicated within 60 days of the report release date

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss when an auditor is required to evaluate a deficiency in internal control.
2. Discuss the documentation process of a control deficiency and what should be included.
3. Discuss the written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements.

B. Suggested Answers to Discussion Problems

1. AU-C 265 does not require the auditor to perform any additional procedures beyond those embodied in AU-C 315, *Understanding the Entity and Its Environment, Including the Entity's Internal Control*. AU-C 265 requires that any time an auditor becomes aware of a deficiency in internal control, the auditor is required to evaluate the deficiency in internal control. If the auditor concludes that a deficiency in internal control is either a material weakness or a significant deficiency, then the auditor is required to make certain communications to those charged with governance and management.
2. Standardized forms have been used by most firms to document the evaluation of control deficiencies. Whatever documentation process is chosen by the auditor, the evaluation should include the auditor conclusions on magnitude, likelihood, and the reasons why the control deficiency would warrant the attention of those charged with governance.
3. The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include the following:
 - Include the definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
 - A description of the significant deficiencies and material weaknesses and an explanation of their potential effects
 - Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following:
 - The purpose of the audit was for the auditor to express an opinion on the financial statements.
 - The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the internal control.
 - The auditor is not expressing an opinion on the effectiveness of internal control.
 - The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

GLOSSARY OF KEY TERMS

AUP—Agreed-Upon Procedures engagement

Cash Basis—A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

Contractual Basis—A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.

Control Deficiency—A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

FRF for SMEs—AICPA’s Financial Reporting Framework for Small- and Medium-Sized Entities

Material Weakness—a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis

OCBOA—Other Comprehensive Basis of Accounting

Regulatory Basis—A basis of accounting that the entity uses to comply with the requirements of financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance department).

Significant Deficiency—a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Special Purpose Framework—A financial reporting framework other than GAAP that is one of the following bases of accounting: Cash basis, tax basis, regulatory basis, contractual basis, and other basis.

Tax Basis—a basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.

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BY SPEAKER

Speaker	Month	Speaker	Month
Russ Madray.....	Jan-Feb	Kurt Oestricheer	Jan-Mar
Jennifer Louis.....	Jan, Mar		

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

1. According to Kurt Oestrieher, which of the following is **not** a GAAP standard setter?
 - A. FASB.
 - B. IASB.
 - C. ASB.
 - D. FASAB.

2. According to Kurt Oestrieher, which of the following is most likely to use the cash basis of accounting?
 - A. Soccer association.
 - B. Retail grocery store.
 - C. Medical marijuana outlet.
 - D. Bakery.

3. According to Kurt Oestrieher, which of the following is **not** a major area of concern in choosing an accounting framework?
 - A. What and how do you measure?
 - B. Who will purchase the business?
 - C. How do you present?
 - D. What are the required disclosures?

4. According to Kurt Oestrieher, if an entity is using an accounting framework that does **not** have disclosure or presentation guidance, which of the following should be used, in accordance with SAS 62?
 - A. Tax.
 - B. Cash.
 - C. Regulatory.
 - D. GAAP.

5. According to Kurt Oestrieher, special purpose frameworks are most frequently found in which of the following engagements?
 - A. Audits.
 - B. Reviews.
 - C. Compilations.
 - D. Special purpose frameworks are not frequently found in any of the above engagements.

Continued on next page

6. According to Jennifer Louis, which of the following is a senior committee of the AICPA that is charged with interpreting and enforcing the AICPA's Code of Professional Conduct?
 - A. AcSEC.
 - B. PEEC.
 - C. PCPEC.
 - D. ARSC.
7. According to Jennifer Louis, which of the following is the effective date of the information systems services ethics interpretation?
 - A. December 15, 2021.
 - B. January 1, 2022.
 - C. July 1, 2022.
 - D. December 31, 2022.
8. According to Jennifer Louis, the information systems service ethics interpretation is focused on which of the following?
 - A. COTS.
 - B. Cloud software.
 - C. Cybersecurity.
 - D. Blockchain.
9. According to Jennifer Louis, the recent ethics guidance relates to what type of records and documents?
 - A. Member work product.
 - B. Client provided records.
 - C. Member workpapers.
 - D. Member prepared supporting schedules.
10. According to Jennifer Louis, which of the following ethics interpretations had a 2021 effective date?
 - A. Leases.
 - B. Information systems services.
 - C. Definition of a loan.
 - D. Staff augmentation arrangements.
11. According to Kurt Oestrieher, AU-C 265 has how many prongs to it?
 - A. Two.
 - B. Three.
 - C. Four.
 - D. Five.

Continued on next page

12. According to Kurt Oestrieher, a control deficiency can be which of the following?
- A. A fraud issue.
 - B. A compliance issue.
 - C. A design issue.
 - D. An intent issue.
13. According to Kurt Oestrieher, after identifying design deficiencies, what should the auditor do next?
- A. Fill out checklists.
 - B. Group similar control deficiencies.
 - C. Evaluate the deficiencies.
 - D. Assert an adverse opinion.
14. According to Kurt Oestrieher, in determining the level of a control deficiency, a practitioner should consider if the deficiency is which of the following first?
- A. A control deficiency.
 - B. A significant deficiency.
 - C. A material weakness.
 - D. If it requires special consideration.
15. According to Kurt Oestrieher, a deficiency or a combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected in a timely basis is which of the following?
- A. A significant deficiency.
 - B. A significant deficiency requiring special consideration.
 - C. A material weakness.
 - D. A group of control deficiencies.

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 2395 Midway Road, Carrollton, Texas 75006. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to CPLgrading@thomsonreuters.com.

How would you rate the topics covered in the March 2022 **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
Special Accounting Frameworks	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
Independence and Ethics Interpretations	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
Communicating Internal Control Deficiencies	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

Which segments of the March 2022 issue of **CPE Network® A&A Report** did you like the most, and why?

Which segments of the March 2022 issue of **CPE Network® A&A Report** did you like the least, and why?

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

How would you rate the effectiveness of the speakers in the March 2022 **CPE Network® A&A Report**? Rate each speaker on a scale of 1–5 (5 highest):

	Overall	Knowledge of Topic	Presentation Skills
Kurt Oestrieher	_____	_____	_____
Jennifer Louis	_____	_____	_____

Which of the following methods would you use for viewing CPE Network® A&A Report? DVD ☐ Streaming ☐ Both ☐

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 and audio/video materials effective? 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

Course Title	
Course Date:	
Start Time:	
End Time:	
Moderator Name, Credentials, and Signature Attestation of Attendance:	
Delivery Method:	Group Internet Based
Total CPE Credit:	3.0
Instructions:	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.
Brief Description of Method of Polling	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.

[illegible]

CHECKPOINT LEARNING NETWORK

CPE NETWORK[®]

USER GUIDE

REVISED SEPTEMBER 3, 2021

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.
- **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 Thomson Reuters.

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

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/>

Requesting Participant CPE Certificates

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

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Email: CPLgrading@tr.com

Fax: 888.286.9070

When sending your package to Thomson Reuters, 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 Thomson Reuters 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

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 one of the following means:

Mail: Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008
Email: CPLgrading@tr.com
Fax: 888.286.9070

When sending your package to Thomson Reuters, 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 Thomson Reuters 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 DVD:

- Watch the DVD.
- 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.
- Mail your completed quizzer and survey to:

Thomson Reuters
PO Box 115008
Carrollton, TX 75011-5008

Self-Study—Online

Follow these simple steps to use the online program:

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



the answer company

THOMSON REUTERS

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We can help.

Virtual Conference: Nov. 13 – 14

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Move forward

Checkpoint Learning provides training and tools to keep you and your team up to date and looking forward in an industry full of change and opportunity.



Webinars

Fit learning into your schedule with instructor-led webinars ranging from one to eight hours.

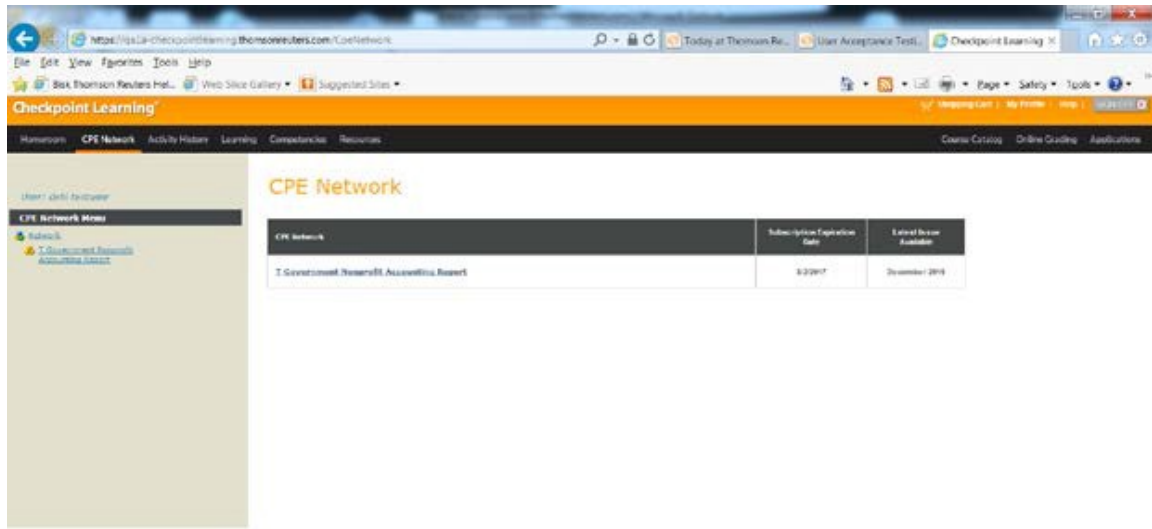


Seminars and conferences

In-person networking, dynamic instructors, nationwide locations plus vacation destinations.

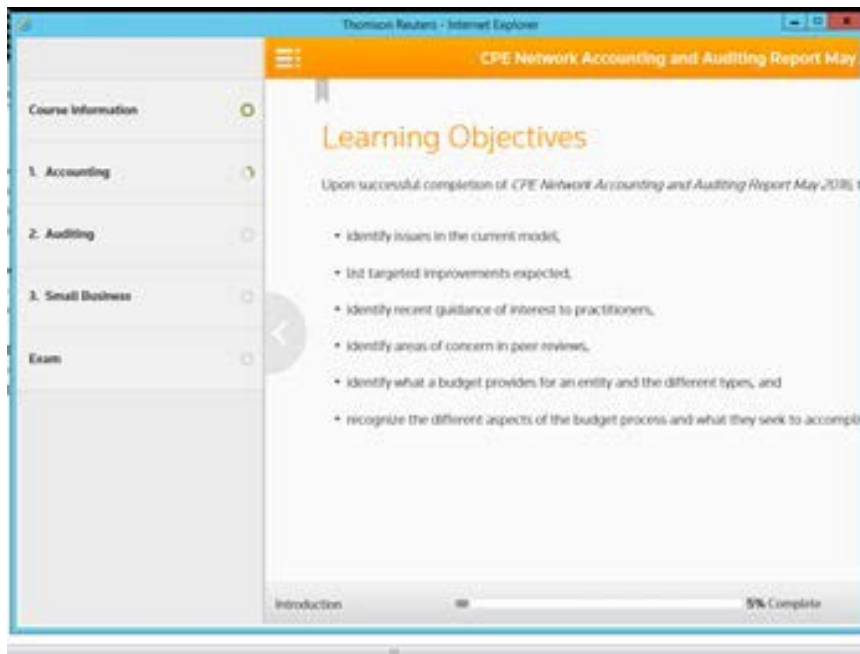


- In the **Network** tab, select the Network Report for the month desired.



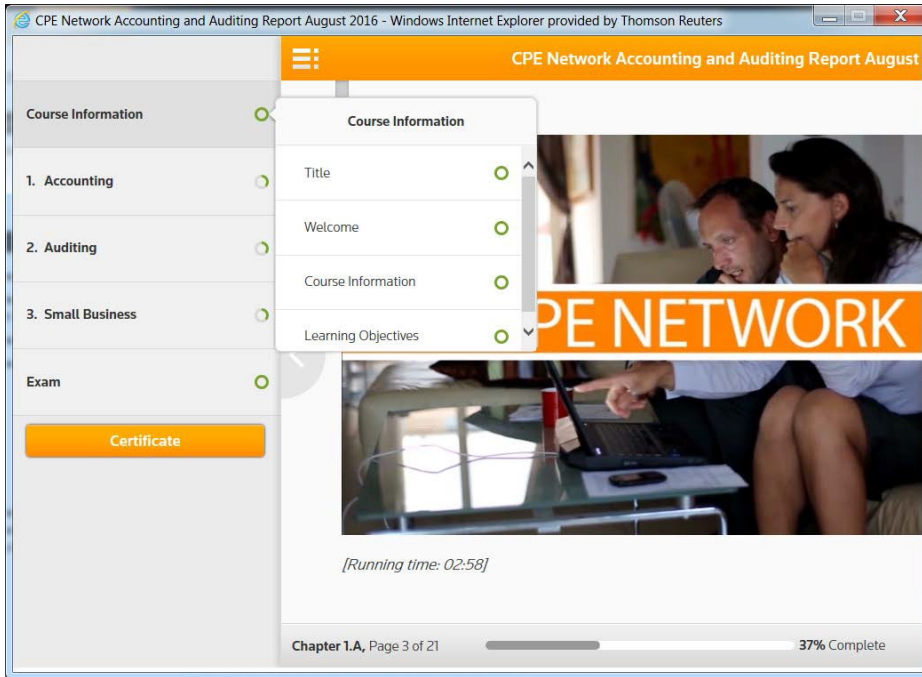
<https://go1a-checkpointlearning.thomsonreuters.com/CpeNetwork/CpeNetworkDetails/Page?SubscriptionId=177994>

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

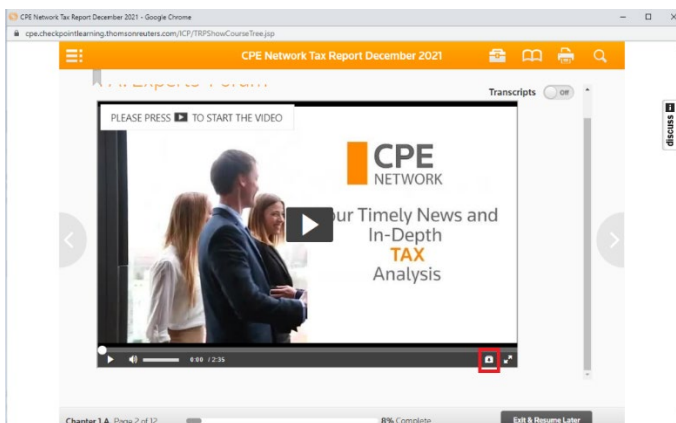


Click down to access the dropdown menu and move between the program Chapters.

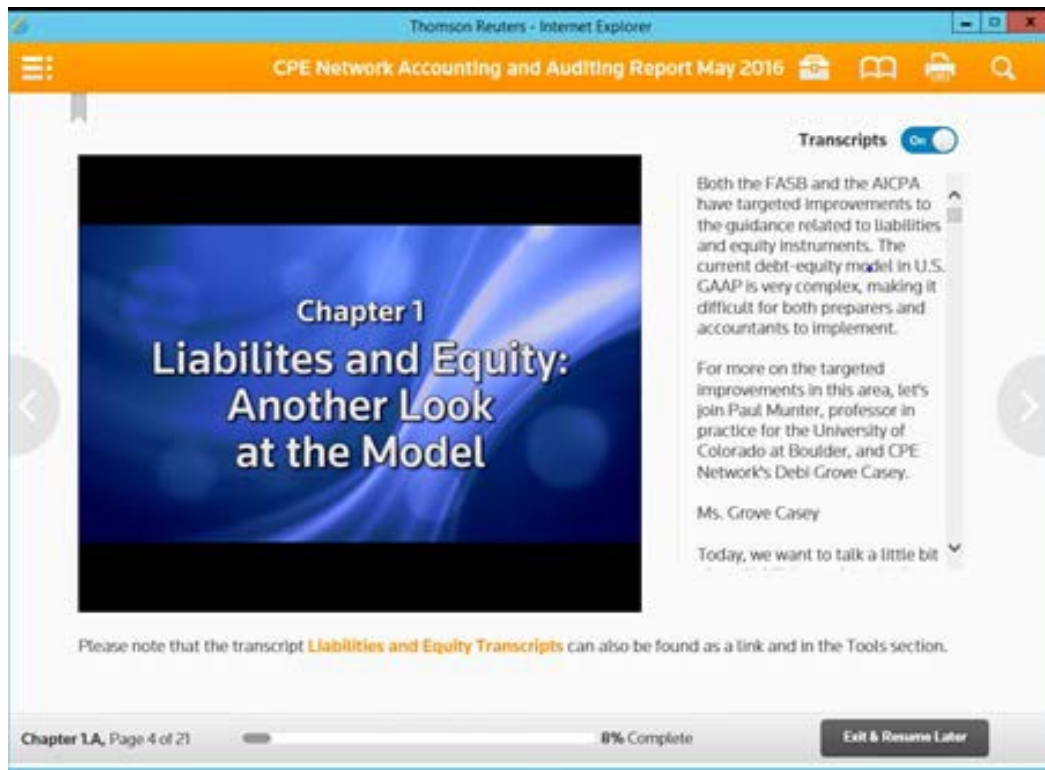
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



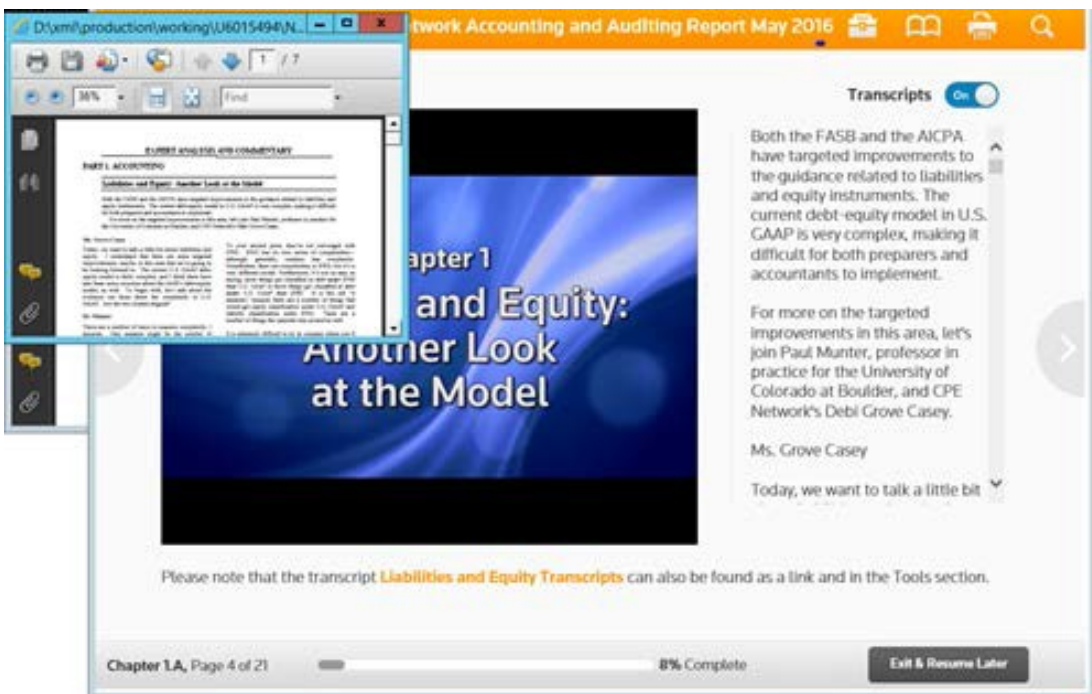
- **Each Chapter is now self-contained.** Years ago, when on the CPEasy site, the interview segments were all together, then all the supplemental materials, etc. Today, each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This more streamlined approach allows administrators and users to more easily access the related materials.



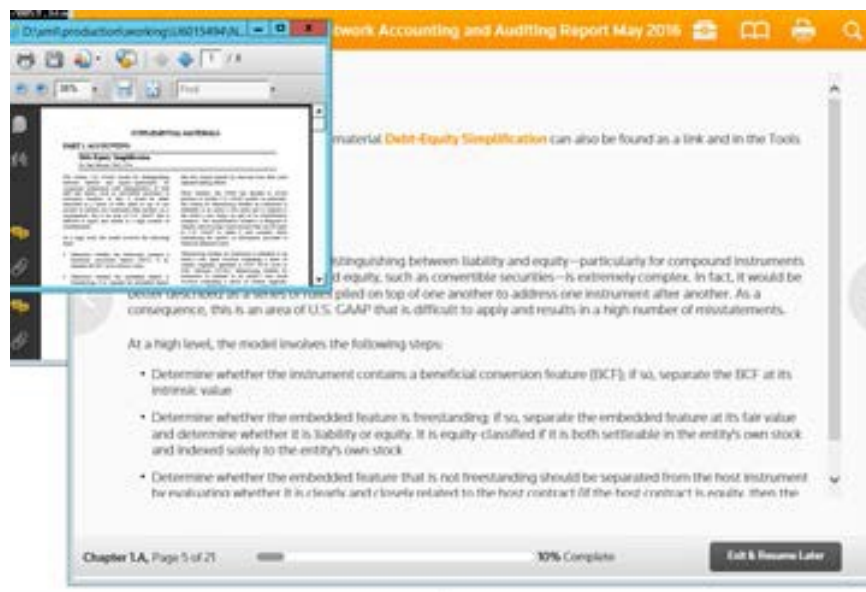
Video segments may be downloaded from the CPL player by clicking on the download button.



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.



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 shows a web interface for the CPE Network Accounting and Auditing Report July 2016. The header is orange with a menu icon, title, and icons for a briefcase, book, printer, and search. The main content area is titled "Suggested Answers to Discussion Problems" and 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

The footer shows "Chapter 3.A, Page 20 of 20", a progress bar at 100% Complete, and an "Exit & Resume Later" button.

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.

The screenshot shows a web interface for the CPE Network Accounting and Auditing Report June 2016. The header is orange with a menu icon, title, and icons for a briefcase, book, printer, and search. The main content area is titled "Course Exams Completed" and contains the following text:

You have completed the exam for this course.

Please choose your next course of action by selecting on one of the buttons below.

"Review My Answers" will take you back through exam, giving you the opportunity to make changes.

Review My Answers

"Grade My Answers" will result in providing you with a final score for this course.

Grade My Answers

The footer shows "Course, Completed", a progress bar at 100% Complete, and an "Exit & Resume Later" 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**.

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.

Delivery Method	Form Name	Location	Notes
"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	800.431.9025 (follow option prompts)	checkpointlearning.techsupport@thomsonreuters.com	<ul style="list-style-type: none">• Browser-based• Certificate discrepancies• Accessing courses• Migration questions• Feed issues
Product Support	800.431.9025 (follow option prompts)	checkpointlearning.productsupport@thomsonreuters.com	<ul style="list-style-type: none">• Functionality (how to use, where to find)• Content questions• Login Assistance
Customer Support	800.431.9025 (follow option prompts)	checkpointlearning.cpecustomerservicet@thomsonreuters.com	<ul style="list-style-type: none">• Billing• Existing orders• Cancellations• Webinars• Certificates