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CPE NETWORK
ACCOUNTING & AUDITING REPORT
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Topics for future editions may include:

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EXECUTIVE SUMMARY

PART 1. ACCOUNTING

Lease Components 3

Russ Madray, CPA discusses lease components and what that means under the new lease guidance in ASCE 842. [*Running time: 43:02*]

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

- Identify what the guidance applies to and the criteria to be met in accounting for the components
- Identify similar accounting literature
- Identify where issues may arise
- Determine the accounting treatment for land that is included in a lease
- Define lease components, non-lease components, and non-components

PART 2. AUDITING

Audit Evidence 27

Kurt Oestriecher, CPA, reviews the guidance related to audit evidence found in SAS 142 and 144 [*Running time: 38:16*]

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

- Identify the guidance on audit evidence, management specialists, and effective dates for new guidance
- Identify the purpose of audit evidence and how it's collected
- Define the types of evidence used in an audit

ABOUT THE SPEAKERS

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

Kurt Oestriecher, CPA is a CPA and partner with the accounting firm of Oestriecher 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.

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PART 1. ACCOUNTING

Lease Components

The new lease guidance was issued in 2016, although it has only recently become effective. The accounting guidance found in Accounting Standards Codification 842 only applies to lease components. After identification of a lease, identification of the components of the lease is the second most important criteria to this guidance. A *lease component* is the right to use an underlying asset that meets the definition of a lease. A *non-lease component* transfers a good or service to the lessee that is separate from the right to use the underlying asset.

For a closer look at lease components and the new lease guidance, let's join Russ Madray, a CPA in Greenville, South Carolina, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk a little bit about ASC 842 and lease components, and ASC 842 is already effective for public companies. And although it was delayed, it will soon be effective for all other entities. Now, part of the implementation and the ongoing application of ASC 842 will require identification of the separate lease and non-lease components within a lease contract. So to begin with, could you give us a quick overview of what exactly a lease component and a non-lease component are?

Mr. Madray

Sure I'd be glad to. This is one of those areas that I think folks are not fully aware of in terms of implementing the topic 842 and the lease accounting guidance. . . . You tend to hear more about the right of use asset, the lease liability and the operating lease, the finance lease and, all those kinds of things. But this is part of it because the initial application of this guidance and, and the ongoing application of this guidance in Topic 842 applies only to a concept called lease components. So, one of the things out there is, identifying leases. Is a contract a lease or does it contain a lease? That's a challenge we might discuss on another day, but after determining that a contract is a lease or contains a lease, the next step is the lessee is going to need to identify the separate lease and non-lease components in the contract.

Now in a nutshell, a lease component is the right to use an underlying asset that meets the definition of a lease, more about that a bit later. A non-lease component transfers a good or service to the lessee, but it's separate from the right to use the underlying asset. So maybe that's our starting point and hopefully that's pretty clear. Lease component specifically relates to the right to use the underlying asset, non-lease components transfer something else to the lessee, but it's separate from the actual right to use the underlying asset. Ultimately, only activities that either convey the right to use the asset i.e., lease component or transfer a good or service to the lessee other than the right to use i.e., a non-lease component. Only those two things are considered components in the contract.

So that gets us to, what about other things like administrative tasks that might be undertaken by the lessees or lessors to set up the contract? What about the lessee's payments to reimburse the lessor for costs that are incurred in connection with the contract? Well, these things do not represent lease components, because they aren't related directly to the right to use the underlying asset. These kinds of things don't meet the definition of a non-lease component because they don't transfer any good or service to the lessee. So these kinds of things are not considered to be separate components of the contract. They are what we're going to call for purposes of our discussion today, noncomponents. So there's the overview of the three, you got lease components, you got non-lease components, and then you got noncomponents. And I think we can explain and demonstrate what those things are and what the implications are, as we go through our discussion today.

Ms. Grove Casey

Well, let's take a closer look at each one of those three and, start out with the lease components, because that would seem like it might be the easiest as we're thinking about those kinds of things and the least nebulous. So can you go into a little bit more detail on what a lease component is and the accounting there?

Mr. Madray

Sure. As I said, the starting point is a lease component, and is directly specific to the right to use the underlying asset. Or it actually could be a right to use multiple underlying assets. We'll get back to that in a moment. But essentially, it meets the definition of a lease, therefore when there's a right to use multiple assets the lessee will need to determine whether each right to use an underlying asset represents a separate lease component for accounting purposes. To do that the lessee will evaluate the situation based on two criteria that will need to be met in order to account for a lease component separately from other lease components in the contract. We have these two criteria on this next slide. One, the lessee can benefit from the right to use the underlying asset either on its own or with other readily available resources; two, the right to use the underlying asset is neither highly dependent on nor highly interrelated with rights to use other underlying assets in the contract.

Now, as you look at those two criteria, they may look familiar. The reason is because they're very similar to the criteria in Topic 606 on revenue from contracts with customers related to identifying separate performance obligations. The FASB decided to use this same model and same criteria because, essentially, think about it from the lessor standpoint--this is a revenue recognition issue. And, lessors are determining separate performance obligations, although Topic 606 does not apply to lease revenue transactions. Instead, Topic 842 has guidance for lessors, but it mirrors almost exactly the guidance in Topic 606. But we're looking at it from the lessee standpoint. So for purposes of that first criteria, and the lessee will focus on whether an underlying asset can be used on its own or whether the asset requires other inputs or interfacing with other assets. Topic 842 describes that term *readily available resources* as goods or services that are sold or leased separately by the lessor or, by some other supplier, or resources that the lessee has already obtained again from the lessor from other transactions or events.

Then, for purposes of the second criteria the lessee will focus on whether each right of use significantly affects the others. Now, all of that in the abstract is a little bit difficult to follow. But we have an example on the next slide that I think will illustrate how a lessee would apply these criteria and determine what are the . . . separate lease components. So take a look at this slide and this example. A lessor leases three things to a lessee, a bulldozer, a truck, and a crane. It'll be used in the lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. And as a result, the lessee could conclude, we don't have all the facts here, but could easily conclude that the leases of the bulldozer, the truck, and the crane are each separate lease components, because both the criteria that we just discussed are met.

Number one, the lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources. So for example, the lessee could readily lease or purchase the truck or crane from somewhere else to use with a bulldozer. They are not dependent upon each other, and can benefit from each one separately. And then the second criterion, despite the fact that the lessee is leasing all three machines for one purpose, which is their construction operations, the machines are not highly dependent on, or highly interrelated with each other. The machines are not in effect inputs to a combined single item for which the lessee is contracting. The lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations and the lessee's ability to get benefit from the lease of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from the lessor. Now, what does all that mean?

In this example again, what we could end up with is, essentially, three different lease components; a lease for the bulldozer, a lease for the truck, a lease for the crane, which would result in accounting for each lease component separately, allocating the lease payments to the different lease components potentially with different issues involving residual values, terms and, so on, but in this case, because the two criteria are met, we're not going to consider each of these assets as separate lease components. They're all combined and treated as one lease component. This isn't an exercise that lessees are going to have to go through because going back to the initial idea that a lease component is the right to use an underlying asset or multiple underlying assets that meets the definition of a lease.

So one of the first things we have to do is determine, are there multiple lease components? And if you ask, that's going to lead to some additional issues with allocation and so on that we will talk about shortly. So ultimately if the right to use an underlying asset does not meet the two criteria for separation, then it's combined with another right of use, so the combined

right of use meets both criteria. And the combined right of use is then accounted for as a single lease component, which is the conclusion we came to in our construction example right here.

As an aside, there is specific guidance in Topic 842 related to the right to use land. Topic 842 requires an entity to account for a right to use land as a separate lease component in all cases, even if the separation criteria that we just discussed are not met, unless the accounting effect of doing so would not be significant.

So for example, if separating the land element would have no effect on the lease classification of any of the other lease components or the amount recognized for the land lease component would be insignificant, then you wouldn't have to worry about doing that. But if the accounting effect of separating the land component is not insignificant, then it's always a separate lease component and that is going to lead to some issues, as I said, with allocating consideration to the land component, as well as classification. Again, because you could have different operating versus finance, depending on the terms related to each lease component. Ultimately the FASB made this decision because of the indefinite economic life and nondepreciable nature of land. Land is different from other assets and therefore should be assessed separately from other assets, regardless of whether those specific criteria are met. So to kind of summarize here, the lease component is specifically the right to use an underlying asset or assets that meets the definition of a lease. There is some special guidance related to land if that's one of the lease components or if it's one of the rights to use the asset. And again, this, I believe will make a little bit more sense when we talk about non-lease components because it's the kind of comparison that begins to make sense, one versus the other.

Ms. Grove Casey

So let's talk about non-lease components. How are they different from lease components? So are we talking about, like, I rented a building, but maybe I don't have guaranteed parking spaces in the parking lot that's attached. That kind of thing.

Mr. Madray

It could be. Remember what I said, a non-lease component is some part of the contract that transfers an identifiable good or service to the lessee, but it's not the right to use the underlying asset. Some examples will probably make sense out of this. We have a slide with some of those examples on it. So common things you see in lease agreements, maintenance services, cleaning services, repair services common area maintenance that might include things like removing snow from the parking lot, or cleaning the exterior windows in an office building. Goods related to the leased asset under a supply agreement, think of things like toner for a leased copy machine, utilities for the leased office space, things like that. . . . let's use the office space as an example.

The lease component would be the right to use the space, the office space itself. But if part of the lease agreement also includes the owner of the building cleaning and maintaining the common areas, you know clearing snow from the parking lot, cleaning the exterior windows and things like that, then that office space lease has both lease components, i.e., the right to use the office space and non-lease components. And again, these things may or may not be enumerated in the contract. That's why we have to be cognizant of the existence of these non-lease components. There's also a difference between how these types of services are accounted for under old GAAP, which was Topic 840 compared to the new guidance in Topic 842. Under the previous guidance lessees would treat maintenance services, for example, as an executory cost, which was considered part of and included in the accounting for the lease.

So for example, common area maintenance provided by a lessor in the lease of office space under the old guidance was considered an executory cost and included in the lessee's accounting for the lease, but under the new guidance, that common area maintenance would be considered a non-lease component, and the lessee will account for those types of services separate from the lease. Again, what this ultimately gets to is only lease components. The consideration, the rent we pay for the office space, only the amount allocated to the lease component ends up in the right of use asset and lease liability that we record initially. Any consideration that's allocated to a common area, maintenance, repair, cleaning services, things like this will not be included in the right of use asset or the lease liability, but instead will be accounted for typically on a current period expense basis as those payments are made, so it makes a difference. Hopefully, that clarifies the idea of the difference between a lease component, which is the part of the contract that actually gives you the right to use an

underlying asset versus non-lease components, which are some parts of the contract that convey other things to you. But they're not specifically the right to use the underlying asset. So hopefully that helps compare and contrast those two types of things that we find in in lease agreements.

Ms. Grove Casey

Well, I believe there's a practical expedient in ASC 842 that relates to identifying and separating the lease and non-lease components. So maybe we want to cover that here to make it a little bit easier on our viewers.

Mr. Madray

You're right. There is a practical expedient. There's an easy way out here, it has some implications. When we have a contract that includes both lease components and non-lease components, and we saw examples of how that could exist a moment ago. The lessee will either separate the lease components and the non-lease components, separate the right to use the office space from the provision of the cleaning services, for example, or the lessee can elect this practical expedient to not separate the lease components from the non-lease components. And instead if this is elected you would account for each of the separate lease components and non-lease components as a single lease component. So the benefit of electing this policy is you don't have to go through and identify what in here conveys the right to use the asset, what in this contract is providing other goods and services to me that I will account for separately. That's the benefit of not having to go through and identify and separate those things. The downside though is, if you elect this policy, it means that all of the contract consideration, in other words, everything you're paying in our example, the office space in the building, everything you're paying, is considered a lease component and therefore, will end up in the initial right of use asset and lease liability. In other words, electing this accounting policy, this practical expedient, will typically result, all other things being equal in the lessee recogniz[ing] a larger right of use asset and larger lease liability upfront than if it had not elected that accounting policy. Now, sometimes it's so insignificant, why not, but in other cases, this could lead to significant differences. If it's a non-lease component, think of the liability side. To be a non-lease component, it's not accrued in that lease liability. It's basically just expensed as a period expense as those things are incurred. But if we elect this policy, it's all considered lease component all wrapped up together, it's all going to get dumped into the liability and the right of use asset. Okay.

Ms. Grove Casey

Well, you mentioned earlier the idea of a noncomponent. Could you explain a little bit further what you were referring to there?

Mr. Madray

Sure. And, we finally get to that third piece. Remember components of a contract include only those items or activities that transfer a good or service to the lessee. So lease components convey the right to use the underlying asset to the lessee. Non-lease components convey some other good or service to the lessee. And we, again, account for them accordingly. But you can also have things in a contract that do not provide any additional good or service to the lessee. In other words, we refer to these things as non-components. Take a look at the next slide, you'll see some examples of things that would be considered non-components. Administrative tasks to set up the initial lease contract or initiate the lease where these tasks don't transfer any kind of good or service to the lessee; real common one, a real estate or property taxes related to the leased asset.

It may be in the lease contract that the lessee pays the property taxes, pays the insurance, the next item there. They may reimburse the lessor; they may pay them directly to the third party, but in no case, does it provide any good or service to the lessee, so it's a non-component reimbursement or payment of other lessor costs; shipping, delivery, installation, underlying asset commitment fees. In other words, any kind of activity in the lease contract that doesn't convey a good or service or right of use of the asset to the lessee. Keep in mind the lessor can incur all kinds of costs in its role as a lessor, as owner of the underlying asset. A requirement for the lessee to pay those costs, again, either as a reimbursement to the lessor, or directly to a third party, does not transfer any good or service to the lessee separate from the right to use the underlying asset.

So again, the common example, reimbursements for lessor real estate taxes, those are owed by the lessor regardless of whether it leases the building or not. Reimbursement of the lessor's property insurance, again, that protects the lessor's investment in the building because the lessor is going to receive any proceeds from any claim. These kinds of things are not

considered a component of the contract because they don't transfer a good or service to the lessee that is separate from the right to use the building. As a result, a non-component cannot be a unit of account, and then as such, no contract consideration is allocated to non-components.

So again, back to why is this important? Take the office space lease the terms of the contract may say that you get X square footage of space in this building. In addition, the rent is X dollars per month. In addition, we provide common area maintenance services and cleaning services. You will also be required to pay a share of property taxes and a share of insurance on the building all as part of this contract. Well, there, again, the right to use the office space is your lease component. Those common area maintenance and cleaning services are your non-lease components. Then those payments of real estate property taxes would be considered non-components.

And at the end of the day, then you're going to take the monthly rent and so forth and allocate it, assuming you don't make that election, the practical expedient, allocate it to the lease components and non-lease components. But nothing is allocated to the non-components, because there is no good or service received by the lessee as a result of those types of services. So no contract consideration is allocated to non-components. We're going to look at an example in a moment with some numbers that I think will help illustrate, clarify, the differences and what can happen with these different types of components.

Ms. Grove Casey

So just to clarify, the consideration in the lease contract needs to be allocated, as you just mentioned to the lease components and the non-lease components, which is really that asset that we're using. But nothing is allocated to the non-components, which are those other intangibles. How does this allocation work? So let's look at your example.

Mr. Madray

Sure. Well Topic 842 requires the lessee to allocate consideration in the contract. And again, consideration of the contract is a fancy way of saying essentially, the rent payments, the lease payments to the separate lease components and the non-lease components based on the standalone prices of those different components-- lease and non-lease components. Again, this sounds a lot like Topic 606 on revenue recognition when it comes to allocating transaction price. Ideally we use observable standalone prices, and if those are available, we use those for allocation purposes. When we say, observable standalone prices, it's the price that the lessor or some other supplier would charge on a standalone basis for the cleaning, for the repairs or whatever it may be. If you don't have observable stand-alone prices, you estimate the standalone prices.

And again, as it is in Topic 606, you maximize the use of observable information to the extent that's available in making those estimates. And then, this is also one of those cases where if there is a remeasurement event, that's another topic we might want to talk about on another day. There are certain events that require remeasurement of the lease asset and lease liability. And if there's a re-measurement event, then the allocation initially at the beginning of the lease, if there's a re-measurement event somewhere down the road, you reallocate the consideration at that point. And there's also another case if there's a contract modification that's not accounted for as a separate lease contract, that also requires a reallocation of the consideration to the lease and non-lease components.

Now, as promised, we have an example to go through a couple of different scenarios to help understand what, what this means and what the implications are. So let's start with the next slide it's labeled as example two. In this example, let's assume the lessor leases 100,000 square feet of an office building to a lessee, for five years the less[or] did not give the lessee any lease incentives. There's no renewal options, no termination options. Assuming the lessee pays $300,000 per year to lease the space, let's assume the contract meets the definition of a lease. The lease term is considered to be five years, and the contract also designates that the lessee is required to pay for costs relating to the asset including real estate taxes and insurance on the building.

Keep in mind the real estate taxes would be owed by the lessor regardless of whether it leased the building. The lessor is also the named insured on the building insurance policy. As a result, in this scenario, the annual lease payments are fixed at $300,000 a year. And in this case, the annual real estate taxes, insurance premiums are going to vary, but they'll be billed by the lessor to the lessee each year in addition to the $300,000. So next slide in this case, the real estate taxes and building insurance are not components of the contract. They are

non-components, essentially for purposes of the lease accounting. We ignore these non-components. In this case, this contract includes a single lease component, which is the right to use the building. The lessee's payments of these amounts, i.e., the taxes and insurance solely represent a reimbursement of lessor's costs and would not represent payments for any goods or services in addition to the right to use the office space.

So in terms of actually accounting for this lease based on these facts, let's assume the rate implicit in the lease is not determinable. The lessee uses its incremental borrowing rate, which we will assume is 5%. They will determine their lease liability by calculating the present value of the lease payments. There's five payments of $300,000 discounted at 5% to arrive at a lease liability and also a ROU asset initial amount of 1,363,785. That's the present value of five payments of 300,000 discounted at 5%. Again, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments, and they don't depend on an index or rate, they're excluded from measurement of the lease liability and will be recognized by the lessee as a current period expense when they actually pay those things. So that's a simple starting point, lease some space in the building also reimburse for property taxes and insurance. Those are non-components. So the entire consideration goes to the lease component. So the initial liability and asset, are simply the present value of the five payments of $300,000.

Now let's go to the next slide. It's labeled example three, and assume we had the same facts and circumstances that we just looked at. Except the fixed annual lease payment is $357,000. There's no additional payments in this case for real estate taxes or building insurance. However, the fixed payment is broken out and itemized in the lease contract. It states that $312,000 is for rent, $35,000 real estate taxes, $10,000 for the building insurance.

In this case, even though it's enumerated in the contract, the payments for the taxes and insurance are not components, they're non-components. In this case, the contract includes a single lease component, which is the right to use the building. So the total payments, five payments of $357,000 are all lease payments. Were they related to that single component of the contract and therefore it would be included in the measurement of the lease liability. Again, assuming the same rate, again, a 5% you'd calculate the present value of five payments of 357,000 discounted at 5% to get a lease liability, right of use asset initial measurement of 1,622,904. So the point here is even though technically the lessor is considering part of the total payment going towards property taxes and insurance, that's still not broken out, nothing allocated to it because those are non-components.

Whereas in the first case, it was the $300,000 rent and then reimbursement still nothing is allocated to that because they're non-components. Here, no additional amounts, they are enumerated in the contract, broken out and identified by the lessor, but still nothing allocated to those because they're non-components. It's all still considered going entirely to the lease component resulting in that right of use asset and lease liability.

Now let's move to the next slide. Example four assuming the same facts. We just had in example three, but let's assume the lease payment, the fixed annual lease payment of $357,000 also covers the lessor's performance of the common area maintenance activities, cleaning, parking lot maintenance, utilities for the building, things like that. In addition, let's assume the lessee paid $10,000 in real estate commissions and legal costs related to the lease negotiation and assume that fee meets the definition of an initial direct cost, which is another concept within Topic 842. So again, consistent with example three, the taxes and insurance are still not considered components of the contract. However, the common area maintenance is considered a component. It's a non-lease component because the lessor's activities do provide some benefit to the lessee. That is the lessee receives a service from the lessor in the form of the CAM activities it would otherwise have to undertake itself or pay some other party to provide like cleaning the lobby, maintain the parking lot, utilities, and so on. In this case, the CAM is a single component, even though it represents separate activities because the lessor performs activities as needed over the same period of time. So we don't need to separate those. We're going to consider those to be one component albeit a non-lease component. So taking a look at the next slide, you'll see how we determine the overall consideration. You see the annual payment as provided for in the lease $300,000, $35,000 property taxes, $10,000, the building insurance, $12,000 common area maintenance, total of $357,000, total over the lease term, you see adds up to $1,785,000.

Now it depends on the accounting policy election as to how we will ultimately account for that. So let's go to the next slide and assume first, the lessee does not elect that practical expedient. In other words, they account for the lease and non-lease components separately. So the table you see here lists the components, the standalone prices for each component and the contract consideration in initial direct costs that we have allocated to each component. And again, assume these standalone prices or observable prices they found that are charged by other lessors and so on. So we see again in terms of the standalone price we've determined the right to lease space in the building would be valued at 1,750,000. The CAM services will be valued at 92,105 for a total 1,842,105. So the lease the right use, the space represents 95%; the CAM services are 5%. We apply 95% of the total 1,785,000 consideration to get the amount allocated to the lease component. We get 1,695,750, 5% of the 1,785,000 to the non-lease component, which is 89,250. We allocate the initial direct cost in the same way, 95% of it to the lease component, 5% of it to the non-lease component. Now we go to the next slide, we'll see the results of our initial lease liability and right of use asset. So again, assuming the same 5% rate the lessee would determine their lease liability by calculating the present value of the allocated lease payments; five payments of $357,000 times 95% discounted at 5%, we would get a lease liability of 1,541,759. Then the right of use asset would be the lease liability plus the allocated portion of the initial direct cost of $9,500 for a total of 1,551,259. The 89,750, which is the contract consideration on any initial direct costs allocated to the non-lease component. The common area maintenance would be recognized over the five-year term of the lease probably on a straight-line basis, unless there were some other rationale for spreading that in some other way. So that is taking those facts and assuming the lessee did not elect the practical expedient to combine these things.

Let's go to the next slide. Now assume the lessee does elect that accounting policy to not separate the lease component from the non-lease components. In this case, there would be only one unit of account, which would include the right to use the building as well as the common area maintenance. So we don't need to go through that allocation process. We simply determine the lease liability by calculating the present value of the five payments of 357,000 discounted at 5%, our initial lease liability would be 1,622,904 for the right of use asset and would be that lease liability plus the initial direct cost of 10,000 for a total right of use asset of 1,632,904.

So hopefully putting some numbers with that. You see the difference it makes, number one in identifying lease components versus non-lease components versus non components. The implication for the accounting, ultimately the implications on the lease liability and the right of use asset, and also the implications for electing or not electing that practical expedient related to separating those components.

So to kind of wrap it all up on Topic 842 applies only to lease components. A lease component is the right to use an underlying asset that meets the definition of a lease. A non-lease component transfers some other good or service to the lessee that's separate from the right to use the underlying asset. And then ultimately, only activities that convey the right to use an asset or transfer some other good or service are considered components, and therefore, have consideration allocated to them. Any other activities would be considered non-components, which would have no impact on the initial lease liability or right of use asset.

Lease Components

by J. Russell Madray, CPA, CGMA

The initial and subsequent measurement guidance in Accounting Standards Codification (ASC) 842, *Leases*, applies only to lease components. So, after determining that a contract is or contains a lease, the lessee will need to identify the separate lease and non-lease components within the contract. A lease component is the right to use an underlying asset that meets the definition of a lease. A non-lease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. Only activities that either convey the right to use an asset or transfer a good or a service to a lessee are considered components in a contract. Therefore, administrative tasks undertaken by lessees and lessors to set up a contract, and a lessee's payments to reimburse the lessor for costs incurred in connection to the contract, do not represent separate components of a contract; in other words, they are non-components.

Lease Components

A lease component is the right to use an underlying asset (or the right to use multiple underlying assets) that meets the definition of a lease. Accordingly, when there is a right to use multiple assets, the lessee must determine whether each right to use an underlying asset represents a separate lease component for accounting purposes. This evaluation centers on two criteria that must be met in order to account for a lease component separately from other lease components in a contract:

1. The lessee can benefit from the right to use the underlying asset either on its own or with other "readily available" resources.

2. The right to use the underlying asset is neither highly dependent on, nor highly interrelated with, rights to use other underlying assets in the contract.

The criteria above may look familiar—they are very similar to the criteria in ASC 606, *Revenue from Contracts with Customers*, related to performance obligations. In the Basis for Conclusions of Accounting Standards Update (ASU) 2016-02, *Leases*, the FASB noted that the identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer (or a lessee) is contracting for a number of separate outputs (rights of use in the case of leases) or, instead, contracting for a single output that incorporates a number of different inputs. Therefore, the criteria should be applied in a similar manner.

For purposes of the first criterion, the lessee should focus on whether an underlying asset can be used on its own, or whether using the asset requires other inputs or interfacing with other assets. ASC 842 describes "readily available resources" as goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).

For purposes of the second criterion, the lessee should focus on whether each right of use significantly affects the others. The following example is adapted from ASC 842-10-55 and illustrates how a lessee would apply these criteria in a contract to use construction equipment.

Example 1 – Identifying Separate Lease Components

Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. Lessee concludes that the leases of the bulldozer, the truck, and the crane are each separate lease components because both of the criteria above are met:

a. Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or crane to use with the bulldozer).

b. Despite the fact that Lessee is leasing all three machines for one purpose (that is, to engage in construction operations), the machines are not highly dependent on or highly interrelated with each other. The machines are not, in effect, inputs

to a combined single item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations, and Lessee's ability to derive benefit from the lease of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from Lessor.

If a right to use an underlying asset does not meet the two criteria for separation, it must be combined with another right of use, so that the combined right of use meets both criteria. The combined right of use is then accounted for as a single lease component.

ASC 842 also requires an entity to account for a right to use land as a separate lease component, even if the separation criteria above are not met, unless the accounting effect of doing so would be insignificant (e.g., separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant). The FASB decided that land, by virtue of its indefinite economic life and non-depreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met. Importantly, the guidance for leases involving land under ASC 842 differs from the legacy guidance for leases in ASC 840, *Leases*, involving land and buildings that do not meet the legacy transfer-of-ownership or bargain-purchase-option classification criteria. Under ASC 840-10-25-38(b), if the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessee would combine the land and the building and account for them as a single lease component. Under the new guidance in 842-10-15-29, this expedient is no longer available. An entity leasing land and other assets must account for the right to use land as a separate lease component, unless doing so would have an insignificant effect on the accounting.

Non-Lease Components

A non-lease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. Many contracts contain both lease and non-lease components. The following are some examples of potential non-lease components:

- Maintenance services
- Cleaning services
- Repair services
- Common area maintenance services (e.g., plowing snow from the parking lot or cleaning exterior windows in an office building)
- Goods related to the leased asset under a supply agreement (e.g., toner for a leased copy machine)
- Utilities for leased office space

There is a difference between how the lessee treats maintenance services related to the underlying asset under ASC 840 compared to ASC 842. Under previous guidance, lessees treated maintenance of the underlying asset as an executory cost, which was considered part of, and included in, the accounting for the lease. For example, common area maintenance provided by the lessor in the lease of building space was considered an executory cost under ASC 840 and included in the lessee's accounting for the lease. However, under ASC 842, maintenance of the underlying asset is considered a non-lease component, and unless the lessee elects the accounting policy to combine a lease component with the related non-lease component(s) (see below), the lessee should account for the maintenance services (i.e., the non-lease component) separate from the lease.

ASC 842-10-55-33 also indicates that warranties provided by the lessor should be evaluated. Generally, warranties with respect to the performance of the underlying asset or to effectively protect the lessee from obsolescence of the underlying asset are not considered non-lease components. However, if the lessor's commitment is more extensive than a typical product warranty, it might indicate that the commitment is providing a service to the lessee that should be accounted for as a non-lease component.

Practical Expedient

When a contract includes both lease and non-lease components, the lessee either: (a) separates the lease components from the non-lease components or (b) elects an accounting policy by class of underlying asset to not separate non-lease components from lease components and, instead, to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.

While electing the accounting policy means the lessee does not separate lease components from non-lease components, it also means that the contract consideration that would otherwise be attributable to the non-lease components are included in determining the lease liability and right-of-use (ROU) asset recognized by the lessee. In other words, electing the accounting policy will typically result in the lessee recognizing a larger ROU asset and lease liability than if it had not elected the accounting policy.

Non-Components

Components of a contract include only those items or activities that transfer a good or service to the lessee. In other words, these "non-components" do not provide an additional good or service to the lessee. The following are common examples of non-components:

- Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee
- Real estate or property taxes related to the leased asset
- Insurance that covers the lessor's interest in the asset
- Reimbursement or payment of the lessor's costs
- Shipping, delivery and installation of the underlying asset
- Commitment fees

A lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset. For example, reimbursements for the lessor's real estate taxes (which are owed by the lessor regardless of whether it leases the building) and building insurance (which protects the lessor's investment in the building because the lessor will receive the proceeds from any claim) are not considered a component of the contract because they do not transfer a good or service to the lessee that is separate from the right to use the building. Whether reimbursements of or payments for the lessor's costs are included in lease payments and contract consideration depends on whether the amount of the reimbursement or payment is fixed or variable, and if variable, whether it is based on an index or rate.

A non-component cannot be a unit of account. As such, no contract consideration is allocated to non-components.

Allocation to Lease and Non-Lease Components

ASC 842 requires the lessee to allocate the consideration in the contract to the separate lease components and the non-lease components based on the standalone prices of the lease and non-lease components. If observable standalone prices are available, they should be used for allocation purposes. Observable standalone prices are those that the lessor or similar suppliers charge on a standalone basis. If observable standalone prices are not available, the lessee will need to estimate the standalone prices. In estimating a standalone price, the lessee should maximize the use of observable information to the extent available. A residual estimation approach may be appropriate when the standalone price is highly variable or uncertain.

The lessee will need to reallocate the consideration in the contract either (1) on remeasurement of the lease liability (e.g., a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset); or (2) at the effective date of a contract modification that is not accounted for as a separate contract.

Comprehensive Example

The following comprehensive example, derived from ASC 842-10-55, illustrates how to identify lease components, non-lease components, and non-components and allocate contract consideration.

Case A

Lessor leases 100,000 square feet of an office building to Lessee for five years. Lessor did not give Lessee any lease incentives and there are no renewal or termination options. Lessee will pay $300,000 per year to lease the space. Assume that the contract meets the definition of a lease and that the lease term is five years. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy (i.e.,

the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at $300,000 per year, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year.

In this case, the real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component—the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. Assume the rate implicit in the lease is not readily determinable and therefore Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the lease payments of $1,500,000 (5 payments of $300,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,363,785. Because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized by Lessee as a current period expense when paid.

Case B

Assume the same facts and circumstances as in Case A, except that the fixed annual lease payment is $357,000. There are no additional payments for real estate taxes or building insurance; however, the fixed payment is itemized in the contract (i.e., $312,000 for rent, $35,000 for real estate taxes, and $10,000 for building insurance). As in Case A, the taxes and insurance are not components of the contract. The contract includes a single lease component—the right to use the building. The $1,785,000 in payments Lessee will make over the 5-year lease term are all lease payments for the single component of the contract and, therefore, are included in the measurement of the lease liability. Assume the rate implicit in the lease is not readily determinable and therefore Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,622,904.

Case C

Assume the same facts and circumstances as in Case B, except that the fixed annual lease payment of $357,000 also covers Lessor's performance of common area maintenance activities (CAM) (e.g., cleaning of common areas, parking lot maintenance, and providing utilities to the building). Lessee also paid $10,000 in real estate commissions and legal costs related to the lease negotiation. Assume that these fees meet the definition of an initial direct cost.

Consistent with Case B, the taxes and insurance are not components of the contract. However, the CAM is a component because Lessor's activities transfer services to Lessee. That is, Lessee receives a service from Lessor in the form of the CAM activities it would otherwise have to undertake itself or pay another party to provide (e.g., cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities). The CAM is a single component in this contract rather than multiple components, because Lessor performs the activities as needed (e.g., plows snow or undertakes minor repairs when and as necessary) over the same period of time.

The contract consideration equals $1,785,000, as follows:

	Annual Payment	Total over Lease Term
Fixed lease payment	$300,000	$1,500,000
Property taxes	35,000	175,000
Building insurance	10,000	50,000
CAM	12,000	60,000
Total contract consideration	$357,000	$1,785,000

Case C1:

Assume that Lessee separately accounts for the lease and non-lease components. The following table lists the components, the standalone prices for each component and the contract consideration and initial direct costs allocated to each component. Based on research by Lessee, the standalone prices are observable prices charged by other lessors for similar office space and suppliers of similar CAM.

Component	Standalone Price	Standalone Price Relative to Total of Standalone Prices	Allocated Contract Consideration	Allocated Initial Direct Costs
Lease (right to space in the building)	$1,750,000	95%	$1,695,750	$9,500
Non-lease (CAM)	92,105	5%	89,250	500
Total	$1,842,105	100%	$1,785,000	$10,000

Assume the rate implicit in the lease is not readily determinable and therefore Lessee uses its incremental borrowing rate of 5%. Lessee determines its lease liability by calculating the present value of the allocated unpaid lease payments of $1,695,750 (5 payments of $357,000 x 95%), discounted at 5%, to arrive at the lease liability initial measurement of $1,541,759.

Lessee's initial measurement of its ROU asset is $1,551,259, calculated as follows:

> Lease liability ($1,541,759) + Initial direct costs ($9,500) + Prepaid lease payments (none) – Lease incentives received (none)

The $89,750 ($89,250 of contract consideration and $500 of initial direct costs) allocated to the non-lease component (CAM) are recognized over the 5-year term of the lease.

Case C2:

Now, assume that Lessee elects the accounting policy to not separate each lease component from the non-lease components related to it. In this case, there is only one unit of account, which includes both the right to use the space in the building and the CAM. In this case, Lessee determines its lease liability by calculating the present value of the unpaid lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability initial measurement of $1,622,904.

Lessee's initial measurement of its ROU asset is $1,632,904, calculated as follows:

Lease liability ($1,622,904) + Initial direct costs ($10,000) + Prepaid lease payments (none) – Lease incentives received (none)

Lease Component

The lessee can benefit from the right to use the underlying asset either on its own or with other "readily available" resources

The right to use the underlying asset is neither highly dependent on, nor highly interrelated with, rights to use other underlying assets in the contract

Example 1 – Identifying Separate Lease Components

Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term

Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources

Despite the fact that Lessee is leasing all three machines for one purpose, the machines are not highly dependent on or highly interrelated with each other

Examples of potential non-lease components

- Maintenance services
- Cleaning services
- Repair services
- Common area maintenance services
- Goods related to the leased asset under a supply agreement
- Utilities for leased office space

Examples of non-components

- Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee
- Real estate or property taxes related to the leased asset
- Insurance that covers the lessor's interest in the asset
- Reimbursement or payment of the lessor's costs
- Shipping, delivery and installation of the underlying asset
- Commitment fees

Example 2 Allocation

- Lessor leases 100,000 square feet of an office building to Lessee for five years
- Lessor did not give Lessee any lease incentives and there are no renewal or termination options
- Lessee will pay $300,000 per year to lease the space
- Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building
- The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is
- Lessor is the named insured on the building insurance policy
- The annual lease payments are fixed at $300,000 per year, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year

Example 2 Allocation

The contract includes a single lease component—the right to use the building

Assume the rate implicit in the lease is not readily determinable and therefore Lessee uses its incremental borrowing rate of 5%

Lessee determines its lease liability by calculating the present value of the lease payments of $1,500,000 (5 payments of $300,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,363,785

Example 3

Assume the same facts and circumstances as in Example 2, except that the fixed annual lease payment is $357,000.

No additional payments for real estate taxes or building insurance

Fixed payment is itemized in the contract (i.e., $312,000 for rent, $35,000 for real estate taxes, and $10,000 for building insurance)

The contract includes a single lease component—the right to use the building

Lessee determines its lease liability by calculating the present value of the lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability and ROU asset initial measurement of $1,622,904

Example 4

Assume the same facts and circumstances as in Example 3, except that the fixed annual lease payment of $357,000 also covers Lessor's performance of CAM

Lessee also paid $10,000 in real estate commissions and legal costs related to the lease negotiation (initial direct cost)

The taxes and insurance are not components of the contract

CAM is a component because Lessor's activities transfer services to Lessee

Example 4

- The contract consideration equals $1,785,000, as follows

	Annual Payment	Total over Lease Term
Fixed lease payment	$300,000	$1,500,000
Property taxes	35,000	175,000
Building insurance	10,000	50,000
CAM	12,000	60,000
Total contract consideration	$357,000	$1,785,000

Example 4 Case A

Component	Standalone Price	Standalone Price Relative to Total of Standalone Prices	Allocated Contract Consideration	Allocated Initial Direct Costs
Lease (right to space in the building)	$1,750,000	95%	$1,695,750	$9,500
Non-lease (CAM)	92,105	5%	89,250	500
Total	$1,842,105	100%	$1,785,000	$10,000

Example 4 Case A

- Lessee determines its lease liability by calculating the present value of the allocated unpaid lease payments of $1,695,750 (5 payments of $357,000 x 95%), discounted at 5%, to arrive at the lease liability initial measurement of $1,541,759
- Lessee's initial measurement of its ROU asset is $1,551,259, calculated as follows:
  - Lease liability ($1,541,759) + Initial direct costs ($9,500) + Prepaid lease payments (none) – Lease incentives received (none)
- The $89,750 ($89,250 of contract consideration and $500 of initial direct costs) allocated to the non-lease component (CAM) are recognized over the 5-year term of the lease

Example 4 Case B

- Assume that Lessee elects the accounting policy to not separate each lease component from the non-lease components related to it
- In this case, Lessee determines its lease liability by calculating the present value of the unpaid lease payments of $1,785,000 (5 payments of $357,000), discounted at 5%, to arrive at the lease liability initial measurement of $1,622,904.
- Lessee's initial measurement of its ROU asset is $1,632,904, calculated as follows:
  - Lease liability ($1,622,904) + Initial direct costs ($10,000) + Prepaid lease payments (none) – Lease incentives received (none)

GROUP STUDY MATERIALS

A. Discussion Problems

1. Describe what is a "lease component."

2. Discuss the accounting for the right to use land under both ASC 840 and ASC 842.

3. Describe what is meant by a "non-lease component" and provide several examples.

4. Discuss the practical expedient related to lease and non-lease components.

5. Describe the concept of a "non-component" and provide several examples.

B. Suggested Answers to Discussion Problems

1. A lease component is the right to use an underlying asset (or the right to use multiple underlying assets) that meets the definition of a lease. Accordingly, when there is a right to use multiple assets, the lessee must determine whether each right to use an underlying asset represents a separate lease component for accounting purposes. This evaluation centers on two criteria that must be met in order to account for a lease component separately from other lease components in a contract:

   - The lessee can benefit from the right to use the underlying asset either on its own or with other "readily available" resources.
   - The right to use the underlying asset is neither highly dependent on, nor highly interrelated with, rights to use other underlying assets in the contract.

2. ASC 842 also requires an entity to account for a right to use land as a separate lease component, even if the separation criteria above are not met, unless the accounting effect of doing so would be insignificant (e.g., separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant). The FASB decided that land, by virtue of its indefinite economic life and non-depreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met. Importantly, the guidance for leases involving land under ASC 842 differs from the legacy guidance for leases in ASC 840, Leases, involving land and buildings that do not meet the legacy transfer-of-ownership or bargain-purchase-option classification criteria. Under ASC 840-10-25-38(b), if the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessee would combine the land and the building and account for them as a single lease component. Under the new guidance in 842-10-15-29, this expedient is no longer available. An entity leasing land and other assets must account for the right to use land as a separate lease component, unless doing so would have an insignificant effect on the accounting.

3. A non-lease component transfers a good or service to the lessee that is separate from the right to use the underlying asset. Many contracts contain both lease and non-lease components. The following are some examples of potential non-lease components:

   - Maintenance services
   - Cleaning services
   - Repair services
   - Common area maintenance services (e.g., plowing snow from the parking lot or cleaning exterior windows in an office building)
   - Goods related to the leased asset under a supply agreement (e.g., toner for a leased copy machine)
   - Utilities for leased office space

4. When a contract includes both lease and non-lease components, the lessee either: (a) separates the lease components from the non-lease components or (b) elects an accounting policy by class of underlying asset to not separate non-lease components from lease components and, instead, to account for each separate lease component and the non-lease components associated with that lease component as a single lease component.

While electing the accounting policy means the lessee does not separate lease components from non-lease components, it also means that the contract consideration that would otherwise be attributable to the non-lease components are included in determining the lease liability and right-of-use (ROU) asset recognized by the lessee. In other words, electing the accounting policy will typically result in the lessee recognizing a larger ROU asset and lease liability than if it had not elected the accounting policy.

5. Components of a contract include only those items or activities that transfer a good or service to the lessee. In other words, these "non-components" do not provide an additional good or service to the lessee. The following are common examples of non-components:

   - Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee

- Real estate or property taxes related to the leased asset
- Insurance that covers the lessor's interest in the asset
- Reimbursement or payment of the lessor's costs
- Shipping, delivery and installation of the underlying asset
- Commitment fees

PART 2. AUDITING

Audit Evidence

SAS 142 on audit evidence will become effective for periods ending on or after December 15, 2022. The current guidance is found in AU-C 500. Audit evidence is information used by the auditor to corroborate or contradict assertions in the financial statements and assists the auditor in reaching a conclusion.

For a look at the guidance on audit evidence and how it may be changing, let's join Kurt Oestriecher, CPA and a partner with Oestriecher and Company in Alexandria, Louisiana, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today we want to talk a little bit about audit evidence and let's start off with where in the guidance our authoritative literature is located.

Mr. Oestriecher

Yes. The key word you said is authoritative, because so often we think of audit evidence as just this theory and that we have a tremendous latitude and we do but there is specific guidance that's in AU-C 500 and the current guidance is based on the clarified standards. There have been various standards over the years and we're all familiar, I hope we're all familiar, now with the fact that SAS 122 to 124 we codified, clarified all existing guidance and that's where we are now. However, the Auditing Standards Board has recently issued SAS 142. And even though it's going to be effective for periods ending on or after December 15th, 2022, it's good guidance to know, 'cause it's more conceptual based. I guess you could say, there's not anything specific in that that says, oh, you have to do A, B, C and D.

It's more about appropriateness and evaluating audit evidence. So throughout this course, we're going to talk about where we are today. And at the end, we will talk about the impact of SAS 142, which again, not a tremendous impact, but there's some good guidance in there. So that's where if you're forever looking at an audit workpaper and determining, have I done enough? I mean, there's a discussion amongst the audit team of do we have enough audit evidence? AU-C 500 is your starting point to make that determination. But I will tell you, it is going to be professional judgment within the concepts that are embodied in AU-C 500.

Ms. Grove Casey

Let's start off by talking about the definition of what audit evidence is.

Mr. Oestriecher

And, that gives that definition. If I were to put 10 auditors in a room of various levels of experience and ask them, please give me your definition of audit evidence. I think I would get 10 different answers and the ones closest to the correct answer would probably be the least experienced CPAs because they're, probably the ones that have recently sat for the CPA exam. They had to look at the definition of audit evidence. When you get an old guy like me involved in that sort of thing, yeah, I remember it. It's just all the stuff that you get to support your opinion. You know, we're very generic, but we do have a specific definition. It is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. That's the first part of the definition.

And it's very important because we never need to lose sight of the fact that everything we do in an audit is to support our opinion from the planning phase of it, to the risk assessment, to the execution of the plan, to the evaluation. It is all to support our opinion. That is what third-party users or regulators are going to use. So that's the first part of the definition. Then it says audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements. So this next part brings to light this very specific and sometimes under respected underlying concept that everything in the financial statements is the representation of management. The auditor does not prepare the financial statements. The auditor does not record the transactions. In a perfect world scenario and

the smaller your audit client, the less perfect your world is, where the client understands your applicable financial reporting framework.

I think for the purposes of this discussion, we'll just call it U.S. GAAP. I think most audits the underlying financial statements are in U.S. GAAP. So management understands the framework with U.S. GAAP. Management has designed their accounting systems so that as transactions are recorded, as journal entries are recorded, as adjustments are made, it is all in keeping with U.S. GAAP and that management asserts to the auditor, yes, we have them all. That's the completeness assertion and we have the proper cutoff. We have proper classifications. We're all familiar with the various assertions. So now it's my job as an auditor to get evidence. Then there's two specific words in there, it either corroborates or contradicts. Now, if we want a nice efficient audit that gets done at the end, hopefully, and we have good management, all the evidence we get corroborates management and their assertions.

And so now we have good sufficient, appropriate audit evidence and we can issue our opinion. However, audit evidence can also contradict. And then that's when you start having discussions with management and those charged with governance. I mean, evidence goes both ways. And I think we need to understand something we learned probably in scientific theory in third or fourth grade, the objective of the auditor is not to find audit evidence that corroborates, it is to find audit evidence, then determine does it corroborate or contradict? And if it contradicts, then we have questions because I know we all like that nice, easy audit where everything I looked at corroborates what management said, I don't have to go back to management and I get the audit out on time. We don't have to do research memos, but we should never design our tests or look for things that just corroborate.

We're actually more concerned with the audit evidence that contradicts. So when we talk later on about what type of evidence we're getting, the sufficiency and appropriateness, we need to understand that with professional skepticism, we should design our procedures I guess that evidence that we find it is better to contradict, but if it doesn't, then that's even better than just finding something that says, oh yeah, just corroborate. So that is the definition of audit evidence. And if we wanted to have a basic exercise at the beginning of every audit, when you start what we call the field work phase, the audit evidence gathering phase we could channel John Wooden, the legendary UCLA basketball coach. I think if anyone follows basketball or knows anything about John Wooden every year, he started his first practice by teaching his All-Americans, ‘cause everyone that went to UCLA was All-American, how to properly put on their socks and tie their shoes so they don't get blisters, something as basic as that.

But even for us, we need to remember when we're going out in the field, it's not to get pretty tick marks. It is the accumulation and evaluation of audit evidence. It is the most important part of the execution of the plan. So understanding this definition before we start, to get your mind right, as to, Hey, this is what we're doing, would not be a bad exercise. Now, even though I will tell you, we don't sit there and recite this before we go out on the audit field work and just start challenging the client, it should always be in the back of your mind as to what am I doing out here? Not just making pretty tick marks.

Ms. Grove Casey

Well, and we want to be in that objective frame of mind, right? So that you're not already swayed in one direction or the other when you're going to do the collection.

Mr. Oestriecher

Yep. Yup. That's the mark of a good auditor.

Ms. Grove Casey

Let's talk about two words that you mentioned sufficiency and appropriateness. Let's talk about the appropriateness first because that's one of the key things; we have to have sufficient, appropriate evidence to support our conclusion.

Mr. Oestriecher

Fortunately, AU-C 500 gives us definitions. Again, you can look at those two words and say, okay, I think that I know what it means, but truly to understand appropriateness every time you are performing an audit procedure ask yourself, what objective am I achieving by performing this audit procedure? And if it's, oh, well it makes this year's work paper look like last year’s work paper then that's really not the answer. Often you will be performing procedures similar to last year in large part because our clients don't change that much from year to year as to the nature of their operations and the types of transactions, but that should not be our

default. We should only arrive at the conclusion that yes, these audit procedures are appropriate after you go through the risk assessment. So from the first part of appropriateness we knew that the measure of the quality of the audit evidence is its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based.

So when you look at the quality, I think there's really three traunches you can look at here. First of all, you look at the type of procedure you're performing. Are you doing inquiry, analytical procedure? You're doing confirmation, observation, inspection, vouching. There's 10 audit verbs out there. I always referred to that as our auditor toolbox. I mean, if you're a carpenter and you're building something and you need a hammer, you're going to need a nail. You're going to need a saw. You're going to need different tools. Well, those are tools. So what type of procedure are we going to do then? You have to look at what type of evidence are you examining when you're doing that. Obviously, if you are observing something that is happening, such as an inventory observation, obviously that's the most obvious, then you or your tool, if you will, that is evidence that is directly obtained by the auditor.

So it doesn't come internal from the organization. It does not come external from a third party, such as a confirmation. That is me using my eyes, my ears, my ability like analytical procedures. That's the end that I guess you could say is auditor designed evidence, okay. Internal evidence. This is evidence that comes from the client itself. So this could be a purchase order. This could be a sales invoice that they sent to someone outside and internal evidence is generally not as, I shouldn't say well-regarded, it is not considered as appropriate as external evidence for certain types of procedures. Certainly for some procedures it is the way you want to go. But obviously if I'm getting something external to the organization, such as a bank confirmation or looking at a bank statement that I go to a website of a bank, we consider that to be external evidence.

An invoice from a vendor is external evidence. External evidence typically carries greater weight than internal evidence because a third party typically has no reason to doctor a document or produce a document that has false information in it. Of course you have internal, external evidence that is something again an invoice is a good example there it comes from a third party, but then it's handled internally by management or people in the accounting department. And again, it carries weight. And then when you're looking at some of these physical documents especially in the post COVID-19 era the question comes up, well, do I have to look at the original document? Or, what if the client just sends me a PDF because we're no longer auditing onsite. And I send the client an email request and say, I need the invoices for these 125 transactions, and they put it in Dropbox. And there's still some people that believe that, Ooh, that's not quite as good as if you actually physically inspect the document. Well in today's world, even before COVID-19 many of our clients, and remember I come from a pretty small firm everything's digital now anyway, they never received paper from their client.

Ms. Grove Casey

I was thinking maybe a screenshot of the account from their screen. You can get a screenshot of the PDF of the statement or the account balance.

Mr. Oestriecher

And that is audit evidence. Now, again, it's not as good as if I had called the vendor and said, could you please give me a copy of invoice 1073-2, and then, compare that to what was recorded by the client. But when you look at the risk assessment and the nature of the item, most of the time, I'm okay with that screenshot, like you said, or a copy. So again, all evidence is available to you and based on whether it's internal, external, all these things that we just talked about, then you, as the auditor, have to determine how appropriate that is based on what you're auditing, the risk assessment. We'll talk about sufficiency next. Obviously, the more audit evidence you're getting the better, of course, if you're getting the wrong kind of evidence, it doesn't matter how much you get. If you're watching the wrong thing, it doesn't matter.

But evidence is evidence. . . . I'm sure most people out there watching the TV shows, you know, Law and Order and, or you've actually I hope not having had to be in a criminal trial on a court case, but, you know, defense attorneys always get evidence thrown out because he didn't have a proper search warrant or something like that, so it's inadmissible evidence. We don't have the concept of inadmissible evidence in an audit. We can gather all the evidence we have and then we get to use our judgment based on these factors I've just discussed as to how much weight we will provide to that evidence or attach to that evidence. And if we determine that it's still not appropriate or sufficient,

then we go perform other procedures. And I think as the auditor is determining whether or not the audit evidence is appropriate, we always have to remember that we design our audits to get reasonable assurance, not absolute assurance.

Now, obviously the audit is the highest level of service we provide, and so there needs to be reasonable assurance, which is a pretty high threshold, but it's not absolute. So when you're looking at the appropriate end game, you might say, yeah, it'd be better if I could go out and physically observe certain things happening. . . or get that third party confirmation on a payable or something like that. Certainly, it's better audit evidence, but it's also still appropriate. I think in almost every instance that I've seen from a risk assessment to just looking at these documents that have been handled internally and see if it makes sense, because again, we're not fraud auditing. I know that people can make false invoices. It's so much easier now to make a false invoice these days than it was 30 years ago. People have the ability to do that.

But we're not fraud auditors. If management wants to pull the wool over our eyes, they can. So I think we need to remember all of those concepts when we're looking at the appropriateness of audit evidence. The last thing I want to share about this topic, and I have done this, so I'm talking from my own experience, we need to make sure that audit evidence we're gathering achieves our audit objectives. The most common inappropriate audit evidence that I see in workpapers is when people are doing cash disbursements testing. And let's say it's a smaller audit and you have already obtained your understanding of internal controls. You performed your risk assessments and you have determined that you are going to assess control risk at maximum because either the controls aren't properly designed, you don't believe they're operating properly, or you believe that both those things exist, but it's just not efficient.

So you're just not going to rely on internal controls, which means you're going to have a larger sample size. We're about to talk about sufficiency. So you're doing your cash disbursements testing, and you pull a sample of 125 cash disbursements. And some of those were your items above ISI and some of them in the sample were below. And so what I'm looking for in cash disbursements is, is the proper amount recorded? Okay. That makes sense. Is it a proper cut off? Is it a proper classification? And in some cases you might be looking for related party transactions for disclosure. So those are typically the attributes that we're looking for. However, if during your understanding of internal controls and maybe you walk through as you just determined that. Yeah. Well, every invoice is supposed to be signed off on by . . . somebody at the director level, let's just say, or a supervisory level.

So you add another tick mark in the column to say, was the invoice properly approved? That is inappropriate audit evidence because you are not relying on controls. What are you going to do with that information? Let's say that of those 125 items you've tested, 75 of them don't have appropriate sign off. Okay. It doesn't change. If you looked at the invoice and determined that yes, it was the right vendor. It was the right amount and everything. You're not going to do an adjusting journal entry. All you're going to do is now you have a finding for the client to say, whoops, you have a weakness in internal controls, but that's not the objective of the audit. In other words, you're not supposed to test control. So I see compliance testing on payroll. People are sitting there looking at doing compliance to see if payroll tax deposits were made on time. Now, if you feel like, Hey, there could be an unrecorded liability because of a penalty, then maybe you need to look at it. But all those types of things, remember we don't compliance audit and we're not testing for controls. And I think in cash disbursements and payroll, and again, I am in the confessional mood now because in my younger years, you see we had 16 column worksheets. That'd be back in the day.

If you're first, you call them--that's the payee, the date, the invoice amount. Well, heck if you had eight other columns left over, you've got to come up with the tick mark for those columns, right or scissors to chop them off, because that reviewer was going to look. But, there was a lot of inappropriate audit evidence. Now it doesn't hurt anything other than make things inefficient. Okay. And then from my standpoint, I questioned, well then did you really know what you're doing in the rest of it? Did you just accidentally get it? So every procedure that you perform to determine if it's appropriate, does it achieve an audit objective? And you have your audit objectives that are linked to your risk assessments. Does it achieve it? And then based on the type of audit evidence you're getting, is it appropriate in the circumstance with the risk assessment?

And if you can't say yes and yes, then you need to say, why am I performing this procedure? And that's what

we've worked very hard in our firm to really focus on those types of procedures. And then every procedure we have a tick mark, you better be able to tell me in your written audit program was this audit program seventh step or eight. And if it's not, and you feel like it was appropriate, then you need to add it to your audit program. So again, the cause and effect of that is when someone is doing their audit based on last year's audit work papers and making this year's look like last year's, and they've never looked at the audit program. So those are some things that we have done in our firm to tighten up and make sure the audit evidence we're obtaining is appropriate in the circumstances.

Ms. Grove Casey

Well, let's take a look at that second part, which is the sufficiency, also known as the weight of your work papers in the past or the size, of the electronic files now.

Mr. Oestriecher

Yeah. That's a size thing. Can you be [weighs with hands], Hey, I got it. It's about right compared to previous years, but I think in this case again, and this is from my experience talking to CPA firms, my experience in our own audit practice, in our firm talking to peer reviewers, this is where, if anything, CPAs obtain too much audit evidence. We all hear the term overauditing. So from a sufficiency standpoint, you say, once I decide, what type of procedure am I going to perform? Am I getting enough audit evidence? And I think sometimes we don't sample enough. Like I have seen bank reconciliations where the audit program says search for old or unusual reconciling items. And there may be 83 outstanding checks and someone has traced all 83 of those outstanding checks to the January or February bank statements to see if it clears, including the transaction for $1.83. You're way, way overdoing it. There you should be looking for other things. So just because you do a lot of work, doesn't necessarily mean you're focusing on the right thing. So don't overaudit. But you have to make sure it is sufficient to support your evidence or your measurement services. So this is where sampling versus testing a hundred percent of the population comes in. And sometimes it is easy to test a hundred percent of the population. We just finished a local governmental audit, very small governmental entity and all their revenues come from one check a month from the local taxing authority. It's a special kind of tax on a certain type of industry. That local taxing authority collects it and then gives it to the economic district. So there are only 12 transactions a year for revenue, and it's very easy to do the audit.

So rather than just sample three or four of them, it would take us longer to document all of our sampling. We can sit there and just look at the file for all 12. I mean, literally in 10 minutes we could have the whole thing done and typically all of these items are above our individually significant items also.

Ms. Grove Casey

So you you'd be looking at them anyway.

Mr. Oestriecher

Right. Look at them anyways. So, just get a hundred percent testing. So like if you only had three asset additions they're all above your limit, you're testing a hundred percent, but when you're not going to test a hundred percent of the population where sufficiency comes into play, where you're sampling. And I think the most common example here is accounts receivable. One of the mistakes people make is they say, okay, we have, $4.8 million in receivables and we pull our sample of ISI.

So anything above a certain amount. Once we did our planning materiality, and we're going to test 100% of those items and you wind up saying, oh, that's $2 million. You know, these 18 receivables were $2 million. So you go, Ooh, well I've covered 2 million of the 4.8, so I'm good. No, you're not, because you have, by definition, eliminated the possibility of $2.8 million of those receivables to ever be selected. So it is not sampling when you just do ISI. The remaining population, that's where you are going to sample to make sure you have sufficiency so that there's a possibility that any one of those receivables could be selected. And this is where you can use judgmental, pure statistical. Most people use PPS, but that's where you look at sufficiency quantity of it. And so there's two places we get into trouble here, one overauditing by looking at every transaction when it's really not feasible to do so, such as the cleared bank account items and two, misapplying the sampling concepts by only stratifying our population between ISI, individually significant items, and non-individually significant items, and then only testing the individually significant items. You do not have sufficient audit evidence if you do that.

Ms. Grove Casey

You can't do that. That's the whole point of stratifying,

Mr. Oestriecher

That's why you do it. So that's where you get quantity. And again, I think here talking to auditors, we tend to be conservative in nature. So we're going to audit it to death. We're going to beat it to death, so it comes to efficiency. If you're spending too much time auditing these areas and . . . looking for those outstanding checks for $8.32 cents, you're kind of missing the forest for the trees where you can better focus your audit evidence on the other areas. So audit evidence does not seem to be as big of an issue as the quality of your audit as the appropriateness of your audit evidence. That's where we seem to have more issues in peer review, where we can do it better.

And I do have one other caveat. You get to apply professional judgment. Don't know where that is. Your job, that you have a license for, I'm assuming I'm talking to licensed CPAs here. Within AU-C 500 there are parameters, but there's a tremendous amount of latitude as to what type of audit procedures to apply. So what is the appropriate audit evidence? What are you looking at, and then sufficiency, but there are, and again, when you get into sampling, there's specific guidance within the standards on audit sampling, that's how you can know that. Yes, even though I have a lot of auditor judgment. I have met these minimum guidelines that are there for us in the standards in the end, when you finish your work paper, you should say, what was I trying to do? Did I get the right evidence? Do I have enough evidence? Document, all your sampling methods and all, then you conclude, you sign off and you move on. And that's the I guess frame of mind that you, as an auditor should be in, when you're evaluating the end product work paper, not got that one workpaper done, what's the next one. So that's again just a mental shift that we're trying and continuing to stress in our firm that that's what we're doing.

Ms. Grove Casey

Well, let's talk a little bit more about the, I don't want to say the prior years, but for continuing clients, it's certainly a different scenario than when it's a first-year client or things have radically changed. Maybe it's a new business, but when you have a continuing engagement, the audit evidence, isn't just, what's in the current work papers, right? We have that binder that carries forward kind of thing. So let's talk about the cumulativeness of audit evidence.

Mr. Oestriecher

And it's not just your permanent file. I mean, if you are relying on the client's internal controls and informational testing controls from previous years, typically you hear the cycle of, we test one third of their controls every three years over a three-year cycle. Now, any new control that's implemented, certainly you would test in the year of implementation. So if you're testing internal controls, I think that it's the most obvious area of the concept of cumulative audit evidence. Now, another factor though, that we often overlook is let's say that you have a high-risk area. So man, you just know, when you look at sufficiency of audit evidence, you're using lower ISI in that area. So you're pulling a lot larger . . . sample size. So instead of testing, 120 documents, you're testing 340 documents in a certain area, but after two or three years, and you find no adjustments in that area, then that's when you can say, okay, yes, this is a complex area.

Whatever drove our risk up, it's still there, but now we can reduce our testing. You're still going to do testing, but you can use that information to reduce your overall sample size, or you start saying, you know what? This year I'll do an analytical procedure in this area because we have found no problems in this last year. There's no changes in the client's business. So instead of detailed testing this year, I'm going to greatly reduce my detailed testing, do analytical procedures and scan the general ledger. That is certainly okay. And then if those analytical procedures as you are scanning lead something to say, I didn't expect that. Now you might go back to the detail, but it is perfectly okay to use prior year audit information or audit evidence to help determine what is appropriate this year. I can't say, well, it was all good last year, so I don't have to do any testing this year. It's the types of procedures that you could modify. And that's that concept of cumulative audit evidence and also the standards.

Talk about the continuation and acceptance that if you've had trouble getting audit evidence in the past, maybe this is time to let that client go. Or as part of your continuance, you are saying, yeah, this is what you arrive at. Obviously, the conclusion for most of your clients, you're always going to have some issues, but most of our clients, fortunately, when we ask for

something, we get it very quickly. So he said, yep, that's a mark in the good box for a client continuance.

Ms. Grove Casey

One of the other things, and certainly this last year has maybe raised this more to the surface. Sometimes we have inconsistencies or doubts about the reliability of the audit evidence. And in some cases, of course, our business environment has changed so dramatically that we may have to do things a little different than we have in the past. Let's talk about what kinds of things we maybe need to do when we have those inconsistencies or the doubts.

Mr. Oestriecher

Right. Who would have ever believed that? I just found out that the CPA that was the department head when I was at Northeast Louisiana university, it's Dr. Hood. he recently passed away in January of 2021 from COVID-19. He actually taught my father when my father was at LSU and in his classes. And he taught, he was an active professor, even though he was department head, if we would've said, yeah, you're going to observe inventory by having a client carrying their phone around and pointing that and saying, yeah, we're at such and such location, he would have banished you to the marketing department and said, you don't have what it takes to be an accountant or an auditor. Real auditors go out there in the rain and snow, but that's the world we're in.

And so I think we're programmed. And I think the older you are, the more you're programmed that, oh, no, you have to do things a certain way. Certainly a video, I guess it's, let's talk about the moon landing didn't really happen or is it recorded in a studio in Utah like some people think, same thing. I mean, if a client can set up something where I've physically observed their warehouse before, if they can go set up a stage somewhere to make it look like the warehouse, and none of that inventory is actually theirs and they were doing this in Duluth, Minnesota instead of in Pineville, Louisiana. Okay. They beat me. So if you have that kind of doubt, then you shouldn't even accept the client. That mean people have talked about that. How do you know that they're actually at the right location?

So you know, have the person filmed the drive all the way over there and watch it, I guess. So in most cases, you're just talking about questions of, Ooh, who, where did this really come from? Is it a related party transaction. So the first thing is modeled by your audit procedures look, perform a different procedure to help corroborate other evidence you've obtained. So maybe you thought one or two types of evidence would be good, but there's a little bit of doubt. So just get more evidence. And then you look at other areas that you got an audit procedure. So maybe it's an issue related to debt. So now you translate, you've also done audit procedures on interest expense and some analytical procedures. So you can also marry those two up to say, and then typically we're doing this anyway, but if there are other areas of the audit that you obtained evidence that also hit on the particular assertions and account balances, where you have these inconsistencies or doubts, that's how you resolve them.

Now, obviously, if you cannot resolve these inconsistencies or doubts, you have a disclaimer of opinion because you can't get sufficient appropriate evidence. And that can happen when you have, we had the hurricanes in Louisiana last year where people had to recreate certain documents. So you wonder where they recreated, certainly that can happen through, through mother nature or other items. So that, that doesn't mean anyone's a bad person. It just means, Hey, if you can't resolve these doubts, you're looking at a disclaimer, not an adverse, but a disclaimer of an opinion.

Ms. Grove Casey

You've mentioned that we have some new guidance here in the form of SAS 142. So let's talk about what kinds of things it made changes to.

Mr. Oestriecher

That was interesting. I'm sure a lot of people out there probably read these standards in their exposure draft forms like you and I do, and look at the background and what the Auditing Standards Board is trying to do. But there's a shift from the design and performance to focus on sufficiency and appropriateness and the concepts have always been there, but that's really what we need to look at because you can design it as well as you want to, but if it's the wrong procedures and you don't have sufficient audit evidence, then you don't have it. So that's what we're trying to focus on now. And that's why I said, even though the standard is not effective until 2022, it's great concepts to apply now. So that's the first thing is, just on the evaluation of it. And then they also give us guidance on automated tools and big data recently in the Journal of Accountancy, there's a good article and then where the tools that are out there that

can help you evaluate extract data. And so we've had these concepts of big data and data extraction for a while. SAS 142 just kind of tells us, it gives us, there's actually specific examples and illustrations of data analytics. It was also talking about, we just talked about remote tools and use of drones, so very specific examples that the way I have read SAS 142 and certainly I'd like to hear your opinion, it now corroborates what we have been forced to do. We got there quicker because of COVID-19, but now we have specific examples and said, yes, you can, you can do this. Is that how you've been interpreting this? That it's almost a ratification.

Ms. Grove Casey

Yes. I think it's a ratification of what we've, I don't want to say forced to do because there were firms that were already doing it, but it certainly corroborates that yes, what we're doing is acceptable and is maybe a best practice because that's what they're giving us examples of.

Mr. Oestriecher

Right, and, I think that's where we're going. It's just a more efficient way to audit. And yes, we understand that if the environment, I mean, I had one, many, many years ago, there was a firm in Kansas that hired our firm to go do inventory observation of cotton bales in the most far-reaching remote places of Louisiana that I didn't even know existed. Okay. It was not only turn off the dirt road, it was turn off the dirt road, off the dirt road. And of course, you're going back in a coat and tie back then, and now they could use, I mean, in the 1980s and early 1990s, the thought of them just having management sitting there with a camera recording, what they're doing well, that's what they do. I would like to be able to fly the drones off over the cotton bales because that's one of the things we had to do is kind of climb up and make sure that they say it's 10 rows across and 20 rows deep that they don't have just the outer shell and that there's flat roll if they're going to get full of cotton.

So it's pretty neat some of the things that we can do to obtain that evidence and I think inventory is a big area where you have the use of the camera tools and things like that. And then again, just some discussion I'm amazed, and our clients are happy also, that we don't spend as much time at their office now. And we were already getting that way in some audits before COVID-19 and we like it because now we don't have to wait and get there at nine o'clock and then we have to leave at 4:30 because it's a government entity, and that's when they close, we can work until 8 or 9 at night and get the other stuff done. So, we have found in our firm that it is much more efficient and these questions came up we were doing this differently than in the past, will our peer reviewers slap us around because of it? SAS 142 says, no, that that's okay. That's still, you know, that's audit evidence. It counts.

Ms. Grove Casey

Yes. Well, and I think that, data analytics is really going to help us out in that efficiency aspect as well, in terms of the sufficiency of our evidence, right?.

Mr. Oestriecher

If you are working on audits that have large volumes of transactions where you can extract data from a general ledger and find unusual spikes in journal entries, and then remember people use journal entries to commit fraud. So if you've identified a high risk that you're a little bit behind the curve if you have not read or educated yourself on data analytical tools, go get a look at the AICPA Journal of Accountancy. And obviously we have through Thomson Reuters lots of volumes of information on that. But that is, that is if you're looking at an auditor to enhance your skills as an auditor to get very good, sufficient, appropriate audit evidence that's an area that you should look at.

Ms. Grove Casey

So do we want to talk a little bit about the professional skepticism because you know, we still do have that, even when we're using these remote observation tools or the drones. I mean, we're not saying don't use your cell phone, but there has to be some best practices in there. And then a little bit of a discussion about our management specialists and maybe even with respect to the data analytics, because I see a number of different certificate programs. I believe the AICPA has one as well about using those big data, right? Finding it and using it, I should say.

Mr. Oestriecher

They actually created a new section, AU-C 501 on management specialists, so using guidance there. So there is some specific guidance out of there. It used to be part of the broad thing of use of a specialist, and now they have management specialist. So that's in AU-C 501. And again, that discussion of professional skepticism we hit on it a little bit earlier in this

discussion, but it wraps it up when you read, like you said, SAS 142, it doesn't say, oh, you need to have filled out this checklist, but it gets back to, we're supposed to be skeptical. We like our clients. Okay. We talk to them about our kids' soccer. They ask about my grandchild now. I mean, so yes, you like them. Ultimately we have to be skeptical. There's that professional skepticism. They should expect it that we question them. We, if there's something that looks unusual, we question them in a nice manner. Okay.

I've always said the three verbs that our clients will use to get rid of us as a lot of people go, oh, it balances. What balance? Oh, it reconciles. So that's stronger if the balance doesn't get there they go to reconcile, then, oh, it cleared. What do you mean by it cleared? Did it clear the bank? To me this concept of clearing, oh, you know, it cleared, what is it? And did it clear the bank? Did it clear? So don't just accept the stock answers that are designed to get you out of their office and move on. So that's what professional skepticism is. If your question's not answered, keep answering, asking in our nice way or in a different way. And if you can't get to it, then that's when maybe you have to go to those charged with governance.

But a lot of times that's the same person in a smaller entity. That's an, you have to start saying, okay, if you can't answer this question, then we're going to have an audit adjustment here, or I have to withdraw from the engagement, or we're going to have a disclaimer of opinion. So you have to have those difficult conversations, but we as auditors and CPAs, when we'd like to be liked, we would like to be nice to people, but professional skepticism says you can do that and do your job just in a very respectful manner. We think that's what we have to, that's what I got from that discussion on it. But there's no, they did not increase the concept of professional skepticism in 142. They just reminded us of the cause of that. That was my interpretation as I read through that portion of the standard.

Audit Evidence

by Kurt Oestriecher, CPA

Introduction

The objective of audit evidence has not changed over the year. An auditor has always been required to obtain sufficient appropriate audit evidence. What has changed is the types of transactions and elements of the financial statements for which an auditor must obtain evidence, and types of audit evidence that is available. This course will explore the nuances of AU-C 500 so that an auditor will better understand what is the most appropriate form of audit evidence and how to properly evaluate that evidence.

Authoritative Guidance

AU-C 500, *Audit Evidence*, is the authoritative guidance for audit evidence for audits conducted in accordance with Generally Accepted Auditing Standards (GAAS) issued by the AICPA. SAS 142, which will be effective for audit periods beginning after December 15, 2022 is the first substantive change to AU-C 500 since the Auditing Standards Board issued the clarity standards. While SAS 142 is not currently effective, the concepts within the standard can be used to improve audit skills immediately. This course will cover current standards and include the concepts of SAS 142 in the discussion.

Definition of Audit Evidence

AU-C 500.06 defines audit evidence as follows:

"Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements."

A key takeaway from this definition is that audit evidence can be obtained to ***either*** corroborate or contradict management assertions. Often, auditors only think of obtaining evidence that corroborates management assertions. While this is the best approach to obtain evidence for many assertions, evidence that contradicts management assertions should be considered when the auditor is obtaining evidence on a financial statement element that has a specific fraud risk or potential for management override of controls. This scenario is most likely to be applied to financial statement elements that are subject to management estimates, such as fair value measurements or other valuation assertions. By developing procedures that test the logical range of management estimates, as well as testing the methodology used by management, the auditor can apply a two-pronged approach to obtain sufficient appropriate audit evidence.

The definition also specifically refers to "assertions in the financial statements". The auditor should always be cognizant of the type of audit evidence being produced, and which financial statement assertion the audit evidence will support. If the auditor cannot identify which financial statement element or disclosure is being tested by the procedure, the suitability of the audit evidence can be questioned.

Appropriateness of Audit Evidence

AU-C 500.06 defines appropriateness of audit evidence as follows:

"The measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusion on which the auditor's opinion is based."

The types of audit procedures ordinarily performed in an audit consist of the following:

- Risk assessment procedures
- Inquiry
- Inspection
- Observation
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

The auditor will determine which type of direct evidence procedure is most appropriate based on the risk of material misstatement for the various audit account classes. In order to make this determination, the auditor should be cognizant of the persuasiveness of

the audit procedure that is selected. For audit areas in which a higher detection risk can be tolerated (when RMM is moderate or low), the auditor may determine that inquiry and analytical procedures are sufficient. When the auditor must set detection risk at low (When RMM is high), more persuasive evidence such as observation and confirmation may be appropriate.

A common mistake in the performance of further audit procedures is the gathering of audit evidence on internal controls in an audit area that the auditor has documented that they will not rely on the entity's internal control. An example is testing the authorization of invoices when testing cash disbursements. If the auditor is not relying on internal controls, the lack or presence of authorization will not change the conclusions reached by the auditor. If an invoice is recorded in the proper account, for the proper amount, and in the appropriate time period, the auditor would not propose an adjustment if the invoice were not properly authorized. Conversely, if there were errors in recording the transaction, a potential adjustment exists even if the invoice is properly authorized.

Another area where inappropriate audit evidence is gathered is testing compliance. If the auditor is concerned about possible unrecorded liabilities due to penalties related to non-compliance, such testing may be appropriate. However, absent such a risk, anytime an auditor is testing compliance with laws or regulations, the auditor may be obtaining evidence that is not appropriate.

If the auditor cannot identify which specific management financial statement assertion is being tested, or which internal control element is being tested (when testing is necessary to support a lower risk assessment due to the reliance on internal control), the auditor should evaluate the appropriateness of the audit procedure performed.

Reliability of Audit Evidence

In determining the appropriateness of the audit evidence obtained, the reliability of such evidence is a key factor. Most forms of audit evidence can be classified as one of the following:

- **Internal evidence** – Documents or other form of evidence that is generated within the auditee and maintained by the auditee. Examples of this type of evidence are receiving reports, purchase orders, and calculations of audit estimates.
- **External evidence** – Documents or other form of evidence that is not executed, prepared or maintained by the auditee. Examples are confirmations and direct inquiry of persons that are not affiliated with the auditee.
- **Internal/external evidence** – Documents that have been initiated either externally or internally and have been used both internally or externally. Examples are payment remittance advices, invoices sent to customers, vendor invoices, and bank statements.

The types of documents listed above typically support the existence of a transaction or obligation, such as a vendor invoice that supports a liability, and are used when inspection or confirmation is the audit procedure of choice. External evidence in most every case will be more reliable than internal evidence. In audit areas for which low detection risk is required, efforts should be made to select audit procedures that utilize external audit evidence when such evidence exists and it is practical to obtain that evidence. An auditor should always be aware that standards require that we obtain audit evidence that allows us to provide ***reasonable*** and not ***absolute*** assurance. There is a cost/benefit for every audit procedure performed, and the more time-consuming audit procedures should be reserved for the audit areas where a high risk of material misstatement has been identified.

If a financial element has physical characteristics that can be observed, such as inventory, an auditor will normally conclude that observation is the most reliable form of audit evidence because the auditor can physically see or touch the asset. However, observation alone may not be sufficient if there is a risk that the inventory or other asset is not owned by the auditee. Additional procedures, such as inspection of titles or deeds may be performed. For audit areas in which there is a significant risk or an identified risk of fraud, an auditor may even determine that a search for public records to support ownership of an asset may be appropriate.

Recalculation and reperformance are audit procedures that are often overlooked for their effectiveness. If an auditor simply relies on amounts presented by the client that are calculated in an internally developed spreadsheet (such as a calculation for the allowance for uncollectible receivables) without recalculating, an error in the spreadsheet could go undetected. It is very

common for employees of an entity to write over formulas in internally developed spreadsheets, thus causing an incorrect calculation. If an auditor determines that it is not necessary to recalculate because the entity protects certain formulas, the auditor is now relying on the IT controls of the client. If those controls are not tested (by determining the formula cells are in fact protected), the auditor cannot make such a reliance and should recalculate.

Analytical procedures are a powerful audit tool that is often underutilized for substantive testing because such procedures are indicators of misstatements instead of direct evidence about the amounts or timing of transactions. However, because analytical procedures provide an overall evaluation of the entire amount reported in an account such as salaries or interest expense, the coverage provided by analytical procedures often more than off-set any limitations of the procedures. For areas that the auditor has determined a low RMM exists, analytical procedure should be considered as a primary audit procedure. If the analytical procedure indicates a misstatement may be present, then other types of audit procedures should be applied.

Inquiry of client personnel without any corroboration is not as reliable as other forms of audit evidence, but that does not mean that this type of audit evidence is useless. For many audit areas, especially related to disclosures, inquiry is the most logical and cost-effective form of audit evidence. An auditor will typically inquire about unrecorded transactions or subsequent events. Because subsequent events are often related to issues that are not recorded in the general ledger, it is difficult, if not impossible, to corroborate a management response to such inquiries. Any inquiry of management that is used as a primary source of audit evidence should be included as a specific representation in the management representation letter.

It is a matter of professional judgement if appropriate audit evidence has been obtained to support the audit opinion. In applying this judgement, the auditor should consider the reliability of the audit evidence as well as the results of the audit procedures when forming a conclusion. The linkage of the nature of the audit procedure to the risk assessment is a critical factor that should also be considered by the auditor.

Sufficiency of Audit Evidence

Sufficiency of audit evidence is the ***quantity*** of audit evidence obtained, and is also referred to as the extent of audit procedures. Over-auditing refers to the gathering of multiple forms of audit evidence, such as applying multiple audit procedures to an account for which low detection risk is acceptable, or testing an entire population instead of using sampling techniques. Under-auditing refers to not gathering enough evidence for audit areas that require low detection risk. Examples of under-auditing or not performing sufficient audit procedures based on the reliability of the audit procedure, using samples sizes that are too small, or sampling when testing the entire population would be appropriate.

Over-auditing occurs when the auditor is not properly planning the audit and critically thinking about the nature of the audit procedures that are appropriate for the risk assessment. The use of sampling techniques should be considered when testing either account balances or transactions. While judgmental sampling is allowed, most auditors will choose a larger sample size than would be required if Probability Proportional to Size (PPS) techniques or pure statistical sampling techniques were utilized. It is far more common to find examples of over-auditing than under-auditing due to the conservative nature of most auditors. However, there are dangers inherent with over-auditing. When an auditor allocates audit resources to areas that have low risk, those resources are not available for audit areas that have a high risk. Most audits have specific deadlines and there is a time window available for the performance of audit procedures. Allocation of audit procedures within that window is vital to ensure that sufficient audit evidence is obtained.

An often-overlooked aspect of auditing is that audit evidence is cumulative. That is, there is some audit evidence that may be obtained in a prior audit period that is still relative to the current audit period. Audit evidence obtained in the understanding of internal controls in prior years can be used to support the auditor conclusion in the current audit period. Inherent risk, and therefore RMM, can be reduced if extensive audit procedures in prior years have yielded no misstatements. This does not mean that the current year balances do not have to be tested, but by decreasing the RMM, the auditor may choose different audit procedures or smaller sample sizes in the current audit.

Impact of SAS 142 on Audit Evidence

Statement on Auditing Standard SAS 142, which will be effective for audit periods ending after December 15, 2022. SAS 142 does not change the concept of audit evidence, but enhances AU-C 500 *Audit Evidence* by addressing emerging technologies and techniques used by both preparers and auditors of financial statements. The concepts of SAS 142 have been incorporated into these materials and for auditors that have evolved their audit procedures and maintained the appropriate level of professional skepticism little may change as a result of SAS 142.

The guidance within this standard does elaborate on issues such as automated tools and techniques as well as the need to establish audit evidence that both corroborates and contradicts management assertions. While the standard is not yet effective, an auditor can immediately improve any audit skills by reading the standard and incorporating the concepts therein immediately.

Summary

The accumulation and evaluation of audit evidence is used to support the opinion of the auditor. With so much emphasis on audit evidence in the planning stages of the audit the last few years, audit evidence from further audit procedures (formerly known as fieldwork), may not have received the appropriate amount of attention from the auditor. An auditor should always critically evaluate the nature, timing, and extent of further audit procedures performed in order to conclude that sufficient appropriate audit evidence has been obtained. A thorough understanding of AU-C 500 (as amended by SAS 142) is necessary in order to ensure that an auditor complies with Generally Accepted Auditing Standards in the United States of America.

GUIDANCE AU-C 500

CURRENT GUIDANCE IS BASED ON SAS 122

SAS 142 IS EFFECTIVE FOR PERIODS ENDING ON OR AFTER DECEMBER 15, 2022

DEFINITION OF AUDIT EVIDENCE

Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements

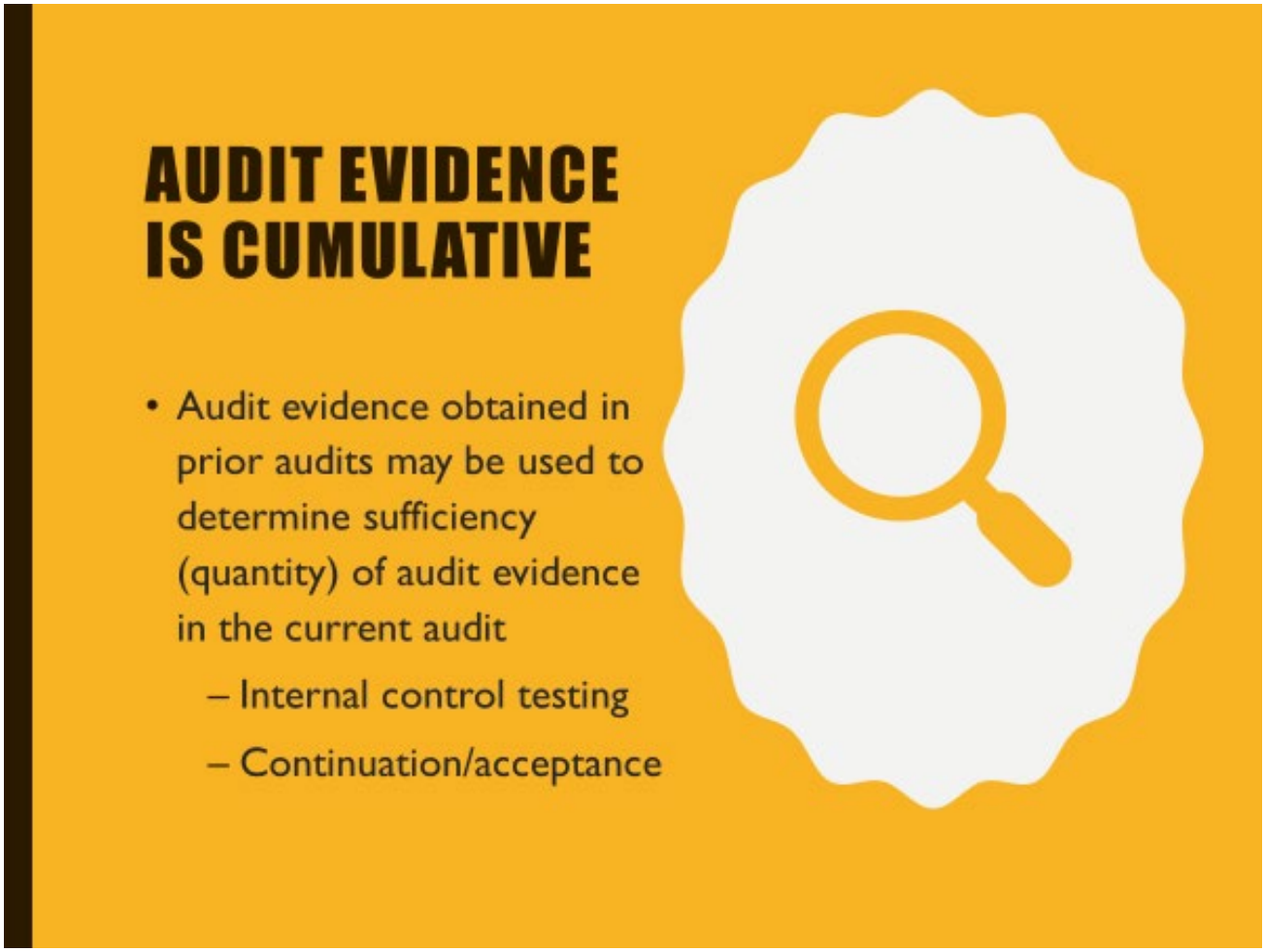
APPROPRIATENESS OF AUDIT EVIDENCE

The measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based

- Internal evidence
- External evidence
- Internal/external
- Original versus copy/image

SUFFICIENCY OF AUDIT EVIDENCE

The measure of the ***quantity*** of audit evidence. The quantity of audit evidence necessary is affected by the assessment of risk of material misstatement and the quality of evidence obtained.


AUDIT EVIDENCE IS CUMULATIVE
• Audit evidence obtained in prior audits may be used to determine sufficiency (quantity) of audit evidence in the current audit
– Internal control testing
– Continuation/acceptance

INCONSISTENCIES/DOUBTS ABOUT RELIABILITY OF AUDIT EVIDENCE

Modify audit procedures

Evaluate audit evidence in relation to other audit evidence obtained in related/corresponding audit areas.

CHANGES AS A RESULT OF SAS 142

- Guidance on evaluating whether sufficient appropriate audit evidence has been obtained
  - Shifts guidance from design and performance of audit procedures to focus on sufficiency and appropriateness

CHANGES AS A RESULT OF SAS 142

Guidance on automated tools and techniques

Provides examples and illustrations
- Data analytics
- Drones and remote observation tools

Broad discussion of professional skepticism

Moves guidance on management specialists to AU-C 501

A. Discussion Problems

1. Discuss the definition of audit evidence and how it has changed with the guidance under SAS 142.

2. Discuss the types of audit procedures typically performed in an audit and how an auditor determines what is most appropriate.

3. Discuss the reliability of evidence and the different forms that auditors typically decide between.

4. Audit evidence must be both sufficient and appropriate. Discuss what is meant by sufficient evidence in an audit.

B. Suggested Answers to Discussion Problems

1. AU-C 500.06 defines audit evidence as follows:

   "Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements."

   A key takeaway from this definition is that audit evidence can be obtained to either corroborate or contradict management assertions. Often, auditors only think of obtaining evidence that corroborates management assertions. While this is the best approach to obtain evidence for many assertions, evidence that contradicts management assertions should be considered when the auditor is obtaining evidence on a financial statement element that has a specific fraud risk or potential for management override of controls. This scenario is most likely to be applied to financial statement elements that are subject to management estimates, such as fair value measurements or other valuation assertions. By developing procedures that test the logical range of management estimates, as well as testing the methodology used by management, the auditor can apply a two-pronged approach to obtain sufficient appropriate audit evidence.

   The definition also specifically refers to "assertions in the financial statements". The auditor should always be cognizant of the type of audit evidence being produced, and which financial statement assertion the audit evidence will support. If the auditor cannot identify which financial statement element or disclosure is being tested by the procedure, the suitability of the audit evidence can be questioned.

2. The types of audit procedures ordinarily performed in an audit consist of the following:

   - Risk assessment procedures
   - Inquiry
   - Inspection
   - Observation
   - Confirmation
   - Recalculation
   - Reperformance
   - Analytical procedures

   The auditor will determine which type of direct evidence procedure is most appropriate based on the risk of material misstatement for the various audit account classes. In order to make this determination, the auditor should be cognizant of the persuasiveness of the audit procedure that is selected. For audit areas in which a higher detection risk can be tolerated (when RMM is moderate or low), the auditor may determine that inquiry and analytical procedures are sufficient. When the auditor must set detection risk at low (When RMM is high), more persuasive evidence such as observation and confirmation may be appropriate.

3. In determining the appropriateness of the audit evidence obtained, the reliability of such evidence is a key factor. Most forms of audit evidence can be classified as one of the following:

   - Internal evidence – Documents or other form of evidence that is generated within the auditee and maintained by the auditee. Examples of this type of evidence are receiving reports, purchase orders, and calculations of audit estimates.
   - External evidence – Documents or other form of evidence that is not executed, prepared or maintained by the auditee. Examples are confirmations and direct inquiry of persons that are not affiliated with the auditee.
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   The types of documents listed above typically support the existence of a transaction or obligation, such as a vendor invoice that supports a liability, and are used when inspection or confirmation is the audit procedure of choice. External evidence in most every case will be more reliable than internal evidence. In audit areas for which low detection

risk is required, efforts should be made to select audit procedures that utilize external audit evidence when such evidence exists and it is practical to obtain that evidence.

4. Sufficiency of audit evidence is the quantity of audit evidence obtained, and is also referred to as the extent of audit procedures. Over-auditing refers to the gathering of multiple forms of audit evidence, such as applying multiple audit procedures to an account for which low detection risk is acceptable, or testing an entire population instead of using sampling techniques. Under-auditing refers to not gathering enough evidence for audit areas that require low detection risk. Examples of under-auditing or not performing sufficient audit procedures based on the reliability of the audit procedure, using samples sizes that are too small, or sampling when testing the entire population would be appropriate.

GLOSSARY OF KEY TERMS

CAM—common area maintenance

ISI—individually significant items

Lease component—right to use an underlying asset that meets the definition of a lease

Non-lease component—transfers a good or service to the lessee that is separate from the right to use the underlying asset

PPS—probability proportional to size

Readily available resources—goods or services that are sold or leased separately by the lessor or, by some other supplier, or resources that the lessee has already obtained again from the lessor from other transactions or events

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FIN 46	Feb-10
SAS 62	Aug-43
SAS 134	Feb-39
SAS 135	Mar-26
SAS 142	Sep-27
SAS 143	Jul-23
SOP 84-1	May 38
SSAE 18	Feb-21
SSAE No. 18	Feb-29
SSAE 21	Feb-22, May 21
SSARS 1	Jul-37
SSARS 21	Jul-37
Topic 210	Aug-3
Topic 323	Feb-16
Topic 360	Jan-8
Topic 606	Sep-4
Topic 805	Feb-16
Topic 840	Sep-5
Topic 842	Jul-5, Aug-28
Topic 850	Aug-43
Topic 852	Feb-16
Topic 952	Jul-6

BY SPEAKER

Speaker	Month
Jennifer Louis	Jan-Aug
Kurt Oestriecher	Feb-May, Jul-Sep
Russ Madray	Jan, Jun-Sep

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

1. According to Russ Madray, the guidance in Topic 842 applies to which of the following?

   A. Lease components.
   B. Non-lease components.
   C. Non-components.
   D. Administrative tasks.

2. According to Russ Madray, how many criteria must be met to account for a lease component separately from another lease component in a contract?

   A. Two.
   B. Three.
   C. Four.
   D. Five.

3. According to Russ Madray, the criteria used in determining if a lease component should be accounted for under ASC 842 by lessors is similar to that in which of the following other accounting topic?

   A. ASC 840.
   B. ASC 606.
   C. ASC 410.
   D. ASC 360.

4. According to Russ Madray, multiple lease components will lead to additional issues with which of the following?

   A. Recognition.
   B. Administrative costs.
   C. Allocation.
   D. Non-lease components.

5. According to Russ Madray, except where the accounting effect is insignificant, ASC 842 requires land to be treated as which of the following?

   A. A non-component.
   B. A separate lease component.
   C. A non-lease component.
   D. Irrelevant to the lease.

Continued on next page

6. According to Russ Madray, under ASC 840 common area maintenance costs would be treated as which of the following?

   A. Part of the right of use asset.
   B. Rent.
   C. Non-lease component costs.
   D. Executory costs.

7. According to Russ Madray, the practical expedient related to ASC 842 allows for which of the following?

   A. Accounting for all of the lease components as a group.
   B. Accounting for all of the non-lease components as a group.
   C. Accounting for each of the separate lease components and non-lease components as a single component.
   D. Accounting for the separate lease components as a group and non-lease components as a single component.

8. According to Russ Madray, which of the following would be a non-component?

   A. Common area repairs.
   B. Property taxes.
   C. Cleaning services.
   D. Snow removal.

9. According to Kurt Oestriecher, the recently issued guidance on audit evidence is found in which of the following?

   A. SAS 122.
   B. SAS 124.
   C. SAS 134.
   D. SAS 142.

10. According to Kurt Oestriecher, when does the new audit guidance on evidence become effective?

    A. For periods beginning on or after December 15, 2021.
    B. For periods ending on or after December 31, 2021.
    C. For periods ending on or after December 15, 2022.
    D. For periods beginning on or after December 31, 2023.

11. According to Kurt Oestriecher, audit evidence does which of the following?

    A. Supports the risk assessment.
    B. Supports the planning.
    C. Supports the opinion.
    D. Supports the workpaper review.

Continued on next page

12. According to Kurt Oestriecher, auditors go out in the field for which of the following?

    A. To get tick marks.
    B. To accumulate and evaluate audit evidence.
    C. To create work papers documenting internal controls.
    D. To reach a conclusion.

13. According to Kurt Oestriecher, which of the following is external evidence?

    A. A purchase order from the client.
    B. A sales invoice from the client.
    C. A bank confirmation.
    D. Analytical procedures performed by the auditor.

14. According to Kurt Oestriecher, which of the following is ***not*** a concept that exists in an audit?

    A. Internal evidence.
    B. External evidence.
    C. Inadmissible evidence.
    D. Audit evidence.

15. According to Kurt Oestriecher, which of the following is a new section in the audit literature related to management specialists?

    A. AU-C 500.
    B. AU-C 501.
    C. AU-C 502.
    D. AU-C 504.

CPE Network®
Accounting & Auditing Report
Volume 34, Issue 8 **September 2021**

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 September 2021 **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
Lease Components	_____	_____	_____	_____	_____	_____
Audit Evidence	_____	_____	_____	_____	_____	_____

Which segments of the September 2021 issue of **CPE Network® A&A Report** did you like the most, and why?

_____

_____

_____

_____

Which segments of the September 2021 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 September 2021 **CPE Network® A&A Report?** Rate each speaker on a scale of 1–5 (5 highest):

	Overall	**Knowledge of Topic**	**Presentation Skills**
Russ Madray	_____	_____	_____
Kurt Oestriecher	_____	_____	_____

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? 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®
CPE Group Attendance Sheet

Firm/Company Name: _____

Account #: _____

Location: _____

Program Title: CPE Network® Accounting & Auditing Report, September 2021 Date: _____

Name	Email	Total Hrs	IRS PTIN ID (if applicable Tax only)	Sign In	Sign Out

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: _____

Group Study PO Box 115008, Carrollton, TX 75011 -5008 Fax (888) 286.9070 cl.tr.com or CPLgrading@tr.com

CHECKPOINT LEARNING NETWORK

CPE NETWORK®
USER GUIDE

Group Live CPE Credit (Sponsored by "Checkpoint Learning Network")

Promotional Information:
CPE Program Sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. If you are delivering this course within your firm, you should complete the following table and circulate it to attendees prior to the classroom course delivery. Refer to the executive summary for certain information noted below. Be sure to include the completed sheet when you request certificates for this event.

Title of Course (Enter full title)	
Date of Class (MM/DD/YYYY)	
Time (Enter time of class)	
Location (Enter location of class)	
Learning Objectives (Refer to executive summary)	
Program Description (Refer to executive summary)	
Instructional delivery method	Group Live
Recommended CPE credit	3.0 Credits
Recommended field of study(ies) (Refer to executive summary)	
Program Level	Update
Prerequisites (Circle One)	• Basic Accounting and Auditing professional experience
	• Basic Tax professional experience
	• Basic Governmental professional experience
Advance preparation	None required
Course registration and, where applicable, attendance requirements (1)	

(1) Insert instructions for your students to register for the class and any other attendance requirements (e.g., bring your laptop, be prepared to work in groups, you will be required to sign in and sign out of the session, etc.

Determining CPE Credit Increments

Group study sessions 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. Discussion leaders must monitor the program length and the participants' attendance in order to request the appropriate numberof CPE credits.

Note: All Network CPE products are developed and intended to be delivered as 3 CPE credits.*

Monitoring 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 CPE group attendance 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 sign the CPE group attendance sheet at the beginning and sign out at the end of the session. If a participant arrives late and/or leaves early, the hours actual hours they attended should be documented on the sign-in sheet and should be reflected on the participant's CPE certificate.

***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 designed by Checkpoint Learning Network. After November 1, 2018, Checkpoint Learning Network will no longer 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).

Note that Checkpoint Learning CPE Network can still be tailored by firms to smaller courses (e.g., 1 credit or 2 credit deliveries); however, when this is done, "Checkpoint Learning Network" cannot act as the sponsor and will not issue certificates of completions to participants. If a firm wishes to tailor (i.e., shorten. lengthen, and/or adjust field(s) of study), the firm delivering the tailored content must become the sponsor and that firm's name and sponsor identification number must appear on the certificates of completion. In these cases, there is no need to send attendance sheets back to Checkpoint Learning Network. If attendance sheets are submitted to Checkpoint Learning Network for modified deliveries as noted above (not withstanding late arrivals and early departures), the attendance sheets will be returned to you.

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 print materials are used, the user should read the materials, watch the DVD, 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 study documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completions should 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

NASBA requires the group study session to include a means for evaluating quality. At the conclusion of the group live session, evaluations should be distributed and collected from participants and sent to Checkpoint Learning Network along with the other course materials. 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

Copyrighted Materials

The 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.

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/

Request Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your group study session should be sent to Checkpoint Learning by one of the following:

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

Email: CPLgrading@thomsonreuters.com

Fax: 888.286.9070

Before sending your package to Thomson Reuters, please be sure to include the following:

___ Promotional Sheet (completed)

___ Group Attendance Sheets (indicating any late arrivals and/or early departures)

___ Subscriber Survey Evaluation Forms

___ Name, title, and credentials of discussion leader(s) entered at the bottom of Group Attendance Sheet

CPE Network Self-Study Options

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

Best Practices Via Teams/Zoom
With the events surrounding the coronavirus many groups are unable to meet in person. Playing the video via Teams/Zoom or other conferencing software is one means of viewing the video. While the video from the Checkpoint Learning online accounts can be played through Teams/Zoom, the user experience will be better if the video files are shared via the desktop, which can be accomplished by copying the files from the DVD to the desktop and then sharing. Please note to enable viewers to hear the video being played follow the below instructions.

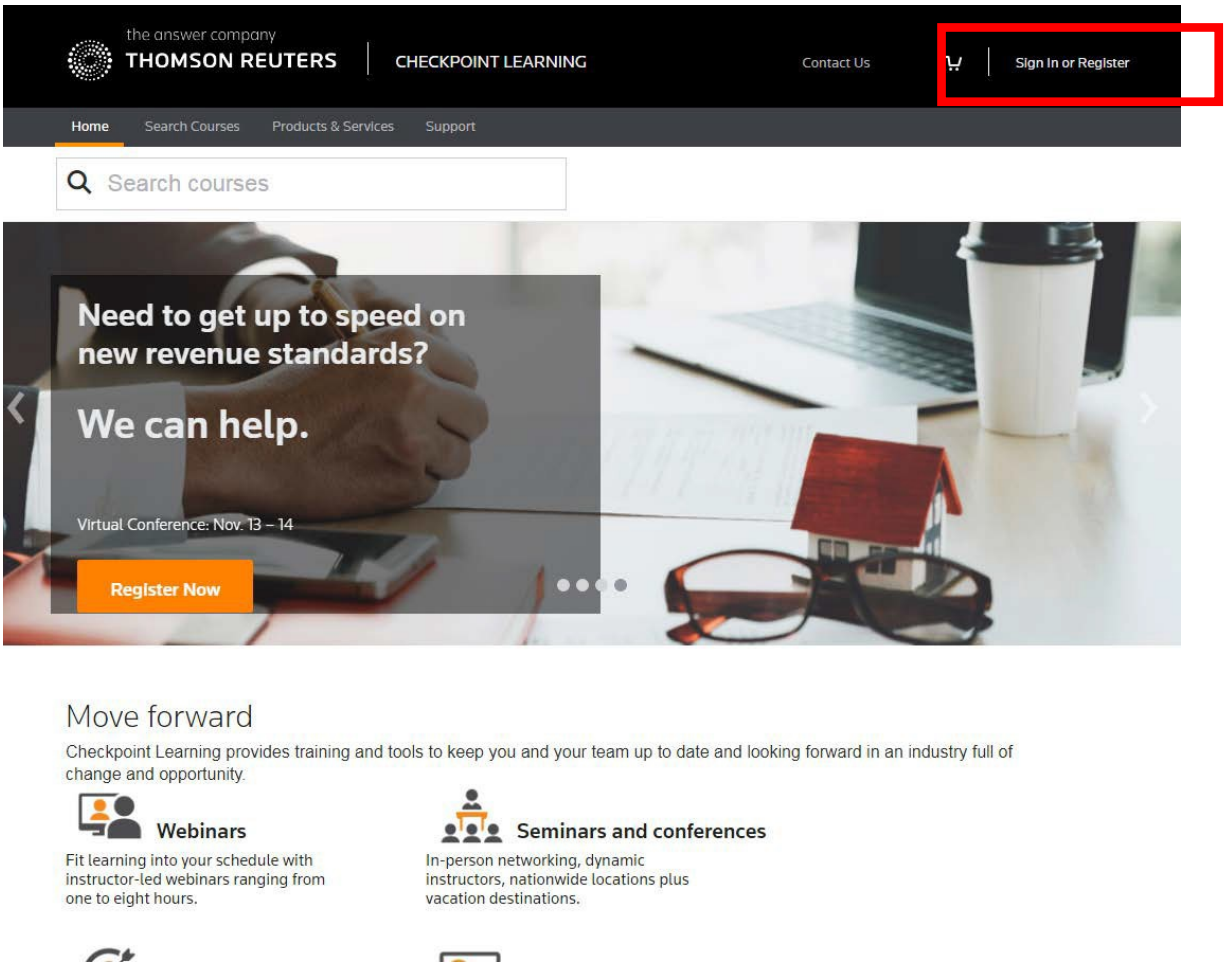
In Teams, when sharing the desktop with others, be sure to check the Share system audio box directly above the desktop to be shared, for the video's audio to be heard by others.

In Zoom, click the Share Screen button in the toolbar. Check the box to Share computer sound at the bottom of the Share Screen popup. Adjust the volume to an appropriate level. Do make sure the video is visible to participants.

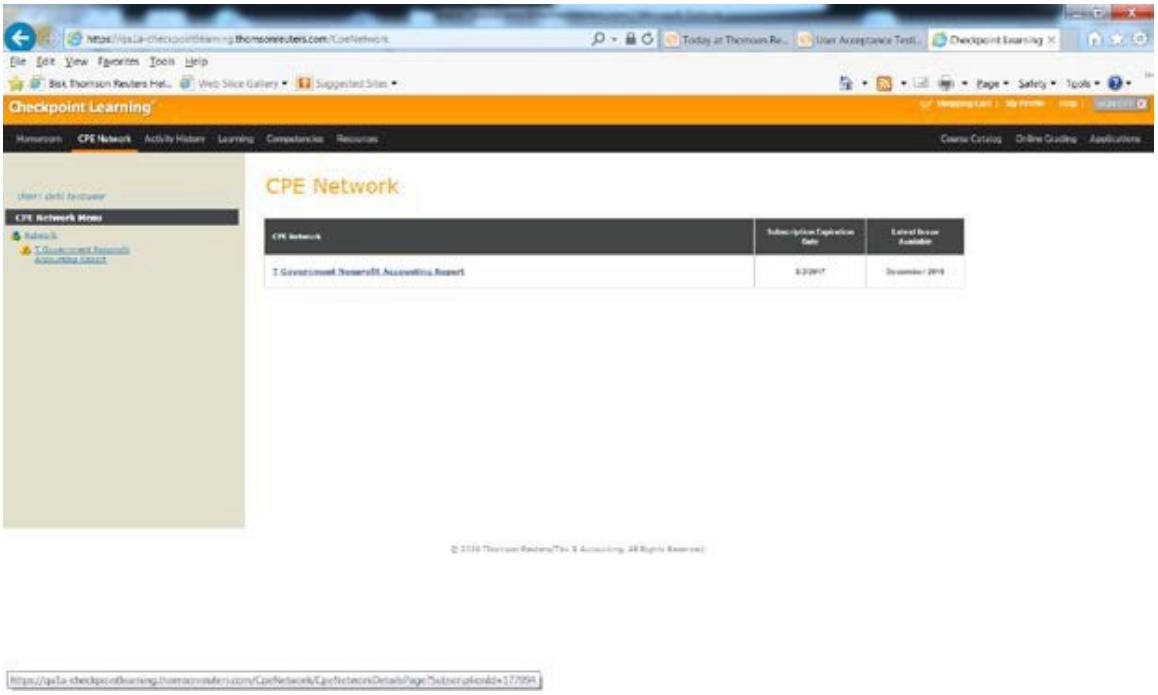
Self-Study—Online

Follow these simple steps to use the online program:

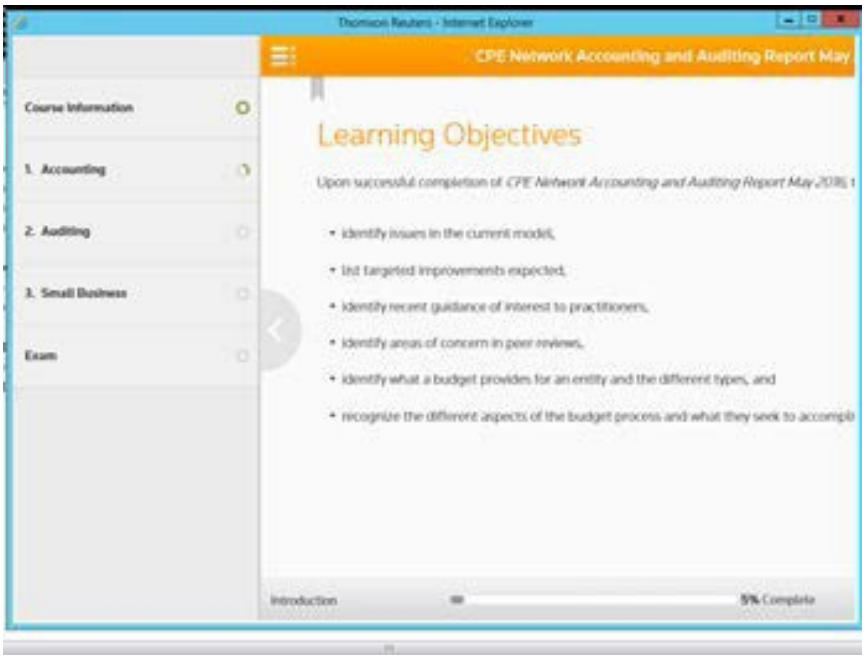
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Sign In or Register").



- In the **Network** tab, select the Network Report for the monthdesired.

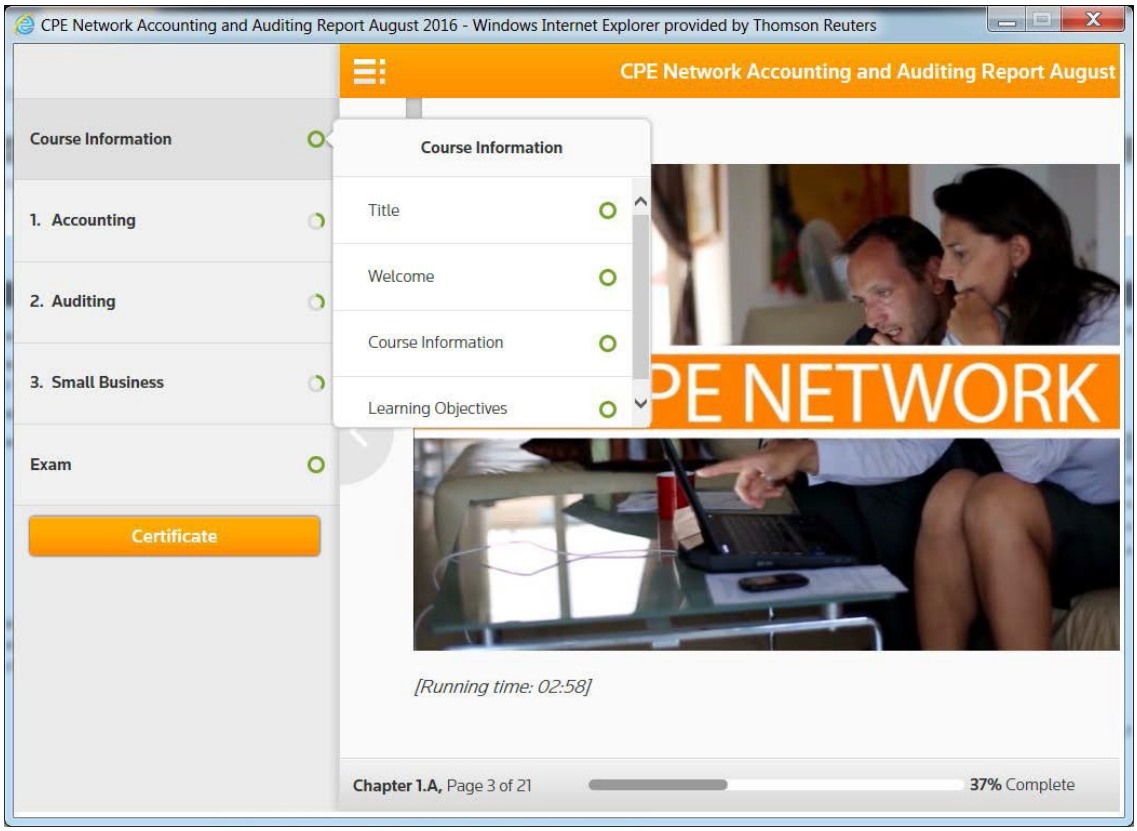


The Chapter Menu is in the gray bar at the left of your screen:

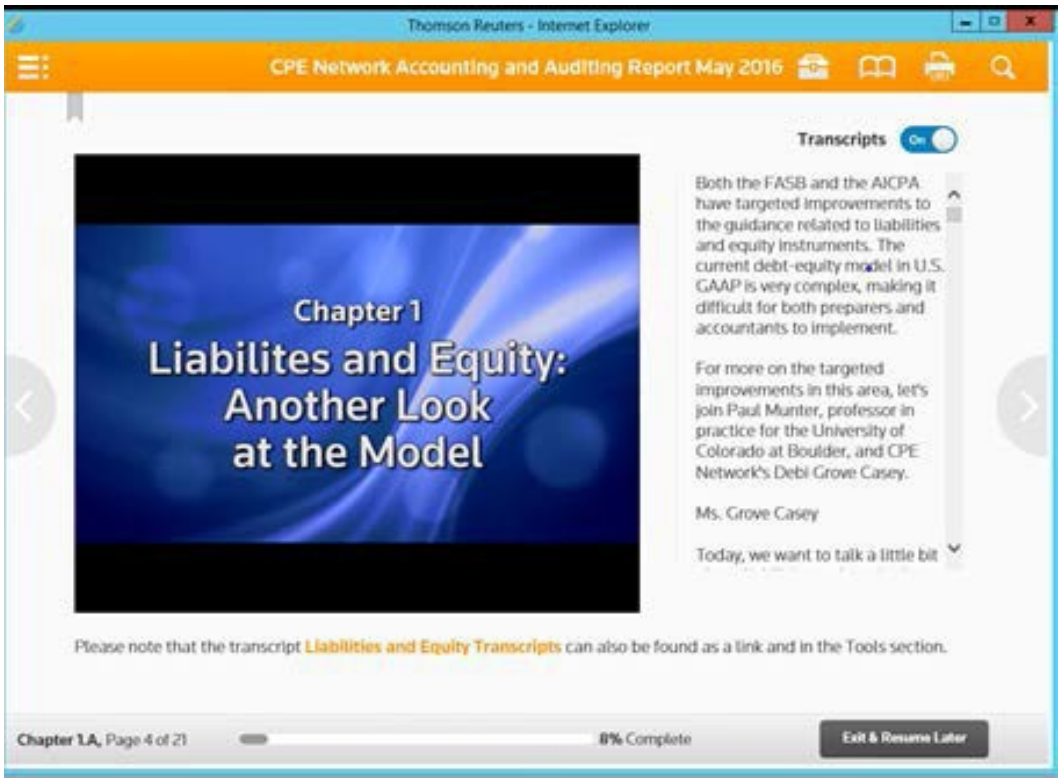


Click down to access the dropdown menu and move between the program Chapters.

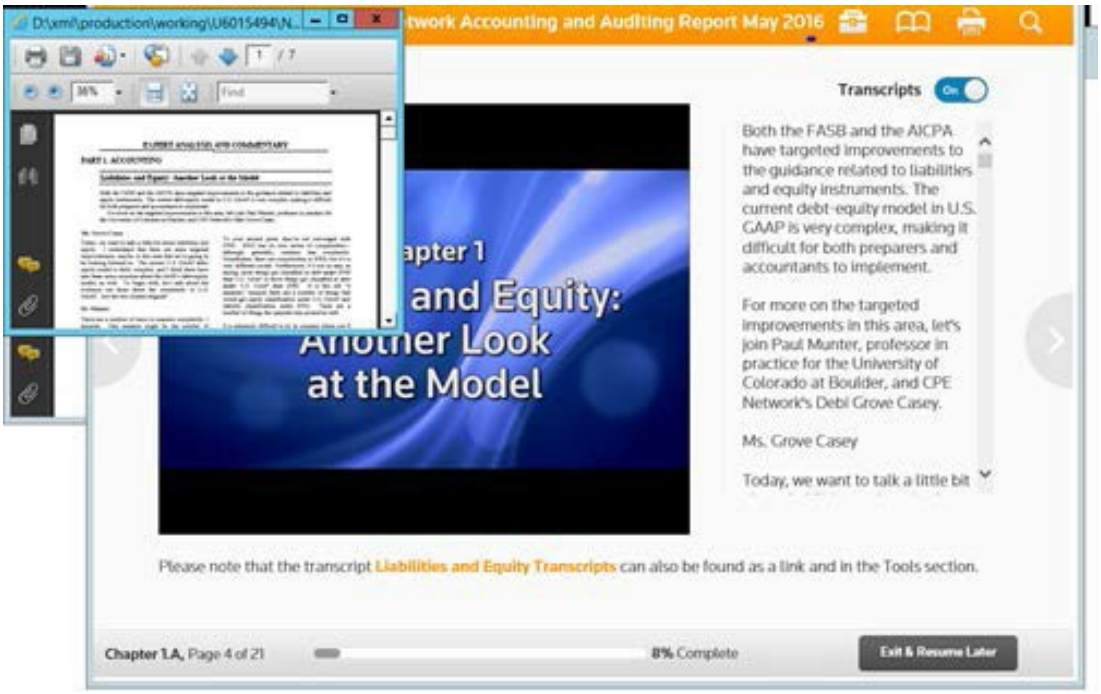
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



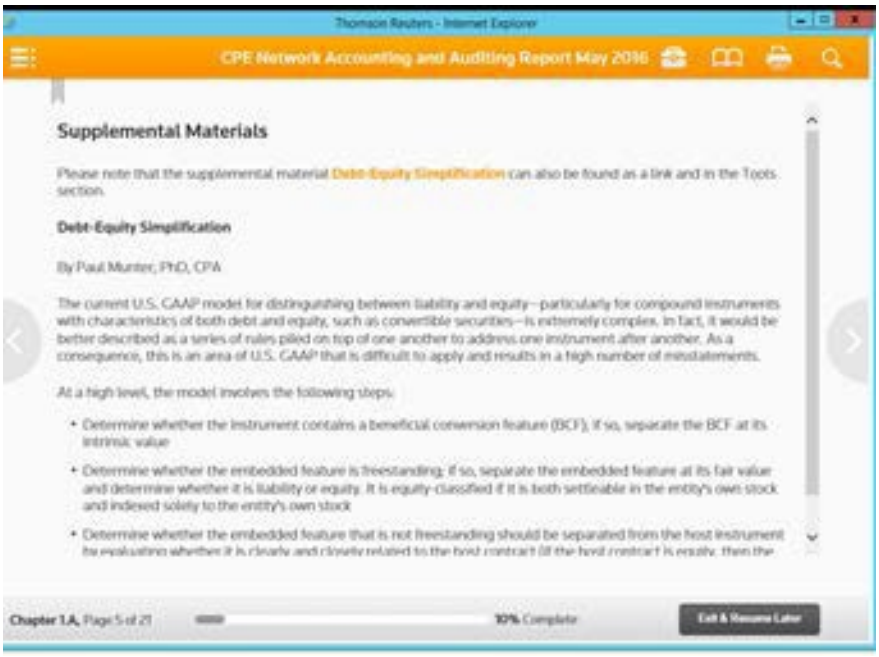
- **Each Chapter is now self-contained.** While on the CPEasy site the interview segments were all together, then all of the supplemental materials, etc., each chapter now contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials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

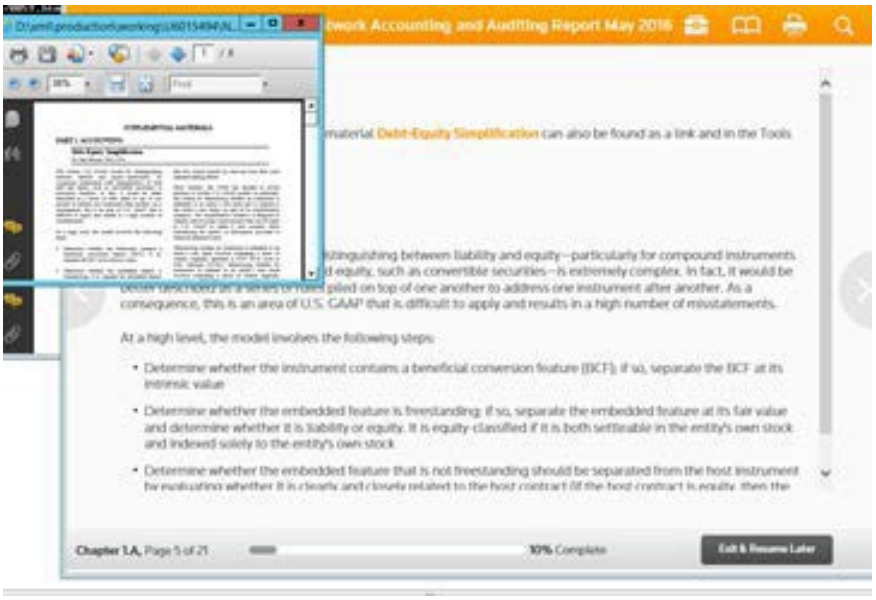


Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled transcripts or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.



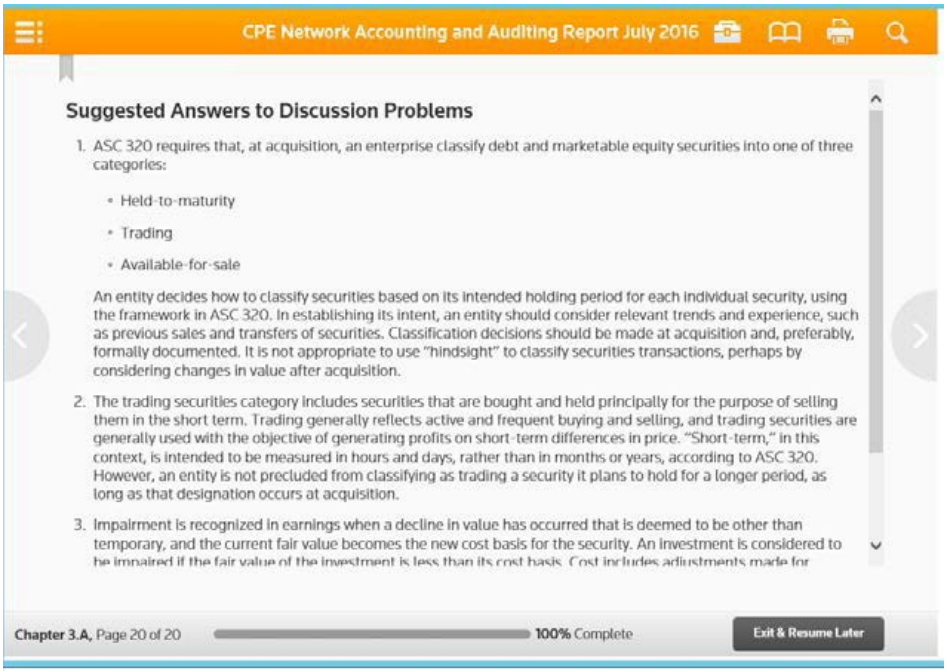
Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.





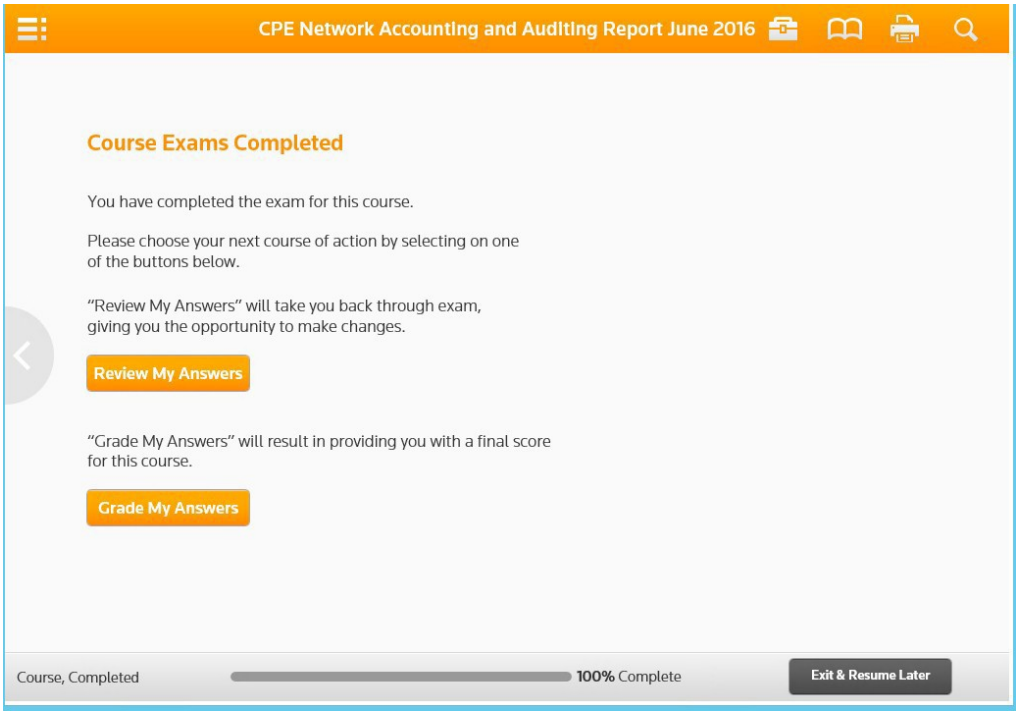
Continuing to click the arrow to the right side of the screen will bring the user to the Discussion p roblems related to the segment.

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



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

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



- Click the button labeled **Certificate** to print your CPEcertificate.
- 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**.

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	• Browser-based • Certificate discrepancies • Accessing courses • Migration questions • Feed issues
Product Support	800.431.9025 (follow option prompts	checkpointlearning.productsupport@ thomsonreuters.com	• Functionality (how to use, where to find) • Content questions • Login Assistance
Customer Support	800.431.9025 (follow option prompts	checkpointlearning.cpecustomerservicet@ thomsonreuters.com	• Billing • Existing orders • Cancellations • Webinars • Certificates

Checkpoint Learning Network: CPE Compliance

Checkpoint Learning Network courses can be group live, group internet based, or self-study. Unless otherwise stated in each course's descriptive information, no other prerequisites or advanced preparation are required.

Checkpoint Learning Network is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: www.nasbaregistry.org.

Checkpoint Learning Network is approved for Group Live, Group Internet Based, and QAS Self Study delivery methods.

Checkpoint Learning Network is an approved IRS Continuing Education Provider to deliver CPE to Enrolled Agents and IRS tax preparers. The IRS Tax Preparer Office requires that any course to be used for IRS PTIN holders must be pre-registered with the IRS. If you are a PTIN holder and are interested in obtaining IRS CE credit, be sure to review the course details in Checkpoint Learning to determine if the course you are considering is accredited to IRS.

What Does It Mean To Be a CPE Sponsor?

Your organization is the CPE Sponsor for this monthly series. The sponsor highlights below 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 attendance of the participants (make notations of late arrivals, early departures, and "no shows")
- Solicit course evaluations from participants
- Award CPE credit
- 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 deliverymethods.
- 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 resolutionpolicy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPEcredits**).**

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 weremet.
2. Prerequisite requirements were appropriate.
3. Program materials wereaccurate.
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 wereeffective.
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

(SAMPLE) Certificate of Attendance (SAMPLE)

This Certifies That:

_____
Participant's Name

Attended:

_____
Course Title

_____
Field(s) of Study and Breakdown

_____
Total CPE Credits

_____
Completion Date

_____
Location (City, State)

_____
Instructor Name(s)

Sponsored By:

_____
Sponsor's Name

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Sponsor's Mailing Address

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Sponsor's Identification Number

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Sponsor's Signature

_____
Sponsor's Signature

In accordance with the standards of the National Registry of CPE Sponsors, CPE credits have been granted based on a 50-minute hour. (Use this Statement if the Sponsor is Registered with NASBA.)

Sample