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CPE NETWORK ACCOUNTING & AUDITING REPORT

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NOTE: As part of the transition to CeriFi, we ask that documentation be sent to CPLgrading@cerifi.com for processing of certificates going forward.

Topics for future editions may include:

- Accounting for Simple Agreements for Future Equity
- SAS 149
- Review Reports

EXECUTIVE SUMMARY

PART 1. ACCOUNTING

Russ Madray, CPA reviews the different bankruptcy guidance available to business organizations and the accounting associated with corporate reorganizations. [*Running time: 39:27*]

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

- Determine which chapter of the bankruptcy code is applicable to reorganizations
- Determine when ASC 852 is applicable and how the financial statements are impacted
- Identify conditions to fresh-start accounting
- Identify the purpose to Subchapter V of Chapter 11

PART 2. AUDITING

Jennifer Louis, CPA looks at fraud trends in special purpose acquisition corporations and cryptocurrency. [*Running time: 34:30*]

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

- Identify the characteristics of SPACs
- Determine the actions taken by the various parties involved in SPACs
- Identify the differences between SPACs and the traditional IPO process
- Identify the risks associated with cryptocurrency
- Determine the rate of fraudulence with regard to crypto-related crimes

PART 3. SMALL BUSINESS

Kurt Oestriecher, CPA, discusses assessing materiality, the requirements related to review engagements, and how it's used in audit engagements.
[*Running time: 32:02*]

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

- Define materiality
- Identify the importance of financial statements and footnotes
- Identify the purpose of SSARS 25
- Identify the percentage typically associated with error related to preliminary materiality
- Determine how materiality is used by auditors

ABOUT THE SPEAKERS

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

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

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

Accounting for Corporate Reorganizations

While bankruptcy law in the United States is codified under Chapter 11 of the Bankruptcy Code, there are two types of filings available to business entities—Chapter 11, reorganization, or Chapter 7, liquidation. Typical Chapter 11 filings are expensive for smaller business entities and sometimes they have difficulty meeting the requirements. In 2019, the Small Business Reorganization Act created a new Subchapter under Chapter 11 that became effective in February 2020.

For more on the new alternatives available to small entities, and the accounting for reorganizations found in ASC 852, let's join Russ Madray, a CPA in Greenville, South Carolina, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today, we want to talk about something that actually is related to a discussion we had a couple of years ago related to the liquidation basis of accounting. The liquidation basis of accounting is used when an entity is going through a Chapter 7 bankruptcy. Today, we are going to take a look at the accounting for an entity that is going through a Chapter 11 bankruptcy, which is slightly different. Typically, those are corporate reorganizations. So, to begin with, can you explain the difference in the Chapter 7 filing and the Chapter 11 filing?

Mr. Madray

Sure. As I think most folks know, bankruptcy law in the United States is codified in federal law under Title 11 of the U.S. Code, typically referred to as the Bankruptcy Code. Under Title 11, there are two types of filings, as you mentioned, for business entities: Chapter 7 and Chapter 11.

Chapter 7 essentially is a liquidation. An entity that has financial issues that are so significant that it really doesn't have any value beyond its identifiable net assets would typically file a petition under Chapter 7. In a Chapter 7 filing, the Bankruptcy Court would assign an independent trustee to manage the business and that process of liquidation. A trustee would usually discontinue the entity's operations and sell its assets to the highest bidder, and then use the proceeds to pay something to the creditors. At completion of that process, the debtor would receive a discharge from its debts. As you mentioned, in a previous discussion we talked about bankruptcy proceedings under Chapter 7 would be accounted for under Topic 205-30, which is the liquidation basis of accounting.

The other type, Chapter 11, however, is by far the most common type of filing for businesses. In a case that is filed under Chapter 11, it is often referred to as a reorganization or a corporate reorganization. In other words, under Chapter 11, the entity is attempting to continue its business by restructuring the debt that existed prior to the proceeding. So, for accounting purposes, a bankruptcy filing under Chapter 11 is not accounted for under the liquidation basis of accounting (obviously), but there is another topic, it is Topic 852, which is reorganizations—a very, very different type of accounting and financial statement presentation that we will talk a bit about today.

One thing, kind of a sidenote here is, as I said, Chapter 11 is by far the most common type of bankruptcy filing for business entities; however, it has been a challenge for small businesses to make use of this type of filing because of the expense and the requirements that are typical for Chapter 11 bankruptcy. In 2019, Congress passed an act called the Small Business Reorganization Act that created a new subchapter of Chapter 11 to make small business reorganizations faster and less expensive. And before we finish up today, I want to circle back around and talk a bit more about what that Act does, and how to make this more accessible to smaller businesses. But first, we are probably going to talk a bit about what this actual accounting side [is].

Ms. Grove Casey

You mentioned that FASB ASC 852 is the appropriate guidance for an entity going through a Chapter 11 filing. Could you give us an overview of that guidance?

Mr. Madray

Sure. Again, it is Topic 852 that addresses the accounting and reporting requirements from entities that have filed a petition with the Court, and also developed a plan to reorganize under the rules of Chapter 11 of the Bankruptcy Code. As you see on the next slide, that guidance in Topic 852 covers entities that are either undergoing a Chapter 11 proceeding or emerging from a Chapter 11 proceeding with a confirmed reorganization plan.

As we mentioned, filings under Chapter 7 would not fall under this guidance. Also, debt restructuring that is taking place outside of Chapter 11 would not fall under this guidance. So, if an entity is simply restructuring its debt by working with its creditors, as opposed to going through the Bankruptcy Court, Topic 852 would not apply to that.

Now, as a sidenote here, even as an entity is going through a reorganization under Chapter 11, that entity would continue to apply U.S. GAAP to recognize and measure transactions. But the issue here is that a Chapter 11 proceeding clearly creates some different information needs for the entity's investors, and creditors, and so on. So, an entity that is undergoing a reorganization under Chapter 11 or has recently emerged (as we will see, there is guidance both during the proceeding and after emerging from the proceeding), will need to comply with some additional presentation and disclosure guidance that we will talk about.

The filing of a petition with the Court begins that reorganization proceeding, and the primary objectives of that proceeding will be to preserve the maximum amount of money to pay back creditors, and then, to restructure the entity in a way that it has a reorganization value and is able to reenter the marketplace.

The entity that is going through a Chapter 11 proceeding would prepare a plan of reorganization to accomplish those two objectives. The plan itself is key to the reorganization because it specifies how the claims of the creditors and equity holders will be handled, and how the entity will be structured after emerging from the proceeding. The plan would then be confirmed by the Court, if the Court determines that all of the conditions we have on this next slide are met.

First, the plan and the plan proponent have complied with the various technical requirements of the Bankruptcy Code (the qualifications for making use of Chapter 11, and so on); that the disclosures made in soliciting acceptance of the plan have been adequate; that dissenting members of consenting classes of impaired claims would receive under the plan at least the amount that they would receive under a Chapter 7 proceeding; that claims entitled to priority under the Bankruptcy Code will be paid in cash; that confirmation of the plan is not likely to be followed by liquidation or another reorganization; that at least one class of impaired claims, apart from insiders, has accepted the plan; and finally, that the plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the so-called cram-down provisions of the Bankruptcy Code. (Under the cram-down provisions, the Court can confirm a plan even if one or more classes of holders of impaired claims or equity securities don't accept it, as long as the Court finds that the plan doesn't discriminate unfairly and is fair and equitable to each of those nonconsenting classes that is impaired by the plan.)

Now, as a sidenote to this, in general, a secured claim would be deemed to be treated fairly and equitably if it remains adequately collateralized and will receive a stream of payments where the discounted value equals the amount of the secured claim on the effective date of the plan. In general, an unsecured claim would be deemed to be treated fairly and equitably if it receives assets where the discounted value equals the allowed amount of the claim, or if the holder of the claim or equity security interest that is junior to the dissenting class will not receive or retain any assets under the plan. An equity security interest would be deemed fairly and equitably treated if that equity interest receives assets where the discounted value equals the greatest of any fixed liquidation preference, or any fixed redemption price, or the value of that interest, or if no junior equity interest will receive any assets under that plan. So, lots of moving parts there in ensuring that the Court will approve the plan of reorganization.

Now, as part of that reorganization plan, the entity will need to evaluate its reorganization value. The reorganization value is the amount of resources that will be available to repay the claims and liabilities that are considered valid in the plan. Generally, that reorganization value would approximate the fair value of the entity before considering any liabilities and would approximate the amount that a willing buyer would pay for the assets of the entity immediately after the restructure. That reorganization value and the terms of the plan would be determined using extensive arm's-length negotiations or litigation between all the interested parties. Of course, there are a number of methods that could be used to determine that reorganization value, but it generally is determined by discounting the future cash flows for that reconstituted business that emerges from Chapter 11 and from the expected proceeds or collections from assets that are not required in that reconstituted business.

As part of this, a disclosure statement is also filed with the Court. The disclosure statement needs to include sufficient information to allow a hypothetical investor to make an informed judgment about the plan. Typically, the disclosure statement will contain a summary of the reorganization plan, historical financial data for the entity, projections regarding the entity's future financial results, and a pro forma balance sheet that would show the value and structure of the entity that would emerge from the reorganization. That disclosure statement also has to be approved by the Court and then provided to all parties that will ultimately vote on the entity's reorganization plan. So, that is how we get to the point of going into a Chapter 11 proceeding. And again, Topic 852 is going to tell us primarily presentation and disclosure guidance for the entity as it moves through that process.

Ms. Grove Casey

When we talked about the liquidation basis of accounting, we talked about how the valuation of things were different. Do the financial statements look different for an entity that is going through a Chapter 11 filing? You just mentioned presentation.

Mr. Madray

Yes, primarily, again, in presentation, because the financial statement of an entity that is going through a Chapter 11 proceeding will need to distinguish between transactions that relate to the reorganization and transactions that relate to the entity's ongoing operations.

We can see these presentation requirements, really, in all of the major financial statements, starting with the balance sheet. As you see on the next slide, an entity that is going through a reorganization would need to segregate these things on the balance sheet: the liabilities that arose before the filing that are subject to compromise by the reorganization, separately from the liabilities that arose before the filing that are not subject to compromise, and separately from the liabilities that have arisen since the filing of the Chapter 11 petition.

An entity that is going through a Chapter 11 proceeding is required to report liabilities at the amount that is expected to be allowed by the Court, even if the entity expects the liability will ultimately settle for less than the amount that is allowed. If there are secured liabilities that could have to be classified as subject to compromise because uncertainties exist as to the amount or quality of that security, then the claim cannot be reclassified until the uncertainty concerning that claim is resolved.

All of the liabilities that existed before the Chapter 11 petition would need to be evaluated using the guidance in Topic 450 related to contingencies. If a liability would need to be accrued, then the liability would be measured at the amount that is expected to be allowed. If the expected allowed claim amount can't be estimated, then that fact would need to be disclosed in the notes to the financial statements.

If an allowed claim is different from the book value of that prepetition liability, the amount of the liability would be adjusted to the amount of that allowed claim and any gain or loss would be presented as a reorganization item in the income statement, separate from those related to ongoing operations. An adjustment is not required if the debt is not a claim subject to compromise in the proceeding (so, a case like a fully secured liability is not going to be subject to compromise and there will be no adjustment made to that). However, as I mentioned earlier, as the proceeding goes forward, the entity might reclassify claims subject to compromise and those not subject to compromise from one category to the other, based on the changing circumstances as we proceed through the Chapter 11 process.

As a sidenote here, Topic 470 requires entities to reclassify certain noncurrent liabilities as current, in particular when the debt becomes callable because of the violation of some provision of the debt agreement. However, for an entity going through a Chapter 11 proceeding, the automatic stay provisions in the Bankruptcy Code would make that type of reclassification unnecessary because creditors aren't allowed; they can't take action to collect receivable once a petition is filed. So, that question comes up quite a bit in these types of filings and it has a fairly clear answer there, that we would not reclassify those as current, even though the debt agreement makes them callable, because of a violation of some part of that.

On the next slide, we have an example, an illustration, of a balance sheet after filing a Chapter 11 petition. You see some things that look a little bit different there. Typically, we would refer to a company in a Chapter 11 proceeding as a *debtor in possession*, as you see in the heading of the balance sheet. Then, the primary difference is down in the liability section. [Under] liabilities not subject to compromise, we have the current liabilities. Then, we have the liabilities that are subject to compromise and further disclosure of what those debts are made up of. Liabilities subject to compromise consist, in this case, of some secured debt, priority tax claims, some senior subordinated secured notes, some trade and other miscellaneous claims, and subordinated debentures. So overall, again, we see the differences in what the balance sheet would look like there.

With the income statement, when going through a Chapter 11 proceeding, the entity would continue to present an income statement that reflects the operations in accordance with the U.S. GAAP, but will need to present any reorganization items, like things we mentioned earlier (gains and losses that arise from the Chapter 11 proceeding, administrative costs, and so on), those are presented separately from the operational items in the income statement. The only exception to this is for discontinued operations that are reported in accordance with the guidance in Topic 205 for discontinued operations—and that is even if they arise directly from the reorganization itself.

According to the guidance in Topic 852, entities cannot defer administrative costs, professional fees, and so forth, relating to the reorganization. Those fees have to be charged to expenses as incurred and reported as such on the income statement. Again, they can't be deferred and then later offset against some gain that might result from the discharge of a liability.

Entities going through a Chapter 11 proceeding report accrued interest only if it is probable that the Court will allow the creditor's claim for that particular interest. Interest expense is not classified as a reorganization item, but interest earned that results directly from undergoing the reorganization (so, generally, all interest that is earned after the Chapter 11 petition), would be classified as a reorganization item.

With all that said, let's take a look at an income statement example (this is taken from Topic 852) on our next slide. Again, we have the company, referred to as a debtor in possession, with typical operational items: revenues, and costs and expenses. We present the earnings before reorganization items and income tax. In this example, a loss on disposal of facilities, professional fees, provision for rejected executory contracts, interest earned on accumulated cash, and then, again, the income tax benefit. Discontinued operations, as I said, is still presented separately, even if it is part of the reorganization proceedings.

Then, the statement of cash flows. Again, entities will present the reorganization items separately within our three categories of operating, investing, and financing activities in that statement. As we know from the guidance of Topic 230 on the statement of cash flows (and Topic 852 repeats this), the direct method for the operating activities section would be a better presentation of the reorganization items. If the entity does choose to present the statement using the indirect method, then they would have to supplement the statement with a schedule or description in the notes that details those operating cash flows that pertain to the reorganization itself.

On the next slide, we have an example from the statement of cash flows. We see we have our cash flows from operating activities, net cash provided by operating activities before reorganization items, and operating cash flows from reorganization items. Then, we have investing activities, we have financing activities, and then, a reconciliation of the net loss to the net cash provided by operating activities, just as we would have in any statement of cash flows.

So, the primary difference for entities that are going through the Chapter 11 proceeding is in the presentation of those items in the balance sheet, the income statement, and statement of cash flows, along with some related disclosures that would be required as they are going through that process.

Ms. Grove Casey

Let's talk a little bit about what happens after they emerge from the Chapter 11 proceedings. Is there specific guidance for the accounting and presentation at that point?

Mr. Madray

Yes, there is. Again, ASC 852 covers the presentation and disclosure during the process, as well as financial statement presentation and disclosure upon emerging from the process. Entities begin to report information post-reorganization as of the date the Bankruptcy Court confirms that reorganization plan.

An entity that is emerging from Chapter 11 applies what is referred to as *fresh-start accounting*. That is applied if all the conditions that we see on the next slide are satisfied immediately before the Court confirms the plan. So, three major things: one, the reorganization value is less than the post-petition liabilities plus the allowed claims; secondly, the former holders of voting shares, under the plan of reorganization, will own less than 50 percent of the voting shares of the emerging entity; and finally, the former voting shareholders' loss of control is not temporary, and the ownership will not revert to those shareholders of the predecessor entity.

So, if these three conditions are met, then the entity will apply fresh-start accounting which, essentially, assigns a new carrying value to every asset and liability of this emerging entity, and they do that in accordance with their business combination guidance in Topic 805. The same way as if you were purchasing a part of a business and assigning that fair value to the identifiable assets, liabilities, and so on. Any excess amounts in this case would be recognized as goodwill. In other words, the assets and liabilities of the successor entity are measured at fair value on the day that the reorganization plan is confirmed.

From the time the entity files the petition for reorganization to the point just before emerging from the process, entities would apply the guidance that we talked about a moment ago with the financial statement presentation and disclosure. Any adjustment that is required from applying that fresh-start accounting or from forgiving the debt would apply to the financial statements of the predecessor entity, not to the new entity that emerges from that reorganization. The successor entity emerges from the reorganization with no balance in retained earnings and no retained deficit.

Importantly, an entity that has emerged from a Chapter 11 proceeding cannot present those post-reorganization financial statements on a comparative basis with financial statements of the predecessor organization. The best way to think of this is an entity that emerges from Chapter 11 is, for accounting purposes, considered to be a new entity, so it would not be appropriate to present anything comparatively with that entity that existed before the reorganization. In fact, beyond not presenting comparative statements, there shouldn't be any kind of discussion or anything in the notes that would describe those statements in a comparative manner or contrast differences with the financial statements because to do so would be like trying to present comparative statements of company A with company B. They are two different entities and two different organizations.

I mentioned a moment ago that an entity will apply fresh-start accounting when it meets those three conditions on the previous slide. Some reorganizations won't satisfy those three conditions and, therefore, will not be able to apply fresh-start accounting. If an entity doesn't qualify for the use of fresh-start accounting, the entity would instead follow the guidelines we have on this next slide. The liabilities that are compromised by the confirmed plan would be adjusted and reported at present value of the amounts to be paid using current interest rates, and any gains from relief of indebtedness would be reported in accordance with the guidance in Topic 220, unusual or infrequently occurring items, and would be presented that way in the income statement. So, you end up with a very different type of accounting if the fresh-start accounting doesn't apply or they don't meet the conditions for that, versus one that does. You really have a brand-new entity, in that case.

Ms. Grove Casey

We haven't talked about disclosures, but I'm assuming that there are some additional disclosure requirements for an entity in Chapter 11.

Mr. Madray

Yes, there certainly are, both as the entity is going through the reorganization process, as well as some disclosures that are required for entities that emerge from that process. First, the ones that are required for entities that are going through the proceedings we see on the next slide. First, we have to disclose any contingent claims that cannot be reasonably estimated, as we talked about earlier under the guidance in Topic 450; the entity will need to report claims by principal categories that are subject to compromise through the reorganization process; the entity would report interest expense at the amount paid or expected to be allowed, to the extent that the amount differs from the amount of interest that is accrued under the prepetition contractual terms; and then, also, should disclose any probable issuance of additional common stock (or any type of equity shares) pursuant to the reorganization plan.

Then, beyond that, as we mentioned when we talked about the statement of cash flows, if the indirect method is used to prepare the statement of cash flows, the entity will need to disclose the details of the operating payments and receipts that are occurring as a result of the reorganization in a supplementary schedule, or in the notes to the financial statements.

On the next slide, we have an example, again taken from Topic 852, that illustrates the disclosures an entity might make after filing a Chapter 11 petition. So, you see some of the narrative about how the petition was filed. It talks about how the debtor continues business operations as a debtor in possession, discloses how the claims are reported differently in the balance sheet, that the debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties, and so on and so forth. I won't read through all of that, but that is just an example of illustrating some of those requirements that are necessary as the entity is proceeding through the Chapter 11 process.

Now, when the entity emerges from the proceedings and applies the fresh-start accounting that we mentioned earlier, three major things need to be disclosed that you see on the next slide: the amount and nature of any adjustment to the historical value of the assets or liabilities, the amount of any indebtedness relief, and also, information related to the determination of that reorganization value, including the valuation method, assumptions, and the tax rates that were used.

On the next slide, we have an example, again, from Topic 852. You see here that on June 30th, 2023, the Bankruptcy Court confirmed the company's plan of reorganization. The company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are adjusted to fair value in accordance with the requirements for business combinations as I mentioned earlier, under Topic 805. The excess of the reorganization value over the fair value was recorded as "reorganization value in excess of amounts allocable to the identifiable assets." Then, it goes through describing how the various items were adjusted.

Then, culminating with a tabular presentation that you see, the Plan of Reorganization and Recovery Analysis summarizes the adjustments that are required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan. So, certainly, there are some significant things to be disclosed during the process, as well as some specific things to be disclosed in the statements for the entity that emerges and applies the fresh-start accounting.

Ms. Grove Casey

Earlier, you mentioned a change in the Bankruptcy Code to make small business bankruptcies faster and less expensive. I think it might be in [Sub]chapter V that I recall hearing about that. Could you tell us about that change?

Mr. Madray

Yes, sure, and I'm glad you brought that back up—I almost forgot. The Small Business Reorganization Act [the Act] created a new subchapter (it is Subchapter V) in Chapter 11 to make these small business bankruptcies faster and less expensive. It applies to businesses that have secured and unsecured debts of less than—this is a very specific number—$2,725,625. The Act took effect in February of 2020 and includes some provisions that will make it easier and faster for smaller businesses to make use of a Chapter 11 filing. On this next slide are some of those provisions.

- Appointment of a trustee. The Act provides for a trustee who would facilitate the small business debtor's reorganization and monitors the debtor's consummation of that plan of reorganization.

- It streamlines the reorganization process. [The Act] removes some procedural burdens and costs that are associated with typical corporate reorganizations. Notably here, only the debtor can propose a plan of reorganization. Small business debtors don't have to obtain approval of a separate disclosure statement or solicit votes to confirm a plan, and generally, there are no unsecured creditors' committees. The Act also requires a debtor to file this plan within 90 days of that bankruptcy filing.

- The Act also removes the requirement that equity holders of the small business debtor provide "new value" to retain their equity interest in the debtor without paying creditors in full. For plan confirmation, the Act only requires that the plan does not discriminate unfairly, is fair and equitable, and provides that all of the debtor's projected disposable income will be applied to payments under the plan or the value of the property to be distributed under the plan is not less than that projected disposable income.

- There is a modification here related to residential mortgages. This new Act removes the prohibition against individual small business debtors modifying their residential mortgages. This Act now allows a small business debtor to modify a mortgage that is secured by a residence if the underlying loan was not used to acquire the residence and was primarily used in connection with the debtor's small business.

- It removes the requirement that the debtor pay administrative expense claims on the effective date of the plan. In a typical bankruptcy, that would be the requirement but, under this Act, a small business debtor can now stretch payment of administrative expense claims out over the term of the plan.

- There are some discharge limitations. In many cases, the Court will grant the debtor a discharge after completion of all payments that are due within the first three years of the plan, or a longer period of the plan that the Court might fix. The discharge relieves the debtor of personal liability of all debts provided under the plan except any debt where the last payment is due after the first three years of the plan, or that is otherwise non-dischargeable. All the exceptions to discharge under the Bankruptcy Code will still apply to the small business debtor—a departure from a typical corporate Chapter 11 filer which, typically, has a more limited set of exceptions to discharge.

So, all in all, the purpose of this Act, as you can see with some of these provisions, makes it a bit more accessible for smaller businesses to make use of a Chapter 11 reorganization. Whereas in the past, many were forced into a Chapter 7 liquidation because they really couldn't make this work, or afford to make this work, in their cases. So, I think it is an improvement in that area of bankruptcy law, at least.

Accounting for Corporate Reorganizations

By J. Russell Madray, CPA

Background

Bankruptcy law in the United States is codified in federal law under Title 11 of the United States Code (Bankruptcy Code), which provides a uniform federal law governing all bankruptcy cases. There are two types of bankruptcy filings under the Bankruptcy Code available to business entities: Chapter 7 and Chapter 11.

In some cases, an entity may have financial issues so significant that it does not have any value beyond its identifiable net assets. In this case, a petition may be filed under Chapter 7. Upon filing, the Bankruptcy Court (Court) assigns an independent trustee to manage the business and the process of liquidation. The trustee usually will discontinue the entity's operations and sell its assets to the highest bidder using the proceeds of sale for the benefit of the creditors. Upon completion of the process, the debtor receives a discharge from its prepetition debts. Bankruptcy proceedings under Chapter 7 are within the scope of Financial Accounting Standards Board *Accounting Standards Codification* (FASB ASC) 205-30, *Presentation of Financial Statements: Liquidation Basis of Accounting*.

However, Chapter 11 is the most common type of filing for businesses. A case filed under Chapter 11 is often referred to as a reorganization proceeding. In other words, a business that files for Chapter 11 protection is attempting to continue its business by restructuring the debt that existed prior to the proceeding. For accounting purposes, bankruptcy proceedings under Chapter 11 are within the scope of FASB ASC 852-10, *Reorganizations—Overall*.

Observation: The benefits of Chapter 11 reorganization have been elusive to many small business debtors given their size and limited financial resources and the expense and requirements of a typical Chapter 11 bankruptcy. However, in 2019, Congress passed the Small Business Reorganization Act (the Act) creating a new Subchapter V of Chapter 11 of the Bankruptcy Code. The purpose of Subchapter V was to make small business bankruptcies faster and less expensive. Generally, the Act only applies to business debtors with secured and unsecured debts of less than $2,725,625. The Act took effect in February 2020.

Reorganization Guidance

FASB ASC 852-10 addresses the accounting and financial reporting requirements for entities that have:

- Filed a petition with the Court
- Developed a plan to reorganize under the going concern rules of Chapter 11 of the Bankruptcy Code

The guidance in FASB ASC 852-10 covers entities that are either:

- Undergoing a Chapter 11 proceeding
- Emerging from a Chapter 11 proceeding with a confirmed reorganization plan

Importantly, the guidance in FASB ASC 852-10 does not apply to the following events:

- Debt restructuring outside of Chapter 11
- Liquidations and plans of liquidation under the Bankruptcy Code

Observation: Even as an entity proceeds through a reorganization under Chapter 11 of the Bankruptcy Code, the entity continues to apply generally accepted accounting principles (U.S. GAAP) to recognize and measure transactions. However, a Chapter 11 proceeding modifies the information needed by an entity's stakeholders. Accordingly, an entity that is undergoing a reorganization, or has recently emerged from it, must comply with additional presentation and disclosure guidelines, as discussed below.

The filing of the petition begins the reorganization proceeding. The primary objectives of the proceeding are to:

- Preserve the maximum amount of money to pay back creditors
- Restructure the entity in a way that it has a reorganization value and is able to reenter the marketplace

The entity prepares a plan of reorganization to accomplish these objectives. The plan is key to the reorganization because it specifies how the claims of creditors and equity holders will be handled and how the entity will be structured after the reorganization. The plan is confirmed by the Court if the Court determines that all of the conditions below are met:

a. The plan and the plan proponent have complied with various technical requirements of the Bankruptcy Code.

b. Disclosures made in soliciting acceptance of the plan have been adequate.

c. Dissenting members of consenting classes of impaired claims would receive under the plan at least the amount they would have received under a Chapter 7 proceeding.

d. Claims entitled to priority under the Bankruptcy Code will be paid in cash.

e. Confirmation of the plan is not likely to be followed by liquidation or further reorganization.

f. At least one class of impaired claims, apart from insiders, has accepted the plan.

g. The plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the cram-down provisions of the Bankruptcy Code (under the cram-down provisions, the Court may confirm a plan even if one or more classes of holders of impaired claims or equity securities do not accept it, as long as the Court finds the plan does not discriminate unfairly and is fair and equitable to each nonconsenting class impaired by the plan).

Observation: In general, a secured claim is deemed to be treated fairly and equitably if it remains adequately collateralized and will receive a stream of payments where the discounted value equals the amount of the secured claim on the effective date of the plan. In general, an unsecured claim is deemed to be treated fairly and equitably if it receives assets where the discounted value equals the allowed amount of the claim, or if the holder of any claim or equity security interest that is junior to the dissenting class will not receive or retain any assets under the plan. Similarly, an equity security interest is deemed fairly and equitably treated if that interest receives assets where the discounted value equals the greatest of any fixed liquidation preference, any fixed redemption price, or the value of such interest, or if no junior equity security interest will receive any assets under the plan.

As part of its reorganization plan, an entity will need to evaluate its reorganization value. The reorganization value is the amount of resources available to repay the claims and liabilities considered valid in the plan. Generally, reorganization value approximates the fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. Reorganization value and the terms of the plan are determined only after extensive arm's-length negotiations or litigation between the interested parties. Several methods are used to determine the reorganization value; however, it is generally determined by discounting future cash flows for the reconstituted business that will emerge from Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved.

A disclosure statement also is filed with the Court. The disclosure statement must include sufficient information to allow a hypothetical investor to make an informed judgment about the plan. The disclosure statement often contains a summary of the reorganization plan, historical financial data for the entity, projections regarding the entity's future financial results, and a pro forma balance sheet that shows the value and structure of the entity that will emerge from the reorganization. The disclosure statement must be approved by the Court and provided to all parties that will vote on the entity's reorganization plan.

Financial Statement Presentation During Reorganization

The financial statements of an entity undergoing a Chapter 11 process will need to distinguish between transactions that relate to the reorganization and those that relate to the entity's ongoing operations.

Balance Sheet

An entity undergoing reorganization should segregate the following in the balance sheet:

- The liabilities that arose before the filing of the Chapter 11 petition that are subject to compromise by the reorganization
- The liabilities that arose before the filing of the Chapter 11 petition that are not subject to compromise by the proceeding
- The liabilities that have arisen since the filing of the Chapter 11 petition

An entity undergoing a Chapter 11 proceeding is required to report liabilities at the amount expected to be allowed by the Court, even if the entity expects that the liability will settle for less than the amount allowed. If there are secured liabilities that could have to be classified as subject to compromise because uncertainties exist as to the amount or the quality of the security, the claim cannot be reclassified until the uncertainty concerning that claim is resolved.

All prepetition liabilities (including those that became evident only after the filing) will need to be evaluated pursuant to the guidelines in FASB ASC 450-20, *Contingencies—Loss Contingencies*. If a liability must be accrued, then the liability should be measured at the amount expected to be allowed. If the amount of the expected allowed claim cannot be estimated, this fact must be disclosed.

If an allowed claim is different from the book value of the prepetition liability, including debt issue costs, premium, or discount, the amount of the liability is adjusted to the amount of the allowed claim and the gain or loss should be presented as a reorganization item in the income statement, separate from those relating to ongoing operations. However, an adjustment is not required if the debt is not a claim subject to compromise by the Chapter 11 proceeding (e.g., in the case of a fully secured liability). As a reorganization progresses, the entity may reclassify claims subject to compromise and those not subject to compromise from one category to the other, as called for by changing circumstances.

Observation: FASB ASC 470-10-45, *Debt—Overall—Other Presentation Matters*, requires an entity to reclassify certain noncurrent liabilities as current, in particular when a debt becomes callable because of a violation of a provision of the debt agreement. However, the automatic stay provisions in Chapter 11 of the Bankruptcy Code make such reclassifications unnecessary because creditors cannot take action to collect receivables once a petition is filed.

Illustration 1

The following is an example from FASB ASC 852-10-55-3 that illustrates how an entity would present its balance sheet after filing a Chapter 11 petition:

XYZ Company
(Debtor in Possession)
Balance Sheet
December 31, 19X1

Assets		**(000s)**
Current assets		
Cash	$	110
Accounts receivable, net		300
Inventory		250
Other current assets		30
Total current assets		690
Property, plant and equipment, net		430
Goodwill		210
Total Assets	$	1,330

Liabilities and Shareholders' Deficit		**(000s)**
Liabilities Not Subject to Compromise Current Liabilities:		
Short-term borrowings	$	25
Accounts payable—trade		200
Other liabilities		50
Total current liabilities		275
Liabilities Subject to Compromise		1,100 (a)
Total liabilities		1,375
Shareholders' (deficit)		
Preferred stock		325
Common stock		75
Retained earnings (deficit)		(445)
		(45)
Total Liabilities & Shareholders' (Deficit)	$	1,330

(a) Liabilities subject to compromise consist of the following:

Secured debt, 14%, secured by first mortgage on building	$	300,000 (b)
Priority tax claims		50,000
Senior subordinated secured notes, 15%		275,000
Trade and other miscellaneous claims		225,000
Subordinated debentures, 17%		250,000
	$	1,100,000

(b) The secured debt in this case should be considered, due to various factors, subject to compromise.

The accompanying notes are an integral part of the financial statements.

Income Statement

While undergoing Chapter 11, an entity continues to present an income statement that reflects the operations of the period in accordance with U.S. GAAP, but it should present reorganization items, such as gains or losses arising from the Chapter 11 proceeding or administrative costs, separately from operational items. The only exception is for discontinued operations that must be reported in accordance with FASB ASC 205-20, *Presentation of Financial Statements—Discontinued Operations*, even if they arise directly from the reorganization.

According to FASB ASC 852-10-45-10, an entity may not defer administrative costs and similar professional fees relating to the reorganization; those fees should be charged to expense as incurred. Further, those costs cannot be deferred to be later offset against a gain that results from the discharge of liabilities.

An entity undergoing Chapter 11 may report accrued interest only if it is probable that the Court will allow the creditor's claim for interest. Interest expense should not be classified as a reorganization item. However, interest earned that results directly from undergoing a reorganization (generally, all interest earned post-petition) should be classified as a reorganization item.

Illustration 2

The following is an example from FASB ASC 852-10-55-3 that illustrates how an entity would present its income statement after filing a Chapter 11 petition:

XYZ Company
(Debtor-in-Possession)
Statement of Operations
For the Year Ended December 31, 19X1
(000s)

		19X1
Revenues:		
Sales	$	2,400
Cost and expenses:		
Cost of goods sold		1,800
Selling, operating and administrative		550
Interest (contractual interest $5)		3
		2,353
Earnings before reorganization items and income tax benefit		47
Reorganization items:		
Loss on disposal of facility		(60)
Professional fees		(50)
Provision for rejected executory contracts		(10)
Interest earned on accumulated cash resulting from Chapter 11 proceeding		1
		(119)
Loss before income tax benefit and discontinued operations		(72)
Income tax benefit		10
Loss before discontinued operations		(62)
Discontinued operations:		
Loss from operations of discontinued products segment		(56)
Net loss	$	(118)
Loss per common share:		
Loss before discontinued operations	$	(0.62)
Discontinued operations	$	(0.56)
Net loss	$	(1.18)

The accompanying notes are an integral part of the financial statements.

Statement of Cash Flows

An entity should present reorganization items separately within the operating, investing, and financing categories in the statement of cash flows. As noted in FASB ASC 852-10-45-13, the direct method permits a better presentation of reorganization items in each category of cash flows. If an entity in reorganization chooses to present its statement of cash flows using the indirect method, it must supplement the statement with a schedule or a description in the notes that details operating cash flows pertaining to the reorganization.

Illustration 3

The following is an example from FASB ASC 852-10-55-3 that illustrates how an entity would present its statement of cash flows after filing a Chapter 11 petition:

XYZ Company
(Debtor-in-Possession)
Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase in Cash and Cash Equivalents
(000s)

	19X1
Cash flows from operating activities:	
Cash received from customers	$ 2,220
Cash paid to suppliers and employees	(2,070)
Interest paid	(3)
Net cash provided by operating activities before reorganization items	147
Operating cash flows from reorganization items:	
Interest received on cash accumulated because of the Chapter 11 proceeding	1
Professional fees paid for services rendered in connection with the Chapter 11 proceeding	(50)
Net cash used by reorganization items	(49)
Net cash provided by operating activities	98
Cash flows from investing activities:	
Capital expenditures	(5)
Proceeds from sale of facility due to Chapter 11 proceeding	40
Net cash provided by investing activities	35
Cash flow used by financing activities:	
Net borrowings under short-term credit facility (post petition)	25
Repayment of cash overdraft	(45)
Principal payments on prepetition debt authorized by court	(3)
Net cash provided by financing activities	(23)
Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of year	-
Cash and cash equivalents at end of year	$ 110
Reconciliation of net loss to net cash provided by operating activities	
Net loss	$ (118)
Adjustments to reconcile net loss to net cash provided by operating activities	
Depreciation	20
Loss on disposal of facility	60
Provision for rejected executory contracts	10
Loss on discontinued operations	56
Increase in postpetition payables and other liabilities	250
Increase in accounts receivable	(180)
Net cash provided by operating activities	$ 98

The accompanying notes are an integral part of the financial statements.

Financial Statement Presentation Upon Emerging from Chapter 11 Proceedings

Generally, an entity should report its financial statements in accordance with the guidelines for post-reorganization status, described below, as of the date the Court confirms the reorganization plan. If a material condition (such as obtaining financing) remains unresolved at the time the Court confirms the plan, the entity does not apply post-reorganization guidelines until the condition resolves.

Fresh-Start Accounting

An entity emerging from Chapter 11 is required to apply fresh-start accounting if all of the following conditions are satisfied immediately before plan confirmation:

- Reorganization value is less than post-petition liabilities plus allowed claims.
- The former holders of voting shares, under the plan of reorganization, will own less than 50 percent of the voting shares of the emerging entity from Chapter 11.
- The former voting shareholders' loss of control is not temporary, and the ownership will not revert to the shareholders of the predecessor entity.

An entity that applies fresh-start accounting assigns a new carrying value to each asset and liability of the successor (post-Chapter 11) entity by following the guidance in FASB ASC 805-20, *Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest*. Excess amounts are recognized as goodwill. In other words, the assets and liabilities of the successor entity are measured at fair value on the day the reorganization plan is confirmed.

From the time that an entity files a petition for reorganization under Chapter 11 to the point just before emerging from the process, an entity must apply the guidelines discussed earlier. Any adjustment required from applying fresh-start accounting or from forgiving a debt applies to the financial statements of the predecessor entity, not the new entity that emerges from the reorganization. The successor entity emerges from the reorganization process with no balance in retained earnings or retained deficit.

Importantly, an entity may not present post-reorganization financial statements on a comparative basis with financial statements of the predecessor entity. Post-confirmation financial statements are those of a new entity.

Observation: The entity should avoid attempts to describe post-reorganization financial statements in a comparative manner or to contrast their differences with financial statements of the predecessor entity as this could be misleading.

Reporting when Fresh-Start Accounting Does Not Apply

The reorganization process of some entities will not satisfy the criteria for fresh-start accounting described above. If an entity's reorganization does not qualify it for the use of fresh-start accounting, the entity instead should follow these guidelines:

- Liabilities compromised by the confirmed plan of reorganization should be adjusted and reported at present value of the amounts to be paid, using current interest rates.
- Gains from the relief of indebtedness should be reported in accordance with the guidance in FASB ASC 220-20, *Income Statement–Reporting Comprehensive Income—Unusual or Infrequently Occurring Items*.

Disclosure Requirements

An entity that is undergoing or emerging from a reorganization proceeding under Chapter 11 must comply not only with general disclosure guidance, but also with the requirements of FASB ASC 852-10-50, *Reorganization—Overall—Disclosure*.

Disclosures During the Reorganization Proceedings

An entity undergoing a reorganization proceeding should provide certain disclosures in accordance with the following guidelines:

- The entity should disclose contingent claims that the entity cannot estimate reasonably as provided in FASB ASC 450-20, *Contingencies—Loss Contingencies*.
- The entity should report claims, by principal categories, that are subject to compromise through the reorganization process.
- The entity should report interest expense at the amount paid or expected to be an allowed claim to the extent that the amount differs from the amount of interest accrued under prepetition contractual terms.
- An entity should disclose any probable issuance of additional common stock (or equivalent) pursuant to the reorganization plan.

Observation: In addition to the disclosures discussed above, when the indirect method is used to prepare the statement of cash flows, the entity must disclose details of operating payments and receipts occurring as a result of a reorganization in a supplementary schedule, or in the notes to the financial statements.

Illustration 4

The following is an example from FASB ASC 852-10-55-3 that illustrates the required disclosures after filing a Chapter 11 petition:

Note X—Petition for Relief Under Chapter 11

On January 10, 2022, XYZ Company (the Debtor) filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence before the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as Debtor-in-possession. These claims are reflected in the December 31, 2022, balance sheet as liabilities subject to compromise. Additional claims (liabilities subject to compromise) may arise after the filing date resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor's assets (secured claims) also are stayed, although the holders of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor's property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to $5,000, which is $2,000 in excess of reported interest expense; therefore, the debtor has discontinued accruing interest on these obligations.

Disclosures After the Reorganization Proceedings

If an entity emerges from Chapter 11 proceedings and applies fresh-start accounting in its initial post-confirmation financial statements, the following must be disclosed:

- The amount and nature of any adjustment to the historical value of assets or liabilities
- The amount of any indebtedness relief
- Information related to the determination of reorganization value, including valuation method, assumptions, and tax rates

Illustration 5

The following is an example from FASB ASC 852-10-55-11 that illustrates the required disclosures following a confirmed plan of reorganization. In this illustration a tabular presentation, entitled Plan of Reorganization Recovery Analysis, is incorporated in the note disclosure. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.

Note X—Plan of Reorganization

On June 30, 2023, the Bankruptcy Court confirmed the Company's plan of reorganization. The Company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are adjusted to fair value in accordance with accounting requirements for business combinations under FASB ASC 805. The excess of reorganization value over the fair value of tangible and intangible assets was recorded as "reorganization value in excess of amounts allocable to identifiable assets." The confirmed plan provided for the following:

- Secured Debt—The Company's $300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for $150,000 in cash and a $150,000 secured note, payable in annual installments of $27,300 commencing on June 1, 2024, through June 1, 2027, with interest at 12% per annum, with the balance due on June 1, 2028.

- Priority Tax Claims—Payroll and withholding taxes of $50,000 are payable in equal annual installments commencing on July 1, 2024, through July 1, 2029, with interest at 11% per annum.

- Senior Debt—The holders of approximately $275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: $87,000 in new senior secured debt, payable in annual installments of $15,800 commencing March 1, 2024, through March 1, 2027, with interest at 12% per annum, secured by first liens on certain property, plant, and equipment, with the balance due on March 1, 2028; $123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 2024, through October 1, 2030, secured by second liens on certain property, plant, and equipment; and 11.4% of the new issue of outstanding voting common stock of the Company.

- Trade and Other Miscellaneous Claims—The holders of approximately $225,000 of trade and other miscellaneous claims received the following for their claims: $38,000 in senior secured debt, payable in annual installments of $6,900 commencing March 1, 2024, through March 1, 2027, with interest at 12% per annum, secured by first liens on certain property, plant, and equipment, with the balance due on March 1, 2028; $52,000 of subordinated debt, payable in equal annual installments commencing October 1, 2024, through October 1, 2029, with interest at 14% per annum; and 25.7% of the new issue of outstanding voting common stock of the Company.

- Subordinated Debentures—The holders of approximately $250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue outstanding voting common stock of the Company.

- Preferred Stock—The holders of 3,250 shares of preferred stock received 12% of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.

- Common Stock—The holders of approximately 75,000 outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The following table (Plan of Reorganization Recovery Analysis) summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan.

		Recovery									
		Elimination of Debt and Equity	Surviving Debt	Cash	IRS Note	Senior Debt	Subordinated Debt	Common Stock (a)		Total Recovery	
								%	Value	$	%
Postpetition liabilities	$ 300,000		$ 300,000							$ 300,000	100%
Claim or Interest											
Secured debt	300,000			$ 150,000		$ 150,000				300,000	100
Priority tax claim	50,000				$ 50,000					50,000	100
Senior debt	275,000	$ (25,000)				87,000	$ 123,000	11.4%	$ 40,000	250,000	91
Trade and other miscellaneous claims	225,000	(45,000)				38,000	52,000	25.7	90,000	180,000	80
Subordinated debentures	250,000	(79,000)						48.9	171,000	171,000	68
	1,100,000										
Preferred stockholders	325,000	(283,000)						12.0	42,000	42,000	
Common stockholders	75,000	(68,000)						2.0	7,000	7,000	
Deficit	(700,000)	700,000									
Total	$ 1,100,000	$ 200,000	$ 300,000	$ 150,000	$ 50,000	$ 275,000	$ 175,000	100.0%	$ 350,000	$ 1,300,000	

(a) The aggregate par value of the common stock issued under the plan is $100,000.

Small Business Reorganization Act

In 2019, Congress passed the Small Business Reorganization Act (the Act) creating new Subchapter V of Chapter 11 of the Bankruptcy Code. The purpose of Subchapter V was to make small business bankruptcies faster and less expensive. Generally, the Act only applies to business debtors with secured and unsecured debts of less than $2,725,625. The Act took effect in February 2020. The Act includes the following provisions:

- Appointment of a Trustee—the Act provides for a trustee who facilitates the small business debtor's reorganization and monitors the debtor's consummation of its plan of reorganization.

- Streamlining the Reorganization Process—the Act streamlines small business reorganizations and removes procedural burdens and costs associated with typical corporate reorganizations. Notably, only the debtor can propose a plan of reorganization. Small business debtors do not have to obtain approval of a separate disclosure statement or solicit votes to confirm a plan, and generally, there are no unsecured creditors' committees. The Act also requires the debtor to file its plan within 90 days of the bankruptcy filing.

- Elimination of the New Value Rule—the Act removes the requirement that equity holders of the small business debtor provide "new value" to retain their equity interest in the debtor without paying creditors in full. For plan confirmation, the Act instead only requires that the plan does not discriminate unfairly, is fair and equitable, and provides that all of the debtor's projected disposable income will be applied to payments under the plan or the value of property to be distributed under the plan is not less than the projected disposable income of the debtor.

- Modification of Certain Residential Mortgages—notably, the Act removes the categorical prohibition against individual small business debtors modifying their residential mortgages. The Act now allows a small business debtor to modify a mortgage secured by a residence if the underlying loan was not used to acquire the residence and was primarily used in connection with the debtor's small business.

- Delayed Payment of Administrative Expense Claims—the Act removes the requirement that the debtor pay administrative expense claims, including those claims incurred by the debtor for post-petition goods and services, on the effective date of the plan. Unlike a typical bankruptcy, a small business debtor may now stretch payment of administrative expense claims out over the term of the plan.

- Discharge Limitations—in many cases the Court will grant the debtor a discharge after completion of all payments due within the first three years of the plan, or such longer period as the Court may fix (not to exceed five years). The discharge relieves the debtor of personal liability for all debts provided under the plan except any debt: (1) on which the last payment is due after the first three years of the plan, or such other time as fixed by the Court (not to exceed five years); or (2) that is otherwise non-dischargeable. All exceptions to discharge under the Bankruptcy Code apply to the small business debtor. This is a departure from a typical corporate Chapter 11 which has a more limited set of exceptions to discharge.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss the differences in bankruptcy filings under Chapter 7 and Chapter 11.

2. Explain how an entity undergoing a Chapter 11 proceeding is required to report liabilities.

3. Describe the relationship between the Small Business Reorganization Act and Chapter 11 of the Bankruptcy Code.

B. Suggested Answers to Discussion Problems

1. In some cases, an entity may have financial issues so significant that it does not have any value beyond its identifiable net assets. In this case, a petition may be filed under Chapter 7. Upon filing, the Bankruptcy Court (Court) assigns an independent trustee to manage the business and the process of liquidation. The trustee usually will discontinue the entity's operations and sell its assets to the highest bidder using the proceeds of sale for the benefit of the creditors. Upon completion of the process, the debtor receives a discharge from its prepetition debts. Bankruptcy proceedings under Chapter 7 are within the scope of Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 205-30*, Presentation of Financial Statements: Liquidation Basis of Accounting*. A case filed under Chapter 11 is often referred to as a reorganization proceeding. In other words, a business that files for Chapter 11 protection is attempting to continue its business by restructuring the debt that existed prior to the proceeding. For accounting purposes, bankruptcy proceedings under Chapter 11 are within the scope of FASB ASC 852-10, *Reorganizations—Overall*.

2. An entity undergoing a Chapter 11 proceeding is required to report liabilities at the amount expected to be allowed by the Court, even if the entity expects that the liability will settle for less than the amount allowed. If there are secured liabilities that could have to be classified as subject to compromise because uncertainties exist as to the amount or the quality of the security, the claim cannot be reclassified until the uncertainty concerning that claim is resolved. All prepetition liabilities (including those that became evident only after the filing) will need to be evaluated pursuant to the guidelines in FASB ASC 450-20, *Contingencies—Loss Contingencies*. If a liability must be accrued, then the liability should be measured at the amount expected to be allowed. If the amount of the expected allowed claim cannot be estimated, this fact must be disclosed.

3. The benefits of Chapter 11 reorganization have been elusive to many small business debtors given their size and limited financial resources and the expense and requirements of a typical Chapter 11 bankruptcy. However, in 2019, Congress passed the Small Business Reorganization Act (the Act) creating a new Subchapter V of Chapter 11 of the Bankruptcy Code. The purpose of Subchapter V was to make small business bankruptcies faster and less expensive. Generally, the Act only applies to business debtors with secured and unsecured debts of less than $2,725,625. The Act took effect in February 2020.

PART 2. AUDITING

Fraud Trends in SPACs and Cryptocurrency

Fraud addresses a wide variety of different scams and crimes. While prior to the internet most fraud was physical or tangible in nature, as the digital age has developed the fraud schemes around it have developed too. Common schemes include identity theft, phishing attacks, malware, employment scams and other behavior that cheats individuals and businesses out of time, money, and sensitive information.

Two areas where fraud is trending include entities known as SPACs and cryptocurrency. SPACs are publicly traded corporations with a two-year life span formed with the purpose of merging with a privately held organization to enable it to go public. SPACs raise a tremendous amount of money from public investors and shorten the IPO process for the target companies.

Meanwhile, cryptocurrency as a digital asset is another area ripe for theft and fraud. While Bitcoin and Ether are two well-known cryptocurrencies, there are hundreds of popular ones. Scammers may use common fraud tactics, but once they're paid in cryptocurrency the trail is more likely to grow cold. It's harder to track than when fiat currency is used.

For more on fraud trends emerging in these areas, let's join Jennifer F. Louis, a CPA with Emergent Solutions Group, LLC, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today we want to talk about a new standard and our roadblocks in transitioning to that standard, and that is SAS 145. To begin, let's talk about what SAS 145 is and when does it become effective?

Ms. Louis

It is effective for the audits of your financial statements for periods ending on or after December 15, 2023. So, really, starting with your calendar year-end 2023 audits, going forward. The goal of this is to re-look at the section of the general accepted auditing standards that deals with understanding the entity and its environment, and assessing risk of material misstatement. Ultimately, it is meant to provide guidance in how to improve the quality of engagements through revisiting what those requirements are within that section of the codified standards.

Ms. Grove Casey

Today, we want to talk a little bit about fraud and certain activities that have recently either come to light or are becoming more prevalent. To begin with, we are going to be talking about SPACs and cryptocurrency. What do you consider fraud to be for today's conversation?

Ms. Louis

Fraud, as you think about it, is really a very, very broad legal term, where generally we would say that somebody intentionally is being dishonest, and they are doing it to receive some sort of benefit. Now, it could be for themselves, it could be for their business, or it could be for any type of organization. Oftentimes, we think about fraud that could be happening with investors, or that they might be scamming somebody out of money or services. So, in the sense of thinking about fraud for today, we are thinking about businesses and the intention to deceive them, and how that might relate to some of the more emerging types of transactions and events that you are seeing out there.

Ms. Grove Casey

Let's talk about what is a SPAC.

Ms. Louis

A *SPAC* [special purpose acquisition company] is a publicly traded corporation. Now, with a SPAC, there is a two-year lifespan for this corporation, and it has the sole purpose, basically, of effecting a merger or a combination [with] a privately held business that would enable it to go public. What happens is that SPACs raise a lot of money, and the goal, ultimately, is to either lessen the risk or shorten the initial public offering process [with the] target companies that they are looking to acquire, merge with, or combine. This often can [have a result] where the target company could get better terms and conditions than what a traditional IPO would have.

Ms. Grove Casey

How long has the concept of SPACs been around?

Ms. Louis

It is interesting because when you think about SPACs, as they call these types of organization, as an alternative to a traditional initial public offering, they actually have had various forms for decades. If you go all the way back to the 1980s, there was something called a *blank check corporation* and regulation was less stringent related to these types of entities. But what happened with those organizations, as you saw if you remember things like penny stock fraud and other things that happened in the early ’90s, it did relate to these types of organizations that were created a decade prior to that.

So, Congress stepped in and started regulating these types of organizations better. They looked at these blank check IPOs to make sure that, for example, the proceeds that were raised were held in regulated escrow accounts and to make sure that they weren’t able to be used for other purposes until the merger was completed with this blank check [corporation]. With the new regulatory framework in place, these blank check corporations were actually rebranded, and that is when you saw SPACs—the new, fresher version of that previous type of situation.

Ms. Grove Casey

What do you perceive as some of the pros and cons of SPACs as an investment vehicle?

Ms. Louis

Well sometimes, [since] the SPAC is formed solely to go out and acquire another entity, sometimes that target entity won’t be a good acquisition. The target itself will completely fail and investors can lose money. But they do offer a different approach to financing for the target companies and the investors. A lot of times, [SPACs] are looking at competing with private equity funds, venture capital funds, and also the traditional IPO process. But they can give more financing opportunities to provide infusion of capital into startups and other companies out there that are ready for some sort of financial boost. This, hopefully, gives more fuel to the fire as we look at growth and innovation and expanding our economy. As investors though, we do need to think about the quality of the target that they are looking at acquiring, and that will, ultimately, improve investor performance overall.

Ms. Grove Casey

Who are the major players in a SPAC?

Ms. Louis

Basically, there is going to be the target (that would be who is getting acquired), there are the investors that are putting money into the SPAC, and then, you also have sponsors. Sponsors are the ones that actually initiate the SPAC process. They invest nonrefundable payments in forming the SPAC.

What happens is, if the SPAC does not result in some sort of merger, acquisition, or combination within its two-year timeframe, then the SPAC has to be dissolved and the funds have to be returned to the investors who were buying shares prior to identifying a company. But the sponsors that put their initial money in to create the SPAC with the bankers and the attorneys and the accountants, they ultimately could lose their money. If it succeeds, then obviously, they are getting the benefit along with all the other investors who put money in to expand the availability of cash flow to purchase the given targets.

Ms. Grove Casey

Typically, how is the SPAC investment structured?

Ms. Louis

Typically, there are going to be securities that are in a class of some common stock. Then, typically, they will structure it also [to include] some warrants that allow the investors to buy more shares in the future at some specified price. The warrants are actually the critical element that attracts the investors. It might be that you issue one warrant for every share of common stock that is purchased but, sometimes, they also do it fractionally where you can purchase one third or one half of a share. But the warrants are the things that traditionally will provide an upside to the investors, and that is an incentive for them to subscribe. The more warrants that are issued, [the more] they are compensating, ultimately, for the risk that the investors are taking by being a part of that SPAC. So that, ultimately, is what you really need to understand and consider about the formation of those organizations.

Ms. Grove Casey

What are the characteristics of a typical SPAC target?

Ms. Louis

What is interesting is that by putting money into a SPAC, you are [accepting the promotor] saying, "Okay, we are going to go find a target," because the whole intention is that [even though] we don't know what the target is yet, you are going to give us money, and you are going to trust that we are going go out and find a really good target within a two-year timeframe.

So, most of the targets—because you have only this two-year window—are going to be startups that may have already been through the venture capital process, and maybe they are looking for an exit strategy from the venture capital investors that were involved in starting up this organization. Typically, it is an organization that might be thinking about a traditional IPO, but they also might be looking at another type of exit strategy, like selling to being bought out by another organization, or being acquired by a private equity firm, or raising more capital through other types of investors.

Often, the organizations are at the stage where they are a startup, and they are looking for another infusion of capital in order to take themselves to the next level. What is nice is that [if they are] in a SPAC, it is like you get a preview of the target as you are trying to search out what your target might be.

Ms. Grove Casey

What advantages do SPACs offer the target company compared to a traditional IPO, say?

Ms. Louis

Well, ultimately, comparing them to traditional IPOs, a lot of it is the speed at which things can happen compared to a traditional IPO. There is greater speed to capital, there tends to be more certainty around what is going to happen, there also tends to be [fewer] regulatory demands, and lower fees that might be involved in the overall process.

So, what can happen is that, for example, the entire SPAC process for a target entity can take as little as three to five months sometimes, with a valuation that might be established within the first month whereas, with a traditional IPO, it could take nine to twelve months and there could be less certainty about the valuation and less certainty about the amount of capital being raised. Remember, with a SPAC, investors are putting their money in upfront and then going to look for a target, versus [an IPO where] I am going to go and offer my stock and I don't know what is going to happen with the capital that is being raised until the end of the IPO process. So, that is the real comparison between the two. That is why they are something that could be desirable for both the investors in the SPAC, as well as the target entities themselves.

Ms. Grove Casey

How can SPACs yield to higher valuations of a target compared to traditional IPOs?

Ms. Louis

Because in a traditional IPO there are underwriters, and the underwriter really is driving the valuation process. The underwriter is out soliciting potential investors which really can be perceived as somewhat of a conflict of interest. The underwriters [may] have a one-off with companies that are looking to go public because the underwriters, ultimately, are involved in this process, and often, as they are allocating shares, they might be looking to their customers, [prioritizing] whoever is their best and most important customer. Also, they might set a price below the market's actual valuation, with the outcome of providing a higher return to the buyers (their customers) and, ultimately, to themselves.

So, that is why there could be [a perception] that underwriters being involved in the traditional IPO could, intentionally or unintentionally, [result in] manipulation of the valuation.

Ms. Grove Casey

So, back before kids, when I had more free money to invest—and time to pay attention to it—in the stock market, there was an entity that I was interested in that had an IPO, and the underwriters were the firm that I was working with. So, I had asked for a round lot. I wasn't asking for [many] shares, I was asking for a hundred shares, and my broker was shocked when we got it—just amazed. So, it was exactly what you were talking about, where the underwriter is in the middle. Just because you ask for a specific number of shares doesn't mean that you are getting it, even as an investor, with an IPO.

Now that we've talked a little bit about what a SPAC is, how is it being used or how can it be used to defraud investors?

Ms. Louis

Definitely, there are downsides. There are always going to be downsides. In a scenario where there was an intention to deceive, there are some key investor protections that are just inherent within the traditional IPO process, but a SPAC actually avoids some of those, some of the federal security law protections that focus on the disclosures and the offering documents that are involved with the underwriters. With a SPAC, there really isn't an offering document and, therefore, the security law protections don't apply to the circumstances. There is no underwriter that is supposed to be filling the role of kicking the tires and trying to set a valuation. Therefore, those investor protections are weakened because of that situation.

So, that is one thing to consider as we think about where there could be overzealous statements concerning current or projected financial conditions in a company. Those might not be as well challenged because the offering documents and the underwriting process is not involved.

Ms. Grove Casey

Well, in the end, SPACs are speculative like any other investment, right?

Ms. Louis

Absolutely. Any investment vehicle has vulnerabilities due to the fact that there is unpredictability in any type of capital market. Now, one thing about SPACs is that typically they rely heavily on things like celebrity sponsors—like Shaquille O'Neal—to generate interest in the SPAC. Yes, it is speculative, but it has some of these other nuances to it that might put forth, maybe, some false expectations or some excitement that a more traditional IPO doesn't really have the capability of generating.

Ms. Grove Casey

Could SPAC mismanagement actually result in an intent to deceive?

Ms. Louis

So, once you have the investors, now you have to identify a target and the SPAC sponsors are being trusted by the investors to actually go out and find that target and to function in the best interest of the investors. And ultimately, the SPAC sponsors, the leadership of the SPAC, doesn't always consult with the unit holders before merging with the target. It may be that they choose to merge with new companies with untested business models or things that pose a significant risk to investors. If you look at 2021, I think I saw one time that investors in 14 SPACs brought class action lawsuits against the SPAC itself (the sponsors and the executives of the SPAC). So, definitely, there is a concern related to that. The management of the SPAC and the way it is formed does create vulnerabilities if you think about management-override-type risks that might exist.

Ms. Grove Casey

Well, hearing about it in theory is one thing, but could you give us an example of a real-life SPAC fraud? Because it helps people.

Ms. Louis

Yes, a recent one that the SEC has been taking action against is, in January 2023, the SEC charged the former CFO of a SPAC that was called African Gold Acquisition Corp. That CFO of the SPAC was charged with embezzling more than $5 million from three different SPACs. Allegedly, this individual embezzled funds from African Gold, and then, also stole funds from another SPAC series that they created that was called Strategic Metals Acquisition Corps 1 and 2. Allegedly, these funds were used to pay for personal expenses and also to engage in trading in cryptocurrency which we are going to talk about later.

So, according to the SEC's complaint, this CFO concealed these unauthorized withdrawals. They falsified the bank account statements of African Gold, and then provided these falsified documents to the accountants and the auditors that were involved in looking at accountability on the part of the SPAC. During the same general timeframe, this same CFO was also raising more money from these other SPACs that existed and misrepresented that the money would be used to create a SPAC when, once again, they were misappropriating the funds and also using that money to conceal the embezzlement that was happening in African Gold.

Ms. Grove Casey

Are there any other SPAC frauds that highlight the misleading of investors?

Ms. Louis

Another one that is a little bit more highly publicized that the SEC is pursuing is related to something called the Stable Road Acquisition Company (SRAC). There are multiple allegations that this particular SPAC, as well, misled its investors regarding a company that it actually identified for merger. So, this relates to a company, Momentus, that was the target. This company was involved in space technology. Definitely, anything that is an alluring new technology or things that involve space are a popular focus in the SPAC market because it is just exciting, by its nature.

Ms. Grove Casey

New frontiers.

Ms. Louis

Yes, new frontiers. Momentus was involved in in-space transportation as one of their core services, to create the destination of going to space. The SEC alleges that Momentus and the CEO misled the SPAC, telling them that the company had successfully tested certain propulsion technology when, in fact, the in-space test had failed and didn't really demonstrate the commercial viability of that technology. Also, Momentus was not fully transparent about their CEO being a Russian national and having issues, maybe, with getting certain governmental licenses that obviously would be needed if you are trying to pursue space technology.

Ms. Grove Casey

Governmental contracts, yes.

Ms. Louis

Yes, there is going to be some interest in that by the U.S. government and others. Stable Road, though, while Momentus was saying, "Okay, they are not being transparent, they are being misleading," Stable Road failed to do due diligence. So, as Momentus was making these claims, Stable Road was just parroting those claims without going out and doing proper due diligence to protect the investors in the SPAC. So, therefore, the SPAC also was charged with misleading investors in the end.

Ms. Grove Casey

That sounds a bit like the next thing I'm about to ask you, which is related to examples of when the SPAC sponsor is misled by the target, because it sounds like there were a couple of things going on in the example you just gave. Not only was there a problem with the due diligence on the part of the sponsor, but also, they were being misled by the target, Momentus.

Ms. Louis

Yes, it was a combination of both, as we think about what the target is saying, and then, what are the obligations of the sponsors to the investors. There was a SPAC related to a music streaming service based in Greece called Akazoo. Akazoo merged with a SPAC and received about $55 million [for] the music streaming service. Prior to the merger, they claimed to have subscribers—that they had 38 million users and 4.6 million paying subscribers. They claimed to have $120 million in revenue but, ultimately, there were really no subscribers and very negligible revenue. So, it is another [example] where the misleading on the part of the target to the SPAC was huge. It was blatant. It was not even something that was subject to interpretation in the end.

Ms. Grove Casey

Let's switch and talk about another area where there is a lot of blatant stuff going on and that is cryptocurrency. Let's talk a little bit about what is the nature of cryptocurrency, and why they have grown in popularity so quickly.

Ms. Louis

Well, certainly because, once again, it is something that is new. People sometimes want to be involved with something new and exciting. Also, it can help them avoid some of the fees that a traditional bank might charge and [provides] the pseudo-anonymity that is desirable for some individuals and groups out there. So, that really is a large part of why you do see certain cryptocurrencies, like Bitcoin, that have evolved and become successful.

Ms. Grove Casey

Well, are there any risks with how cryptocurrency is stored—other than forgetting the password or somebody dying that had the only password?

Ms. Louis

Well, definitely that is a [concern]. You hold it in this digital wallet. The wallet can be online, it can be on your computer, it can be on a hard drive, but it is an address, just a virtual address. It is a long string of numbers and letters. And if something happens to your wallet, then definitely you have the risk of maybe not being able to recover your funds, whether it is something that is just lost, or stolen, or otherwise compromised.

Ms. Grove Casey

Why are the risks with cryptocurrency so different from traditional fiat currency? Because it seems like you have—I want to say all of the risks of traditional fiat currency—but then, you have these other tech-related [risks]. Your hardware might be a risk, too.

Ms. Louis

Right, certainly there is cybercrime and cyber risk, but also, the cryptocurrency accounts aren't backed by anything. There is no fiat-currency backing by U.S. dollars. As we think about things that would be deposited into an FDIC-insured bank account, if something happens to your cryptocurrency account, then the government has no obligation to step in and help you get your money back. If the wallet service goes out of business or is hacked, that is your loss.

Ms. Grove Casey

Are there any risks in paying for transactions with cryptocurrency over more traditional methods of consideration? Because I know it is not just businesses that are now accepting it, there are governments that are accepting it for what I would refer to as very small dollar amounts. I know there was one county that I had heard was accepting it for the cost of a driver's license, which is under $20. That just seems like the fees incurred in converting that currency would not make it a worthwhile endeavor there.

Ms. Louis

Yes, and if you think about it, why not just use a credit card? The credit card company can dispute a purchase. They have a process of helping you get your money back. There are certain protections that occur if you are paying for something using a credit card, [and] because of the way that things are set up in digital wallets with blockchain technology, payments aren't reversible. So, you need to think about, am I certain that I know where my money is going? Am I comfortable that there is not some sort of fraudulent activity occurring (because of the fact that I am [using] this irreversible, distributed ledger technology)?

Ms. Grove Casey

Statistically, how common are crypto-related fraud scams?

Ms. Louis

The Federal Trade Commission, in essence, said that about one out of every four dollars reported [involving] crypto-related crimes was fraudulent. That is more than any other payment [method] out there. That is from a June 2022 statistic from the Federal Trade Commission. So, it is something that, yes, is certainly a mechanism that is being used for a lot of scams and fraudulent-type things that are out there.

Ms. Grove Casey

Talk to me a little bit more about investment scams involving crypto.

Ms. Louis

A lot of times, they try to promise you zero risk, or you will make lots of money, and [often], these investment opportunities are started on social media or online dating apps. They are trying to incentivize somebody. [For example,] where an investment manager or somebody reaches out to you and promises, "If you give us this money, we are going to make a huge [return for] you." Then, ultimately, it might be that you actually can't get your money out of your investment account that you established. You go to log on to your account and can't take the money out. Or sometimes, you can get it out, but they are not telling you about all these high, hidden fees that exist. So, we always need to be careful about anything that seems too good to be true. It probably is.

Ms. Grove Casey

Talk to me more about the impersonation scams that involve cryptocurrency. It would seem like it is fairly easy to do because you are not actually dealing with a person.

Ms. Louis

Right, but they make it seem like you are dealing with [a person]. "I'm from Amazon," or "I'm from your bank." They will call, text, email you, contact you on social media and, in essence, what they are doing is they are pretending to be somebody that you trust to try and convince you to either buy cryptocurrency or [they might say], "Hey, you need to make a payment," and demand that it be made in crypto as opposed to some other more traditional means.

Ms. Grove Casey

Can you give me an example of real-life cryptocurrency investment schemes?

Ms. Louis

There was one from January 2023 that is being pursued in the Federal District Court in San Diego that relates to something called Bitconnect. This was a massive cryptocurrency investment scheme that had a worldwide effect.

Within the U.S., though, there was the founder and the promoter, basically fraudulently marketing Bitconnect's initial coin offering and its digital currency exchange as being a lucrative investment. It touted that there was this proprietary technology, this trading bot, that was going to be able to generate substantial profits and guarantee returns. In the end, it just ended up being a Ponzi scheme where early investors in bitcoin were able to benefit from the money of later-round investors.

Ms. Grove Casey

FTX has been in the news recently. Could you remind everyone about the nature of that alleged fraud scheme?

Ms. Louis

Yes, it is similar in that Sam Bankman-Fried (SBF), the former CEO who created FTX which was a crypto exchange, misled investors and misused money, the allegations [state]. And in the end, they are estimating about $8 billion in customer deposits that were initially unaccounted for. What was this exchange doing in funneling depositors' money? Using it in a privately held crypto hedge fund, using money to make undisclosed venture investments, purchasing lavish real estate, making political donations. [They were] taking control of the deposits and using them for these different purposes.

Ms. Grove Casey

Didn't Bankman-Fried also have a related-party hedge fund involved in his alleged fraud?

Ms. Louis

Yes, so if you hear Alameda, that was his privately held hedge fund. Alameda got special treatment on his FTX exchange platform, in essence, giving Alameda an unlimited line of credit from the FTX customers to sustain Alameda. Also, having written the source code—allegedly written the source code—for faster execution times for any Alameda transactions on the exchange, compared to other transactions on the exchange. So, a variety of things using Alameda to really manipulate the process.

Ms. Grove Casey

Almost like an operational fraud. Any final thoughts before we wrap up for today?

Ms. Louis

Just realizing that any investment opportunity, any form of consideration, whether it is traditional or emerging, is going to be susceptible to fraud. You really want to make sure that you are understanding the nature of the transactions, and you understand the risks that could be different compared to those other, more traditional investment areas.

Fraud in Emerging Activities—SPACs and Crypto

By Jennifer Louis, CPA

Overview

Fraud is a broad legal term that refers to situations where someone is intentionally dishonest in order to receive some kind of benefit from a person, business, or entity. Fraud covers a wide range of different scams and crimes, but almost all examples of fraud fall under two categories of victims:

- Business fraud occurs when customers, employees, or investors scam your business out of money or services.
- Personal fraud occurs when another person, group, or company tricks you into giving up money, services, or sensitive information that can be used for identity theft.

Common fraud schemes can range from identify theft, phishing attacks, malware, employment scams, and more. This segment will focus on two emerging fraud trends: SPACs and cryptocurrency.

What is a SPAC

A SPAC is a publicly traded corporation with a two-year life span formed with the sole purpose of effecting a merger, or “combination,” with a privately held business to enable it to go public. SPACs raise money largely from public-equity investors and have the potential to lower the risk and shorten the initial public offering (IPO) process for their target companies, often offering them better terms than would a traditional IPO.

SPACs, which offer an alternative to traditional IPOs, have been around in various forms for decades. When SPACs first appeared as blank-check corporations in the 1980s, they were not well regulated and, as a result, they were plagued by penny-stock fraud, resulting in huge losses for investors by the early 1990s. Congress stepped in to provide much-needed regulation, requiring, for example, that the proceeds of blank-check IPOs be held in regulated escrow accounts and barring their use until the mergers were complete. With a new regulatory framework in place, blank-check corporations were rebranded as SPACs.

Not all SPACs will find high-performing targets, and some will fail completely. However, they offer investors and targets a new set of financing opportunities that compete with later-stage venture capital, private equity, direct listings, and the traditional IPO process. They provide an infusion of capital to a broader universe of start-ups and other companies, fueling innovation and growth. SPAC sponsors today are more reputable than they may have been in the past, and the quality of their targets has improved. This has improved SPAC investment performance.

Major Players in a SPAC

SPACs have three main stakeholder groups: sponsors, investors, and targets. Each has a unique set of concerns, needs, and perspectives.

The SPAC process is initiated by the sponsors. They invest risk capital in the form of nonrefundable payments to bankers, lawyers, and accountants to cover operating expenses. If sponsors fail to create a combination within two years, the SPAC must be dissolved, and all funds returned to the original investors. The sponsors lose not only their risk capital but also the not-insignificant investment of their own time. But if they succeed, they earn sponsors’ shares in the combined corporation.

Original investors in a SPAC buy shares prior to the identification of the target company, and they have to trust sponsors who are not obligated to limit their targets to the size, valuation, industry, or geographic criteria that they outlined in their IPO materials. Investors receive two classes of securities: common stock (perhaps at $10 per share) and warrants that allow them to buy shares in the future at a specified price (perhaps at $11.50 per share).

Warrants are a critical ingredient in the risk-alignment compact between SPAC sponsors and investors. Some SPACs issue one warrant for every common share purchased; some issue fractions (often one half or one third) of a warrant per share; others issue zero. Given that warrants, which provide additional upside to early investors, are incentives to subscribe, the greater the number of warrants issued, the higher the perceived risk of the SPAC.

After the sponsor announces an agreement with a target, the original investors choose to move forward with the deal or withdraw and receive their investment back with interest. Even if they decide to pull out, they can keep their warrants. In this sense, the SPAC provides them with a risk-free opportunity to evaluate an investment in a private company.

Most SPAC targets are start-up firms that have been through the venture capital process. Firms at this stage commonly consider several options: pursuing a traditional IPO, conducting a direct IPO listing, selling the business to another company or a private equity firm, or raising additional capital (typically from private equity firms, hedge funds, or other institutional investors). SPACs can be an attractive alternative to other late-round options.

SPACs are highly customizable and can address a variety of combination types. Although targets are commonly a single private company, sponsors may also use the structure to roll up multiple targets. SPACs can also take companies public in the United States that are already public overseas and even combine multiple SPACs to take one company public.

SPACs offer target companies specific advantages over other forms of funding and liquidity. Compared with traditional IPOs, SPACs often provide higher valuations, less dilution, greater speed to capital, more certainty and transparency, lower fees, and fewer regulatory demands.

For targets, the entire SPAC process can take as little as three to five months, with the valuation set within the first month, whereas traditional IPOs often take nine to twelve months, with little certainty about the valuation and the amount of capital raised until the end of the process.

Another important advantage is that SPACs often yield higher valuations than traditional IPOs do, for a variety of reasons. In traditional IPOs, targets largely cede the valuation process to the underwriters, who directly solicit and manage potential investors. In the traditional process there is an inherent conflict of interest in that underwriters often have a one-off and transactional relationship with companies looking to go public, but they also have an ongoing relationship with their regular investors. To a large extent, the underwriters control the allocation of shares and use the process to reward their best and most important clients. They often set an initial price below the market's actual valuation, providing higher returns to their buying customers and to themselves.

SPAC Fraud Potential

A SPAC issuer does not necessarily find a shortcut through the SEC review process and will face scrutiny of its disclosures very similar to that applied to those submitted by other IPOs. However, there are opportunities to defraud investors in a variety of ways.

SPAC acquisitions circumvent certain key investor protections. Using a SPAC avoids one of the strongest investor federal securities law protections. The securities laws require companies, their directors, and the underwriters of an offering to verify the accuracy of the disclosures in the offering documents. With a SPAC and no offering documents, these securities law protections are inapplicable and there are no underwriters to "kick the tires."

Conflicts of interest leave room for deception. For example:

- The interests of the SPAC sponsors, who typically acquire their shares in the SPAC at nominal prices to consummate any merger, may not have the same interests as shareholders who purchased their shares in the SPAC for much more.

- The interests of a private acquisition target to incentivize it to make overzealous statements concerning the current or projected financial condition of the company in order to reap the benefits of being a public company.

SPACs are speculative investments, and speculative investments are always vulnerable to unpredictable changes in the market. Critics of SPACs point out that they often rely heavily on celebrity sponsors, like Shaquille O'Neale, to generate interest.

Economic factors, including rising interest rates, have made it more difficult for SPACs to find suitable companies for a merger. The absence of new public listings makes it harder for SPACs to find a deal by the two-year deadline. Additionally, stock prices are falling across the board, and the price of a SPAC share might dip below the original share price, resulting in losses for the investor before the stock even debuts.

Because SPACs bypass the disclosures associated with a traditional IPO, there is less information available about them publicly. SPACs do not always have to consult with unitholders before merging with a company, and investors are often relying on the SPAC to perform adequate due diligence.

Over the course of time, SPACs have demonstrated their vulnerability to fraud and questionable management. The company they identify for a merger may mislead the SPAC, or the SPAC CEO may fail to consider the investors' best interests. SPACs also may choose to merge with new companies with untested business models, which always pose a significant risk to investors.

Cryptocurrency Overview

Cryptocurrency is a type of digital currency that generally exists only electronically. Bitcoin and Ether are well-known cryptocurrencies, but there are many different cryptocurrencies, and new ones keep being created.

People use cryptocurrency for many reasons—quick payments, to avoid transaction fees that traditional banks charge, or because it offers some anonymity. Others hold cryptocurrency as an investment, hoping the value goes up.

You can buy cryptocurrency through an exchange, an app, a website, or a cryptocurrency ATM. Some people earn cryptocurrency through a complex process called "mining," which requires advanced computer equipment to solve highly complicated math puzzles.

Cryptocurrency is stored in a digital wallet, which can be online, on your computer, or on an external hard drive. A digital wallet has a wallet address, which is usually a long string of numbers and letters. If something happens to your wallet or your cryptocurrency funds—like your online exchange platform goes out of business, you send cryptocurrency to the wrong person, you lose the password to your digital wallet, or your digital wallet is stolen or compromised—you are likely to find that no one can step in to help you recover your funds.

Because cryptocurrency exists only online, there are important differences between cryptocurrency and traditional currency, like U.S. dollars.

- **Cryptocurrency accounts are not backed by a government.** Cryptocurrency held in accounts is *not* insured by a government, like U.S. dollars deposited into an FDIC-insured bank account. If something happens to your account or cryptocurrency funds, the government has no obligation to step in and help get your money back. For example, the company that provides storage for your wallet goes out of business or is hacked.
- **Cryptocurrency values change constantly.** The value of a cryptocurrency can change rapidly, even changing by the hour. Cryptocurrencies can be more volatile than more traditional investments, such as stocks and bonds. An investment that is worth thousands of dollars today might be worth only hundreds tomorrow. And, if the value goes down, there is no guarantee it will go up again.

Risk of Paying in Cryptocurrency

There are many ways that paying with cryptocurrency is different from paying with a credit card or other traditional payment method.

1. **Cryptocurrency payments do not come with legal protections.** Credit cards and debit cards have legal protections if something goes wrong. For example, if you need to dispute a purchase, your credit card company has a process to help you get your money back. Cryptocurrencies typically do not come with any such protections.

2. **Cryptocurrency payments typically are not reversible.** Once you pay with cryptocurrency, you can usually only get your money back if the person you paid sends it back. Before you buy something with cryptocurrency, know the seller's reputation by doing some research before you pay.
3. **Some information about your transactions likely will be public.** People talk about cryptocurrency transactions as anonymous, but the truth is not that simple. Cryptocurrency transactions typically will be recorded on a public ledger, called a "blockchain." That is a public list of every cryptocurrency transaction—both on the payment and receipt sides. Depending on the blockchain, the information added to the blockchain can include details like the transaction amount, as well as the sender's and recipient's wallet addresses. It is sometimes possible to use transaction and wallet information to identify the people involved in a specific transaction. And when you buy something from a seller who collects other information about you, like a shipping address, that information can also be used to identify you later on.

Crypto-Related Scams

Cryptocurrencies like Bitcoin and Ethereum have made thousands of people into overnight millionaires. But anything that promises to get you rich quickly can be a target for fraudsters.

Per the Federal Trade Commission (FTC), in June 2022, crypto-related crimes amount to about one out of every four dollars reported lost to fraud—more than any other payment method. The median individual reported loss was $2,600. The vast majority of those who reported being bilked used Bitcoin to pay scammers, at 70 percent, followed by Tether and Ether. The victims typically are part of a younger age group—those aged 25–40 are three times as likely to lose money due to fraud. Fake investment opportunities were behind $575 million of all crypto losses reported to the FTC, far more than any other fraud type.

Scammers are using some tried-and-true scam tactics—only now they are demanding payment in cryptocurrency. Investment scams are one of the top ways scammers trick you into buying cryptocurrency and sending it on to scammers. But scammers are also impersonating businesses, government agencies, and a love interest, among other tactics.

Cryptocurrency fraud cases can come in many variations. For example, Ponzi schemes, fake cryptoasset websites, malware, pump-and-dump scams, and fake initial coin offerings (ICOs), to name a few.

Investment Scams

Investment scams often promise you can "make lots of money" with "zero risk," and often start on social media or online dating apps or sites. These scams can, of course, start with an unexpected text, email, or call, as well. And, with investment scams, crypto is central in two ways: it can be both the investment and the payment.

Here are some common investment scams, and how to spot them.

- **A so-called "investment manager" contacts you out of the blue.** They promise to grow your money, but only if you buy cryptocurrency and transfer it into their online account. The investment website they steer you to looks real, but their promises are fake. If you log in to your "investment account," you won't be able to withdraw your money at all, or only if you pay high fees.
- **A scammer pretends to be a celebrity who can multiply any cryptocurrency you send them.** But it isn't a celebrity, it is a scammer. And if you click on an unexpected link they send or send cryptocurrency to a celebrity's QR code, that money will go straight to a scammer instead.
- **An online "love interest" wants you to send money or cryptocurrency to help you invest.** As soon as someone you meet on a dating site or app asks you for money, or offers you investment advice, it is likely a scam. The advice and offers to help you invest in cryptocurrency are probably scams.
- **Scammers guarantee that you will make money or they promise big payouts with guaranteed returns.** Nobody can make those guarantees, much less in a short time. And there is nothing "low risk" about cryptocurrency investments—even if there are celebrity endorsements or testimonials from happy investors. Those are easily faked.

- **Scammers promise free money.** They will promise free cash or cryptocurrency, but free money promises generally are fake.

- **Scammers make big claims without details or explanations.** No matter what the investment, find out how it works and ask questions about where your money is going. Honest investment managers or advisors want to share that information and will back it up with details.

Before investing in crypto, search online for the name of the company or person and the cryptocurrency name, plus words like "review," "scam," or "complaint." See what others are saying.

Impersonation Scams

In a business, government, or job impersonator scam, the scammer pretends to be someone you trust to convince you to send them money by buying and sending cryptocurrency. For example:

- **Scammers impersonate well-known companies.** These come in waves, and scammers might say they are from Amazon, Microsoft, FedEx, your bank, or many others. They will text, call, email, or send messages on social media. Sometimes they put a pop-up alert on your computer. They might say there is fraud on your account, or your money is at risk—and to fix it, you need to buy crypto and send it to them. If you click the link in any message, answer the call, or call back the number on the pop-up, you will be connected to a scammer.

- **Scammers impersonate new or established businesses offering fraudulent crypto coins or tokens.** They will say the company is entering the crypto world by issuing their own coin or token. They might create social media ads, news articles, or a slick website to back it all up and trick people into buying. But these crypto coins and tokens are a scam that ends up stealing money from the people who buy them. Research online to find out whether a company has issued a coin or token. It will be widely reported in established media if it is true.

- **Scammers impersonate government agencies, law enforcement, or utility companies.** They might say there is a legal problem, that you owe money, or your accounts or benefits are frozen as part of an investigation. They tell you to solve the problem or protect your money by buying cryptocurrency. They might say to send it to a wallet address they give you—for "safe keeping." Some scammers even stay on the phone with you as they direct you to a cryptocurrency ATM and give step-by-step instruction on how to insert money and convert it to cryptocurrency. They will direct you to send the crypto by scanning a QR code they give you, which directs the payment right into their digital wallet.

- **Scammers list fake jobs on job sites.** They might even send unsolicited job offers related to crypto-like jobs helping recruit investors, selling or mining cryptocurrency, or helping convert cash to crypto. But these so-called "jobs" only start if you pay a fee in cryptocurrency. As your first task in your "job," these scammers send you a check to deposit into your bank account. (That check will turn out to be fake.) They will tell you to withdraw some of that money, buy cryptocurrency for a made-up "client," and send it to a crypto account they give you. But if you do, the money will be gone, and you will be on the hook to repay that money to your bank.

To avoid business, government, and job impersonators, consider the following:

- No legitimate business or government will ever email, text, or message you on social media to ask for money. And they will never demand that you buy or pay with cryptocurrency.

- Never click on a link from an unexpected text, email, or social media message, even if it seems to come from a company you know.

- Don't pay anyone who contacts you unexpectedly, demanding payment with cryptocurrency.

- Never pay a fee to get a job. If someone asks you to pay upfront for a job or says to buy cryptocurrency as part of your job, recognize it as a scam.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Describe the major stakeholders in a SPAC.

2. Explain how using a SPAC for acquisitions can sidestep certain investor protections.

3. What are some of the risks associated with using cryptocurrency to transact business?

B. Suggested Answers to Discussion Problems

1. SPACs have three main stakeholder groups: sponsors, investors, and targets. Each has a unique set of concerns, needs, and perspectives.
    - The SPAC process is initiated by the sponsors. They invest risk capital in the form of nonrefundable payments to bankers, lawyers, and accountants to cover operating expenses. If sponsors fail to create a combination within two years, the SPAC must be dissolved.
    - Original investors in a SPAC buy shares prior to the identification of the target company, and they have to trust sponsors who are not obligated to limit their targets to the size, valuation, industry, or geographic criteria that they outlined in their IPO materials.
    - Most SPAC targets are start-up firms that have been through the venture capital process. Firms at this stage commonly consider several options: pursuing a traditional IPO, conducting a direct IPO listing, selling the business to another company or a private equity firm, or raising additional capital. SPACs can be an attractive alternative to other late-round options.

2. SPAC acquisitions circumvent certain key investor protections. Using a SPAC avoids one of the strongest investor federal securities law protections. The securities laws require companies, their directors, and the underwriters of an offering to verify the accuracy of the disclosures in the offering documents. With a SPAC and no offering documents, these securities law protections are inapplicable and there are no underwriters to "kick the tires."

3. There are many ways that paying with cryptocurrency is different from paying with a credit card or other traditional payment method.
    - Cryptocurrency payments do not come with legal protections. Credit cards and debit cards have legal protections if something goes wrong. Cryptocurrencies typically do not come with any such protections.
    - Cryptocurrency payments typically are not reversible. Once you pay with cryptocurrency, you can usually only get your money back if the person you paid sends it back.
    - Some information about your transactions likely will be public. Depending on the blockchain, the information added to the blockchain can include details like the transaction amount, as well as the sender's and recipient's wallet addresses. It is sometimes possible to use transaction and wallet information to identify the people involved in a specific transaction.
    - Cryptocurrency accounts are not backed by a government. Cryptocurrency held in accounts is not insured by a government, like U.S. dollars deposited into an FDIC-insured bank account. If something happens to your account or cryptocurrency funds, the government has no obligation to step in and help get your money back.
    - Cryptocurrency values change constantly. The value of a cryptocurrency can change rapidly, even changing by the hour. Cryptocurrencies can be more volatile than more traditional investments, such as stocks and bonds.

PART 3. SMALL BUSINESS

Assessing Materiality

While materiality is always of concern to the auditor, not all of the assessments are made using quantitative criteria. Qualitative criteria should also be used. SAS 138 revised the definition of materiality to include considerations that would influence judgment of a reasonable user.

For more on the factors auditors should consider in assessing materiality, let's join Kurt Oestriecher, a CPA and a partner with Oestriecher and Company in Alexandria, Louisiana, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So, today we want to talk about a subject that is near and dear to the heart of most auditors and really practitioners, and that is assessing materiality. To begin with, let's talk a little bit about the use of materiality, how we determine it, and go from there. How we might go about not just assessing materiality, but deciding what number is going to give us the warm fuzzies.

Mr. Oestriecher

The other way to look at that instead of the warm and fuzzies is what's the number that won't get my butt in trouble with either a third party, litigation, peer review, or something?

Ms. Grove Casey

Well, there's that, too.

Mr. Oestriecher

Because, you know, materiality. One of the great concepts on this, I think—people believe that because we are CPAs, we are very anal-retentive people that get everything to the penny. [That we] will sit at our dining room table—it used to be with pen and paper, but now on a computer—until we balance our bank accounts to the penny. And we do this the day that our bank statements show up in our inbox—30 years ago, I'd say we would get the bank statement in our mailbox—and we would just fuss and fight and make our family mad until everything was down to the penny.

Now, we don't do that. Engineers do that. And I'm glad engineers do that because they build bridges and airplanes and things that really, five percent of the time the plane will crash, and we're okay with that. No, I'm not okay with that. The materiality threshold for engineers is where it needs to be.

For us, I think the best way to say what is *material* is the amount that would influence a user's conclusions. You and I have looked at [the] financial statements of large, publicly traded companies. They round off to the nearest million. Okay. When you look at budgetary, when you hear people in Congress [say], "Well, the cost of this is going to be somewhere between $1.3 and $1.4 billion." Okay. Right there they're telling us $100 million, "Eh, it's not that big." So, it's all about the context of what you're dealing with.

I think one of the great, interesting things in our profession is clients that we perform bookkeeping services for—and I've got a great bookkeeping staff here. They actually will get everything reconciled to the penny, and the general ledger on the cash account will tie to the penny. And their sales tax return will tie to the penny [to] whatever sales tax payable is. They even take out the vendor's compensation. For those of you that don't live in sales tax states, thank God you don't know what I'm talking about. Here in Louisiana, we have a 10.5% local and state sales tax combined. So, everything's to the penny. What's so ironic, Debi, is I'm signing a compilation report on those, providing no assurance, but in an audit, okay, the cash is off $1,200. I'm not going to have the client do an adjustment for that, and I'm not going to modify my opinion. So, it is not only the context of what you're working on, but it's also the context of what is expected. And, quite frankly, our bookkeeping clients expect things to balance to the penny, but the third-party users of audited financial statements are like, "Eh, close enough." So, understanding that is the first thing. Now, please understand that if I am reviewing a bookkeeping account, and I notice that what's on the general ledger doesn't agree to the bank reconciliation by, I don't know, $40, I'm not sending that one back. We'll just fix that next month. So, the concept does come into play even on compilations.

But I will tell you this. We do a lot of work for churches, and in some of the churches you have a hierarchy. There's some independent churches out there, but Catholic, Episcopalian, Methodists. There are the—I don't want to call them governing bodies, but that's probably the best option or best description. In every quarter, they provide these reports to the diocese that say, “Here's the money that came in. Here's the money that went out. Here's how much is left.” It's pure cash basis, and there's a fee that is paid to the diocesan level. That's how the diocese supports itself in the operations. And I can tell you that the committees for these churches are generally retired people that have nothing better to do than to pore through these reports and want to know why a $6.34 item was put into supplies rather than office expense. So, I use that as an example. Materiality, to a large extent, is what the client or the third-party user deems important. I have learned on these clients that it is an extraordinarily low threshold. They have learned that it costs $300 an hour for me to fix these things, so they have changed their mind on the things that they would want me to reclassify because, remember, they're the ones that classified it initially. So, that's kind of how you get back. But I think that's the greatest example of how materiality is in the eye of the beholder. And you can't just simply say, if the client says fix this, it's important to them, so you fix it.

Ms. Grove Casey

Yes, I think the other example of where that would occur is state and local government.

Mr. Oestriecher

Yes.

Ms. Grove Casey

Particularly towns. The level of materiality there is very, very low in the eyes of the taxpayers.

Mr. Oestriecher

Correct. Yes, I would agree.

Ms. Grove Casey

Let's talk about some of the characteristics that are not numerical in nature because it's not just quantitative factors. It's qualitative factors. So, what kinds of things apply there?

Mr. Oestriecher

Right. When you look at that—and this is guidance that you will find in just some general technical practice aids from the AICPA, but it's also within definitions within the audit standards, the attestation standards, and the compilation, review and preparation standards. It's things like turning a profit into a loss, so that's a big deal. I was actually an expert in a trial a couple of years ago, and the other side was making a big deal that had certain things not been recorded, that there would have been brackets. I still remember their expert showing the jury, “There would have been brackets, and those brackets would have been a stop sign.”

So, if you're talking about something that—let's say it's a very large client, and they have a very minimal profit of maybe $10,000 to $15,000. And you're looking at a $30,000 adjustment to the allowance account—increasing it—and now that would turn that profit into a loss. If it just moved the profit from $2.8 million to $2,770,000, you probably would not think of that as material. But if it takes a $20,000 profit and turns it into a $10,000 loss, that same $30,000—now understand, we have the same size assets for our company, same revenues—that is one of the things that inherently people need to consider. It doesn't automatically mean it. Again, the context of an expert in a trial is a lot different because they're trying to convince the jury that, “Oh, that was a big deal.” But it does mean something to people. Did you make money, or did you lose money? So, I think that's the first thing we want to look at.

I think even larger than that is debt covenant violations. We're going to talk specifically a little bit later about what you do with materiality in an audit or a review. But when we are determining if something is material or to the extent of testing or inquiries—we may do inquiries in a review, testing in an audit—we're going to focus on the debt violations because that is very material. If it is a current ratio, if it is a times interest earned ratio—whatever it might be—now you look at the accounts that are in the numerator and the denominator because almost all debt covenants or a ratio of some sort. That's when you say, “Okay, if we don't adjust this number, now the debt covenant is going to be violated.” Now, the other side of my brain thinks, “Well, if you have a certain number that you have to reach—times interest earned 4.0—and you're at 4.03, I know that if I’m the banker, I’m going to take a closer look at this.” And really, what's the difference between 4.03 and 3.99? You're in that gray area.

Ms. Grove Casey

That range.

Mr. Oestriecher

But it's also a legal thing where now the bank can call the loan. So, maybe the client wants to make sure that they can't call the loan because they know the bank's looking for an excuse to call the loan. Now we start looking at things that are estimates that might be in the numerator or denominator where management can manipulate it. I think that's very, very important that just a few dollars that may not be part of your preliminary materiality in either an audit or a review, but it can swing that. So, we absolutely look at debt covenants.

Compensation. This is where—you've heard this, I've heard this—anyone that can make decisions on how to report, how to measure, and how to adjust items on the financial statements should never have their compensation tied to any kind of financial performance. A number may not be material to the company, but now it triggers a $15,000 bonus for me. I can assure you that in the grand scheme of things, I'm at the stage of my life that $15,000 wouldn't make or break me. I know it would just make my wife very happy. It makes the government happy. They get their third, and then Sandy has $10,000 to go blow on something else that I would never spend money on. And it could be a lot bigger numbers than that. So, any kind of impact on bonus or compensation.

Ms. Grove Casey

Well, you're inappropriately incenting them to do something you'd prefer they didn't.

Mr. Oestriecher

Exactly. Here's an interesting thing, though. Almost all of these folks, for some companies, have stock options. I've got clients that work for privately held companies that eventually may go public, and they work in the financial reporting division, and they have stock options. So, that's where it's like, okay, how does it impact? It may not be a bonus. It could be a stock option or triggering the ability to exercise an option.

One of the big ones I want to talk about—when we talk about qualitative factors, we think of materiality initially, or we tend to. Certainly I always did. What's on the balance sheet? What's on the income statement? Then occasionally, maybe the cash flows, but that tends to be where we focus. Disclosures are important. If we were to go ask a member of the FASB or the GASB, “Which is more important, the amount reported in the financial statements or the amounts and information that is reported in the disclosures? Please tell me which is more important,” I think every member of both the FASB and GASB would say they're equally important.

Ms. Grove Casey

I agree.

Mr. Oestriecher

I don't know if you agree with that, but that's personally what I think, and I've talked to a couple of these folks. That's why, when you look at the GAAP codification, Section 50 always deals with disclosures. And we call it, I mean, there's presentation GAAP, measurement GAAP, and disclosure GAAP. I think presentation GAAP—how it's presented—that's where they'd say, "Well, because everyone has to present things same way, maybe that isn't as important, even though we know it can affect classification of current and non-current liabilities." That could be where, hey, now materiality comes into play because it impacts some ratios—maybe your current ratio.

Getting back to disclosures, there are certain things in disclosures—remember, it's not just a summary of information that's contained in the financial statements. Oftentimes, the disclosures will contain information that's not directly related to any asset, liability, revenue, or expense. Concentrations [are] a big thing. Again, I was involved in an issue one time where parties were in dispute, and part of the dispute was that there has to be a disclosure of management's policy for mitigating certain risks when there are concentrations. Management had appropriately disclosed that policy, but the CPA firm did not get any evidence as to whether or not the policy was being followed. But that wasn't the objective. In other words, the disclosure requirement never said, "Oh, and by the way, we are following our policy." [It] just says, "What is the policy?" If that policy or that concentration is important to a third party, then it is up to the third party to maybe send in their bank examiner—or not bank examiner, but their internal people—to say, "Okay, how closely are you following the policy?" So, in that discussion, eventually all parties agreed, sort of, that, okay, yeah, that wasn't the CPA's responsibility. But it showed to me how important that policy was to a third party in evaluating any off-balance-sheet risks that the entity could have. So, how material is that? We can't quantify that. We just have to look and say, "Okay." I'm going to use this example, and I could understand for that particular industry, why that policy for mitigating risks on this concentration would be important to both the company and any third party that maybe wanted to purchase the company, or invest, or lend money to the company.

So, how important is that disclosure compared to say disclosure on their policy for cash and cash equivalents? The answer is [that] the policy for cash and cash equivalents on this particular entity was not very material because they didn't even have any cash equivalents. It was very simple. The money in the bank was cash, and that's all cash that they had. Cash was a very small percentage of their balance sheet, and there was not much exposure should their cash disappear because it was all below the FDIC limits. So, when I'm determining should I obtain audit evidence on [the] adequacy of the disclosure, omission of the cash or cash equivalents probably wouldn't be material. Had the disclosure on the policy to mitigate a very real risk been omitted, that would be important to a user; therefore, it would be material. You can't quantify it. It's a qualitative issue. Maybe you can say, "Well, what is the maximum exposure of risk?" But I wouldn't even go there because it's hard to determine what the maximum exposure of risk is. If somehow you can, and you determine that the maximum exposure of risk was below our tolerable misstatement, then maybe you could get away and say, "Okay, well, it wasn't material." But there's another component to this on disclosures. Generally, in the size firm that I work with, we are assisting the client in preparing the financial statement. So, if we're going through a checklist and we see the disclosure is not there, generally we don't pass and say [it's] not material. We talk to the client, get the information, and we put the disclosure in. There are some disclosures you can pass as being not material, but again, you've got to look at how important is that information, not what is the dollar amount that's involved.

Ms. Grove Casey

You mentioned the off-balance-sheet risk. The standard setters seem to have a policy of their own where we start out with disclosure once an issue has been raised or brought to their attention, and then we move on to measurement, right?

Mr. Oestriecher

Correct.

Ms. Grove Casey

So, first we talk about it, and then we make you quantify it. If there's something where you see disclosure coming up, you might want to think about it because, sooner or later, we're going to get down to measurement.

Mr. Oestriecher

That's a great example. Remember fair value was initially disclosed.

You measured it. Derivatives were first disclosed. That's a great point that we disclose it first, but disclosures are important. They should not be an afterthought. Materiality does apply to disclosures, and you have to look more qualitative rather than quantitative.

Ms. Grove Casey

Let's talk about materiality in a review engagement because our level of assurance there is a little bit less, but we still have to make a materiality assessment.

Mr. Oestriecher

That is something new with SSARS 25, and I hope everyone out there knows that. It's been around for a couple of years now. But that is a major difference in, historically, my—37 years I've been in this profession now, and you never had to calculate materiality. But now we have to. So, what SSARS 25 requires is that you make a determination of materiality.

Now, I've said I'm going to do this. I don't know if I'll have the guts to do it, but if I actually know the last year that I'm in practice, on every review that I perform, I'm going to document materiality. I'm not going to put a dollar amount; I'm just going to say the amount that would influence a user's conclusion. It says you have to document materiality. It doesn't say you have to quantify it. But I can assure you that peer reviewers, opposing counsel, and probably your state board of accountancy say, "Yes, [it's] kind of implied that you come up with a number." So, we come up with a number.

Once you come up with that number, there are three things you have to do with that number. You have to use it to design your review procedures, which again are primarily inquiry and analytical procedures. You use it to evaluate the results of your procedures. And the third thing that you do is you have to update your materiality calculation—or your materiality determination, I should say—should new or additional information come to your attention during the course of your review procedures. I can tell you that third thing doesn't happen very often, because generally we are basing materiality off the larger of assets or revenues, and we generally don't have gigantic adjustments that would move that needle very much. But it's still in there.

Let's talk about that first one—using materiality to design your review procedures. For full disclosure, I was on the committee that writes these standards 20 plus years ago, and when we wrote SSARS No. 10, we actually thought about, [at] that time, putting a requirement in the standards that you calculate materiality because the review report states, "We did not become aware of any material modifications." And common sense tells us that you should have an idea of what is material when you write that report. But the discussion we got into is we said, "Okay, but once we do that, when you think of an audit," and we're going to talk about that a little bit, "we use some of the derivatives of our planning materiality to determine sample sizes and other items. You don't do that kind of detailed testing."

I went into our first year of reviews under SSARS 25 with a very open mind and said, "Okay, the standards say that once I come up with this number, that I should use it to design my inquiry and analytical procedures." I can tell you I've never had that epiphany where it says, oh, I am choosing better inquiries or performing better analytical procedures because I came up with this artificial number that is largely based on the exact methodology we use in audits where we take the larger of total assets and revenues; multiply it by, or come up with, a base number; multiply it by a percentage; and then multiply that by another number to come up with what would be the equivalent of tolerable misstatement. We actually call that *preliminary materiality* in a review engagement. That's the terminology we use here in our firm. Because remember, the standard doesn't tell you how to do it; it just says you can do it.

Here's another way that I could do it, Debi. I could look at and go, "$28,000 is material," and just document and use my professional judgment. Why don't people do that? Why do they go through this form to do it? Because they want to do it the way everybody else is doing it. In case you ever get sued, you can show consistency in generally accepted practices. But please don't be fooled. Remember, we don't have generally accepted compilation and review standards. A lot of people believe that if something is widely used in practice aids—and I know a lot of people use the Thomson Reuters/PPC, but there are other third-party practice aids out there—they believe if we do something everybody else does, we have to do it that way because that's generally accepted practice. There's no such thing as generally accepted compilation and review standards, so you can do it however you want to. What I would recommend is, whatever methodology you use in your firm, just be consistent from one engagement to the next and also from one year to the next.

Truthfully, we are now coming up with this number, and we're setting it aside. I have not changed the way that I choose or design inquiries or analytical procedures now that I have that number. I'm using it, but I've always used it because I've had in the back of my mind the areas that are subject to management's estimate—that's where I need to perform inquiry and analytical procedures. Areas where there have been new GAAP pronouncements. I am still not and will never perform specific analytical procedures on dues and subscriptions, and I didn't need a number to tell me that number is not going to be material. So, we put it in there, we check off that we use it, but I can tell you from a practical standpoint, it has not impacted us. Even when we're evaluating the results, remember, we're not finding the small $180 invoice that was transposed when it was put in the general ledger. We don't find that in a review because we're not doing that level of detail work. That's the type of small adjustment we pass on in an audit all the time. So, calculate it; revise it if you need it; check off that you've done it. But from a practical standpoint, I have not seen an impact on how people actually perform the meat and potatoes, which is the inquiry and analytical procedures.

Ms. Grove Casey

So, let's talk about materiality in an audit engagement because you may actually use that number for a lot of things in an audit.

Mr. Oestriecher

Absolutely. It's very important. And then the numbers that you come up with in an audit—if you're using things like PPS (probability proportional to size) sampling, that is going to greatly impact your sample size [and] your efficiency in the audit. Again, efficiency doesn't mean just profitability. Efficiency means, am I obtaining the appropriate sufficient audit evidence? Am I getting a large enough sample? If you come up with a much lower number than, let's say, I would have, well, now you're going to have a lower tolerable misstatement [and] lower individually significant items. So, you and I might be doing a similar audit where there's $12 million in accounts receivable. Because I used higher materiality numbers and I'm comfortable with them, I may wind up only confirming 80 accounts receivable. You might wind up confirming 360 accounts receivable because you used a different number. We could use the same modeling—PPS, probability proportional to size. It's just how we came up with that materiality number.

That's why it's important, and it doesn't mean that I'm right and you're wrong or you're right and I'm wrong. It just means we need to understand that concept so that—okay, most of these third-party practice aids, say use the larger of assets or revenues, but if there's a huge disparity, I might come up with two numbers. For testing balance sheet accounts, I'll use the asset materiality number. For income and expense accounts, I can use the income number. Again, completely allowed there. There's no set formula you have to use. This is where your professional judgment comes in. So, use your judgment, use those predetermined formulas, but understand the impact.

I've seen individually significant items range anywhere from one third of tolerable misstatement to one tenth. If you're going to choose one tenth, be prepared to do a lot of work. And you may believe that's completely appropriate. For things where we have a higher risk of material misstatement, we may use a lower ISI [individually significant item] amount because that's going to give us more coverage. It's going to give us larger sample sizes, which is appropriate because we have a higher risk in that particular account. Accounts that have a lower risk, we may use a higher individually significant item [amount] because, remember, typically anything in a population is going to be tested that we consider to be an ISI. We test those 100%, and then the items below that, that's where we use some sort of a sampling methodology. So, it's where you put that line between 100% testing. Very, very important, but be consistent with how you use it. Again, I think most people are using those third-party practice aids.

Ms. Grove Casey

Well, that sampling guide, when it first came out, was one of my favorite tools by the AICPA because it really explained things clearly in my mind related to sampling. Let's talk about performance materiality and ISIs because sometimes we need to stratify that sample.

Mr. Oestriecher

Correct. Remember, once we come up with preliminary materiality, we typically always use a smaller percentage of that. That little gap—and most people use 75%—that 25% gap represents sampling error, audit error, human error, to say, "Look, we're trying to get reasonable assurance here, not absolute assurance." And so, because we're not testing everything, that's your first margin for error, so that gets you down to tolerable misstatement. I've used different terms for this. I've seen different terms used, but usually people go with *tolerable misstatement* for that.

But then you get into your ISI that I discussed earlier, and again, this is where you're going to want to use, in my opinion, ranges of ISI based on where your risk of material misstatement is. You will not see me using a very low ISI for things like cash [or] prepaid insurance because generally those things are not high-risk areas. But revenues—especially when you're looking at cutoff inventory, all of those revenues, recognition itself—that's where you're going to use maybe a lower ISI. So, understanding that relationship and documenting it is important. And if you start to find some errors, you might say, "Wait a second, now I need to sample less. I need to get more." So, you go back, and you change that number. You bring that number down, and you test more items 100% if it is not within acceptable—if the results of your initial procedures aren't within what you were expecting. And I say acceptable range—I should say acceptable, you know, what your initial amount was, the ranges, whatever. The results are going to be what the results are. You just hope that if I pull a sample size of 100 items, two of them might have errors and 98 of them are fine. If I see that 40 of them had errors, I'm like, "Okay, I can't just extrapolate this. I've got to go find out what the real errors are."

Your materiality shouldn't be something that's calculated at the beginning and then ignored. It is fluid throughout the engagement. It should be referred to, and, just as we talked about in a review, it will be used to help evaluate your misstatement at the end.

Ms. Grove Casey

Let's talk a little bit more about evaluating misstatements. It's not just calculating one number and ignoring it. Like you said, we need to actually pay attention.

Mr. Oestriecher

I think one of the things—and I won't say it's a mistake; it's just because an auditor has his or her right to evaluate materiality using their professional judgment. But an approach that I do not use is to say, "Okay, if at the end of my audit I have all my lead schedules, and I have potential misstatements and known misstatements, and I combine those, and they're below my tolerable misstatement, that does not automatically mean that, oh, everything's fine and I can issue an unqualified opinion." I think that is one of the items that you would want to look at. But we talked about qualitative factors earlier. Now that I know what's ultimately my net income and we looked at those debt covenants, I think it is just one of the factors that should be used in an overall final evaluation of what type of a report you should issue. So, that is the point where your materiality—which has been a very useful tool and very important tool that gave you a numerical reference, if you will, to say this is the appropriate sample size—now it kind of morphs into just one piece of information as part of your overall guidance in determining what your final materiality should be or the final potential misstatement. So, don't just use only your preliminary materiality to determine whether or not you're issuing the appropriate opinion, in my opinion.

Ms. Grove Casey

Is there anything that you want to mention overall tied to materiality and making the assessment? Just a thought on my part related to the documentation of your materiality in the review is that you probably want to document the process that you went through so that you can get that consistency that you mentioned.

Mr. Oestriecher

Right, I think that's it. Again, while you can use your professional judgment, I really do like any—I won't going to endorse any one practice aid over the other, but our firm uses the practice aids. We use them consistently. I think communicating that to the entire audit team, if you have audit team; if it's a review, generally it's one person. I think this number should be available when you have your overall risk discussion because when you're talking about risks you're talking about risks of material misstatement. Well, what's material? So, that kind of gives us an idea when we're looking at and performing our preliminary analytical procedures.

I think getting it done early; documenting, as you said; and then, always keep in mind, we have to do a reevaluation. And it's not just that the numbers change. Let's say that we become aware—oh, there is a debt covenant that we weren't aware of, or now we find out that the company is trying to sell, or there's something else that would impact how users would perceive the financial statements. Those are all things that could cause us to say, “let's go back and reevaluate materiality.” That's what we try to do within our firm and understand that while it's an important piece, it isn't the evidence-gathering piece, but it is still a very important piece of the audit. And now, as a result of SSARS 25, it's also a very important and required piece of a review. I'll re-state what I said earlier. While I think there is great intent, I truly don't think it has changed the way we perform reviews if you were properly determining what inquiries and analytical procedures to perform all along. For some people, it might have been an eye-opener to go, “Ooh, maybe I need to spend some time making inquiries on allowance for doubtful accounts because it's material and it's subject to estimates.”

Assessing Materiality under AICPA Audit and Review Standards

By Kurt G. Oestriecher, CPA

Introduction

Members of the accounting profession understand that perfection is unattainable in the preparation of financial statements due to the vast number of transactions and amount of judgment that is involved. Because it is accepted that misstatements may and will occur, the concept of materiality is important for both the issuers of financial statements and the CPAs that are engaged to audit or review the financial statements.

While we always attempt to quantify materiality, it is important to remember that materiality is a concept and not necessarily an equation. An amount or disclosure that would influence a user's conclusion regarding the amounts presented and disclosed in the financial statements is ultimately what would be considered material.

This discussion will address both the specific issues related to materiality within the audit and review standards, and the concepts that must be applied by the accountant.

Materiality in Review Engagements

Review Requirements under SSARS

Prior to the issuance of SSARS No. 25, an accountant performing a review engagement was not required to quantify or document materiality. For periods ending after December 15, 2021, and later, an accountant is now required to determine and document materiality. The following guidance related to materiality is provided in AR-C 90:

Objective (AR-C 90.07)

The objective of the accountant when performing a review of financial statements is to obtain limited assurance as a basis for reporting whether the accountant is aware of any ***material*** modifications that should be made to the financial statements….

Materiality in a Review of Financial Statements (AR-C 90.19–.20)

The accountant should determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.

The accountant should revise materiality for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.

Knowledge of the Entity (AR-C 90.22)

The accountant should obtain knowledge about the entity, including an understanding of the entity's business and the accounting principles and practices used by the entity sufficient to identify areas in the financial statements in which there is a greater likelihood that ***material*** misstatements may arise….

Designing and Performing Review Procedures (AR-C 90.24–.25)

The accountant should design and perform analytical procedures and make inquiries and perform other procedures, as appropriate, to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements….

The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of ***material*** misstatements.

Evaluating Evidence Obtained from the Procedures Performed (AR-C 90.45)

If, during the performance of review procedures, the accountant becomes aware that information coming to the accountant's attention is incorrect, incomplete, or otherwise unsatisfactory, the accountant should—

a. request that management consider the effect of those matters on the financial statements and communicate the results of its consideration to the accountant and

b. consider the results communicated to the accountant by management and whether such results indicate that the financial statements may be ***materially*** misstated.

Determining Materiality in a Review Engagement

No specific calculation of materiality is required in a review engagement. However, many accountants have used widely accepted tables from audit guidance to calculate a planning materiality threshold in review engagements. The danger in this practice is that planning materiality in an audit is used to determine the nature, timing, and extent of audit procedures. In a review engagement, an accountant will only perform two primary types of procedures: inquiry and analytics. The timing of procedures is typically not an issue as all work is performed after year end. Therefore, the extent of procedures is the only issue in a review that could be impacted by a calculation of planning materiality.

While nothing precludes an accountant from using a planning materiality calculation to determine which elements of a financial statement will be subject to analytical procedures, the dollar amount of an element of the financial statements should not be the only factor considered. Issues such as judgment, prior adjustments, new standards, and inquiries of management carry more weight than dollar thresholds in determining the scope of analytical procedures.

Determining the Materiality of Accounting Framework Departures (Usually United States GAAP in a Review Engagement)

When an accountant determines that a departure from the reporting framework exists (e.g., a measurement or a disclosure departure), the accountant must then determine if the departure is material. The accountant should not rely exclusively on the required planning materiality calculation in making this determination, but instead look at the misstatement both individually and in the aggregate to determine if the departure would influence a user's conclusions about the financial statements.

An issue to consider when determining whether a departure is material is the procedure that led the accountant to the departure. In the audit world, it is common to find very small departures when examining invoices, purchase orders, and similar documents. In a review engagement, such procedures are ordinarily not performed. Therefore, any departures that are determined to exist were first indicated by a broad procedure (either inquiry or analytical). If an analytical procedure (e.g., a ratio or a comparison to a prior period) yields questions and follow-up procedures reveal a departure, it is very likely that the departure is material.

Materiality in Audit Engagements

Planning Materiality

AU-C 320 provides guidance to the auditor on determining planning materiality in an audit. Much like the review standards, the audit standards refer to the discussion of materiality that may be contained in the applicable financial reporting framework selected by management. The general concepts related to materiality contained in most frameworks are as follows:

- Misstatements are generally considered to be material if they could reasonably be expected to influence the economic decisions of users.
- Materiality judgments are made in light of surrounding circumstances and are affected by both the size and the nature of the misstatements.

- Judgments related to materiality are based on the needs of users as a group. The possible effects on specific individual users are generally not considered. (An exception to this general concept would be if the audit report is restricted to a single user.)

Audit standards require an auditor to define both planning materiality and performance materiality (AU-C 320.10–.11) and revise the preliminary materiality judgments as the audit progresses if the auditor becomes aware of information during the audit that would have caused the auditor to adjust the preliminary amounts had they been known at the time.

The audit standards do not require specific calculations for determining planning materiality, but the application and explanatory material describe methods the auditor may use. The guidance reflects the same concepts that are typically found in non-authoritative third-party practice aids that use a benchmark such as revenues or total assets as a base. The base amount is then multiplied by some factor to determine planning materiality. This method is not required by the standards, but using a methodology employed by many auditors is beneficial. Due to the conservative nature of many auditors, an auditor using judgment would probably select a materiality amount much lower than the standard calculations. This lower materiality amount would lead to an increased level of testing and may lead to inefficient auditing. If the auditor, using judgment alone, selected a materiality amount much higher than the standard calculations, it might be difficult to defend that position and the materiality calculations in litigation or other proceedings if there is an alleged audit failure.

Materiality and Professional Judgment

While the concept of professional judgment is clear throughout the audit standards, AU-C 320.04 specifically addresses the issue. Often, auditors believe that materiality can be calculated and reduced to a dollar amount. This is a very difficult position to defend. When determining whether a misstatement is material, an auditor is better served by documenting why the dollar amount of the misstatement or the omitted disclosure would not influence a user. This approach indicates the auditor's understanding that his or her professional judgment is the overriding criteria, not a mathematical calculation.

Performance Materiality

A concept related to materiality that is often misunderstood is performance materiality. AU-C 320.09 defines *performance materiality* as follows:

> The amount or amounts set by the auditor at less than materiality for the financial statements taken as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement.

Based on the definition, performance materiality should never be used as a measure when determining the impact of uncorrected misstatements on the auditor's report. Performance materiality is an artificial amount, always less than expected materiality, that is used to account for the fact that there may be misstatements that are not detected by audit procedures. There is a fallacy that if uncorrected misstatements are less than performance materiality, then the financial statements are not materially misstated. Use performance materiality as a planning tool, not an evaluation tool.

Materiality in Evaluation of Misstatements

After all of the audit evidence has been evaluated, the auditor may determine that misstatements are present. A *misstatement* is a measurement, presentation, or disclosure that is not in accordance with the accounting framework selected by management (most commonly United States GAAP).

When uncorrected misstatements have been identified, AU-C 450 requires the auditor to evaluate those misstatements. The first step in this process is to determine if the misstatement or misstatements would have caused a difference in the planning materiality. If so, the auditor should determine whether the scope of procedures performed is still appropriate.

When determining whether the uncorrected misstatements are material, individually or in the aggregate, the auditor should consider the following:

- The size and nature of the misstatements, both in relation to the particular class of transactions, account balance, or disclosure and the financial statements taken as a whole.
- The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements taken as a whole.

When considering whether a misstatement is material, the auditor should take into account the nature of the misstatement.

Factual misstatements are misstatements that are absolute. A specific amount on an invoice that should have been included as a liability (accounts payable) but was recorded in the subsequent period is an example of a factual misstatement. It is common for factual misstatements to be corrected because it is easy for both the auditor and management to agree on the misstatement.

Judgmental misstatements typically arise when the auditor and management disagree over the judgment applied to accounting estimates.

Because a judgmental misstatement is not absolute, consideration should be given to any arguments presented by management. However, once the auditor determines a misstatement exists, the auditor should apply the same factors in determining whether the uncorrected misstatement is material as used for a factual misstatement.

Projected misstatements arise when a misstatement is discovered in sampling and then projected to the entire population. This type of misstatement is the most difficult to address, especially when projecting to a population that is supported by a subsidiary schedule such as accounts receivable. If a projected misstatement is material, the auditor should consider additional testing to determine if there was an abnormal sample. The issue with booking the adjustment is that while the known misstatements can be adjusted to the proper subsidiary account, there is no plausible method of adjusting the projected misstatements to any subsidiary account. In this instance, an entity can adjust to a separate general ledger account, and in future years, when the actual misstatements are detected, the entity can then adjust the subsidiary account against the control account created when posting the audit adjustment.

Documenting the Auditor's Evaluation of Misstatements

AU-C 450 requires the following documentation of the evaluation of misstatements:

- The amount below which misstatements would be regarded as clearly trivial.
- All misstatements accumulated during the audit and whether they have been corrected.
- The auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.

Reporting When Uncorrected Material Misstatements Exist

An important concept that is sometimes overlooked is that management is responsible for the financial statements while the auditor is only responsible for the auditor's report. Just because an auditor may determine that material misstatements exist, the auditor cannot force management to adjust accounts or modify the disclosures. In cases where management refuses to correct the misstatement, the auditor must consider the effect of the misstatement on the audit report. AU-C 705 provides guidance to the auditor on reporting when material misstatements exist.

The auditor can express either a qualified or an adverse opinion when there is a material uncorrected misstatement in the financial statements. An adverse opinion is appropriate when the auditor believes that the uncorrected misstatements are both material and pervasive. If the auditor concludes the misstatements are not pervasive, then a qualified opinion should be issued.

It is never appropriate to issue a disclaimer of opinion when the auditor determines that there is a material uncorrected misstatement. The disclaimer is used when the auditor is precluded from making a determination due to a scope limitation or some other factor that does not allow the auditor to accumulate sufficient appropriate evidence.

When issuing either a qualified or adverse opinion, the auditor should add a paragraph that explains the reason for the opinion. Management should also disclose the departure in the notes to the financial statements, and the modification paragraph should refer the reader to the disclosure in the notes to the financial statements. In an interesting twist, the failure of management to disclose the departure is a departure in and of itself, and should also be evaluated as a misstatement.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss the use of materiality in review engagements.
2. Discuss the determination of materiality in review engagements.
3. Discuss the auditor's evaluation of types of misstatements and materiality.

B. Suggested Answers to Discussion Problems

1. Prior to the issuance of SSARS No. 25, an accountant performing a review engagement was not required to quantify or document materiality. For periods ending after December 15, 2021, and later, an accountant is now required to determine and document materiality. The accountant should determine materiality for the financial statements as a whole and apply this materiality in designing the procedures and evaluating the results obtained from those procedures.

   The accountant should revise materiality for the financial statements as a whole if the accountant becomes aware of information during the review that would have caused the accountant to have determined a different amount initially.

2. No specific calculation of materiality is required in a review engagement. However, many accountants have used widely accepted tables from audit guidance to calculate a planning materiality threshold in review engagements. The danger in this practice is that planning materiality in an audit is used to determine the nature, timing, and extent of audit procedures. In a review engagement, an accountant will only perform two primary types of procedures: inquiry and analytics. The timing of procedures is typically not an issue as all work is performed after year end. Therefore, the extent of procedures is the only issue in a review that could be impacted by a calculation of planning materiality.

   While nothing precludes an accountant from using a planning materiality calculation to determine which elements of a financial statement will be subject to analytical procedures, the dollar amount of an element of the financial statements should not be the only factor considered. Issues such as judgment, prior adjustments, new standards, and inquiries of management carry more weight than dollar thresholds in determining the scope of analytical procedures.

   When an accountant determines that a departure from the reporting framework exists (e.g., a measurement or a disclosure departure), the accountant must then determine if the departure is material. The accountant should not rely exclusively on the required planning materiality calculation in making this determination, but instead look at the misstatement both individually and in the aggregate to determine if the departure would influence a user's conclusions about the financial statements. Some factors to consider when making this decision include whether the misstatement—

   - turns a profit into a loss or vice versa,
   - causes a violation of a debt covenant or other agreement,
   - affects compensation of management, and
   - the impact of omitted disclosures.

3. After all of the audit evidence has been evaluated, the auditor may determine that misstatements are present. A misstatement is a measurement, presentation, or disclosure that is not in accordance with the accounting framework selected by management (most commonly United States GAAP).

   When uncorrected misstatements have been identified, AU-C 450 requires the auditor to evaluate those misstatements. The first step in this process is to determine if the misstatement or misstatements would have caused a difference in the planning materiality. If so, the auditor should determine whether the scope of procedures performed is still appropriate.

When determining whether the uncorrected misstatements are material, individually or in the aggregate, the auditor should consider the following:

- The size and nature of the misstatements, both in relation to the particular class of transactions, account balance, or disclosure and the financial statements taken as a whole.

- The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements taken as a whole. When considering whether a misstatement is material, the auditor should take into account the nature of the misstatement.

Factual misstatements are misstatements that are absolute. A specific amount on an invoice that should have been included as a liability (accounts payable) but was recorded in the subsequent period is an example of a factual misstatement. It is common for factual misstatements to be corrected because it is easy for both the auditor and management to agree on the misstatement.

Judgmental misstatements typically arise when the auditor and management disagree over the judgment applied to accounting estimates. Some of the more common areas where judgmental misstatements my occur include the following:

- Allowance for doubtful accounts

- Depreciation

- Fair value

- Asset impairments

- Pension obligations

Because a judgmental misstatement is not absolute, consideration should be given to any arguments presented by management. However, once the auditor determines a misstatement exists, the auditor should apply the same factors in determining whether the uncorrected misstatement is material as used for a factual misstatement.

Projected misstatements arise when a misstatement is discovered in sampling and then projected to the entire population. This type of misstatement is the most difficult to address, especially when projecting to a population that is supported by a subsidiary schedule such as accounts receivable. If a projected misstatement is material, the auditor should consider additional testing to determine if there was an abnormal sample. The issue with booking the adjustment is that while the known misstatements can be adjusted to the proper subsidiary account, there is no plausible method of adjusting the projected misstatements to any subsidiary account. In this instance, an entity can adjust to a separate general ledger account, and in future years, when the actual misstatements are detected, the entity can then adjust the subsidiary account against the control account created when posting the audit adjustment.

GLOSSARY OF KEY TERMS

Blank Check Corporation—a special purpose acquisition company, is an early or development stage entity created specifically for the purpose of acquiring or merging with one or more existing businesses

Chapter 7—Chapter 7 of the Bankruptcy Code is the liquidation chapter.

Chapter 11—Chapter 11 of the Bankruptcy Code is the reorganization chapter

Cryptocurrency— a digital currency that, unlike traditional money, isn't created or backed by a government

IPO—Initial Public Offering

ISI—Individually Significant Item

Known Misstatement—the amount of misstatements specifically identified

Material—The amount that would influence a user's conclusions

Materiality—Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements

Preliminary Materiality—based on forecasted or estimated financial results

PPS—Probability Proportional to Size

Small Business Reorganization Act—Created a new subchapter (V) under chapter 11 for the reorganization of small business debtors

SPACs—Publicly traded corporations with a two-year life span formed with the purpose of merging with a privately held organization to enable it to go public

Subchapter 5 of Chapter 11—Created by the Small Business Reorganization Act in 2019; this subchapter made small business bankruptcies faster and less expensive

Tolerable Misstatement—an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements

CUMULATIVE INDEX 2023

BY TOPIC

BY CITATION

BY SPEAKER

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

1. According to Russ Madray, which of the following statements best describes a Chapter 11 bankruptcy?

   A. It is accounted for using the liquidation basis of accounting.
   B. It is considered a reorganization, and the entity's existing debt is restructured.
   C. The entity's operations are discontinued, and its assets are sold to the highest bidder.
   D. It is uncommon for businesses, which usually declare bankruptcy under Chapter 7.

2. According to Russ Madray, when does the guidance in FASB ASC 852 apply?

   A. When an entity is restructuring its debts without declaring bankruptcy.
   B. When an entity declares bankruptcy under Chapter 7.
   C. When an entity declares bankruptcy under Chapter 11.
   D. When the entity stops using U.S. generally accepted accounting procedures (GAAP).

3. According to Russ Madray, how does a Chapter 11 bankruptcy affect an entity's financial statements?

   A. Transactions related to the reorganization must be presented separately from those related to ongoing operations.
   B. Liabilities are reported at the amount the entity expects they will be settled for, even if that is less than the amount expected to be allowed by the court.
   C. The entity is required to reclassify certain noncurrent liabilities as current under Topic 470 even if automatic stay provisions are in place.
   D. An income statement that reflects the entity's ongoing operations should not be included in the entity's financial statement presentation.

4. According to Russ Madray, what is one of the conditions for an entity to use fresh-start accounting?

   A. The reorganization value is less than the post-petition liabilities plus the allowed claims.
   B. Former holders of voting shares still own the majority (over 50%) of shares after the reorganization.
   C. Former shareholders' loss of control is only temporary and ownership will revert back to them.
   D. The new entity makes any adjustments required by the fresh-start accounting or debt forgiveness.

5. According to Russ Madray, what is the purpose of Subchapter V, which was added to Chapter 11 by the Small Business Reorganization Act?

   A. To reduce the amount of discharge limitations allowed to small business debtors.
   B. To prohibit small business debtors from modifying residential mortgages in response to bankruptcy.
   C. To increase the personal liability of shareholders in large businesses.
   D. To make small business bankruptcies faster and less expensive.

Continued on next page

6. According to Jennifer Louis, which of the following is a characteristic of a special purpose acquisition company (SPAC)?

   A. SPACs are privately held companies; they are not publicly traded.
   B. SPACs typically have a five-year lifespan but can exist longer in certain situations.
   C. SPACs are formed to help privately held businesses go public via merger or combination.
   D. Like blank check corporations, SPACs have little regulation or recognition by Congress.

7. According to Jennifer Louis, what actions are taken by the sponsors of a SPAC?

   A. They make nonrefundable payments to initiate the SPAC process.
   B. They represent the target entity that will be acquired by the SPAC.
   C. They invest money in the existing SPAC by buying shares.
   D. They recommend when it is time for the SPAC to be dissolved.

8. According to Jennifer Louis, how does a SPAC compare to the traditional IPO process?

   A. There is more certainty as to what will happen in the traditional IPO process.
   B. There are more regulatory demands when using a SPAC.
   C. Lower fees are involved with the traditional IPO process.
   D. Capital is received more quickly when using a SPAC.

9. According to Jennifer Louis, how do the risks associated with cryptocurrency differ from those associated with fiat currency?

   A. Companies that own digital wallets will dispute fraudulent purchases to help individuals obtain a refund.
   B. Cryptocurrency is not backed by fiat currency, so the U.S. government (FDIC) has no obligation to refund any loss.
   C. Purchasing cryptocurrency is a zero-risk investment, which is an improvement on payment methods that use fiat currency.
   D. Payments of cryptocurrency made using blockchain technology are only reversible for a limited period of time.

10. According to Jennifer Louis, for every four dollars reported to the Federal Trade Commission (FTC) involving crypto-related crimes, how many were fraudulent?

   A. One dollar.
   B. Two dollars.
   C. Three dollars.
   D. Four dollars.

Continued on next page

11. According to Kurt Oestriecher, which of the following statements best describes materiality?

    A. It is a quantitative percentage that is exact and the same for an entity in all situations.
    B. It is the amount that would influence a user's conclusions and can vary by engagement.
    C. It is higher for bookkeeping engagements than it is for audit engagement.
    D. It is whatever amount will protect the practitioner from civil litigation.

12. According to Kurt Oestriecher, which are more important—financial statement amounts or the related disclosures?

    A. Amounts are the most important.
    B. Disclosures are the most important.
    C. Amounts and disclosures are equally important.
    D. Amounts are more important unless the entity's financial reporting system is complex.

13. According to Kurt Oestriecher, what is the purpose of SSARS No. 25?

    A. It requires practitioners to calculate materiality for review engagements.
    B. It requires practitioners to calculate materiality for compilation engagements.
    C. It sets a specific level of materiality that practitioners cannot change or update.
    D. It provides a very specific process for determining materiality that practitioners must adhere to.

14. According to Kurt Oestriecher, after preliminary materiality is determined, what percentage is typically an appropriate gap to represent sampling error, audit error, human error, etc., when providing reasonable (not absolute) assurance?

    A. 5%.
    B. 10%.
    C. 25%.
    D. 50%.

15. According to Kurt Oestriecher, materiality should be considered which of the following?

    A. The most important factor for determining the auditor/reviewer's opinion on the financial statements.
    B. A useful tool that, in combination with other things, helps auditors issue an appropriate opinion.
    C. A number or range established early in the process that does not change throughout the audit/review engagement.
    D. A tool that auditors/reviewers can rely on in place of using their professional judgment.

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 **CPLgrading@cerifi.com**. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to **CPLgrading@cerifi.com.**

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

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
Accounting for Corporate Reorganizations	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Fraud Trends in SPACs and Cryptocurrency	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Assessing Materiality	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|

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

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

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

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

	Overall	**Knowledge of Topic**	**Presentation Skills**
Russ Madray	|______|	|______|	|______|
Jennifer Louis	|______|	|______|	|______|
Kurt Oestriecher	|______|	|______|	|______|

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

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If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ ______________________________

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____

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 ☐ __________________________

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Once Again, Thank You…

Your Input Can Have a Direct Influence on Future Issues!

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Program Title: CPE Network Accounting and Auditing Report, August 2023 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: __________

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

			First CPE Hour			CPE Hour 2			CPE Hour 3			FOR TR USE ONLY
First Name	**Last Name**	**Student Email**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Certificate Issued?**

CHECKPOINT LEARNING NETWORK

CPE NETWORK®
USER GUIDE

REVISED May 1, 2023

Welcome to CPE Network!

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

This User Guide has the following sections:

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

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

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

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

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

Copyrighted Materials

“Group Live” Format

CPE Credit

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

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

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

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

Advertising / Promotional Page

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

Monitoring Attendance

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

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

Real Time Instructor During Program Presentation

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

Elements of Engagement

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

Make-Up Sessions

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

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

Awarding CPE Certificates

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

Subscriber Survey Evaluation Forms

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

Retention of Records

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

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

Finding the Transcript

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

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

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

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

Requesting Participant CPE Certificates

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

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

Email: **CPLgrading@tr.com**

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL of the following items:

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

Incomplete submissions will be returned to you.

“Group Internet Based” Format

CPE Credit

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

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

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

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

Advertising / Promotional Page

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

Monitoring Attendance in a Webinar

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

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

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

Examples of polling questions:

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

Additional Notes on Monitoring Mechanisms:

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

Real Time Moderator During Program Presentation

“Group internet based” programs must have a **qualified, real time moderator while the program is being presented.** Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

Make-Up Sessions

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

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

Awarding CPE Certificates

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

Subscriber Survey Evaluation Forms

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

Retention of Records

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

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

Finding the Transcript

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

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

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

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

Requesting Participant CPE Certificates

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

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

Email: CPLgrading@tr.com

Fax: 888.286.9070

When sending your package to Thomson Reuters, you must include ALL the following items:

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

Incomplete submissions will be returned to you.

"Self-Study" Format

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

Self-Study—Print

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

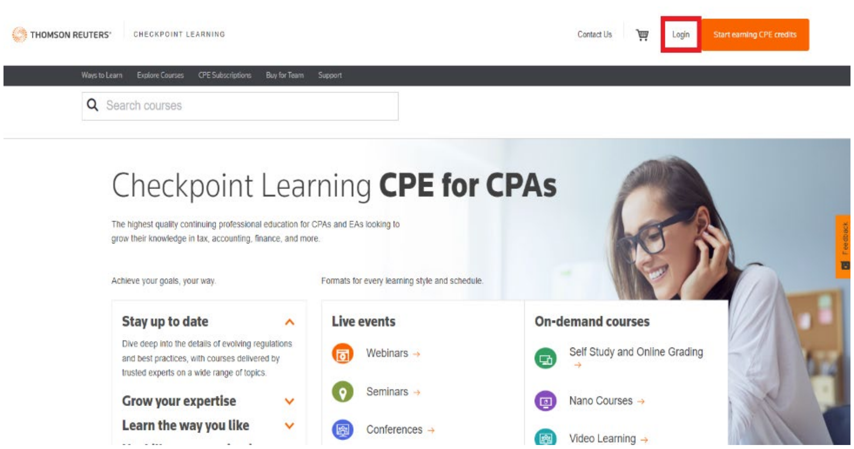
- Watch the DVD.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
-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

  Thomson Reuters
  PO Box 115008
  Carrollton, TX 75011-5008

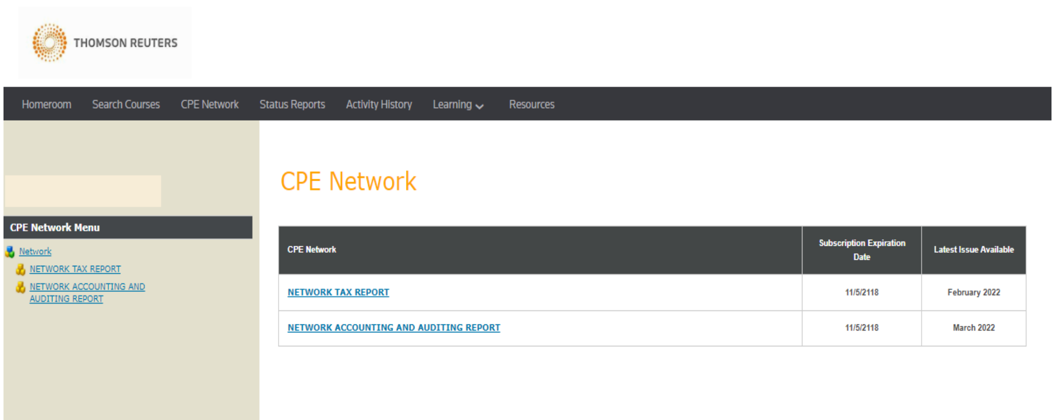
Self-Study—Online

Follow these simple steps to use the online program:

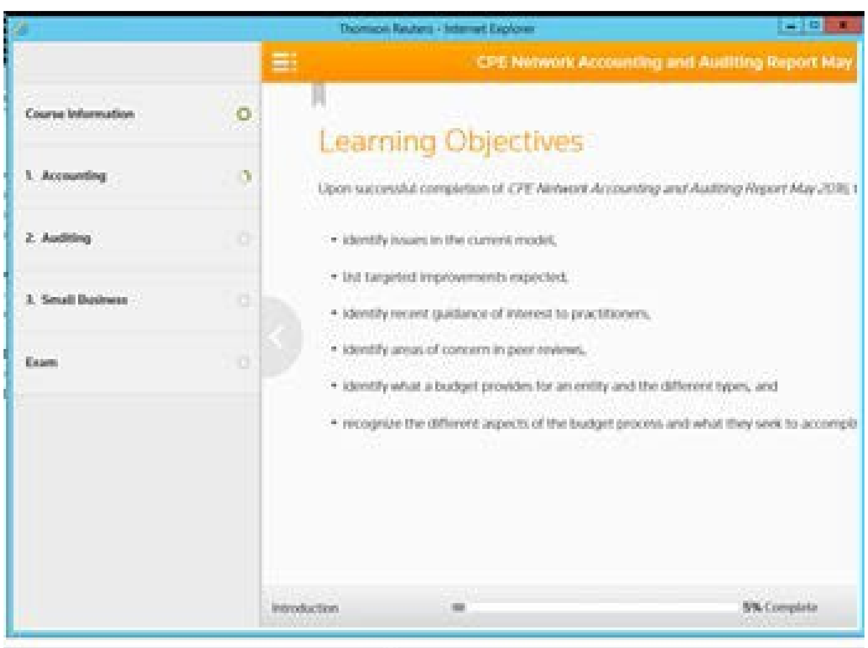
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Login or Register").



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

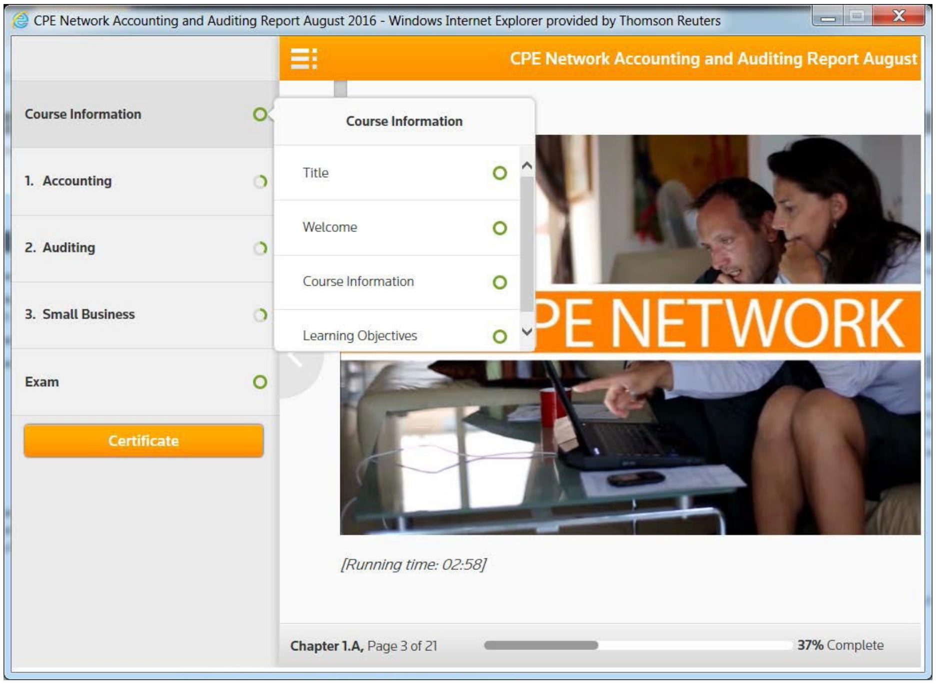


The Chapter Menu is in the gray bar at the left of your screen:

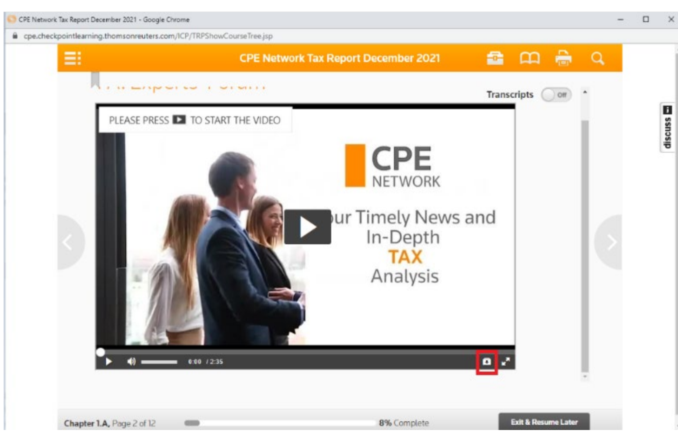


Click down to access the dropdown menu and move between the program Chapters.

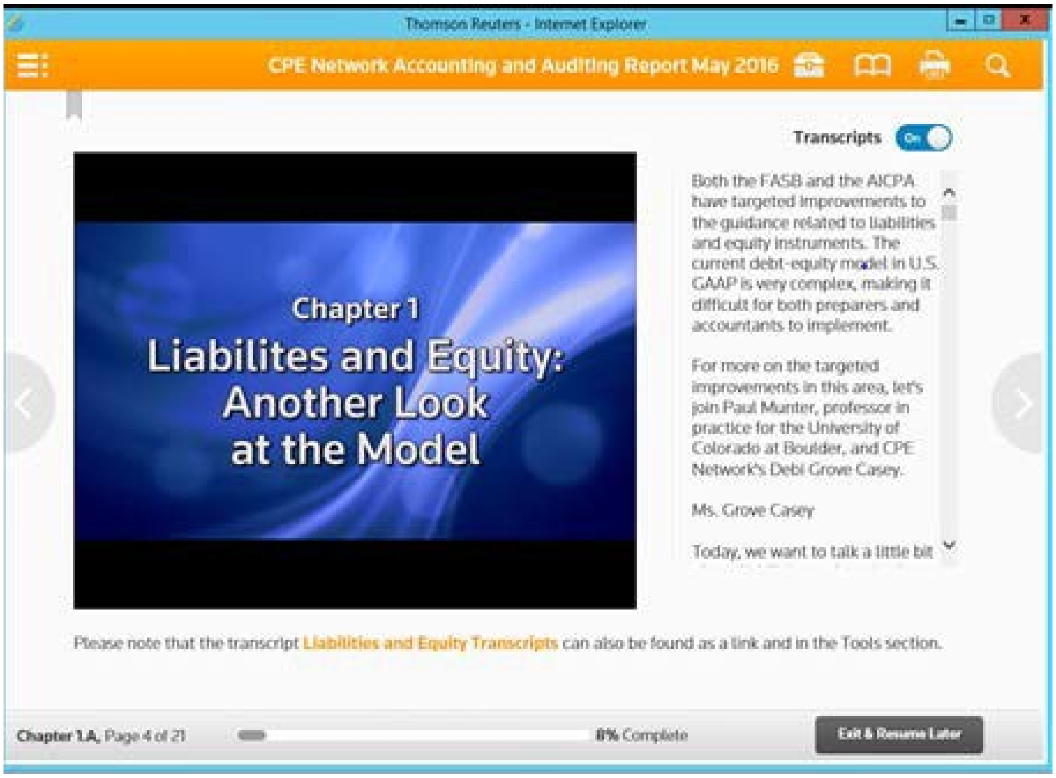
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



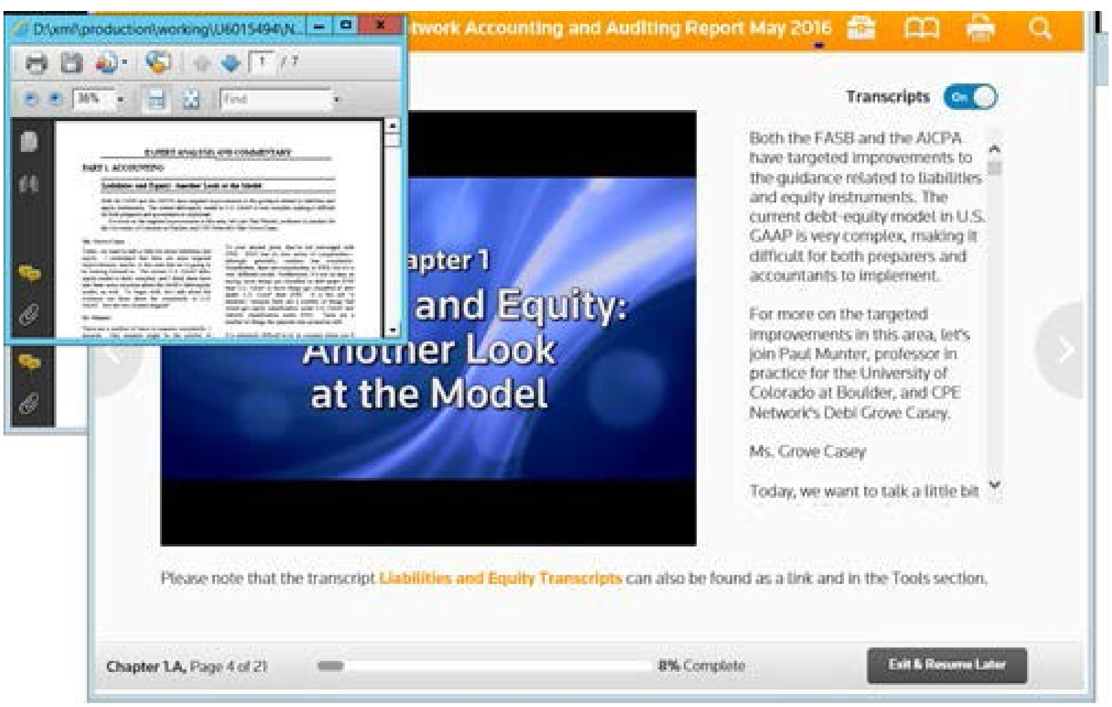
- **Each Chapter is now self-contained.** Years ago, when on the CPEasy site, the interview segments were all together, then all the supplemental materials, etc. Today, each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental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



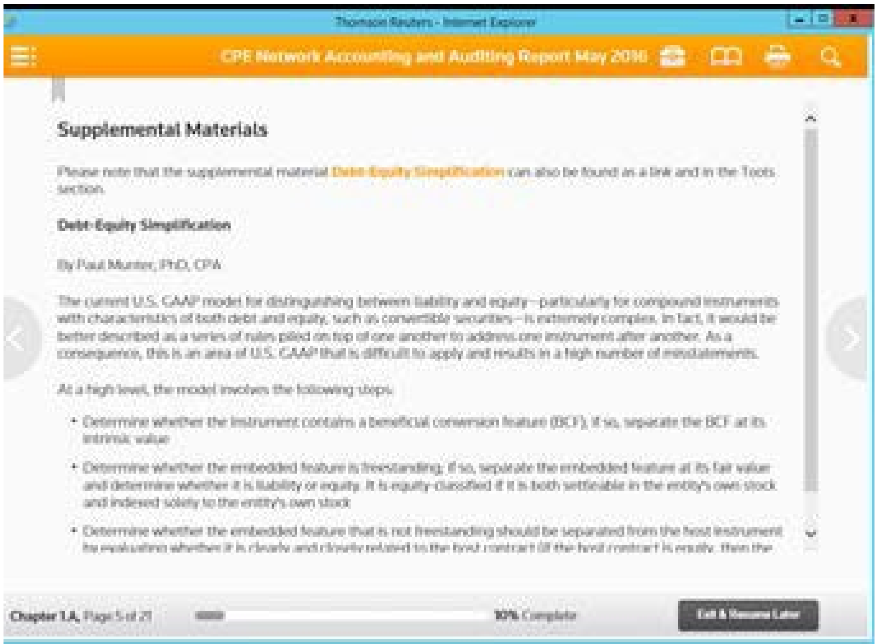
Video segments may be downloaded from the CPL player by clicking on the download button. Tip: you may need to scroll down to see the download button.

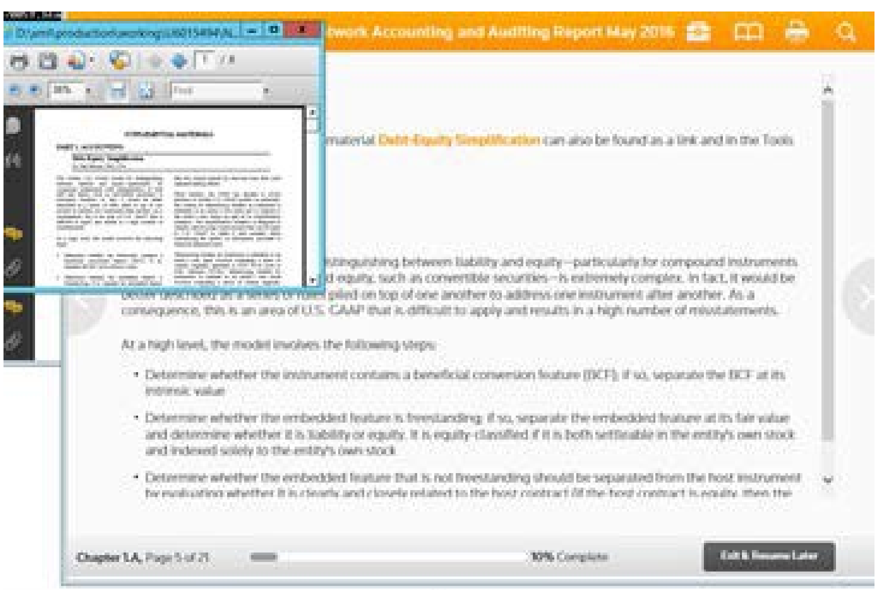


Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.



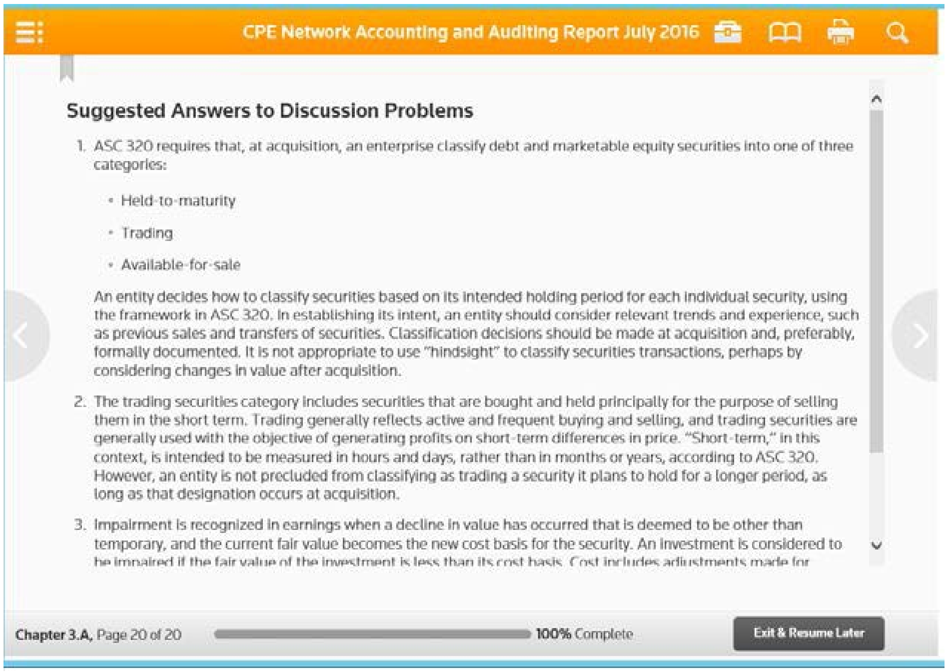
Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.





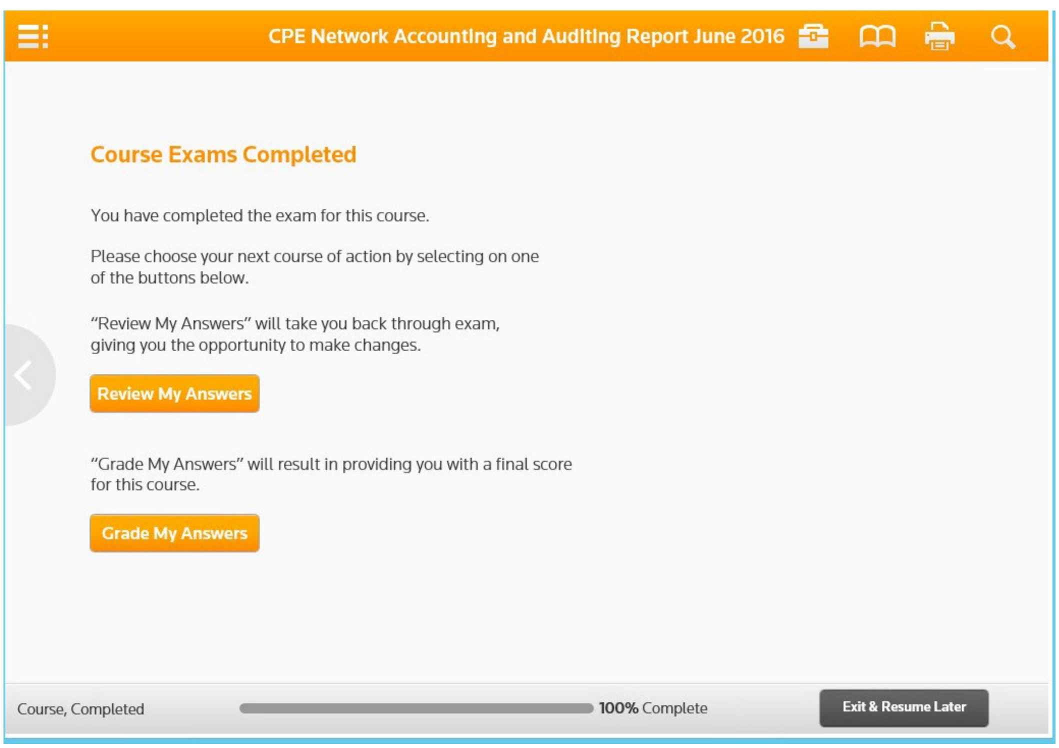
Continuing to click the arrow to the right side of the screen will bring the user to the Discussion p roblems related to the segment.

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

Additional Features Search

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

Search Results are displayed with the number of hits.

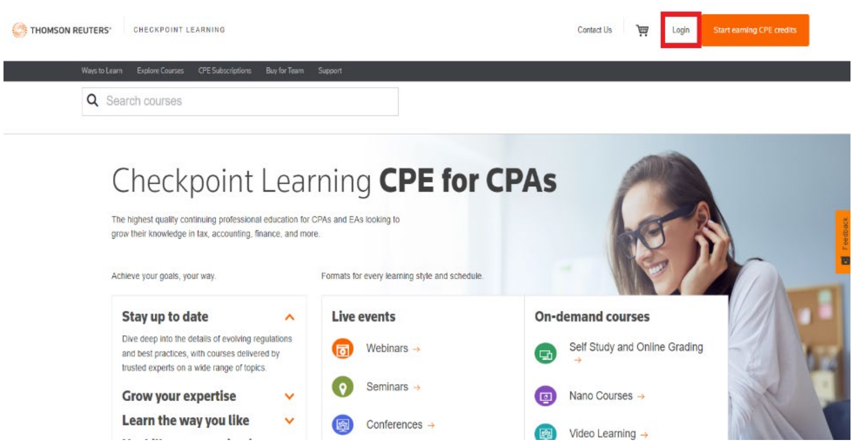
Print

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

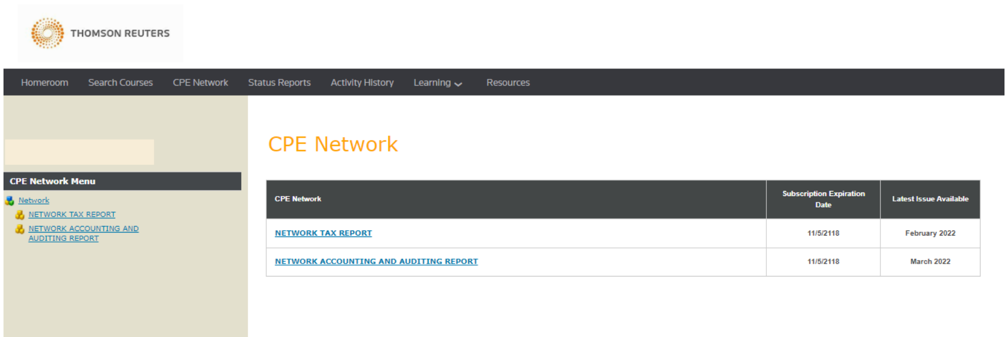
Transitioning From DVDs

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

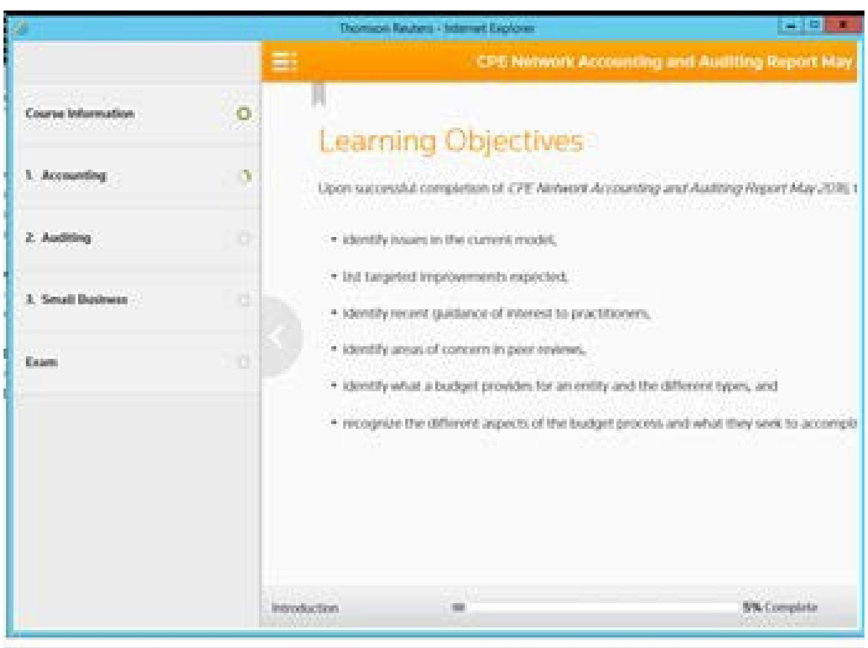
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Login").



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

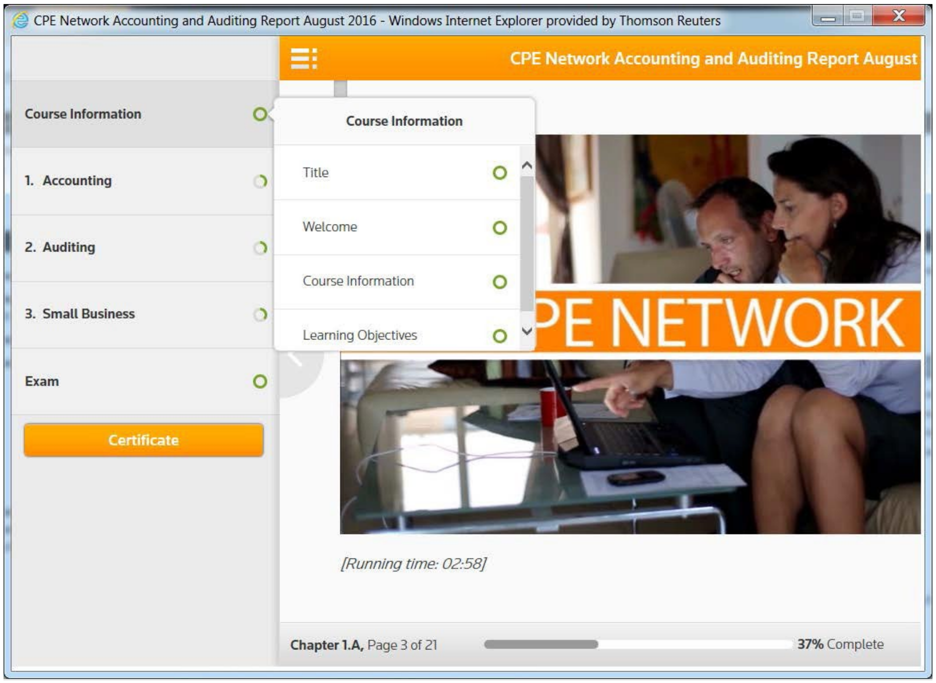


The Chapter Menu is in the gray bar at the left of your screen:

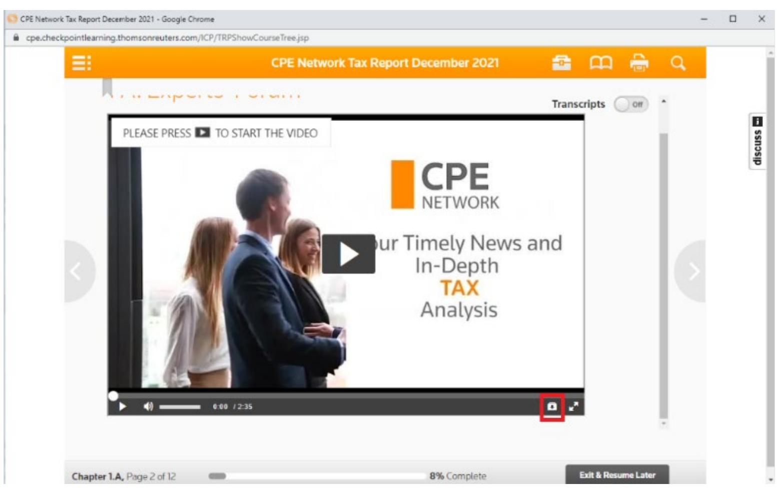


Click down to access the dropdown menu and move between the program Chapters.

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



- Each Chapter is self-contained. Each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions.



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

PDFs may be downloaded from either the course toolbox in the upper right corner of the Checkpoint Learning screen or from the email sent by CPENetworkgroupstudy.

What Does It Mean to Be a CPE Sponsor?

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

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

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

CPE Sponsor Requirements

<u>Determining CPE Credit Increments</u>

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

Program Presentation

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

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

Disclose Significant Features of Program in Advance

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

Monitor Attendance

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

<u>Real Time Instructor During Program Presentation</u>

"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).

<u>Awarding CPE Certificates</u>

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.

<u>Seminar Quality Evaluations for Firm Sponsor</u>

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

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

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

Retention of Records

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

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

Appendix: Forms

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

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

Getting Help

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

Support Group	**Phone Number**	**Email Address**	**Typical Issues/Questions**
Technical Support	800.431.9025 (follow option prompts	checkpointlearning.techsupport@ thomsonreuters.com	• 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.cpecustomerservice@ thomsonreuters.com	• Billing • Existing orders • Cancellations • Webinars • Certificates