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Top Accounting and Auditing Issues for 2022 | CPE Course

Salvatore A. Collemi, CPA
Lynn Fountain, CPA, CGMA, CRMA
Robert K. Minniti, CPA, CFE, CrFA, CVA, CFF, MAFF, CGMA, PI, DBA
Cecil Patterson, Jr., CPA, MBA

Wolters Kluwer

Contributors

Contributing Editor . . . . . Salvatore A. Collemi, CPA
Lynn Fountain, CPA, CGMA, CRMA
Robert K. Minniti CPA, CFE, CrFA, CVA, CFF, MAFF, CGMA, PI, DBA
Cecil Patterson, Jr., CPA, MBA

Production Coordinator . . . . . Mariela de la Torre; Jennifer Schencker; Gokiladevi Sashikumar

Production . . . . . Sharon Sofinski; Anbarasu Anbumani

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2700 Lake Cook Road
Riverwoods, IL 60015
800 344 3734
CCHCPELink.com

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Introduction

Top Accounting and Auditing Issues for 2022 CPE Course helps CPAs stay abreast of the most significant new accounting and auditing standards and important projects. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by these changes. The topics reviewed in this course were selected because of their impact on financial reporting and because of the role they play in understanding the accounting and auditing landscape in the year ahead.

Module 1 of this course reviews top accounting issues.

Chapter 1 focuses on the challenges accountants and auditors face due to the COVID-19 pandemic. It reviews existing standards in accounting and auditing, and auditing standards and changes made to be implemented for 2021 and later.

Chapter 2 covers new COVID-19 frauds and scams. It examines how criminals are trying to take advantage of the virus to line their pockets with ill-gotten gains. It outlines information technology (IT) and other frauds as well as cybersecurity in a COVID-19 environment. The chapter also discusses the internal controls businesses should be using to protect themselves.

Chapter 3 Chapter 3 provides an up-to-date overview of some of the most common accounting and financial reporting matters in light of the COVID-19 pandemic and resulting economic downturn. It focuses on critical accounting technical areas that have been impacted as well as cases where substantial judgment and professional skepticism are necessary to assess the facts and ensure that the operative standards are applied.

Module 2 of this course reviews top auditing issues.

Chapter 4 discusses Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, from the AICPA's Audit Standards Board (ASB). SAS No. 132 includes many significant changes in authoritative professional standards concerning going concern issues. It represents changes to the Generally Accepted Auditing Standards (GAAS) concerning "going concern" reporting for entities.

Chapter 5 provides external auditors with practical and insightful perspectives on how to audit transactions under the Financial Accounting Standards Board's (FASB) new leasing standard, Accounting Standards Codification (ASC) Topic 842, *Leases*. It discusses the new accounting and financial reporting requirements and how to substantively and analytically test them in accordance with *Professional Standards*.

Chapter 6 provides external auditors with both practical and insightful perspectives on how to navigate an audit engagement of a private company during the global pandemic. Readers will learn which areas of the audit have increased in risk exponentially due to the COVID-19 pandemic and which viable alternative audit procedures are available in circumstances where traditional audit procedures are just not possible. Readers will acquire a deeper understanding of how to fulfill their professional responsibilities in order to perform an audit in this challenging environment in accordance with *Professional Standards*.

Chapter 7 reviews recent issues from the AICPA's Auditing Standards Board (ASB) for private entities, including implementation issues with new effective dates. New and revised audit standards, attestation standards, and other recent pronouncements about auditing are discussed. Also, the revised auditing standards resulting from the COVID-19 pandemic are examined for current application.

Study Questions. Throughout the course you will find Study Questions to help you test your knowledge, and comments that are vital to understanding a particular strategy or idea.

Answers to the Study Questions with feedback on both correct and incorrect responses are provided in a special section beginning at ¶ 10,100.

Final Exam. This course is divided into two Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the Final Exam. Complete one or all three Final Exams for continuing professional education credit.

Go to **cchcpelink.com/printcpe** to complete your Final Exam online for immediate results. My Dashboard provides convenient storage for your CPE course Certificates. Further information is provided in the CPE Final Exam instructions at ¶ 10,300. **Please note, manual grading is no longer available for Top Accounting and Auditing Issues. All answer sheets must be submitted online for grading and processing.**

August 2021

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COURSE OBJECTIVES

This course provides an overview of important accounting and auditing developments. At the completion of this course, the reader will be able to:

- Recognize the difficulties of auditing for management and auditors during the COVID-19 pandemic
- Describe selected accounting standards (GAAP) and COVID-19 issues from the Financial Accounting Standards Board (FASB)
- Describe Statements on Auditing Standards (SASs) from the AICPA Auditing Standards Board (ASB) and COVID-19–related issues
- Recognize changes from the AICPA ASB for 2021 and future years
- Recognize how criminals are trying to take advantage of the COVID-19 pandemic
- Identify internal controls companies should be using to protect themselves
- Describe IT and other frauds as well as cybersecurity in a COVID-19 environment
- Examine the impact of preparation of current and forward-looking financial statements
- Identify specific technical accounting and financial reporting areas that may be affected by conditions of the COVID-19 pandemic
- Identify emerging topic matters for accounting and financial reporting
- Recognize actions to take when there are indicators that the fair value of an entity may be below its carrying amount
- Outline the process for testing long-lived assets, which includes the use of assumptions and estimates that may change due to the COVID-19 pandemic
- Identify an asset that can be traded or seen as packages of capital that may be traded
- Recognize which Accounting Standards Codification (ASC) Topic provides guidance on determining when to recognize costs and information that must be disclosed in the notes to the financial statements
- Describe conditions evaluated when testing goodwill for impairment in a COVID-19 environment

- Identify updates on ASB No. 132
- Describe updates on selected AICPA auditing standards
- Describe updates on selected FASB standards
- Recognize and apply going concern audit deficiencies
- Identify updates on selected related and connected issues
- Differentiate SASs superseded by the new standards
- Describe correct statements regarding SAS No. 132
- Differentiate Accounting Standards Update (ASU) Sections and how they apply
- Identify a going concern condition or event related to the supply chain
- Recognize the FASB's new leasing standard requirements
- Identify the new accounting and reporting requirements of leases
- Identify which audit procedures to perform
- Recognize how to properly audit the transition requirements and initial adoption of the new standard
- Recognize the types of transactions that fall within the scope of ASC Topic 842
- Identify the first question to be considered when determining whether an arrangement contains a lease
- Identify an example of an initial direct cost (IDC) of a lease
- Identify areas of the audit where risk has gone up significantly due to the COVID-19 pandemic
- Recognize viable alternative audit procedures to perform
- Describe how to address potential reporting implications
- Differentiate FASB ASC Topics and how they apply
- Recognize the specific steps in the order of asset impairment testing
- Summarize the auditing pronouncements that may impact private companies that come from the Auditing Standards Board (ASB) of the AICPA and review other recent audit releases that affect the non-issuing entities
- Identify the changes in Statement on Auditing Standards (SAS) Nos. 141, 142, and 143
- Recognize changes to attestation in Statement on Standards for Attestation Engagements (SSAE) Nos. 20, 21, and 22
- Understand auditing issues and financial reporting considerations related to the COVID-19 pandemic

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MODULE 1: TOP ACCOUNTING ISSUES—CHAPTER 1: Accounting, Auditing, and COVID-19

¶ 101 WELCOME

The COVID-19 pandemic has altered entire economies. Businesses have had to evolve, and many companies had to completely change their business model mid-year 2020. As a result, accounting and auditing best practices may look drastically different. This chapter focuses on the challenges accountants and auditors face due to the COVID-19 pandemic. It reviews existing standards in accounting and auditing, and auditing standards and changes made to be implemented for 2021 and later.

¶ 102 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Recognize the difficulties of auditing for management and auditors during the COVID-19 pandemic
- Describe selected accounting standards (GAAP) and COVID-19 issues from the Financial Accounting Standards Board (FASB)
- Describe Statements on Auditing Standards (SASs) from the AICPA Auditing Standards Board (ASB) and COVID-19–related issues
- Recognize changes from the AICPA ASB for 2021 and future years

¶ 103 REMOTE AUDIT PROCEDURES

The change to completely remote work due to COVID-19 restrictions has challenged the accounting and auditing profession in many ways, particularly for audit and attest engagements. For many auditors, it has been difficult to imagine not going on-site for an audit. At some firms, audit staff do not even have their own desks but instead share space in a large room lined with locking cabinets where they can keep their personal items when they are in the field. But no matter how an audit is performed, on-site or remotely, three critical components of auditing remain the same: computer use, collaboration, and corroboration.

Computer Use

"Computer use" in this context extends to broadly leveraging technology, tools, and techniques. In today's world, most audit firms use technology in a manner that replicates the paper-based world of audit from decades ago. Working remotely makes this even more difficult because replicating the paper-based world requires auditors to be on-site at a client's location.

Although accountants and auditors are now working in a remote world out of necessity, many of these remote working techniques should have been deployed years ago. Technology makes it easier than ever to innovate new ways of getting work done. By leveraging technology, auditing professionals can find new—and often, better—methods for performing the work they would normally do on-site, even if they cannot be there in person.

One typical audit procedure is inquiry. Most auditors do this on-site so they can have face-to-face conversations with the client's staff. But with video technology, professionals can now conduct face-to-face conversations remotely with easy-to-use tools like Skype, Microsoft Teams, and GoToMeeting. One advantage of using videoconferencing tools is that the conversations with clients can be recorded and transcribed. Tools like Otter.ai and Rev.com make transcription quick and affordable, if not free. Summaries of the client conversations can be easily added to the audit file.

Collaboration

Collaboration in a remote world may mean establishing ways for the audit team to communicate with clients and ways to communicate with other members of the team. Whether internally or externally, this collaboration is key to maintaining relationships with staff and clients. There are several ways for auditors to maintain, or possibly improve, a collaborative relationship with clients:

- Establish a plan before fieldwork begins.
  - — Auditors and their clients should agree to the methods they will use to share documents and for videoconferencing. Include the timelines for getting the work done.
  - — Clients should be added as contacts in the videoconferencing tool.
  - — For sharing documents, auditors should mandate the use of a cloud-based system such as Suralink, SharePoint, or Collaborate. These are more secure and easier to manage than a series of emails with attachments.
- Teach clients how to use remote technologies.
  - — An auditor can be a true asset and hero to their client by taking the time to show them tips and tricks on getting the most out of these tools.
- Provide a sense of stability.
  - — Establish a plan of regular check-ins and stick to them.
  - — Auditors should use these check-ins to deepen their understanding of the client—not just as a checklist exercise, but to more fully grasp what clients are going through.

Corroboration

Obtaining audit evidence to corroborate a client answer or management position is a key component of the audit. The level of corroborative information obtained should be greater as the risk becomes greater. This can be determined as the team reflects on the risk assessment procedures. The audit standards require documentation such that an experienced professional who is not familiar with the client could understand what was done and be able to repeat the procedure. Documentation of the evidence obtained is necessary, but the documentation standard does not require that the audit file contain actual copies of every document examined.

¶ 104 GOING CONCERN

The COVID-19 pandemic has caused the financial position of many organizations to deteriorate. For clients in certain industries (e.g., restaurants, hospitality) and in certain geographical areas, the entity's ability to continue as a going concern may be called into question.

The auditor should start by assessing whether there are events or conditions (e.g., the pandemic) that raise substantial doubt that the entity can continue as a going concern. Management is also required to evaluate the entity's ability to continue as a

going concern. Next, the auditor should ask for that evaluation and consider whether it is complete and accurate. The look-forward period is one year from the date the financial statements are issued or available to be issued, unless otherwise specified in the financial reporting framework.

"Substantial doubt" means that in management's judgment, it is probable that the client will not continue as a going concern. When substantial doubt exists, disclosure in the financial statement notes is required, regardless of whether the doubt is alleviated by management's plans. After determining whether there is substantial doubt, the auditor should consider management's plans to alleviate that doubt. Then, assess the impact on the auditor's report as follows:

- If management's plan alleviates substantial doubt, an unmodified opinion may be issued.
- If the going concern basis of accounting is appropriate but substantial doubt remains, an emphasis-of-matter paragraph is required.
- If the going concern basis of accounting is not appropriate, an adverse opinion should be issued.

Even if there is not substantial doubt about any entity's ability to continue as a going concern, an auditor may still conclude that an emphasis-of-matter paragraph is necessary. This would be the case if an unusually important subsequent event or major catastrophe is disclosed in the financial statements and, in the auditor's opinion, it is necessary to draw the user's attention to the matter. In determining whether the COVID-19 pandemic meets this definition for a given client, auditors should consider the circumstances of that client and exercise their professional judgment.

¶ 105 SCOPE LIMITATIONS

As auditors work with clients throughout the pandemic, there is a real possibility that scope limitations will occur. For example, confirmations that are a key source of evidence may not be returned and alternative procedures may not be considered sufficient, or it may not be possible to evaluate the design and implementation of relevant controls at the client.

When assessing the impact of a scope limitation, auditors should focus on whether they are material and pervasive. *Pervasive* effects are those that, in the auditor's judgment, meet one or more of the following criteria:

- Are not confined to specific elements, accounts, or items of the financial statements
- If they are confined, represent or could represent a substantial proportion of the financial statements
- With regard to disclosures, are fundamental to the users' understanding of the financial statements

Scope limitations that are material but are not pervasive to the financial statements result in a qualified opinion, whereas scope limitations that are both material and pervasive result in a disclaimer of opinion.

¶ 106 SUBSEQUENT EVENTS

For audits of calendar-year-end 2019 financial statements, COVID-19–related subsequent events are likely to be Type II events (i.e., events that provide evidence of conditions that arose after the date of the financial statements). These include declines in the fair value of investments. Although these events would not require recognition in the financial statements, disclosure may be required.

Auditors should assess the appropriateness of the subsequent-event disclosures in the financial statements, and if an appropriate disclosure is not made, a modified auditor's opinion may be appropriate. For audits of clients with year-ends that fall in 2020, pandemic-related events may require adjustments to the financial statements or additional disclosures as Type I events (i.e., events that provide evidence of conditions that existed at the date of the financial statements).

¶ 107 RISKS AND UNCERTAINTIES

Management is required to disclose risks and uncertainties that could significantly affect (1) amounts reported in the financial statements in the near term or (2) the near-term functioning of the entity. Risks and uncertainties can stem from the nature of the entity's operations, significant estimates, or current vulnerabilities due to certain concentrations.

Many entities will be required to disclose risks and uncertainties associated with COVID-19, as the pandemic may meaningfully impact significant estimates and exacerbate concentrations. Examples include market and geographical concentrations in an area severely affected by COVID-19, and concentrations in the volume of business with one customer, supplier, etc. As such, auditors should assess whether the robustness of disclosures appears appropriate.

¶ 108 FINANCIAL REPORTING CONSIDERATIONS RELATED TO COVID-19

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 275, *Risks and Uncertainties*, requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations.

The effects of the COVID-19 crisis may negatively impact significant estimates and exacerbate a vulnerability due to certain concentrations (e.g., business concentration in a market or geographical area severely affected by the effects of COVID-19), as discussed in the following section.

Significant Estimates

FASB ASC 275-10-50-8 states the following regarding significant estimates:

> Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued . . . indicates that both of the following criteria are met:
>
> - It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
> - The effect of the change would be material to the financial statements.

Current Vulnerabilities Due to Certain Concentrations

According to FASB ASC 275-10-50-16:

> Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.
>
> Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.
>
> Financial statements shall disclose the concentrations described in paragraph 275-10-50-18 if, based on information known to management before the financial statements are issued or are available to be issued . . . , all of the following criteria are met:
>
> - The concentration exists at the date of the financial statements.
> - The concentration makes the entity vulnerable to the risk of a near-term severe impact.
> - It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

FASB ASC 275-10-50-18 provides the following examples of concentrations that should be disclosed if they meet the preceding criteria:

- Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this Subtopic, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
- Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- Concentrations in the market or geographic area in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this Subtopic, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

Examples of concentrations that are likely to be affected by COVID-19 include specific markets or geographical areas in which the entity conducts its operations, diminishing volume of transactions with a particular customer or a supplier, or limited supply of material or availability of labor or services.

Disclosures of Risks and Uncertainties Related to COVID-19

FASB ASC 275 requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations.

The effects of the COVID-19 pandemic may meaningfully impact significant estimates and exacerbate a vulnerability due to certain concentrations (e.g., business concentration in a market severely affected by the effects of COVID-19). Finally, COVID-19 may pose risks to the actual functioning of entities in certain industries (e.g., restaurants, hotels, airlines, etc.). Because of the pandemic, for entities with year-ends that fall after the declaration of the state of emergency, the necessity for and robustness of the disclosures may require additional scrutiny by the auditor.

Subsequent Events

Entities may need to evaluate whether the consequences of COVID-19 represent subsequent events. FASB ASC 855, *Subsequent Events*, defines *subsequent events* as events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events:

- The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (i.e., recognized subsequent events).
- The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date (i.e., nonrecognized subsequent events).

For calendar year-end 2019 financial statements, any COVID-19–related subsequent events identified likely are to be nonrecognized subsequent events. Some nonrecognized subsequent events may be of such a nature that financial statement disclosure is required to keep the statements from being misleading. In these situations, financial statements must include disclosure of the following:

- The nature of the event or events, and
- An estimate of the financial statement effect of the event or events, or a statement that the estimate cannot be made.

Occasionally, such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet.

It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements. Judgment is required, and each entity will need to carefully evaluate its relevant facts and circumstances to determine the appropriate treatment for events related to COVID-19 and determine whether the pandemic is viewed as a current period event based on their financial reporting year-end.

Given the recent stock market volatility, guidance about market-value declines was offered in AICPA Technical Q and As. The guidance was for a typical private company, a nonissuing entity:

- *Inquiry*: In light of overall market decline, should the decline in market value of an asset subsequent to the balance sheet date result in the adjustment of the financial statements?
- *Reply*: FASB ASC 855-10-25-1 states that "[a]n entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements."
- FASB ASC 855-10-25-3 states that "[a]n entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued."

- FASB ASC 855-10-55-2 provides a list of examples of nonrecognized subsequent events, including changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before financial statements are issued.

In complying with the requirements of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, the overall objectives of the auditor are to:

- Obtain sufficient appropriate audit evidence about whether subsequent events are appropriately recognized and disclosed in the financial statements.
- Respond appropriately to facts that become known after the audit report date that, had they been known to the auditor as of the report date, may have caused the auditor to revise the report.

For audits of calendar year-end 2019 financial statements, any COVID-19–related subsequent events identified likely will be events that provide evidence of conditions that arose after the date of the financial statements (historically referred to as Type II events). Although recognition in the financial statements is not required, subsequent event disclosures may be required. If appropriate disclosure of subsequent events is not made in the financial statements, a modified auditor's opinion may be appropriate.

Many entities with year-ends after December 2019 will have pandemic-related events that may require an adjustment to the financial statements or additional disclosures (historically referred to as Type I events). Auditors will have to work with clients to ensure any subsequent events have been accurately identified and reflected in the financial statements as required by FASB ASC 855. If management is either unable or unwilling to identify those events and properly reflect them in the financial statements, this could result in a modification to the auditors' opinion.

Going Concern

FASB ASC 205-40 requires management to evaluate an entity's ability to continue as a going concern within one year after the date the financial statements are issued (or available to be issued, when applicable). Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or that its plans alleviate that substantial doubt.

The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the accessibility to financing that is available for the entity. The consequences of COVID-19 may impact those factors and may cause a deterioration in an entity's operating results and financial position. As such, entities and practitioners may need to consider recent pertinent information related to their assessments of going concern.

The look-forward period is one year from the date the financial statements are issued (or available to be issued, when applicable). With circumstances changing hourly due to COVID-19, and severe impacts in some industries (restaurants, entertainment, airlines, etc.), management's evaluation of conditions or events that may affect the entity's ability to continue as a going concern under U.S. generally accepted accounting principles (U.S. GAAP) could be extremely difficult.

In some cases, management's ability to evaluate going concern issues could cause difficulty in complying with the relevant U.S. GAAP requirements (FASB ASC 205, *Presentation of Financial Statements*, and, more specifically, FASB ASC 205-40). When management performs an evaluation of the entity's ability to continue as a going concern, but auditors are unable to gain access to that information or believe the supporting documentation is inaccurate or incomplete, auditors need to consider a scope limitation or other modification of the auditor's opinion.

If, after considering management's evaluation of going concern, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans, then the auditor should evaluate whether the financial statements include adequate disclosure of management's plans and, if adequate, an unmodified auditor's report may be appropriate.

If auditors conclude that use of the going concern basis of accounting is appropriate, but substantial doubt about the entity's ability to continue as a going concern remains, then the auditor's report, modified to add an emphasis-of-matter (EOM) paragraph in accordance with paragraphs .24–.25 of AU-C section 570, should be issued. If the financial statements have been prepared on the going concern basis and auditors conclude that use of the going concern basis of accounting is inappropriate, then the auditor should express an adverse opinion.

Management is struggling with some of the assumptions and forecasts related to going concern given the volatility of the current environment. Auditors should keep in mind that management's assumptions are just that and, in these times of uncertainty, making some of these evaluations or forecasts might be difficult. Therefore, in many cases, management's best estimate would be acceptable and may not result in a scope limitation.

STUDY QUESTIONS

1. Which of the following ASC Topics requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term of the reporting entity?

- **a.** ASC Topic 275
- **b.** ASC Topic 280
- **c.** ASC Topic 310
- **d.** ASC Topic 326

2. Which of the following statements is correct regarding subsequent events?

- **a.** Entities are not required to evaluate whether the consequences of COVID-19 represent subsequent events.
- **b.** For calendar year-end 2019 financial statements, any COVID-19–related subsequent events identified likely are to be nonrecognized subsequent events.
- **c.** A recognized subsequent event is one that provides evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date.
- **d.** If appropriate disclosure of subsequent events is not made in the financial statements, a modified auditor's opinion is required.

Inventory Observations

Many clients have had to close their warehouses during the COVID-19 pandemic and cannot do year-end inventory counts. If clients are unable to perform physical inventory counts at year-end due to unforeseen circumstances, they might decide to perform those physical counts on an alternative date. Auditors may be able to observe the rescheduled counts and perform additional audit procedures on intervening transactions.

If the physical inventory counts are to take place later than originally scheduled, auditors will have to perform additional procedures such as reviewing and testing inventory rollforwards. For businesses that have closed storefronts and warehouses, this may not be a difficult task because there may be very few receipts or shipments coming in if facilities have been closed between year-end and the count date.

Another traditional alternative procedure can be performed if the client is using a cycle count procedure and a perpetual inventory system. A cycle count procedure relates to the client essentially having an internal control in place where, on a periodic basis, many times quarterly, the client conducts its own test counts of just a portion of inventory. Then, the client goes back to its perpetual system and compares the counts, making any corrections as necessary to the general ledger.

Auditors may need to perform procedures to obtain assurance that client inventory locations have in fact been locked down for a period. This might include obtaining live feeds of security camera footage taken of the retail locations and warehouses during that time and reviewing shipping and receiving records during that time to ensure movement was minimal.

AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*, notes that if inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending physical inventory counting, unless impracticable, and perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. The belief is that the COVID-19 pandemic may be considered a circumstance rendering in-person attendance during physical inventory counting impracticable.

In some cases, clients may be able to perform the usual physical inventory counts, but auditors are unable to attend due to travel restrictions. In those cases, auditors may take advantage of technologies, including camera systems with live video feeds, to observe inventory counts. Of course, auditors should be aware that procedures performed virtually might be a bit more limited and may pose additional audit risks that will need to be addressed.

When there are multiple inventory locations, auditors will need to address control of inventory counts to obtain evidence that inventory was not moved from one location to another during the inventory counts. If the audit risks cannot be reduced to an acceptable level, this will pose a scope limitation.

Many auditors have questioned whether they can use cameras and other technologies to observe inventory if they are unable to attend in person. The auditing standards do not prohibit use of technology when performing inventory observations. If auditors are satisfied with the inventory counting process, they may be able to utilize such technologies to observe these counts. Of course, auditors may need to ensure there is some level of comfort that the videos are live feeds of client inventory locations, perhaps, for example, by confirming visually with key staff and using voice technology to have cameras moved to specified locations on command and direct certain boxes to be opened.

In cases where clients are unable to perform a physical inventory count at year-end or auditors are unable to obtain sufficient appropriate audit evidence that those counts were conducted properly (either unable to attend physical counts in person or remotely, or unable to test rollforward of inventory from balance sheet date to inventory observation date), these issues likely will present scope limitations that will impact auditor reports. In cases where inventory balances are material but are not pervasive, this will result in qualified audit opinions.

Alternatives that auditors might discuss with clients include issuing qualified opinions now, and then performing agreed-upon procedures engagements on inventory after COVID-19–related travel restrictions ease. Or perhaps if the auditors have not already been engaged to perform the audit, having clients discuss with financial statement users whether review engagements would be sufficient for the year-end, supplemented with agreed-upon procedures on inventory after year-end when counts can be taken. Of course, auditors should follow the guidance in paragraphs .14–.15 and.A35–.A39 of AU-C section 210, *Terms of Engagement*, when considering changing the terms of the engagement.

Fraud Inquiries

Auditors should be on higher alert for fraud risks given the uncertain times during the COVID-19 crisis. For companies that have laid off key personnel and have workforces moving out of the typical office environment, there could be a breakdown in internal control. Auditors may need to adjust audit procedures as necessary to help appropriately address any potential fraud risks that could have a material effect on the financial statements.

AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, lays out several requirements and procedures that may be more challenging in a remote audit. For example, auditors must still have an appropriate discussion among the engagement team to understand what fraud risk factors may be affecting the entity in this environment. Paragraph.A17 of AU-C section 240 indicates that inquiries of management and others within the entity are generally most effective when they involve an in-person discussion.

However, due to the current circumstances related to the pandemic, these inquiries could be done via videoconferencing technology. The key consideration is whether the way the inquiries are made allow the auditor to "read the body language" of the person to whom the inquiries are directed. Therefore, when fraud interviews cannot be performed in person, use of videoconferencing would be preferable to audio-only conferencing because auditors would be able to see people's body language.

Access to Books and Records

During the pandemic, accessing client books and records may present hurdles for some auditors, especially in cases where clients still maintain mostly paper records. Auditors may be able to obtain client-prepared copies or scans of key records, but they must consider the authenticity of those records and perhaps perform additional audit procedures to be satisfied that those records are complete, accurate, and authentic.

When auditors are unable to access client books and records, they may have to inform clients that audits cannot be completed until books and records can be accessed. In cases where clients are required to have audited financial statements before specific dates, perhaps due to bank covenant requirements, auditors may want to encourage their clients to contact the users of the financial statements, such as bank credit officers, as soon as possible to see if waivers or extensions can be obtained.

Internal Control

In an ever-changing and somewhat unstable environment, auditors should inquire about any changes in the client system of internal control since the time that preliminary work was performed. In many cases, those controls may have changed dramatically, and procedures may have been changed to accommodate remote workforces and process flows. In such cases, auditors would need to evaluate how much reliance can be placed on those controls that were only in effect for a portion of the year.

If client sites are closed and auditors are unable to perform audits on-site, performing walkthroughs and certain tests of internal control will be challenging. In these cases, auditors may not be able to rely on controls and may have to increase substantive testing. An understanding of internal control assists auditors in identifying the types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

Even when auditors have no plans to rely on the operating effectiveness of controls, they still are required to obtain an understanding of internal control relevant to audits and to determine that those controls have been placed in operation.

Obtaining an understanding of controls may be achieved remotely; however, inquiry alone is not sufficient to determine whether such controls have been placed in operation. Therefore, auditors must consider what evidence can be obtained remotely to determine if effectively designed controls have been placed in operation. If auditors are unable to obtain sufficient appropriate audit evidence to perform and complete the risk assessment process, then they may have scope limitations.

Use of SOC 1 Reports by User Auditors

Among the many consequences of COVID-19 are the additional challenges auditors may face when auditing the financial statements of an entity that outsources functions to a third party that are integral to its business operations. AU-C section 402, *Audit Considerations Related to an Entity Using a Service Organization*, requires a user auditor, among other things, to obtain an understanding of the following:

- The nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit.
- The design and implementation of controls at the service organization, depending on the nature and significance of such services.
- If the user auditor plans to rely on controls at the service organization, the operating effectiveness of controls at the service organization.

The understanding should be sufficient to enable the user auditor to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures in the audit of the entity's financial statements. Many user auditors rely on a SOC 1 report on the controls at a service organization to obtain the required understanding. However, because of the recent pandemic, the issuance of SOC 1 reports may be delayed or such reports may not be available.

Obtaining an understanding of the nature of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit may be obtained remotely. For example, the user auditor may be able to obtain and read one or more of the following:

- User manuals
- System overviews
- Technical manuals

- Contract or service level agreement between the user entity and the service organization
- Reports by service organizations, internal auditors, or regulatory authorities on controls at the service organization

Although the user auditor is likely to be able to obtain information about the design of controls from reading many of the same aforementioned documents, merely reading many of those documents will not provide the user auditor with evidence about whether such controls were suitably designed and implemented at the service organization.

Auditors have questioned whether it is necessary to obtain a SOC 1 report in all cases when an entity outsources to a service organization functions that are integral to its business operations. If there is a high degree of interaction between the user entity and the service organization (e.g., a payroll processor), the user entity may have implemented effective controls over the transactions processed by the service organization. In that case, the user auditor may not find it necessary to obtain an understanding of controls at the service organization, and a SOC 1 report may not be necessary. Instead, the user auditor may test controls at the entity to obtain evidence about their design and implementation.

In other situations, there may be a lower degree of interaction between the user entity and the service organization (e.g., a broker-dealer that buys and sells securities based on a trust account). Because the service organization may be both initiating the transactions and maintaining accountability for them, it may be necessary to obtain an understanding of the design and implementation of controls at the service organization.

If a SOC 1 report is not available and the nature of the services provided by the service organization are significant to the audit, obtaining an understanding of the design and implementation of controls at the service organization may be more challenging amid social distancing restrictions. If a SOC 1 report is not available, the user auditor should discuss with senior management the expected date of receipt of the SOC 1 report and emphasize the need for it. If it is unlikely that the report will be available in a timely manner, the user auditor may consider what other procedures might be performed to obtain evidence about the design and implementation of controls at the service organization.

Because visiting, or having another auditor visit, the service organization to perform procedures is likely to be impracticable as long as travel restrictions and social distancing requirements are in place, the user auditor may consider obtaining and reading the prior-period SOC 1 report and performing the following procedures for the gap period:

- Contacting relevant individuals at the service organization, through the user entity, and making inquiries (these inquiries should be documented) about the following:
  - — Significant changes within the system (including relevant system controls), including procedures or controls that changed to accommodate employees working remotely and process flows; and
  - — System events that affected the service organization's ability to achieve its service commitments to users.
- Reading system documentation and any amendments to contracts or service-level agreements from the service organization to the user entity that address significant system changes
- Reading communications from the service organization to the user entity about its COVID-19 responses and the effects on the system

If, in the user auditor's professional judgment, sufficient appropriate evidence to determine if effectively designed controls were placed in operation has not been obtained, the user auditor may have a scope limitation.

If the user auditor has historically elected to test controls at the service organization and wishes to continue to do so, the user auditor will need to obtain a SOC 1 type 2 report. If a SOC 1 type 2 report is not available at the time of the audit, the user auditor should discuss with senior management the date by which the report is expected to be received. Depending on the expected delay, the user auditor may discuss with senior management whether it is feasible to delay the issuance of the auditor's report on the entity's financial statements until the SOC 1 type 2 report has been received and any matters arising from the use of the report have been addressed.

If the entity is required to have audited financial statements before a specific date, the user auditor may want to encourage senior management to contact users of the audited financial statements, such as bank credit officers, as soon as possible to see if waivers or extensions can be obtained.

If it is unlikely that the SOC 1 type 2 report will be received, the user auditor may be unable to rely on the operating effectiveness of controls at the service organization. In that case, the user auditor should consider revising the audit strategy to a substantive procedures approach where reliance on controls operating effectively is not anticipated. If an entirely substantive procedures approach will not provide sufficient appropriate audit evidence (i.e., substantive procedures alone are not sufficient) and a SOC 1 type 2 report is not available, the user auditor may have a scope limitation.

Use of External Confirmations

How should auditors handle situations where responses to account confirmations might be limited due to the COVID-19 pandemic? As noted in AU-C section 505, *External Confirmations*, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by auditors from confirming parties may be more reliable than evidence generated internally by the entity. In cases where a client site has been shut down or key staff are no longer on-site, obtaining external confirmations could be an alternative way to obtain audit evidence.

However, there could be situations in which those audit confirmations are not completed and sent back to the auditors, perhaps due to the respondent's office closures or mail issues. In such cases, auditors would have to design additional audit procedures to gain sufficient appropriate audit evidence related to the relevant assertions for the particular account balance or class of transaction for which confirmation was requested.

Typically, if auditors are able to design and perform additional tests of those relevant assertions, non-receipt of confirmations in and of itself should not result in a scope limitation. However, if auditors are unable to obtain sufficient audit evidence through review of the client books and records and are relying on receipt of audit confirmations as a key source of audit evidence, the non-receipt of those confirmations could result in a scope limitation (where balances are material to the financial statements).

Due to increasing business closures and movement to telecommuting models, auditors may consider sending electronic confirmations rather than paper confirmations. Some firms may have process flow software where this could be done quite easily and might result in a better response rate. Asking clients to contact their vendors and suppliers in advance may be prudent to understand the best way to contact these parties in the current environment.

In addition, auditors should be aware that although oral confirmations may be the fastest and most effective way to obtain evidence about account balances, they would be considered akin to an inquiry of a third party. In considering procedures, firms also should consider that, given sensitivity to cash flow in certain parts of the economy, more accounts receivable may remain outstanding when audit procedures are performed than in prior audits.

STUDY QUESTIONS

3. U.S. GAAP requires that in connection with preparing financial statements for each annual and interim reporting period, management should evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about the company's ability to continue as a going concern within how many years after the date that the financial statements are issued?

a. One year
b. Two years
c. Three years
d. Four years

4. Which of the following AU-C Sections notes that if inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending physical inventory counting, unless impracticable?

a. AU-C Section 501
b. AU-C Section 505
c. AU-C Section 520
d. AU-C Section 550

Audit Planning in the COVID-19 Environment

The first standard of fieldwork indicates that "the auditor must adequately plan the work and must properly supervise any assistants." Auditors should take note that remote working does not excuse having required audit planning meetings. Auditors should ensure they still are holding these discussions as needed and having substantive discussions on engagement risks with the engagement team prior to commencing audit fieldwork.

Management Representation Letters

Should auditors be adding additional representations related to COVID-19 to the management representation letter? During this pandemic, additional representations could be added to the management representation letter, depending on the circumstances of an engagement. Those additional representations may relate to the going concern assumption, subsequent events, risks and uncertainties, fraud, and significant estimates, among others.

In some situations, the client is unable to provide the signed original management representation letter with an original signature on their company letterhead. Using electronic means to obtain signed management representation letters is acceptable if auditors can obtain appropriate evidence of management's receipt and acknowledgment of the representations. In other words, confirmation that the signatory knowingly and willingly signed the representation letter.

Whether auditors accept electronic signatures, scanned images of signatures, and so on, is a matter of firm risk management practices as well as applicable state laws or regulations addressing legal acceptability of electronic signatures.

Auditors have also asked whether it is acceptable for management representation letters to be on "plain paper" rather than on company letterhead. The standards do not require use of client letterhead. However, as a matter of best practice, it might be prudent for companies to note the company name and address at the top of the letter.

Depending on what is omitted from management's representation letter, the failure to obtain all representations does not necessarily result in a scope limitation. If management does not provide one or more of the requested written representations, auditors should:

- Discuss the matter with management;
- Reevaluate the integrity of management and evaluate the effect this may have on the reliability of representations (verbal or written) and audit evidence in general; and
- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with AU-C section 705A, *Modifications to the Opinion in the Independent Auditor's Report.*

Emphasis-of-Matter Paragraphs and Types of Auditor's Reports

Should auditors be including EOM paragraphs related to COVID-19 in their audit reports? Auditors may conclude that an event has such a material impact on the entity that it would be appropriate to include an EOM paragraph in the auditor's report directing the reader's attention to the event and its effects.

As paragraph .06 of AU-C section 706A, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, notes, EOM paragraphs are included in the auditor's report if the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Paragraph.A2 of AU-C section 706A indicates that a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position is an example of circumstances when auditors may consider it necessary to include an EOM paragraph. Whether the COVID-19 pandemic constitutes a major catastrophe for the client is a matter of the auditor's professional judgment.

What if the auditor encounters situations where an unmodified auditor's report is not appropriate? What type of auditor's report should be issued? In situations where auditors encountered misstatements of the financial statements or scope limitations, auditors may find the following table from paragraph .A1 of AU-C section 705A helpful.

	Auditor's Professional Judgment About the Pervasiveness of the Effects on the Financial Statements	
Nature of Matter Giving Rise to the Modification	**Material but not Pervasive**	**Material and Pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Accountant's Compilation Report

Should a separate paragraph be included in the accountant's compilation report on financial statements that omit substantially all the disclosures required by U.S. GAAP disclosing uncertainties related to COVID-19? Accountants are permitted to issue a compilation report on financial statements that omit substantially all disclosures required by a financial reporting framework (accounting principles generally accepted in the United States of America, or U.S. GAAP, is a commonly used financial reporting framework) if the omission of the disclosures is not undertaken with the intention of misleading the users of such financial statements.

The accountant's report is required to include a statement that the financial statements are not designed for those who are not informed about the matters that would have been disclosed had the omitted disclosures been included in the financial statements.

The accountant may, using professional judgment, add a separate paragraph in the accountant's compilation report addressing an unrecognized subsequent event related to the COVID-19 pandemic to reduce the risk that a user may be misled even if the subsequent event is not disclosed in the financial statements. Such a statement may read as follows:

> *The Company expects the economic uncertainties resulting from the COVID-19 pandemic to negatively impact its operating results. However, the related financial impact and duration cannot be reasonably estimated at this time.*

Fair Value of Investments

If an entity reports its investments at fair value in accordance with FASB ASC 820, *Fair Value Measurement*, it would not be appropriate to disregard observable market prices at the measurement date unless those prices are from transactions that are not orderly. FASB ASC 820 establishes a framework for measuring fair value when U.S. GAAP requires or permits a fair value measurement. *Fair value* is defined in FASB ASC 820 as "[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

FASB ASC 820-10-35-41 indicates that "[a] quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except as specified in paragraph 820-10-35-41C." In other words, if a security trades in an active market at the measurement date, its fair value will equal the quoted price. FASB ASC 820 defines *active market* as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis" and does not provide bright lines or rules of thumb for what constitutes an active market.

To assist entities with determining fair value in periods of market disruption, paragraphs 54C–54H of FASB ASC 820-10-35 provide guidance on measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased. In situations when there has been a significant decrease in the volume or level of activity, it may be appropriate to consider other valuation techniques in estimating the fair value.

As indicated in FASB ASC 820-10-35-54H, "[a] reporting entity's intention to hold the asset or to settle or otherwise fulfill the liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement." FASB ASC 820-10-35-54I lists circumstances that may indicate a transaction is not orderly, whereas FASB ASC 820-10-35-54J provides guidance on how to consider such transitions.

Estimating fair value requires significant judgment in normal circumstances. However, in the pandemic environment characterized by market volatility and an uncertain outlook, applying judgment in determining fair value will be even more challenging.

Asset Impairments

Among the many consequences of the COVID-19 pandemic, business and production disruptions, supply chain interruptions, negative impacts on customers, volatility in the equity and debt markets, reduced revenue and cash flows, and other economic consequences may occur. The entities whose operations are negatively affected by COVID-19 may need to consider testing their assets for impairment.

Goodwill

FASB ASC 350-20 provides guidance on accounting and reporting for goodwill and requires that goodwill be tested for impairment on an annual basis and between annual tests in certain circumstances. FASB ASC 350-20-35-3C provides the following examples of events and circumstances (triggering events) that may warrant an interim test:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets
- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets' a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit; the testing for recoverability of a significant asset group within a reporting unit; or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
- If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)

As indicated in FASB ASC 350-20-35-3F, these examples are not all-inclusive, and an entity should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit. Given the current economic environment, many entities are likely to conclude that triggering events are present, causing them to perform an interim goodwill impairment test.

Private companies and not-for-profit entities that have elected the accounting alternative under FASB ASC 350-20 to amortize goodwill are still required to test it for impairment upon a triggering event at either the entity level or the reporting-unit level. FASB ASC 350-20 uses the same triggering events guidance for entities that have elected the accounting alternative as for those that have not. As a result, entities that

have elected the accounting alternative are also likely to conclude that they have a triggering event, requiring them to test goodwill for impairment.

The likelihood of goodwill actually being impaired will depend on many factors, including the recency of the acquisition giving rise to goodwill. In other words, goodwill that results from a recent acquisition and which, therefore, has not yet been amortized over a significant period, is more likely to be impaired than goodwill that results from a more distant acquisition.

Entities should also consider whether to test their other assets for impairment and to make sure they perform those tests in the appropriate order. FASB ASC 350-20-35-31 requires that goodwill be tested for impairment only after the carrying amounts of the other assets of the reporting unit have been tested for impairment under other applicable accounting guidance.

Indefinite-Lived Intangible Assets

Entities' indefinite-lived intangible assets (such as certain trademarks) may also need to be evaluated for impairment. Paragraphs 15–20 of FASB ASC 350-30-35 provide guidance on impairment testing of indefinite-lived intangible assets and require that they be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired (triggering events).

FASB ASC 350-30-35-18B provides examples of such events and circumstances, which are similar to those considered for goodwill. As a result, entities needing to perform interim testing of goodwill for impairment are also likely to conclude that they should test their indefinite-lived intangible assets.

Long-Lived Assets

Long-lived assets to be held and used (including property, plant, and equipment, finite-lived intangible assets, and right-of-use assets recognized under FASB ASC 842, *Leases*) are tested for impairment in accordance with the guidance in paragraphs 17-35 of FASB ASC 360-10-35.

FASB ASC 360-10-35-21 requires that they be tested for recoverability (which involves comparing undiscounted cash flows for a long-lived asset or asset group being evaluated with the carrying amount of that asset or asset group) whenever events or changes in circumstances indicate that their carrying amount may not be recoverable and provides the following examples of such events:

- A significant decrease in the market price of a long-lived asset (asset group)
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

FASB ASC 360-10-35-17 states that an impairment loss should be recognized only if the carrying amount is not recoverable and exceeds fair value. An impairment loss should be measured as the amount by which the carrying amount exceeds fair value. Given the impact of COVID-19, many entities may conclude that they should test their long-lived assets to be held and used for recoverability. As provided in FASB ASC 360-10-35-22, when such assets are tested for recoverability, it also may be necessary to review depreciation estimates and methods or the amortization period.

Other Assets

In addition to the assets discussed in the preceding paragraphs, other assets may need to be tested for impairment. Impairment models under U.S. GAAP vary depending on the asset subject to the impairment test. Impairment models' consideration of future events also vary significantly under current U.S. GAAP. This can even be the case for the same asset; for example, a financial asset using the "incurred loss" model for impairment versus a financial asset using the current expected credit losses model. Asset impairment considerations (and the related professional guidance for reference) may include the following:

- Financing receivables (e.g., trade accounts receivables, loans)
  - — FASB ASC 310, *Receivables*
  - — FASB ASC 326, *Financial Instruments—Credit Losses* (if adopted)
- Inventories
  - — FASB ASC 330, *Inventory*
- Contract assets
  - — FASB ASC 310, *Receivables*
- Equity securities
  - — FASB ASC 320, *Investments—Debt and Equity Securities*, or FASB ASC 321, *Investments—Equity Securities*, if Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, has been adopted
- Debt securities
  - — FASB ASC 320 or FASB ASC 326, if ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* has been adopted
- Other investments
  - — FASB ASC 325, *Investments—Other*
- Deferred tax assets
  - — FASB ASC 740, *Income Taxes*

Impairment Testing Order

It is important to perform impairment testing in the appropriate order. Consistent with FASB ASC 360-10-35-27, the order is as follows:

- Adjust the carrying amounts of any assets (such as accounts receivable and inventory) and liabilities (such as accounts payable, long-term debt, and asset retirement obligations) not covered by FASB ASC 360-10 that are included in an asset group in accordance with other applicable GAAP.

- Test for impairment and adjust carrying amounts of indefinite-lived intangible asset(s) that are included in an asset group under FASB ASC 350-30.
- Test long-lived assets (asset group) and amortizable intangible assets under FASB ASC 360-10.
- Test goodwill of a reporting unit (or, for private companies, an entity) that includes the aforementioned assets under FASB ASC 350-20.

This sequence is necessary because it allows any required adjustments to the carrying amount of the reporting unit (or, for private companies, an entity) to be made prior to the performance of the goodwill impairment test.

Unusual or Infrequent Events

Determining whether the COVID-19 pandemic is unusual in nature or an infrequent occurrence requires significant judgement. FASB ASC 220-20-45-1 states:

> A material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence or both shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be presented as a separate component of income from continuing operations or, alternatively, disclosed in notes to financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the face of the income statement net of income taxes.

The FASB ASC Master Glossary offers the following definitions:

- **Infrequency of occurrence:** The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see FASB ASC 220-20-60-1).
- **Unusual nature:** The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (see FASB ASC 220-20-60-1).

Deferred Tax Assets

Recognition of unexpected losses and impairments as a result of the COVID-19 pandemic may impact the entity's tax accounting, including the realizability of the deferred tax assets (DTAs). FASB ASC 740-10-30-2(b) requires that a valuation allowance be established for a DTA if it is more likely than not that the related tax benefit will not be realized. Realization of DTAs depends on the existence of sufficient taxable income of the appropriate character within the carryback and carryforward period available under the tax law. FASB ASC 740-10-30-18 lists four sources of future taxable income. FASB ASC 740-10-30-17 states the following:

> All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years.

Entities should consider each source of income incrementally to determine the amount of the valuation allowance needed, if any. FASB ASC 740-10-30-18 also states that "if one or more sources are sufficient to support a conclusion that a valuation

allowance is not necessary, other sources need not be considered." FASB ASC 740-10-30-21 notes that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."

STUDY QUESTIONS

5. If an auditor is unable to obtain sufficient appropriate audit evidence and the auditor believes the potential effects are both material and pervasive, then the auditor should issue which of the following types of opinion?

- **a.** Unqualified opinion
- **b.** Adverse opinion
- **c.** Disclaimer of opinion
- **d.** Qualified opinion

6. Which of the following identifies the first step in the impairment testing order?

- **a.** Test for impairment and adjust carrying amounts of indefinite-lived intangible asset.
- **b.** Test long-lived assets and amortizable intangible assets under FASB ASC 360-10.
- **c.** Test goodwill of a reporting unit.
- **d.** Adjust the carrying amounts of any assets/liabilities not covered by FASB ASC 360-10.

7. When fraud interviews cannot be performed in person, why is the use of videoconferencing preferable to audio-only conferencing?

- **a.** Videoconferences are easier to record.
- **b.** The auditor can see the client's body language.
- **c.** The auditor can examine the client's office in the background.
- **d.** It is more difficult to hear clients in an audio-only conference.

¶ 109 MAJOR ISSUES AND CHANGES FOR AUDITORS

The effective dates of seven private company auditing standards were delayed for one year as the result of a vote April 20, 2020, by the AICPA's ASB. This vote delayed the effective dates of SAS Nos. 134–140 to provide relief to audit firms amid the challenges created by the coronavirus pandemic.

The delay is found in SAS No. 141 (discussed later) and is designed to ensure that firms will be able to implement the standards in the highest quality manner possible when distractions due to the pandemic subside. The standards are primarily related to substantial changes to the statements for periods ending on or after December 15, 2021. Early implementation is permitted.

Firms that already have methodologies or tools in place and implementation planned may wish to move forward with those plans despite the change in the effective date, according to AICPA Chief Auditor Bob Dohrer.

SAS Nos. 134–140 are interrelated and, within this group, subsequent SASs amend previously issued SASs. The effective dates of SAS Nos. 134–140 were aligned so that they would be implemented at the same time. Accordingly, the ASB recommends that all these SASs be implemented concurrently. The new SASs are as follows:

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, issued May 2019
- SAS No. 135, *Omnibus Statement on Auditing Standards—2019*, issued May 2019
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, issued July 2019
- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, issued July 2019
- SAS No. 138, *Amendments to the Description of the Concept of Materiality* (and SSAE No. 20 of the same title), issued December 2019
- SAS No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134*, issued March 2020
- SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*, issued April 2020
- SAS No. 141, *Amendment to the Effective Dates of SAS Nos. 134–140*, issued May 2020. This statement delays the effective dates of SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, from periods ending after December 15, 2020, to December 15, 2021, in order to provide more time for firms to implement these SASs in light of the effect of the coronavirus pandemic.

Scope of AU-C Section 700

This section addresses the auditor's responsibility to form an opinion on the financial statements. It also addresses the form and content of the auditor's report issued as a result of an audit of financial statements. This section applies to an audit of a complete set of general purpose financial statements and is written in that context.

This section is not applicable when the auditor is forming an opinion and reporting on financial statements of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA). In such circumstances, SAS No. 136 applies. Section 705, *Modifications to the Opinion in the Independent Auditor's Report*, and Section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, of this SAS address how the form and content of the auditor's report are affected when the auditor expresses a modified opinion (a qualified opinion, an adverse opinion, or a disclaimer of opinion) or includes an emphasis-of-matter paragraph or other-matter paragraph in the auditor's report.

This section does not require the communication of key audit matters. Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, of this SAS addresses the auditor's responsibility to communicate key audit matters when the auditor is engaged to do so.

AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, addresses special considerations when financial statements are prepared in accordance with a special purpose framework. AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, addresses special considerations relevant to an audit of a single financial statement or of a specific element, account, or item of a financial statement.

The requirements of this section promote consistency and comparability in auditor reporting. Consistency in the auditor's report, when the audit has been conducted in

accordance with generally accepted auditing standards (GAAS), promotes credibility in the marketplace by making more readily identifiable those audits that have been conducted in accordance with recognized standards. Consistency also helps promote users' understanding and identification of unusual circumstances when they occur.

Auditor's Objectives

The objectives of the auditor are to do the following:

- Form an opinion on the financial statements based on an evaluation of the audit evidence obtained, including evidence obtained about comparative financial statements or comparative financial information.
- Express clearly the opinion on the financial statements through a written report (Ref. par. .A3).

Auditor's Report for Audits Conducted in Accordance With GAAS

The auditor's report should be in writing (Ref. par. .A23–.A24). The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. The report also should be addressed, as appropriate, based on the circumstances of the engagement.

Auditor's opinion. The first section of the auditor's report should include the auditor's opinion and should have the heading "Opinion." The Opinion section of the auditor's report should also do the following:

- Identify the entity whose financial statements have been audited.
- State that the financial statements have been audited.
- Identify the title of each statement that the financial statements comprise.
- Refer to the notes.
- Specify the dates of or periods covered by each financial statement that the financial statements comprise.

When expressing an unmodified opinion on financial statements, the auditor's opinion should state that, in the auditor's opinion, the accompanying financial statements present fairly, in all material respects, [. . .] in accordance with [the applicable financial reporting framework]. The auditor's opinion should identify the applicable financial reporting framework and its origin.

Basis for opinion. The auditor's report should include a section, directly following the Opinion section, with the heading "Basis for Opinion," that does the following: (Ref. par. .A35)

- States that the audit was conducted in accordance with GAAS and identifies the United States of America as the country of origin of those standards (Ref. par. .A36–.A37).
- Refers to the section of the auditor's report that describes the auditor's responsibilities under GAAS.
- Includes a statement that the auditor is required to be independent of the entity and to meet the auditor's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit (Ref. par. .A38–.A39).
- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going concern. When applicable, the auditor should report in accordance with AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

Key audit matters. When the auditor is engaged to communicate key audit matters, the auditor should do so in accordance with section 701 of this SAS.

Responsibilities of management for the financial statements. The auditor's report should include a section with the heading "Responsibilities of Management for the Financial Statements."

This section of the auditor's report should describe management's responsibility for the following:

- The preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- When required by the applicable financial reporting framework, the evaluation of whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern [for the time period set by the applicable financial reporting framework, as applicable].

The description about management's responsibility for the financial statements in the auditor's report should not reference a separate statement by management about such responsibilities, even if such a statement is included in a document containing the auditor's report.

Auditor's responsibilities for the audit of the financial statements. The auditor's report should include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements." This section of the auditor's report should do the following:

- State that the objectives of the auditor are to:
  - — obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and
  - — issue an auditor's report that includes the auditor's opinion.
- State that reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists.
- State that the risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- State that misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

The "Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report should further describe an audit by stating that, in performing an audit in accordance with GAAS, the auditor's responsibilities are to:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures

responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, no such opinion is expressed. In circumstances in which the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor should omit the following: "but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, no such opinion is expressed."
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in the auditor's judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

The "Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report should also state that the auditor is required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that the auditor identified during the audit.

Other reporting responsibilities. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under GAAS, these other reporting responsibilities should be addressed in a separate section in the auditor's report with the heading "Report on Other Legal and Regulatory Requirements" or another heading that is appropriate to the content of the section.

If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs .22–.37 of this section should be included under a section with the heading, "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" should follow the "Report on the Audit of the Financial Statements."

Signature of the auditor. The auditor's report should include the manual or printed signature of the auditor's firm. It should also include the city and state where the auditor's report is issued.

Date of the auditor's report. The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence of the following:

- All the statements and disclosures that the financial statements comprise have been prepared.
- Management has asserted that it has taken responsibility for those financial statements.

Pre-SAS No. 134 Codification of GAAS Available Through 2021

To assist auditors and firms that do *not* implement SAS Nos. 134–140 prior to December 15, 2021, a "Pre-SAS No. 134" edition of the auditing standards (the AU-C sections) in AICPA *Professional Standards* is now available. This edition contains SAS Nos. 122–133,

as amended, and remains effective through 2021 and should be followed when SAS Nos. 134–140 have not been implemented.

Each AU-C section in this edition is designated with a "B" suffix (for example, "AU-C section 200B") to denote content that does not reflect the codification of SAS Nos. 134–140 or the amendments to other SASs made by SAS Nos. 134–140. Upon implementation of SAS Nos. 134–140, auditors and firms should no longer utilize this edition.

SAS No. 142

In July 2020, the AICPA Auditing Standards Board (ASB) issued SAS No. 142, *Audit Evidence*, which supersedes AU-C section 500, *Audit Evidence*, and amends various other sections of SAS 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended.

SAS No. 142 explains what constitutes audit evidence in an audit of financial statements and sets out attributes of information that are taken into account by the auditor when evaluating information to be used as audit evidence. Taking these attributes into account assists the auditor in maintaining professional skepticism.

The revisions to SAS No. 142 address the evolving nature of transacting business as well as the evolution of audit services. Issues addressed include use of emerging technologies and techniques by both preparers and auditors, the application of professional skepticism, the expanding use of external information sources to provide audit evidence, and more broadly, the relevance and reliability of audit evidence. Following is a brief description of the key changes resulting from the issuance of SAS No. 142:

- Expanded guidance on evaluating whether sufficient appropriate audit evidence has been obtained
  - — Expands the objective of the extant standard to be more broadly focused on considering the attributes of information to be used as audit evidence in assessing whether sufficient appropriate audit evidence has been obtained.
  - — Previously, the objective focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence rather than evaluating the sufficiency and appropriateness of the audit evidence itself.
  - — This change in focus is accomplished by establishing attributes of information to be used as audit evidence when evaluating whether sufficient appropriate audit evidence has been obtained by the auditor.
  - — Attributes of reliable information include its accuracy, completeness, authenticity, and susceptibility to bias.
- Automated tools and techniques
  - — Provides examples to illustrate how automated tools and techniques, such as audit data analytics, drones, or remote observation tools, may be used by the auditor and thus recognizes more prominently in the standard the increased use of automated tools and techniques.
  - — SAS No. 142 also states that an auditor may use automated tools and techniques to perform both a risk assessment procedure and a substantive procedure concurrently if the objectives of both types of procedures are achieved. The standard also contains an exhibit illustrating this concept.
- Professional skepticism
  - — Incorporates the concepts surrounding professional skepticism throughout the standard.

— This content includes the auditor's consideration of susceptibility of information to bias and whether the audit evidence obtained corroborates or contradicts management's assertions.

- Management specialists
  — Includes an amendment relocating content dealing with management's specialists from section 500 to section 501, *Audit Evidence—Specific Considerations for Selected Items*.

SAS No. 142 is effective for periods ending on or after December 15, 2022.

SAS No. 143

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (issued July 2020), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. This standard enables auditors to appropriately address the increasingly complex scenarios that arise from new accounting standards that include estimates.

SAS No. 143 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, and section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and amends various other AU-C sections in AICPA Professional Standards.

The following are some of the fundamental aspects of SAS No.143 that enhance the auditing standards relating to auditing accounting estimates and the auditor's focus on factors driving estimation uncertainty and potential management bias. The SAS:

- Explains the nature of accounting estimates and the concept of estimation uncertainty
- Provides information about scalability of the SAS for all types of accounting estimates, from those that are relatively simple to those that are complex
- Requires a separate assessment of inherent risk and control risk at the assertion level
- Includes an enhanced risk assessment intended to address the challenges auditors face when auditing accounting estimates by providing risk assessment requirements that are more specific to estimates and addresses the increasingly complex business environment and complexity in financial reporting frameworks
- Emphasizes that the auditor's further audit procedures need to be responsive to the reasons for the assessed risks of material misstatement at the relevant assertion level
- Refers to relevant requirements in other AU-C sections and provides related guidance to emphasize the importance of the auditor's decisions about controls relating to accounting estimates
- Addresses the exercise of professional skepticism when auditing accounting estimates
- Requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework.

SAS No. 143 is effective for audits of financial statements for periods ending on or after December 15, 2023.

¶ 110 CONCLUSION

The COVID-19 pandemic has brought many changes to the accounting and auditing world. There will be many more as well as time goes by. Stay tuned for the future.

MODULE 1: TOP ACCOUNTING ISSUES—CHAPTER 2: New COVID-19 Frauds and Scams

¶ 201 WELCOME

The COVID-19 pandemic and the shutdown of the worldwide economy resulted in new fraud risks for businesses. Criminals came up with new scams within days of the virus outbreak. This chapter examines how criminals are trying to take advantage of the virus to line their pockets with ill-gotten gains. It outlines information technology (IT) and other frauds as well as cybersecurity in a COVID-19 environment. The chapter also discusses the internal controls businesses should be using to protect themselves.

¶ 202 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Recognize how criminals are trying to take advantage of the COVID-19 pandemic
- Identify internal controls companies should be using to protect themselves
- Describe IT and other frauds as well as cybersecurity in a COVID-19 environment

¶ 203 REVIEW OF FRAUD

The Association of Certified Fraud Examiners (ACFE) "2018 Report to the Nations on Occupational Fraud and Abuse" revealed that U.S. companies reported more than $7 billion in total losses due to fraud on an annual basis. The average cost was $130,000 per case, and 22 percent of fraud cases resulted in losses of more than $1 million.

According to the 2019 Federal Bureau of Investigation (FBI) Internet Crime Report, from 2015 to 2019, there were 1,707,618 total fraud complaints, reporting a total of $10.2 billion in losses. In that period, the annual total loss figures rose from approximately $1.1 billion in 2015 to $3.5 billion per year in 2019, representing a significant increase in cyber fraud. Although updated statistics for 2020 are not yet available as of this writing, experts estimate that cyber fraud losses for that year will be much higher, at approximately $4.5 billion.

Cyber fraud is growing due to a number of factors, including large numbers of people working from home during the pandemic, more reliance on technology, and fraudsters' ability to work around certain types of internal controls. Before getting into a detailed discussion about the causes and types of COVID-19–related fraud, a review of fraud is presented.

The Fraud Triangle

Fraud can be defined simply as someone making a false statement that somebody else relied upon to their detriment. In the case of occupational fraud, the false statement is an employee's breach of his or her fiduciary responsibility to the employer. When a person accepts employment, they agree to work in their employer's best interest. If an employee breaches that fiduciary responsibility—for example, to embezzle funds or

because of a conflict of interest—that is a fraud, because the employee had promised to do what was best for the employer.

Dr. Edwin Sutherland was one of the first people in the United States to study fraud, and he came up with the term *white-collar crime* to differentiate crimes of trust, such as fraud, from other crimes like burglary, robbery, etc. One of Dr. Sutherland's students, Dr. Donald Cressey, wanted to go a step further and find out what made people commit fraud. Dr. Cressey interviewed hundreds of convicted felons who were imprisoned for embezzlement and fraud to learn why they committed the crimes.

Dr. Cressey found that three factors were always present in the frauds: pressure, opportunity, and rationalization. These three factors constitute the fraud triangle. Dr. Cressey referred to pressure as an "unsharable financial need"—a need for funds that the fraud perpetrators could not obtain through their normal access to money, whether that was their paycheck, their savings account, or another source. He learned that there are many types of pressure to commit fraud. The pressure could come from the perpetrator's greed, desire to "keep up with the Joneses," overextension of credit card debt, unexpected home repair or medical bills, a spouse losing their job, and more.

At one point during the COVID-19 crisis, 53 million people in the United States had been laid off, which put a great deal of pressure on many individuals. Other pressures came from COVID-19 medical bills or a breadwinner passing away from the virus. Unfortunately, the pandemic also caused spikes in gambling, alcoholism, drug addiction, and depression, which resulted in more pressures.

Rationalization refers to fraudsters' ability to convince themselves that it is okay to commit the fraud. The third part of the fraud triangle is opportunity. Businesses can implement internal controls to reduce or eliminate the opportunities for employees to commit fraud. However, it has been difficult for many businesses to keep their internal controls up-to-date during times of rapid change, such as that experienced during the pandemic. Changes during the pandemic include some businesses shutting down and others having their employees work from home. In addition, the use of new technologies exploded, such as electronic meeting and collaboration platforms, using the cloud to transfer and save documents, and doing work like preparing tax returns remotely without ever meeting with clients in person.

These factors caused many issues for the accounting industry, as well as for accounting clients. These massive changes in how organizations do business allowed opportunity for criminals to creep in. Remember that change always comes with risk.

The Elements of Fraud

The three basic elements of fraud are the act of theft, concealment, and conversion. The act of theft means a perpetrator has to actually commit a fraudulent act. An individual can plan the most elaborate fraud, but if nothing is stolen and nobody is harmed, then there is no fraud.

Once the fraudulent act occurs, there is a concealment. Criminals sometimes go to great lengths to conceal what they did, for various reasons. Usually, they don't want to lose their job, or don't want to go to jail.

The third element of fraud is conversion. Fraudsters have to convert what they stole into something they can use. For example, if a criminal stole fixed assets or inventory, he will want to convert them into cash. Criminals who steal electronic data, Social Security numbers, or credit card numbers will need to sell them to get cash, or, in the case of credit card numbers, use them to make online purchases. Those who steal a large amount of money may need to launder it so that they can actually spend it without alerting the IRS or the Financial Crimes Enforcement Network (FinCEN).

Occupational Frauds

Occupational frauds are crimes an employee commits against the employer. There are three basic types of occupational frauds: financial statement fraud, asset misappropriation, and corruption. Accountants are quite familiar with financial statement fraud, or "cooking the books." Asset misappropriation, the most common type of occupational fraud, includes not only the theft or embezzlement of tangible assets, but also the theft of intangible assets, such as customer lists, and employees' personal information such as their name, Social Security number, date of birth, salary, and health information.

The third type of fraud, corruption, is the misuse of one's position with the organization for personal gain. There are many different types of corruption, and corruption often occurs in concert with asset misappropriation and/or financial statement fraud. For example, an employee might be stealing assets or getting bribes, and cooking the books to cover up their fraudulent activity.

Non-Occupational Frauds

Non-occupational frauds are those that are not directly related to one's employment. They include the following:

- Medical insurance fraud
- Unemployment fraud
- Workers' compensation fraud
- Product liability fraud
- Advertising fraud
- Identity theft
- Credit card fraud
- Internet frauds
- Liability fraud
- Employment fraud

The number of incidents of medical insurance fraud has increased because of the COVID-19 pandemic. Unemployment fraud, which will be discussed later in this chapter, has risen dramatically during the crisis. Workers' compensation fraud can include people who are either falsifying injuries or exaggerating injuries in order to get compensation.

During the pandemic, there have been many cases of business identity theft. One example is fraudsters stealing a small business's identity and then applying for a Paycheck Protection Program (PPP) loan or Economic Injury Disaster Loans (EIDL) for the business. Credit card fraud is an issue for both individuals and businesses, as are Internet frauds, employment frauds, and other types of liability frauds.

¶ 204 COVID-19 CYBERSECURITY RISKS

Several cybersecurity risks are related to the COVID-19 pandemic. One of those risks is civil litigation. If a company experiences a data breach that discloses its employees' information, those employees will likely sue the company. A recent appellate court ruling affirmed liability for employers who do not protect employees' confidential information.

According to one study, small businesses with fewer than 10,000 records compromised could have data breach costs of around $4 million. It is exceptionally expensive for a large organization to be a victim of a data breach, with resulting costs of billions of

dollars. Companies whose data is breached also may be fined by the government for failing to provide proper internal controls and cybersecurity. They will also face damage to their reputation and loss of customers.

Usually, when the government settles on a data breach or other type of fraud lapse, it requires 20 years of ongoing audits for the company where, for example, the cybersecurity internal controls are audited by a third-party, independent auditor. In addition to paying these costs, the company also experiences a disruption to its business.

Many risks are associated with cyber fraud. A company that is a victim of ransomware might have to make major payments to retrieve its encrypted data. Baltimore and Atlanta are just two of the cities that were hit with ransomware in 2019.

Cybersecurity Risk Factors

The two main cybersecurity risk factors for businesses are its employees and IT systems.

Employees. In some cases, employees do not really understand the risks of fraud to the organization. That is why they must be educated about fraud risks and receive cybersecurity training. Employees also must be able to recognize red flags for fraud in their daily work.

Another issue is employees who override internal controls. During the pandemic, many employers sent employees home with a company computer and gave the employees a virtual private network (VPN). The VPN encrypts data being sent over the Internet when employees connect with company systems. However, some employees experienced a slowdown when connected to the VPN, so they disabled it to work more efficiently. This type of override makes it easier for criminals to intercept that data.

Employee inattention is another cybersecurity risk factor. For example, an employee receives a phishing email, or a smishing text message, and they absentmindedly click on the link. Due to inattention, the employee doesn't worry about where the email or text came from, and their action allows a perpetrator to download malware to the computer or to gather sensitive data from it.

Employees face other cybersecurity risks when working remotely. In a vishing attack, a fraudster may call an employee working at home, pretending to be from the company's IT department. The fraudster tells the employee that he needs to run a software update on the employee's computer: "I'm going to send you an email. I need you to click on the link." When the employee clicks on the link, the fraudster can infect the employee's computer with malware or viruses.

During the pandemic, many employees working at home have been using their personal devices, such as their personal cell phones and personal computers, for work. Obviously, this poses a risk because they likely do not have the same cybersecurity protections on their personal devices that the company has on its business devices, putting company information at risk.

IT systems. When a company has hundreds or thousands of remote workers, such as during the pandemic, that increases the complexity of the company's IT network, which can put data in peril. Outdated technology—failing to update software or hardware—is another concern, especially for governments. For example, some federal government agencies are still using computer hardware and software from the 1960s and 1970s.

Obviously, anytime employees bring their own devices, there is an opportunity for fraud. This is true whether they use their own devise exclusively for work or whether they are coming to the office and charging their smartphone using their work computer.

Anytime there is that type of connection, information is at risk. If there is malware on the smartphone, it can migrate onto the company servers.

Businesses must have internal controls in place for the new reality caused by the pandemic. For example, most companies did not have effective internal controls in place to protect themselves during Zoom meetings. The technology was quickly adopted to keep businesses running during the COVID-19 crisis. There are always risks when adopting or expanding the use of new technology.

Company personnel also must be educated about the additional risks brought on by the pandemic, such as those posed by file sharing, cloud computing, collaboration from remote locations, and others.

STUDY QUESTIONS

1. Which fraud theory was developed by Dr. Donald Cressey?
   a. Theory of differential reinforcement
   b. Fraud triangle
   c. Theory of differential association
   d. Social learning theory
2. Which of the following is an element of fraud?
   a. Opportunity
   b. Rationalization
   c. Pressure
   d. Concealment
3. Which of the following types of occupational frauds occurs most frequently?
   a. Corruption
   b. Financial statement fraud
   c. Tax fraud
   d. Asset misappropriation
4. Which of the following is a cybersecurity risk for employees working from home?
   a. Government settlement
   b. Damage to reputation
   c. Using personal devices
   d. Complex IT systems

¶ 205 COVID-19 SCAMS AND FRAUDS

This section discusses specific scams and frauds tied to the COVID-19 pandemic, how criminals are perpetrating them, and how organizations can protect themselves. Every time there is a natural disaster, whether a hurricane on the Gulf Coast, wildfires on the West coast, or a volcanic eruption in Hawaii, scammers find a way to use the catastrophe to steal money. The same is true for the COVID-19 crisis.

The types of scams that criminals began committing during the pandemic were new to many law enforcement agencies. Therefore, law enforcement had a learning curve to get up to speed. In other cases, the scams were just regurgitations of scams

used in the past, but with a new twist. Overall, however, during the pandemic, the number—and types—of scams increased.

Testing Scams

In testing scams, criminals sell fake at-home COVID-19 test kits online or go door-to-door performing fake tests for money or insurance information. Door-to-door scammers typically visit people's home and tell them they are on a contact list of somebody diagnosed with the coronavirus. The scammer says she is not allowed to reveal who the infected person is, but recommends that the victim be tested and offers to sell a COVID-19 testing kit to the victim. The problem is that the testing kit is fake. Con artists are typically adept at selling their phony bill of goods.

Vaccination Card Scams

A COVID-19 vaccination card may be required for many reasons, including to travel, to attend certain events, to avoid wearing a face mask, or to return to work. Some people believe it is easier to get a phony vaccination card than to actually get vaccinated. Consequently, vaccination card fraud is prevalent at the time of this writing.

Any offer to purchase or sell a COVID-19 vaccination card or vaccination passport should be considered fraud. Some scammers are offering to buy vaccination cards from people who haven't yet put their name on the card. That way, the scammer can insert his or her own name on the card, or sell the card to someone else to insert their name. Phony vaccination cards are being sold on the Internet.

Photos of COVID-19 vaccination cards should not be shared on social media. Posting content that includes your date of birth, healthcare details, or other personally identifiable information can allow a criminal to steal your identity.

COVID-19 Contact Tracers

This fraud scheme includes fraudsters posing as COVID-19 contact tracers and asking victims for personal information such as driver's license numbers, medical insurance information, and Social Security numbers.

The fraud is perpetrated in a live phone call, a phishing scam, or smishing scam. The scammer may even ask the victim certain health questions to gather information that they can sell on the dark net or use to steal the victim's identity. They may even call an employer and ask about medical insurance information for an employee they say is in the hospital with COVID-19 and on a ventilator. This should be a red flag for fraud.

COVID-19 Survey Scams

Fraudsters are calling victims to ask them to participate in COVID-19 surveys. They often offer gifts or rewards for participating in the survey, such as a gift card or an opportunity to win a prize. When the victim agrees to participate, they are asked for a great deal of personal information. Both individuals and companies can be targeted by these survey scams. Fraudsters might ask an employer how many of its employees have been out sick with COVID-19, or what percentage of verified transmission is in the workplace. Some of these scammers might be looking for ways to get class action lawsuits going for COVID-19 transmissions, but others are trying to obtain employees' personal information or company information that can be bought and sold on a daily basis on the dark net.

Prevention Scams

Prevention scams involve people selling fake COVID-19 prevention devices or drugs online, over the phone, or door-to-door. In one case, a Hollywood actor was arrested by

the FBI for pedaling bogus coronavirus cures. Another common scam was the sale of fake personal protective gear, such as knockoff N95 face masks. This was especially prevalent when supplies were short. At one time, 39 million fake masks that were destined to go to U.S. healthcare workers were brought into the country. There were even some cases of fake ventilators being sold.

App Scams

A common mobile app scam involved an app that appeared to be designed to track the spread of the COVID-19 virus, but that inserted malware that compromised the victim's devices and personal and business information. Fraudsters also promoted a "virus sniffing" app that would allow a smartphone to sniff out the virus in the air. It supposedly would alert users if their phone sniffed any virus so that they could leave the area and not be exposed to COVID-19. Some of these apps were used to install malware on the victims' cell phones or computers and then steal personal and business information.

Phishing Scams

Phishing is the practice of sending emails supposedly from reputable organizations to fraudulently obtain people's personal information. In a common fraud scheme, people received phishing emails that appeared to be sent from entities such as the World Health Organization (WHO), the Centers for Disease Control and Prevention (CDC), or the Food and Drug Administration (FDA), notifying victims that they had identified COVID-19 in the victim's home or office. Obviously, these are a red flag for fraud. Numerous types of phishing emails have been sent in connection with the pandemic.

Bailout Scams

In bailout scams, fraudsters pretending to be from the IRS or Treasury Department contact individuals claiming they needed to verify their bank account information to send them their government bailout money.

Stimulus Check Scams

Many fraud schemes are related to government stimulus checks and other COVID-19–related programs. One scheme involved text messages or emails that appeared to be sent by stores, offering stimulus checks to individuals. The victims were asked to supply their personal information to get the stimulus check, and then thieves used the information to steal their identity.

Another stimulus check fraud centered around legitimate checks sent accidentally to deceased people, and their living relatives or scammers cashing them. In the first round of stimulus checks that were sent to individuals, the IRS also accidentally sent some checks to prisoners. By the second and third rounds of stimulus checks, the IRS began attempting to collect the money from those who cashed checks fraudulently.

Business Loan Scams

Many of these scams are centered around PPP loans and EIDLs. Both programs are backed by the Small Business Administration (SBA). The PPP offers loans to businesses affected by the pandemic to keep their employees on the payroll. EIDLs provide economic relief to small businesses and nonprofits who are experiencing economic hardships. Unfortunately, a great deal of fraud has been perpetrated in these programs because their purpose was to get money out the door fast to keep small businesses open, sometimes at the expense of data security. In response to this fraud, in 2020, the SBA announced it will audit all PPP loans over $2 million to make sure they are valid.

Scams included fraudsters pretending to be from the government who contacted businesses to get them to apply for government stimulus loans, allowing the fraudsters to gather sensitive information. Also, scammers will ask for personal information of employees who are currently working, have been laid off, or who might be laid off in the future.

Organizations are at risk of fraudsters applying for these loans in the organization's name, or people applying for these loans and misusing the funds. Even those who legitimately applied for some of these loans exposed themselves to risk because the SBA did not have the best internal controls in place. One news article stated that the SBA admitted the personal information of 8,000 applicants had been exposed.

As is true of any new loan program, there were issues with the PPP and EIDL. Numerous organizations that were not eligible for PPP funds received them. For example, Harvard University and Ruth Chris Steakhouse erroneously received millions of dollars, but Ruth Chris Steakhouse gave the money back. If the government finds out that a company has committed these frauds, it can come after the company, with punishments that include jail time and fines

Funeral and Cremation Scams

The number of funeral and cremation scams increased dramatically in 2021 because the most recent stimulus bill allowed for the government to pay for funerals and cremations of individuals who died from the COVID-19 virus. The Federal Emergency Management Agency (FEMA) has warned the public about fraudsters targeting those who lost loved ones due to COVID-19. The agency offered $9,000 for funeral expenses for an individual whose COVID-19–related death occurred between January 20 and December 30, 2020. Multiple cases of people altering death certificates to indicate the death was COVID-19 related have been uncovered.

Also, scammers began calling people by phone or contacting them by text messages or email, pretending to be from funeral homes and asking for money to cremate their friends or relatives.

Fraudsters also pretended to be from funeral homes in an attempt to gather personal data about people who are deceased. This fraud illustrates that criminals look to take advantage in any way to get the money from victims' accounts into their own accounts.

Business Frauds

As mentioned earlier, phishing emails are a type of business fraud perpetrated during the pandemic. In these frauds, criminals notified businesses that their facility had been identified to be high risk for COVID-19 transmission. The criminals said they were working with local businesses to disinfect high-risk areas with special Centers for Disease Control (CDC) and Environmental Protection Agency (EPA) industrial-strength disinfectants that could kill the coronavirus. Obviously, this was fraud. They were not working hand-in-hand with the CDC or the EPA to disinfect offices.

They also sent similar types of emails to individuals, stating the victim had to pay X amount of money or the email sender would visit the victim's house and infect it with COVID-19. Fraudsters have been using many scare-tactic techniques to get victims to click on email links. In one fraud scheme, perpetrators sent emails spoofing Chase Bank, stating the individual was able to claim "up to 35,700 USD on the United States COVID-19 relief program." Of course, that program does not exist. A big red flag is the use of the term *USD*, which usually indicates the sender is from a foreign country.

Robocall Scams

While working from home, employees are hearing a new crop of illegal robocalls. These automated calls are from fraudsters trying to gather personal and business information. Although many of these calls are obvious because they use a robotic voice, others are harder to distinguish because the voice sounds like a real person's, until the receiver of the call notices that the "person" can't answer questions or continue a conversation. Businesses must determine how to handle these situations and make sure they have internal controls in place around phishing, vishing (a form of phishing by telephone), and smishing (a form of phishing by text message). Employees should receive training on how to handle calls, emails, and text messages from third parties or potential customers, especially those in which somebody is asking for sensitive data.

Data Breaches

The year 2020 saw a huge increase in the number of data breaches related to the pandemic. For example, the pharmaceutical industry was hit with data breaches from countries such as North Korea, China, Russia, and Iran. The scammers were trying to obtain research and development information on COVID-19 vaccines. Rather than investing billions of dollars into their own vaccine research program, these thieves tried to steal the information from companies that were developing or had already developed a vaccine.

With more employees telecommuting, hackers are hoping companies will drop their online defenses, or that IT departments will be overwhelmed, making it easier to infiltrate company IT systems to steal data. More employees working resulted in many more denial of service (DOS) attacks, which are designed to take down a company's website so criminals can install malware and steal data.

As companies increasingly moved to contactless payments during the pandemic, there were also more issues related to fraudulent credit cards and credit card fraud. For businesses or clients that accept credit card or cryptocurrency payments through a third-party processor, the new Form 1099-K rules state that the federal threshold for issuing the Form 1099-K will drop to $600.

Router security for employees who are working from home is another issue employers must consider. Businesses are giving employees company computers or company devices, and remote employees are connecting them to their home network. But what else is hooked up to that home network? The employee might have TVs, their home thermostat, their garage door opener, their car, their music system, their gaming systems, and even more devices on the same network. If employees do not have good encryption and good cybersecurity for these devices, criminals can hack into the system and get to their work computers.

There are a couple of internal controls the employer can put in place in these situations. One is to require the employee to have two separate Internet service providers, one for the business home office and another for all the personal home devices. Another control is to have the employee segment the router to ensure there is one segment for business and one for the home devices. Each should have its own separate user ID and password.

Unemployment Scams

Due to the effects of the COVID-19 pandemic, in a matter of months, the United States went from having the lowest level of unemployment in years to having 50 million people unemployed. State unemployment agencies were not ready for that type of expansion, and to complicate matters, the federal government changed the rules, increasing who was eligible for unemployment benefits.

Moreover, states had outdated computer systems for unemployment claims that could not handle the increased numbers of people applying for aid. In addition, sole proprietors, gig workers, and independent contractors were suddenly eligible for unemployment benefits.

Unemployment programs also now covered people who had a breadwinner in their family who died from COVID-19, even if they had never worked. For example, consider a scenario where a husband was staying home, taking care of the kids, and the wife was employed. The wife contracted the coronavirus and died. Even though the husband was not employed, he could now get unemployment benefits due to changes to the program to help individuals suffering from the virus.

All these factors resulted in unemployment frauds skyrocketing in 2020, and this type of fraud continues to be an issue in 2021. Unemployment fraud affected many states, from Hawaii to Texas to New York. California had billions of dollars in unemployment fraud.

One example of unemployment fraud centers around people who received debit cards for unemployment benefits from a state they do not live or work in. This type of fraud should be immediately reported to the bank that issued the card, as well as to the local police department, the Federal Trade Commission, and the Internet Crime Complaint Center (IC3).

Scammers frequently applied for unemployment in another person's name, and often in another state, which makes it difficult for the victim to track and correct the fraud. In one case, a California Employment Development Department worker filed multiple phony unemployment claims, including one in the name of U.S. Senator Dianne Feinstein. Often, victims are unaware of these crimes and only discover them later, when they get an audit notice from the IRS for failing to report all the unemployment payments they never received and never applied for.

Many businesses had their unemployment insurance premiums rise to super-high levels because fraudsters used the business's information to apply for fraudulent unemployment benefits for individuals. The fraudster had to steal an individual's identity but also had to claim to be an employer.

¶ 206 CONSEQUENCES OF COMMITTING FRAUDS

When fraud perpetrators steal money, they typically do not give it back. In most cases, they have already spent it. According to the Association of Certified Fraud Examiners "2018 Report to the Nation on Occupational Fraud and Abuse," 53 percent of fraud victims were not able to recover their losses due to fraud. Only 15 percent recovered all losses (usually when the fraud was detected early), and 32 percent made only a partial recovery. Keep in mind that many recoveries, especially for small businesses, are based on their insurance policies.

But typically, businesses that experience COVID-19 frauds do not get anything back from the fraudsters. If by chance the perpetrators go to jail, they are not going to be paying the money back. Most of the time that money has been spent, and is often transferred overseas. After these criminals are released from jail, many leave the country and enjoy their ill-gotten gains in another country.

¶ 207 INTERNAL CONTROLS

As discussed throughout this chapter, to deal with fraud related to the COVID-19 pandemic, or even with usual types of fraud, organizations must have internal controls in place to protect the personal information of their customers, their vendors, and even

their employees. Organizations should train their employees on frauds, the most recent scams, and how to avoid them.

Employers in the healthcare industry must ensure that their employees, especially their remote employees, are aware of the various types of phishing, vishing, and smishing scams. Generally, common sense tells us that if something is too good to be true, it's probably a scam. Businesses will have a lot of work to do in 2021 and 2022 because of the explosion of frauds tied to the COVID-19 pandemic.

STUDY QUESTIONS

5. Phishing is done via _____.

- **a.** Social media
- **b.** Email
- **c.** Phone calls
- **d.** Text messaging

6. A data breach occurs when which of the following occurs?

- **a.** Information is electronically copied from a credit card by a waiter at a restaurant.
- **b.** A fraudster takes a picture of a credit card while standing in line at a store.
- **c.** Information is stolen from a company computer.
- **d.** A shell company is used to process transactions on stolen credit cards.

7. A fraud perpetrator's greed illustrates which part of the fraud triangle?

- **a.** Pressure
- **b.** Opportunity
- **c.** Rationalization
- **d.** Conversion

MODULE 1: TOP ACCOUNTING ISSUES—CHAPTER 3: Accounting and Financial Reporting Considerations Related to COVID-19 and the Economic Downturn

¶ 301 WELCOME

The purpose of this chapter is to provide an up-to-date overview of some of the most common accounting and financial reporting matters in light of the COVID-19 pandemic and resulting economic downturn. It focuses on critical accounting technical areas that have been impacted as well as cases where substantial judgment and professional skepticism are necessary to assess the facts and ensure that the operative standards are applied.

¶ 302 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Examine the impact of preparation of current and forward-looking financial statements
- Identify specific technical accounting and financial reporting areas that may be affected by conditions of the COVID-19 pandemic
- Identify emerging topic matters for accounting and financial reporting
- Recognize actions to take when there are indicators that the fair value of an entity may be below its carrying amount
- Outline the process for testing long-lived assets, which includes the use of assumptions and estimates that may change due to the COVID-19 pandemic
- Identify an asset that can be traded or seen as packages of capital that may be traded
- Recognize which Accounting Standards Codification (ASC) Topic provides guidance on determining when to recognize costs and information that must be disclosed in the notes to the financial statements
- Describe conditions evaluated when testing goodwill for impairment in a COVID-19 environment

¶ 303 INTRODUCTION

The COVID-19 pandemic is affecting major economic/financial markets, and virtually all industries/governments are facing challenges. As the spread of the pandemic continues and the economy works towards a sense of normalcy with the rollout of the vaccine, entities are experiencing conditions associated with a general economic downturn, including (but not limited to) the following:

- Financial market volatility and erosion of market value
- Deteriorating credit and liquidity concerns
- Further increases in government intervention
- Increasing unemployment

- Broad declines in consumer discretionary spending
- Increasing inventory levels and reductions in production because of decreased demand and supply constraints
- Layoffs and furloughs, and other restructuring activities

The significance of the topics will vary by industry and entity, but there are certain accounting and reporting issues that will have a pervasive impact and challenge as a result of the pandemic. This chapter discusses these key accounting and financial reporting considerations related to conditions that may result from the COVID-19 pandemic.

¶ 304 ONGOING ASSESSMENT OF THE IMPACT OF THE COVID-19 PANDEMIC

Operations, Liquidity, and Capital Resources

Companies are in the process of making a diverse range of operational adjustments in response to the effects of the COVID-19 pandemic, including the following:

- Transitioning to telework
- Adjusting supply chain and distribution
- Suspending/modifying certain operations to comply with health and safety guidelines to protect employees, contractors, and customers
- Dealing with return-to-work procedures

These adjustments may have an impact on a company that would be considered a material issue to creditors and shareholders when contemplating an investment or voting decision. Affected companies should consider their obligations to disclose various information to investors and should clearly disclose material uncertainties.

Most public entities will need to disclose the impact of the COVID-19 pandemic in various sections of Securities and Exchange Commission (SEC) filings of their 10K (annual financial report) and their 10Q (quarterly financial report). This includes addressing issues and challenges within the risk factors section, management discussion and analysis (MD&A), the business section, legal proceedings, disclosure controls and procedures (DCP), internal control over financial reporting (ICFR), and financial statements.

In Disclosure Guidance (DG) Topic 9 (issued March 25, 2020) as well as DG Topic 9A (issued June 23, 2020), the SEC staff provided questions for companies to consider in developing disclosures related to the COVID-19 pandemic's impact. Even if an organization is not publicly traded, dictates from the American Institute of Certified Public Accountants (AICPA) and recommendations from Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board (GASB), and the SEC are relevant when considering how to report and record transactions. The SEC staff recognizes in DG Topic 9 that "the impact of COVID-19 on companies is evolving rapidly and its future effects are uncertain."

The questions in DG Topic 9 address topics such as:

- Economic outlook
- Operating results
- Near and long-term financial condition
- Liquidity and capital resources
- Debt or other financial obligations

- Known trends and uncertainties
- Significant judgments and estimates
- BC plans
- ICFR and DCP
- Human capital
- Customer demand
- Supply chain matters

DG Topic 9A provides additional questions for companies to consider in light of operational adjustments and financing arrangements in response to the COVID-19 crisis. The questions cover a broad range of topics but highlight a consistent theme, which is improving disclosures related to liquidity, capital resources, and going-concern considerations.

Financial Condition, Liquidity, and Capital

As a result of the uncertainty associated with the pandemic, entities have faced challenges related to selecting appropriate assumptions and developing reliable estimates. Questions that focus on financial condition, liquidity, and capital resources address matters such as:

- Recent financing transactions
- Collateral or guarantee requirements
- Access to credit lines and other unused sources of capital
- Supply chain financing arrangements
- Contract modifications that may affect financial condition or liquidity
- Changes to the cost of capital, credit ratings, planned capital expenditures, share repurchases and dividend payments

Estimates, and Consistency of Assumptions and Estimates

Assumptions/estimates may be required for more than one purpose (e.g., assumptions on forecasted revenues used in multiple impairment tests, assessments of realizability of deferred tax assessments, evaluation of an entity's ability to continue as a going concern). To develop estimates, all available information should be considered. Also, personnel must consider external events when assessing whether:

- Changes in assumptions/estimates from the previous period were appropriate, or
- It was appropriate in the current period not to have updated/changed the assumptions used in the previous period.

CARES Act

The Coronavirus Aid, Relief, and Economic Security (CARES) Act is an economic stimulus legislation that was passed in response to the COVID-19 pandemic's effect on the economy in the United States. Government assistance has been a significant factor for many businesses during the pandemic. In light of this, questions to consider when making forecasts/estimates include:

- Short-term and long-term impact of any loan, grant, tax relief, or other assistance on a registrant's financial condition, liquidity, and capital resources
- Material terms, conditions, or restrictions of any assistance
- A company's ability to comply with such terms, conditions, or restrictions

- Any expected changes to operations or finances when such terms, conditions, or restrictions no longer apply
- The potential need to pay back the loans to the government if certain restricting conditions are not met
- Any significant estimates or uncertainties associated with the accounting for such assistance

¶ 305 IMPACTED ACCOUNTING TOPICS

There are many accounting and financial reporting issues that should be on the radar of accounting professionals. The following chart lists some of the impacted areas.

Impacted Areas			
Forward-looking cash flow estimates	Impairment testing and recoverability of impairment of assets	Indefinite lived intangible assets other than goodwill and LLA	Accounting for financial assets: • Inventory • Leases • Equity method investments • Revenue recognition
Leases	Goodwill	Subsequent events	Going concern
Disclosures	ICFR	Exist or disposal costs	Loss contingencies
Future operating losses	Insurance recoveries	Government grants	

Definitions

Before beginning the discussion of these issues, a review of accounting definitions is in order.

Impairment of assets. Impairment describes a reduction in the value of a company asset (fixed or intangible), so as to reflect a decline in the quality, quantity, or market value of the asset.

Indefinite lived asset. This term describes an asset for which there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the entity (e.g., certain brands, trademarks, licenses).

Long-lived asset (LLA). An asset that is expected to provide economic benefits over a future period of time (greater than one year). LLAs may be tangible, intangible, or financial assets.

Recoverability. An asset's fair value less costs to sell, or its value in use. The concept focuses on the greatest value that can be obtained from an asset, by either selling or using it.

Triggering event. A triggering event occurs when there are indicators the fair value of an entity may be below its carrying amount. This may result in the need to perform an impairment analysis.

Lease modification accounting. Addresses the subsequent accounting for leases for changes occurring after the commencement date.

Lease modification. A change in the scope/consideration for a lease that was not part of the original terms and conditions (treated as a separate lease).

Discounted cash flows. Cash flows adjusted to incorporate the time value of money.

Undiscounted cash flows. Cash flows not adjusted to include time value of money.

Concession. Any reduction in price, rent, or other benefit provided to a tenant or buyer as an inducement to buy or lease.

Valuation assumption. An assumption/estimate of future events that includes a margin for adverse deviations and is used in calculating the actuarial liabilities.

Going Concern

A going concern is a business that is assumed will meet its financial obligations when they fall due. It functions without the threat of liquidation for the foreseeable future, which is usually regarded as at least the next 12 months or the specified accounting period.

The following questions focus on going concern:

- Conditions that may raise substantial doubt about a registrant's ability to continue as a going concern
- A company's plans to address such condition
- A company's progress toward implementing those plans

DG Topics 9 and 9A both encourage entities to "provide disclosures that allow investors to evaluate the current/expected impact of the COVID-19 crisis through the eyes of management" and "proactively revise and update disclosures as facts and circumstances change."

Forward-Looking Cash Flow Estimates

Forward-looking is a business term used to identify predictions that publicly-traded corporations make about future business conditions, restructurings, earnings estimates, and other fundamental company information. Forward-looking information is pervasive in an assessment of:

- The impairment of nonfinancial assets (including goodwill),
- The realizability of DTA, and
- The entity's ability to continue as a going concern.

The COVID-19 pandemic has created complexities in this process. There is a high degree of uncertainty about the ultimate trajectory of the pandemic and the path and time needed for a return to a "steady state." Future cash flows may be impacted and entities must make good-faith estimates, prepare comprehensive documentation supporting those estimates, and provide robust disclosure of key assumptions.

Good-faith estimates in the current reporting period could result in material recorded impairments. If unforeseen favorable developments occur in subsequent quarters, the recognized impairment is no longer indicated, but it cannot be reversed.

Indefinite-Lived Intangible Assets Other Than Goodwill

The COVID-19 pandemic may have resulted in the need to evaluate indefinite-lived assets for impairment. These are typically tested annually for impairment (more frequently if a change in circumstances indicates *more likely than not* the asset is impaired).

An impairment loss is recognized if the fair value of the asset is equal to the excess of the carrying amount of the intangible asset over its fair value. It may be challenging to make impairment projections during the pandemic. Entities are expected to use their best estimate of all required business valuation assumptions. They must consider if there are indicators that an intangible asset classified as indefinite-lived has become finite-lived.

Long-Lived Assets

Changes due to the pandemic may indicate the entity should test its LLA assets for recoverability. The entity should consider whether it is experiencing:

- A decline in revenues,
- An increase in costs (i.e., a decline in net cash flows), or
- Both as a result of the COVID-19 pandemic.

The requirement to test LLA classified as held and used for recoverability is "whenever events/changes in circumstances indicate its carrying amount may not be recoverable." The COVID-19 crisis may result in the following triggering events, which would in turn require an assessment of the asset's value:

- A "significant decrease in the market price of a LLA,"
- A "significant adverse change in the extent/manner in which a LLA is being used or in its physical condition," or
- A "current-period operating/cash flow loss combined with projection/forecast demonstrating continuing losses associated with use of LLA."

Reductions in estimates of undiscounted cash flows due to the expected duration of the pandemic may indicate the asset is not recoverable. ASC 360 outlines a process for testing these assets. This process includes the use of "assumptions/estimates" that may change due to the pandemic. Therefore, companies must remain cognizant and ensure estimates are reasonable.

Leases

As a result of the COVID-19 crisis, certain entities are experiencing significantly reduced consumer traffic. Lessees in some markets are receiving rent abatements or other economic incentives. This activity has raised questions about the appropriate accounting for leases during these times.

Rent abatement entitles the tenant to suspend rent payments or pay only a portion of the rent until a landlord completes property repairs. Lessors must consider if the consequences give rise to a lease modification (the application of the lease modification framework is in ASC 840/ASC 842). Alternatively, they may be accounted for outside of the modification framework (e.g., as the resolution of a contingency or variable rent expense or income).

Generally, under ASC 840/ASC 842, economic relief that was agreed to or negotiated outside of the original agreement most likely represents a lease modification. In this case, both the lessee and lessor would be required to apply the respective modification frameworks defined in ASC 840/842. However, if the lessee was entitled to the economic relief because of contractual/legal rights, the relief would be accounted for outside of the modification framework.

Determining whether concessions provided to lessees constitute a lease modification can be costly for both lessees and lessors. Guidance in the lease standards takes into account lease concessions made in the ordinary course of business but did not contemplate wide-ranging concessions resulting from a global pandemic.

FASB staff have acknowledged that the economics of these concessions may not be aligned with the underlying premise of the modification framework, under which the concession would be recognized. The FASB determined it would be appropriate for entities to make a *policy election* regarding how to account for lease concessions resulting directly from the COVID-19 pandemic.

How can a policy election help? Rather than analyzing each lease individually, entities can elect to account for lease concessions "as though the enforceable rights/obligations for concessions existed, regardless of whether they explicitly exist in the contract." Entities that choose to apply the relief can either:

- Apply the modification framework for these concessions in accordance with ASC 840/ASC 842 as applicable, or
- Account for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework.

In making the election, entities would not need to perform a lease-by-lease analysis to evaluate the enforceable rights. Instead, they may simply treat the change as if the enforceable rights were included/excluded in the original agreement. However, FASB staff observed the election not to apply modification accounting is only available when total cash flows resulting from modified contract are "substantially the same or less" than cash flows in the original contract. The FASB did not define "substantially the same" but expects companies to apply reasonable judgment. The FASB emphasized that clear/concise disclosure of the accounting policy election remains integral to allow for stakeholders' understanding.

Leases (ASC 842): Right-of-Use Assets

Impairments to right-of-use (ROU) assets (*right-of-use* pertains to the lessee's right to occupy, operate, or hold a leased asset during the rental period; in the old lease standard, an asset would be recorded straight to the balance sheet) could occur as a result of business closures, supply chain disruption, or other consequences of the pandemic. ROU assets are subject to impairment/disposal guidance in ASC 360 (the lessee tests ROU assets for impairment consistent with other LLAs).

Along with reevaluation of leases on a go-forward basis, individuals must consider whether a decision to no longer use a leased asset constitutes an abandonment of that lease from an accounting standpoint. Abandonment occurs when a tenant, under its obligations in a lease, leaves the premises before the lease period has ended. When abandonment occurs, the entity writes off the asset balance and any associated accumulated depreciation. The company's conclusion may represent a triggering event that prompts the company to perform a recoverability test.

The following list of definitions is helpful in understanding this topic:

- **Financial asset (FA).** A liquid asset that gets its value from a contractual right or ownership claim. Unlike land, property, commodities, or other tangible physical assets, FAs do not necessarily have inherent physical worth or a physical form.
- **Financial instrument (FI).** An asset that can be traded, or can also be seen as packages of capital that may be traded. These assets can be cash, a contractual right to deliver or receive cash or another type of FI, or evidence of one's ownership of an entity.
- **Contract assets.** An entity's right to consideration in exchange for goods/services that the entity has transferred to a customer that is conditional on something other than the passage of time.
- **Equity security.** Represents ownership interest held by shareholders in an entity (a company, partnership, or trust) realized in the form of shares of capital stock, which includes shares of both common and preferred stock.

- **Measurement date.** With respect to any redemption/purchase of securities, the measurement date is the date that is six months prior to delivery of notice of such redemption or the date of such purchase.

STUDY QUESTIONS

1. An asset where there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of an entity is:

a. An indefinite lived asset

b. A long-lived asset

c. An impaired asset

d. A concession

2. With respect to any redemption or purchase of securities, the measurement date is the date that is ____ prior to delivery of the notice of such redemption or the date of such purchase.

a. 3 months

b. 6 months

c. 9 months

d. 12 months

Accounting for Financial Assets, Financial Instruments, and Contract Assets

Recently, there have been severe declines in the fair value of many financial assets, particularly equity securities. The ability of debtors to comply with the terms of loans and similar instruments has been adversely affected by the economic circumstances created by COVID-19. Entities will need to carefully consider and apply the appropriate impairment and loss recognition guidance to their financial assets, financial instruments, and contract assets.

Entities should also consider the need to assess investments and loans for impairment. The COVID-19 pandemic may cause market volatility, affecting the fair value of investments (credit spreads may widen or a counterparty's creditworthiness may be affected). To assess/measure impairment losses, entities with significant equity securities accounted for using the measurement alternative should group investments sharing similar attributes.

Factors to consider when evaluating these assets for impairment include (but are not limited to) the following:

- Any appreciation in fair value since the original acquisition of the investment that has not been recognized as a remeasurement event. Investors may determine that although the fair value of investments is due to COVID-19 market impact, there is still sufficient "cushion" between fair value and carrying amount so that *no* impairment loss has been incurred.
- **Industry in which the investee entity operates.** An investee that operates in a sector that has performed relatively well during the pandemic may be less susceptible to material impairment losses. Other companies have been severely affected and thus have a higher risk of material impairment losses.

- **The geographic location of the investee entity.** If the entity invested in nonmarketable equity securities in locations with few price declines, those investments may be less susceptible to impairment losses.
- **Quantitative significance of the investee entity.** Entities with numerous investments may "scope" the evaluation to focus on investments that are of a magnitude where impairment losses could be material.
- **Size of the investee entity.** Since the onset of COVID-19, performance of small-cap equities has been poorer than that of other equities in the United States. Investments in smaller companies may be more significantly affected by the COVID-19 pandemic. The term *small cap* describes companies with a relatively small market capitalization. A company's market capitalization is the market value of its outstanding shares. The definition of *small cap* varies, but it generally means a company with $300 million to $2 billion in market capitalization.
- **Other factors specific to the investee entity.** An investor may be aware of specific information that positively/negatively affects an individual investee due to the pandemic.
- **Liquidity risk premiums.** Fair value of an illiquid equity investment could be more greatly impacted by the pandemic than a readily tradable equity security.

ASC 321 allows entities to elect to measure certain qualifying equity securities without a readily determinable fair value at cost, less impairment, and to mark them to fair value when observable price changes in identical/similar investments from the same issuer occur (the "measurement alternative"). The standard contains specific disclosure requirements that apply in any financial reporting period when an entity uses the measurement alternative in ASC 321. Entities should consider disclosing the significant judgments they applied in estimating impairment losses.

For FAs, ASC 326 provides guidance on how to measure credit losses on financial instruments. It comprises three topics (Overall, Measured at Amortized Cost, and Available-for-Sale Debt Securities). The impairment model applied to FAs (other than equity investments) depends on the investment's classification and whether the entity has adopted ASC 326.

Asset Impairment

ASC 326 affects entities holding financial assets that are not already accounted for at fair value through net income. The standard has two main provisions: "Assets Measured at Amortized Cost" and "Available-for-Sale Debt Securities." The following guidance applies if ASC 326 has not yet been adopted.

Available-for-sale (AFS) and held-to-maturity (HTM) debt securities. ASC 320 classifies debt and equity securities into one of three categories: held-to-maturity, trading, or available-for-sale. ASC 320 governs the accounting for passive investments in all debt securities, and for equity securities with readily determinable fair values, impairment of a debt security is considered other than temporary if the entity intends to sell the security as of the measurement date or has determined it is *more likely than not* it will be required to sell the security before the recovery of its amortized cost basis. Due to the COVID-19 crisis, an entity may need to recognize an impairment loss if sales of AFS debt securities are inevitable because it must replenish cash and other capital resources that have been expended and it has not generated sufficient replacement cash flows.

Entities should be mindful that, in determining credit losses, credit rating agencies are often slow to reflect credit rating downgrades. Entities therefore should consider credit losses that exist *as of the balance sheet date* that are not yet reflected in credit ratings.

Loans. Creditors that lend to entities adversely affected by the economic instability of the pandemic should assess whether certain events indicate that an impairment evaluation is required. Economic uncertainty could result in loan modifications that must be accounted for as a troubled debt restructuring (TDR) per ASC 310-40.

TDR is a debt restructuring where a creditor (for economic/legal reasons related to a debtor's financial difficulties) grants a concession it would not otherwise grant. The CARES Act gives financial institutions temporary relief from the TDR accounting/disclosure requirements for certain loan modifications made in response to the COVID-19 pandemic.

Net investments in sales-type or direct financing leases. Lessors should evaluate net investments in leases in accordance with ASC 842. From a lessor perspective, a sales-type lease is a finance lease in which the fair market value (or if lower, the present value of lease payments) of the underlying asset is not equal to its cost, resulting in a selling profit/loss (lessees' term is finance *leases*).

A direct financing lease is a financing arrangement where the lessor acquires assets and leases them to customers with the intent of generating revenue from the interest payments. The lessor recognizes the lease gross investment and the related amount of unearned income.

Evaluation should take into consideration changes in both (1) the credit risk of the lessee and (2) cash flows expected to be derived from the underlying leased property at the end of the lease. A deterioration in market conditions may lead to a decline in the leased asset's value, resulting in an impairment of the net investment in the lease even if the lessee's credit quality has not deteriorated.

Receivables. Receivables from entities may need to be evaluated for collectibility. Organizations should pay attention to the assessment of recoverability when receivables are overdue, even if there is the right to charge interest for late payment. They should also evaluate receivables from customers in geographic regions that are most affected by the COVID-19 pandemic, even if those receivables are not yet past due.

Entities may incur additional write-offs of receivables deemed uncollectible or may be required to establish additional reserves on receivables due from entities that are affected by the impacts of the COVID-19 crisis. In addition, entities should consider how the COVID-19 pandemic may affect their disclosure requirements under ASC 310-10-50.

Contract assets (CAs). CA recorded amounts should be evaluated for impairment by assessing the customer's ability to pay. The customer's ability to pay may be adversely affected by the economic instability resulting from the impacts of the pandemic.

ASC 326 affects entities holding financial assets that are not already accounted for at fair value through net income. The standard has two main provisions: "Assets Measured at Amortized Cost" and "Available-for-Sale Debt Securities." Entities that adopted ASC 326 will apply the current expected credit loss (CECL) impairment model to recognize credit losses on FAs with contractual cash flows carried at amortized cost, net investments in leases, reinsurance receivables, and off-balance sheet credit exposures. Since the CECL model is based on expected losses rather than incurred losses, an allowance for credit losses under ASC 326 reflects (1) a risk of loss and (2) losses that are expected over the contractual life of the asset.

ASC 326 requires entities to disclose the method they used to estimate credit losses (including discussion of factors that influenced management's estimate of expected credit losses.) Entities should consider disclosing the quantitative effect of the

pandemic on the allowance for credit losses (and credit loss expense). Further, they should consider disclosing how modifications not accounted for as TDRs affected credit loss estimates, including allowance for credit losses on accrued interest receivable.

STUDY QUESTION

3. The CARES Act gives financial institutions temporary relief from the troubled debt restructuring rules in ASC 310-40 for:

a. All loan modifications made after the enactment of the CARES Act.

b. All loan modifications made beginning March 20, 2020 until further notice.

c. All loan modifications made in the one-year period after the CDC officially declared the COVID-19 outbreak a pandemic.

d. Certain loan modifications made in response to the COVID-19 pandemic.

Inventory

ASC 330 requires most inventory be measured at lower of cost or:

- Market value (for inventory measured by using last in, first out [LIFO] or the retail inventory method) or
- Net realizable value (for all other inventory).

The COVID-19 pandemic may affect the recoverability of inventory balances. Entities with seasonal inventories or those that have inventory that may be subject to expiration may have to assess their need for a larger reserve for obsolescence. Other entities may have to assess whether a decline in future estimated stock price has arisen. This may require a write-down in inventory cost. Manufacturing entities may have to reassess practices for fixed overhead cost absorption if production volumes become abnormally low.

Entities should determine whether the utility of their inventory on hand has been impaired. Interim impairment losses are reflected in the interim period in which they occur, with subsequent recoveries recognized as gains in future interim periods.

ASC 330 provides guidance on the accounting and reporting of inventory in the financial statements. An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in the production of which it is used. Per ASC 330, variable production overhead costs should be "allocated to each unit of production on the basis of the actual use of the production facilities." Allocation of these costs to each item occurs on the expectation that production facilities are running at *normal production* capacity.

The pandemic may affect entities in such a way that may result in an abnormal reduction of an entity's production levels (e.g., a labor/material shortage, unplanned downtime). In those circumstances, an entity should *not* increase the amount of fixed overhead costs allocated to each inventory item. Rather, the unallocated fixed overhead costs are *recognized in profit or loss* in the period in which they are incurred.

Classification of Current and Noncurrent Financial Liabilities

Liabilities are generally classified as current in an entity's balance sheet if they are reasonably expected to be settled by the entity within 12 months of the end of the reporting period. Unstable trading conditions in affected regions may increase the risk that entities breach financial covenants. If such a breach occurs on or before the end of

the reporting period and gives the lender the right to demand repayment within 12 months of the end of the reporting period, the liability would generally be classified as *current* in the borrower's financial statements.

Revenue from Contracts With Customers (ASC Topic 606)

As a result of the changes in circumstances experienced by both an entity and customers due to the pandemic, an entity may need to make considerations when assessing Topic 606. These considerations include:

Contract enforceability. Topic 606 provides criteria to be met to account for a contract with a customer, including the approval of the parties to the contract and commitment to perform respective obligations. If enforceable rights/obligations do not exist, revenue cannot be recognized until certain conditions are met.

Collectibility. A contract does not exist unless "it is probable the entity will collect substantially all consideration which it will be entitled in exchange for the [promised] good/services that will be transferred." If the impacts of the COVID-19 pandemic result in a significant deterioration of a customer's ability to pay, the entity should reassess collectibility.

Contract modification. A price concession which is provided solely as a result of the pandemic may represent a modification that changes the parties' rights and obligations. The entity must determine whether the contract will be accounted for as a new and separate contract, a continuation of an existing contract, or combination of contracts.

Venture capital. Because of the significant uncertainty associated with the pandemic's effects on an entity/customers, it may be challenging for the entity to make appropriate estimates of venture capital. The entity must document judgments made and the data or factors considered.

Material right. To mitigate any decline in sales, an entity may offer its customers sales incentives. In this circumstance, the entity should evaluate whether a sales incentive represents (1) a material right under ASC 606 that is associated with a current revenue contract or (2) a discount that is recognized in the future upon redemption. In addition, for new or modified contracts, an entity may need to update its estimate of the stand-alone selling price of a material right or reassess its breakage assumptions

Significant financing component (SFC). The entity may provide extended payment terms to assist customers that are experiencing liquidity issues. If an entity modifies payment terms for an existing customer contract, it should consider the same guidance on price concessions. While an extension of payment terms does not itself indicate a contract is not collectible, the entity may need to consider procedures for assessing collectibility.

Implied performance obligation. Free goods/services provided solely as a result of the COVID-19 pandemic are not a contract modification, particularly if they are broad based and not negotiated with the customer. However, an entity may need to determine whether it has developed a practice that creates an *implied promise* in future contracts.

Revenue recognition. Revenue cannot be recognized until control of the goods/services transfers to the customer. Organization's will need to evaluate their timing of revenue recognition.

STUDY QUESTIONS

4. Unstable trading conditions may increase the risk that entities breach financial covenants. A liability would generally be classified as current in the borrower's financial statements if such a breach occurs on or before the end of the reporting period and gives the lender the right to demand payment within _____ of the end of the reporting period.

- **a.** 6 months
- **b.** 9 months
- **c.** 12 months
- **d.** 18 months

5. With respect to revenue recognition of contracts with customers in a pandemic environment, which of the following statements is true?

- **a.** If the impacts of the COVID-19 pandemic result in a significant deterioration of a customer's ability to pay, the entity should reassess collectibility.
- **b.** ASC 360 provides criteria to be met when accounting for a contract with a customer.
- **c.** A price concession provided solely as a result of the pandemic must be accounted for as a new and separate contract for revenue recognition purposes as it will always represent a modification that changes the parties' rights and obligations.
- **d.** Variable consideration estimates are not impacted by the COVID-19 pandemic.

Exit or Disposal Cost Obligations

The impacts of the COVID-19 pandemic may result in incurring costs associated with exit or disposal activities (e.g., involuntary employee termination benefits or costs to consolidate or close facilities and relocate employees). ASC 420 provides guidance on determining when to recognize such costs and the accompanying information that must be disclosed in the notes to the financial statements that include:

- The period in which an exit or disposal activity is initiated, and
- Any subsequent periods until the activity is completed.

Loss Contingencies

Economic instability resulting from the COVID-19 crisis may cause entities to incur losses that should be recognized, disclosed, or both. All loss contingencies should be evaluated unless the contingency is within the scope of other authoritative literature.

ASC 450 defines a loss contingency as: "[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur." ASC 420 establishes an accounting model for costs associated with exit or disposal activities based on the FASB's conceptual framework for recognition of liabilities and fair value measurements. ASC 450-20 requires accrual of a loss contingency when:

- It is probable that a loss has been incurred, and
- The amount can be reasonably estimated.

To accrue a loss contingency, the entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss associated

with it. Loss contingencies that do not meet both recognition criteria may need to be disclosed in the financial statements. Given the uncertainty associated with the pandemic, entities may find it challenging to develop estimates for loss contingencies.

Entities must disclose both recognized and unrecognized contingencies, if certain criteria are met. For unrecognized contingencies, disclosure of the contingency nature and an estimate of the possible loss or range of loss (or a statement that an estimate cannot be made) is required. Disclosure is called for if there is a reasonable possibility that a loss may be incurred but has not been accrued in the financial statements because the amount is not probable or reasonably estimable. Disclosure is also required if there is a reasonable possibility of unrecorded losses in excess of the amount accrued in the financial statements.

Insurance Recoveries

Entities that incur losses stemming from the pandemic may be entitled to insurance recoveries. Also, entities may have business interruption insurance that provides coverage for lost profits due to a suspension of its operations.

If an entity incurs a loss attributable to the impairment of an asset or to the incurrence of a liability and it expects to recover all or a portion of that loss through insurance, it should record an asset for the amount which recovery from the claim is considered probable (not to exceed the amount of total losses recognized). The conclusion that a potential insurance recovery is probable may involve significant judgment and should be based on all relevant facts and circumstances.

Other potential challenges when evaluating whether a loss is considered recoverable through insurance include:

- The need to consider whether losses stemming from the pandemic are specifically excluded as a covered event;
- The extent of coverage and limits, including multiple layers of insurance from different carriers; and
- The extent, if any, to which the insurance carrier disputes coverage.

Consultation with legal counsel may also be necessary to evaluate all alternatives regarding the factors that led to the insurance recoveries and make proper determinations regarding the accounting for those recoveries.

Business interruption insurance differs from other types of insurance coverage. It is designed to protect prospective earnings and profits of the insured entity. Business interruption insurance also generally provides for reimbursement of certain costs and losses incurred during the interruption period. Such costs may be analogous to losses from property damage and, accordingly, it may be appropriate to record a receivable for amounts whose recovery is considered probable. Entities should consult with their independent auditors in connection with their evaluation of whether a receivable may be recorded for expected insurance recoveries associated with fixed costs incurred during an interruption period.

In circumstances where there is a loss of profit margin, this is considered a gain contingency and should be recognized when the gain contingency is resolved. Because of the complex nature of the settlement negotiation process, such recognition generally occurs at the time of final settlement or when nonrefundable cash advances are made

Goodwill

As a result of the pandemic, it is expected that more entities will test goodwill for impairment between annual testing dates. Accounting for intangible asset impairment testing is governed by ASC 350, *Intangibles–Goodwill and Other*. Under ASC 350, an

entity is required to test goodwill for impairment at the reporting-unit level at least annually or "between annual tests if an event occurs/circumstances change that would more likely than not reduce the FV of a reporting unit below its carrying amount." Conditions that would require the entity to consider an assessment include:

- A deterioration in general economic conditions
- A deterioration in the environment in which an entity operates
- A change in the market for an entity's products or services
- Overall financial performance, such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

Entities must recognize that due to the impact of COVID-19 and the resulting economic circumstances, impairment of goodwill may need to be tested more frequently.

Renegotiation of Financial Liabilities

An increase in entities experiencing financial difficulty because of the pandemic may lead to a number of debt restructurings. Borrowers must assess whether a restructuring results in a substantially different instrument where the modification is accounted for as an extinguishment of the original liability and recognition of new liability.

A fair value measurement must be made on the basis of the assumptions that market participants would use in pricing an asset/liability. Entities are required to maximize the use of relevant observable inputs and minimize the use of unobservable inputs. In times of extreme market volatility, entities cannot ignore observable market prices on the measurement date.

Fair Value Measurement and Disclosures

Entities must determine whether an individual transaction is orderly. They cannot assume that an entire market is "distressed" and place less weight on observable transaction prices in measuring fair value. An *orderly transaction* is one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities to take place and to ensure that it is not a forced *transaction*. In addition to considering whether observable transactions are orderly, entities should take into account the following valuation matters that could be significantly affected by the COVID-19 pandemic:

- An evaluation of the inputs used in a valuation technique and, in particular, the need to include the current market assessment of credit risk (counterparty and the entity's own credit risk) and liquidity risk, both for derivative and nonderivative instruments.
- An assessment of whether an entity can rely on data from brokers and independent pricing services when determining fair value.

Subsequent Events

There are two types of subsequent events:

- An event that provides additional information about preexisting conditions that existed on the balance sheet date (referred to as a *recognized subsequent event*), and
- A subsequent event that provides new information about a condition that did not exist on the balance sheet date (referred to as a *non-recognized subsequent event*).

It may be challenging to separate recognized/unrecognized subsequent events in a marketplace that is extremely volatile and where major developments occur daily. Although entities may not have all facts "on hand" on the balance sheet date, once such

facts are gathered, an assessment must be based on conditions as they existed on the balance sheet date. As the global landscape evolves, entities are encouraged to remain vigilant, document the nature/timing of events, and consult with their accounting advisers.

Going Concern

As a result of COVID-19 and its effects, entities need to consider whether they have the ability to continue as a going concern within one year after the date on which the interim or annual financial statements are issued (or available to be issued, when applicable). The initial assessment (before consideration of management's plans) will require an entity to consider, among other things:

- The extent of operational disruption
- Potential diminished demand for products or services
- Contractual obligations due or anticipated within one year
- Potential liquidity and working capital shortfalls
- Access to existing sources of capital (e.g., available line of credit)

An entity can only base the initial assessment on information available (known/reasonably knowable) as of the issuance date of the financial statements. It may be able to alleviate substantial doubt if it is probable that its plans will be effectively implemented, and mitigate conditions that raise substantial doubt *within one year* after the issuance date of the financial statements.

The entity must provide comprehensive disclosures in its annual/interim financial statements when events or conditions are identified that raise substantial doubt about their ability to continue as a going concern even when management's plans alleviate such doubt.

Entities must carefully consider their circumstances and risk exposures when analyzing how recent events may affect their financial reporting. Specifically, financial reporting and related financial statement disclosures need to convey all material current or potential effects of the COVID-19 pandemic. SEC registrants must consider whether to disclose information in areas such as MD&A or the risk factors section in addition to their disclosures in the footnotes to the financial statements.

¶ 306 INTERNAL CONTROL CONSIDERATIONS

Because of the impact of the COVID-19 pandemic, entities may need to implement new internal controls or modify existing ones. This is especially true in light of the increased use of technology and the many remote working situations. Public entities must disclose in their quarterly or annual filings any changes in internal controls that have materially affected, or are reasonably likely to materially affect, ICFR.

Entities must consider the operating effectiveness of controls, including assessing any breakdown in review-type controls or the inability of individuals to perform control duties because of absences. Entities should also consider how a lack of information may affect management's ability to effectively operate controls (e.g., personnel may not be available in affected areas to provide information that is essential to the effective operation of an internal control).

If an existing control cannot be performed, management should identify and design alternative controls to compensate for the lack of information and to potentially identify control deficiencies. Entities should also consider management's ability to complete its financial reporting process and prepare its financial statements on a timely basis. Delays in closing the underlying financial records may increase the potential for error in the

financial statements and merit the use of new or modified controls to offset the increased risk of potential financial statement error.

In addition, entities will need to ensure they have properly designed and implemented controls related to the selection and application of GAAP for the accounting and disclosure issues arising from the pandemic.

¶ 307 DISCLOSURES

The SEC's Division of Corporation Finance released a joint statement providing considerations public companies should take into account as they prepare for earnings releases or investor calls. The statement stresses the need for timely information regarding a company's financial and operating status and future expectations. Company disclosures should reflect the state of affairs and outlook and, in particular, respond to investor interest in:

- Where the company stands today, operationally and financially;
- How the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and its customers, is progressing; and
- How operations/financial condition may change as efforts to fight COVID progress.

The statement also highlighted the importance of disclosures of forward-looking information regarding the economic recovery. The SEC's Division of Corporation Finance issued DG Topic 9, states, in part:

> We understand reporting companies share the view that timely, robust, and complete information is essential to functioning markets and they want to file periodic/current reports in a timely manner, notwithstanding the available relief. The Division encourages timely reporting while recognizing it may be difficult to assess/predict with precision the broad effects of COVID-19 on industries or individual companies.

On June 23, 2020, the SEC's Division of Corporation Finance issued DG Topic 9A2 as a supplement to DG Topic 9. DG Topics 9 and 9A provide disclosure and other considerations associated with the evolving impact of the pandemic, including guidance on earnings releases, non-GAAP measures, and material nonpublic information.

Topic 9A: Coronavirus (COVID-19)—Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources provides additional views regarding operations, liquidity, and capital resources disclosures companies should consider with respect to business and market disruptions related to the COVID-19 pandemic. The topic statement came with the following qualifier:

> The statements in this Disclosure Guidance represent the views of the Division of Corporation Finance. This guidance is not a rule, regulation or statement of the SEC. Further, the Commission has neither approved nor disapproved its content. This guidance, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

The division continues to monitor how companies are disclosing the effects and risks of COVID-19 on their businesses, financial condition, and results of operations. They continue to encourage companies to provide disclosures that allow investors to evaluate the current and expected impact of the COVID-19 pandemic through the eyes of management and to proactively revise and update disclosures as facts and circumstances change.

These disclosures should enable an investor to understand how management and the board of directors are analyzing the current and expected impact of the COVID-19 pandemic on the company's operations and financial condition, including liquidity and capital resources.

¶ 308 RISK FACTORS AND MANAGEMENT DISCUSSION AND ANLYSIS

MD&A supplements the financial statements by providing information about a registrant's financial condition, results of operations, and liquidity. Registrants must disclose information about the most significant risks facing the entity or its securities. Many companies already disclose general risk related to issues such as potential natural disasters/pandemics. They should consider whether to clarify that these types of risk are no longer hypothetical and provide more specificity about the actual/potential future impact of the COVID-19 pandemic on their business. The SEC emphasized the importance of updating this disclosure and stated that a company must disclose: "a company specific risk factor or factors explaining the impact, if material, of the COVID-19 pandemic on its business."

The MD&A should discuss the material quantitative and qualitative impact of the COVID-19 pandemic on an entity's business, such as the following:

- Potential issues such as changes in consumer behavior, including an unusual increase or decrease in demand
- Store or facility closures
- Declines in customer traffic
- Supply chain interruptions
- Production delays or limitations
- Risk of loss on significant contracts
- Liquidity challenges or debt covenant issues
- Regulatory risks
- Impact on human capital

Early-warning disclosures should be considered by management in connection with accounting areas that require significant judgment (contingencies, valuation assessments, impairments). These are frequently included as part of the Critical Accounting Estimates section of the MD&A.

Given the uncertainty associated with the COVID-19 pandemic, there is likely to be a substantial increase in the level of judgment to apply in estimating future results and the range of reasonably likely outcomes. Consider expanding disclosures about:

- The key assumptions used in the most significant estimates, and
- The sensitivity of such estimates to changes that could reasonably occur as events associated with COVID-19 continue to develop.

¶ 309 SUMMARY

There are an abundance of accounting and financial reporting impacts that all organizations (public, private, not-for-profit, government) should consider when recording transactions and preparing financial statements. Due to the volume of considerations, we have highlighted those that would be relevant to most companies and industries. Organizations are strongly urged to research accounting issues prior to final recording in the books and records. For a public organization, this is critical to adequate filing.

STUDY QUESTIONS

6. The SEC and Division of Corporate Finance in Disclosure Guidance 9 and 9A encourage companies to make disclosures that enable an investor to understand:

- **a.** How the board of directors is analyzing management's performance in the pandemic environment and how management's decision-making is impacting the company's cash flow.
- **b.** How management and the board of directors are performing in the pandemic environment and how their decision-making is being evaluated by institutional shareholder advisory services.
- **c.** Whether the board of directors and management are accurately disclosing the company's financial condition in the Management Discussion and Analysis.
- **d.** How management and the board of directors are analyzing the current and expected impact of COVID-19 on the company's financial condition, including liquidity and capital resources.

7. Due to the impact of the COVID-19 pandemic and resulting economic circumstances, impairment of goodwill:

- **a.** Must be tested every two years.
- **b.** May be tested more frequently than annually.
- **c.** No longer must be tested.
- **d.** Must be tested only if the entity received federal pandemic assistance.

CPE NOTE: When you have completed your study and review of chapters 1-3, which comprise Module 1, you may wish to take the Final Exam for this Module. Go to **cchcpelink.com/printcpe** to take this Final Exam online.

MODULE 2: TOP AUDITING ISSUES—CHAPTER 4: Going Concern: SAS No. 132

¶ 401 WELCOME

This chapter discusses Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, from the AICPA's Audit Standards Board (ASB). SAS No. 132 includes many significant changes in authoritative professional standards concerning going concern issues. It represents changes to the Generally Accepted Auditing Standards (GAAS) concerning "going concern" reporting for entities.

¶ 402 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify updates on ASB No. 132
- Describe updates on selected AICPA auditing standards
- Describe updates on selected FASB standards
- Recognize and apply going concern audit deficiencies
- Identify updates on selected related and connected issues
- Differentiate SASs superseded by the new standards
- Describe correct statements regarding SAS No. 132
- Differentiate Accounting Standards Update (ASU) Sections and how they apply
- Identify a going concern condition or event related to the supply chain

¶ 403 OVERVIEW OF SAS NO. 132

SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, is effective for audits of financial statements for periods ending on or after December 15, 2017. It is also effective for reviews of interim financial information for interim periods beginning after fiscal years ending on or after December 15, 2017.

The primary objective of SAS No. 132 was to consider the accounting provisions of the Financial Accounting Standards Board (FASB) 2013 and 2014 standards (discussed later) and the Governmental Accounting Standards Board (GASB) standards of state and local governments.

Issued in February 2017, SAS No. 132 supersedes SAS No. 126 (AICPA, Professional Standards, AU-C sec. 570); amends SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, section 800, Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, as amended; and section 930, *Interim Financial Information* (AICPA, Professional Standards, AU-C sec. 800 and 930).

SAS No. 132 addresses the auditor's responsibilities in the audit of financial statements relating to the entity's ability to continue as a going concern and the implications for the auditor's report. It applies to all audits of a complete set of financial statements, regardless of whether the financial statements are prepared in accordance with a general-purpose or a special-purpose framework.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for a reasonable period of time. A complete set of general-purpose financial statements is prepared using the going concern basis of accounting, unless the liquidation basis of accounting is appropriate. Special-purpose financial statements may or may not be prepared in accordance with an applicable financial reporting framework for which the going concern basis of accounting is relevant.

As a result, when the going concern basis of accounting is not relevant, the requirement of SAS No. 132 is to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting do not apply.

However, irrespective of whether the going concern basis of accounting is relevant in the preparation of special-purpose financial statements, the requirements of this SAS apply regarding the auditor's responsibilities to perform the following:

- Conclude, based on the audit evidence obtained, whether substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time.
- Evaluate the possible financial statement effects, including the adequacy of disclosure regarding the entity's ability to continue as a going concern for a reasonable period of time.

NOTE: The auditor's responsibilities under SAS No. 132 apply even if the applicable financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific evaluation of the entity's ability to continue as a going concern.

Some financial reporting frameworks explicitly require management to evaluate the entity's ability to continue as a going concern for a reasonable period of time and provide disclosures related to the entity's ability to continue as a going concern. For example, FASB Accounting Standards Codification (ASC) ASU 2014-15 requires management to evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable).

Management's evaluation of the entity's ability to continue as a going concern for a reasonable period of time involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of conditions or events. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of a condition or event increases significantly the further into the future a condition or event or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management evaluation specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business, and the degree to which it is affected by external factors affect the judgment regarding the outcome of conditions or events.
- Any judgment about the future is based on conditions or events that are known and reasonably knowable at the date that the financial statements are issued (or at the date that the financial statements are available to be issued, when applicable). Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, when the going concern basis of accounting is a fundamental principle in the preparation of financial statements, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

Inherent Limitations in Evaluating the Entity's Ability to Continue as a Going Concern

The potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The auditor cannot predict such future conditions or events.

Accordingly, the absence of any reference to substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in an auditor's report cannot be viewed as a guarantee of the entity's ability to continue as a going concern for a reasonable period of time.

Objectives

The auditor's objectives are as follows:

- To obtain sufficient appropriate audit evidence regarding, and to conclude on, the appropriateness of management's use of the going concern basis of accounting, when relevant, in the preparation of the financial statements.
- To conclude, based on the audit evidence obtained, whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists.
- To evaluate the possible financial statement effects, including the adequacy of disclosure regarding the entity's ability to continue as a going concern for a reasonable period of time.
- To report in accordance with SAS No. 132.

¶ 404 IN FRONT OF THE ISSUES

An entity's ability to continue as a going concern is a fundamental principle in the preparation of financial statements. Whether the organization is public, private, not-for-profit, or governmental, stakeholders want to know that the organization will be around in the near term.

The issue of going concern is not new and has been embedded in auditing literature (in the United States and internationally) for years. However, the issue came to the forefront in the aftermath of the global financial crisis in the last decade when companies declared bankruptcy and went out of business rapidly, often in the midst of the reporting cycle. Stakeholders were left wondering, "What happened? Why was I not alerted that the company was in financial stress? Where were the auditors?"

Call for Greater Transparency

In response to those questions, investors, regulators, and other stakeholders called for greater transparency in the financial statements and their accompanying disclosures. Calls for transparency also went out to the auditors who are responsible for rendering an opinion on those financial statements.

With that as a backdrop, auditing standard-setters around the world undertook projects to revise the auditor reporting standards. For example, the International Auditing and Assurance Standards Board (IAASB) began a project to overhaul its auditor's report standards. The IAASB's project culminated in the issuance of the revised suite of auditor's report standards in January 2015. Among the key changes were revisions to the IAASB's International Standard on Auditing (ISA), *Going Concern* (ISA 570 Revised).

In the United States, the American Institute of Certified Public Accountants (AICPA) GAAS addressed going concern in SAS No. 126. At the time SAS No. 126 was issued, FASB standards did not address management's responsibilities for evaluation of substantial doubt about an entity's ability to continue as a going concern. However, FASB was contemplating the development of an accounting standard addressing going concern evaluation. As a result, SAS No. 126 clarified SAS No. 59 of the same title but did not converge with the IAASB's auditing standard on going concern.

In August 2014, FASB issued its accounting standard that addresses management's responsibilities with respect to going concern, ASU No. 2014-15. Ostensibly, this new accounting standard "makes management go first" and is aligned with the principle that management is responsible for the preparation of the financial statements. ASU No. 2014-15 is effective for annual periods ending after December 15, 2016, and for interim periods thereafter.

ASU No. 2013-07

ASU No. 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, was issued in April 2013. There was minimal guidance in U.S. generally accepted accounting principles (GAAP) that addresses when it is appropriate to apply, or how to apply, the liquidation basis of accounting. Consequently, there was diversity in practice. The amendments in ASU 2013-07 were issued to clarify when an entity should apply the liquidation basis of accounting.

In addition, the guidance provides principles for the recognition and measurement of assets and liabilities and requirements for financial statements prepared using the liquidation basis of accounting. The amendments apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP, except investment companies that are regulated under the Investment Company Act of 1940.

The amendments require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either:

- A plan for liquidation is approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties, or
- A plan for liquidation is being imposed by other forces (e.g., involuntary ban).

The amendments require that financial statements be prepared using the liquidation basis of accounting to present relevant information about an entity's expected resources in liquidation by measuring and presenting assets at the amount of the expected cash proceeds from liquidation.

The entity should include in its presentation of assets any items it had not previously recognized under U.S. GAAP but that it expects to either sell in liquidation or use in settling liabilities (e.g., trademarks). U.S. GAAP provides minimal guidance on the application of the liquidation basis of accounting.

This guidance is designed to improve the consistency of financial reporting for liquidating entities. An entity should recognize and measure its liabilities in accordance

with U.S. GAAP that otherwise applies to those liabilities. The entity should not anticipate that it will be legally released from being the primary obligor under those liabilities, either judicially or by creditors.

The entity also is required to accrue and separately present the costs that it expects to incur and the income that it expects to earn during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities. In addition, the amendments require disclosures about an entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process.

The amendments are effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein, and early adoption is permitted. Entities should apply the requirements prospectively from the day that liquidation becomes imminent.

Entities that use the liquidation basis of accounting as of the effective date in accordance with other topics (e.g., terminating employee benefit plans) are not required to apply the amendments. Instead, they should continue to apply the guidance in those other topics until they have completed liquidation.

ASU No. 2014-15

ASU No. 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, was issued in August 2014. Under GAAP, continuation of a reporting entity as a going concern is presumed as the basis for preparing financial statements unless and until the entity's liquidation becomes imminent. Preparation of financial statements under this presumption is commonly referred to as the going concern basis of accounting.

If and when an entity's liquidation becomes imminent, financial statements should be prepared under the liquidation basis of accounting in accordance with Subtopic 205-30, *Presentation of Financial Statements—Liquidation Basis of Accounting* (see ASU 2013-07). At that time, there was no guidance in GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern or to provide related footnote disclosures.

However, U.S. auditing standards and federal securities law required that an auditor evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statements being audited.

The FASB received input indicating that because of the lack of guidance in GAAP and the differing views about when there is substantial doubt about an entity's ability to continue as a going concern, there is diversity in whether, when, and how an entity discloses the relevant conditions and events in its footnotes.

The amendments in ASU 2014-15 provide guidance in GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. In doing so, the amendments should reduce diversity in the timing and content of footnote disclosures. The amendments in this ASU apply to all entities.

In connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial

statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued (or at the date that the financial statements are available to be issued when applicable).

Substantial doubt about an entity's ability to continue as a going concern exists when relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or available to be issued). The term *probable* is used consistently with its use in Topic 450, *Contingencies*.

The amendments in this ASU are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter, and early application is permitted.

GASB

GASB Statement No. 56 establishes requirements related to management's responsibilities for assessing going concern for state and local governmental entities.

IAASB and ASB

In January 2015, the IAASB issued its revised auditor reporting standards, which, among other things, included revisions to its going concern standard (ISA 570). A key change in the revised ISA 570 was expanded descriptions of management's and auditors' responsibilities regarding going concern in the auditor's report. The IAASB's auditor reporting standards, including ISA 570, are effective for audits of financial statements for periods ending on or after December 15, 2016.

In July 2016, the ASB released an exposure draft, Proposed Statement on Auditing Standards, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to supersede SAS No. 126. It is the ASB's strategy to converge its standards with those of the IAASB. Accordingly, in developing SAS No. 132, the ASB used ISA 570 as the base.

Overall, respondents to the exposure draft supported the ASB's proposal to update SAS No. 126 in light of the impending effective date of FASB ASU No. 2014-15. SAS No. 132 does not reflect any revisions related to the convergence with the IAASB's other auditor reporting standards. Those revisions will be contemplated as part of the ASB's overall auditor's report project, which is ongoing.

SAS No. 132 was written to be neutral regarding accounting frameworks so that it can be applied to audits of financial statements prepared under different financial accounting frameworks. However, in discussing certain concepts, reference to certain accounting terms is necessary. To better explain and illustrate those concepts, the ASB used terminology that is more commonly used in the United States, such as terminology from the FASB standards and GASB statements (e.g., *substantial doubt*).

The Changes

The ASB retained several concepts from SAS No. 126, including a requirement for the auditor to separately conclude whether there is substantial doubt about an entity's ability to continue as a going concern, among other matters. The ASB believes the following are the most significant changes to the existing auditing standards resulting from the issuance of SAS No. 132. SAS No. 132 clarifies that the auditor's objectives include separate determinations and conclusions with respect to:

- The appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements; and
- Whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists, based on the audit evidence obtained.

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

The application material of SAS No. 132 explains that the intent to provide the necessary financial support may be evidenced by either:

- Obtaining from management written evidence about the third-party commitment; or
- Confirming directly with the supporting party.

The application material further explains that when the financial support is provided by an owner-manager, the evidence regarding intent may be in the form of a support letter or a written representation. Finally, the application material provides illustrative wording of a third-party support letter.

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

Use of emphasis paragraphs when substantial doubt is alleviated. SAS No. 132 includes application material to explain situations when an auditor decides to include an emphasis paragraph to highlight the liquidity issues related to management disclosures when the auditor concludes that substantial doubt has been alleviated by management's plans (this is sometimes referred to as "close-call" situations).

Interim financial information. In issuing SAS No. 132, the ASB also amends its interim financial information standard, AU-C Section 930, *Interim Financial Information*. Under the existing standard, the auditor is required to perform inquiries and consider the adequacy of disclosures to address the issue of substantial doubt about the entity's ability to continue as a going concern if:

- Conditions or events that may indicate substantial doubt about an entity's ability to continue as a going concern existed at the date of the prior-period financial statements, regardless of whether the substantial doubt was alleviated by the auditor's consideration of management's plans; or
- In the course of performing review procedures on the current-period interim financial information, the auditor becomes aware of conditions or events that might indicate the entity's inability to continue as a going concern.

From the review report perspective, the standard provides the auditor an option to include an emphasis-of-matter paragraph when management's disclosures are adequate. The ASB decided to require performing review procedures to address the situations when the applicable financial reporting framework includes requirements for manage-

ment to evaluate the entity's ability to continue as a going concern for a reasonable period of time in preparing interim financial information.

The amendments to the standard reflect a new requirement for the auditor to include an emphasis-of-matter paragraph in the review report when certain conditions or events exist related to substantial doubt about an entity's ability to continue as a going concern. This decision was based on the ASB's desire to achieve consistency in auditor reporting in both the annual audit and interim financial information.

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

STUDY QUESTIONS

1. Which Statement on Auditing Standards prescribes requirements related to an auditor's consideration of an entity's ability to continue as a going concern?

a. SAS No. 126
b. SAS No. 132
c. SAS No. 134
d. SAS No. 142

2. Which of the following identifies the look-forward period with respect to going concern considerations?

a. One year
b. Two years
c. Three years
d. Four years

3. Based on the requirements of ASC Topic 205, an entity is required to prepare its financial statements using the _____ basis of accounting when liquidation is imminent.

a. Cash
b. Accrual
c. Liquidation
d. Fair value

¶ 405 GOING CONCERN AND AUDIT PROBLEMS

Since 2017, U.S. GAAP has required management to assess an entity's ability to continue as a going concern. Subtopic 205-40 contains the requirements management must follow in conducting its assessment and the disclosures the entity may have to make as a result.

Management's assessment is a two-step process that requires determining whether it is probable the entity will be unable to meet its obligations over a defined period. That period, referred to as the *look-forward period*, spans one year from the assessment date, the date the entity's financial statements are issued or are available to be issued.

Because the assessment concludes on the assessment date, it reflects events or conditions that occurred after the reporting date up to the assessment date, in other words subsequent events. Management must perform this assessment at each reporting period, so the look-forward period is continuously rolling forward. The two-step process is as follows:

- Step 1
  - — Assess if substantial doubt is raised.
  - — In effect, is it probable that the entity will not be able to meet its obligations?
  - — If the answer is no, then no disclosures are required.
- Step 2
  - — If the answer is yes, then is substantial doubt alleviated by management's plans?
  - — If management's plans *do not* alleviate substantial doubt, then substantial doubt exists, and disclosure is required.
  - — If disclosure *does* alleviate substantial doubt, then it is still raised and disclosure is still required.

Points for the Auditor to Consider

Management's going concern assessment contains only two steps, but each step contains specific concepts and requires considerable judgment. Understanding these concepts is essential to conducting a going concern assessment. Some of the key concepts in management's going concern assessment are:

- Substantial doubt
- Probable
- The look-forward period
- The assessment date

Substantial Doubt and the Auditor

Substantial doubt about an entity's ability to continue as a going concern is raised when it is probable the entity will not be able to meet its obligations during the look-forward period.

Under Step 1, management determines whether events and circumstances raise substantial doubt about the entity's ability to continue as a going concern. Management can make this determination by breaking the process into smaller steps that collectively identify what the entity has, owes, and needs to continue to operate throughout the look-forward period. Step 1 notably requires a thorough analysis of the entity's debt arrangements and detailed cash flows forecasts.

If management determines events and circumstances do not raise substantial doubt, it concludes its going concern assessment with no disclosure or other action. Otherwise, management proceeds to Step 2 to determine whether substantial doubt exists and which disclosures to provide.

Substantial doubt about an entity's ability to continue as a going concern exists when such doubt is raised and is not alleviated by management's plans. Under Step 2, management determines whether it has plans to alleviate the substantial doubt that is

raised in Step 1. For its plans to alleviate the substantial doubt, management must establish that it is probable the plans:

- Will be timely implemented,
- Are approved and feasible; and
- Successfully mitigate the conditions and events that raise the substantial doubt.

This demonstration may prove challenging when key elements of the plan are beyond management's control. Additional forecasting to that done under Step 1 is often necessary.

Disclosures

Subtopic 205-40 is a disclosure standard. Therefore, the result of management's going concern assessment is potential disclosures. There is no direct effect on the entity's accounting. There are three potential disclosure outcomes from management's going concern assessment.

- **No disclosure:** No disclosure is required if management concludes under Step 1 that substantial doubt has not been raised.
- **Disclosures when substantial doubt raised but alleviated:** Even when management's plans alleviate substantial doubt (Step 2), the entity needs to disclose certain information about its conclusions regarding the going concern assessment.
- **Disclosures when substantial doubt exists:** When management's plans do not alleviate substantial doubt, the entity needs to disclose that substantial doubt exists.

Auditor Considerations

Although management's going concern assessment has no direct effect on an entity's accounting, it can have indirect implications. It also affects an entity's risk assessment and internal controls over financial accounting (ICFR). Management's conclusion that substantial doubt is raised or exists can indirectly affect such accounting matters as hedge accounting, current versus noncurrent debt classification, deferred tax asset valuation allowances, and impairment testing. Properly conducting a going concern assessment requires a strong risk assessment process and strong ICFR. Management can take certain steps to ensure these processes adequately address the going concern assessment.

Auditor Assessment

An entity's auditors should perform their own going concern assessment like an entity's management. U.S. auditing standards and U.S. GAAP are similar as to requirements, but some differences exist.

An entity's auditors should conduct a similar independent going concern assessment. A finding by the auditors that substantial doubt exists leads to either an explanatory paragraph for PCAOB audits or an emphasis-of-matter paragraph for U.S. GAAS audits in the auditor's report.

Auditor Responsibilities

U.S. auditing standards require that an auditor independently evaluate whether there is substantial doubt about an entity's ability to continue as a going concern. The auditor's specific responsibilities are to:

- Obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
- Conclude, based on the audit evidence obtained, whether substantial doubt exists about the entity's ability to continue as a going concern during the look-forward period; and
- Evaluate the possible financial statement effects (including the adequacy of disclosure) regarding the entity's ability to continue as a going concern during the look-forward period.

The AICPA going concern standard, AU-C 570, was amended after the issuance of Subtopic 205-40 to align the going concern assessment to that of the accounting framework applied by the entity, either U.S. GAAP or IFRS. Therefore, conclusions under AICPA auditing standards and U.S. GAAP should be consistent.

The Public Company Accounting Oversight Board (PCAOB) going concern standard, AS 2415, is similar to the U.S. GAAP requirements but was not amended to specifically reflect the guidance in Subtopic 205-40. The PCAOB issued a staff position paper that stated auditors should look to the requirements in the accounting framework applied by the entity but noted that a determination by management that no disclosure is required under Subtopic 205-40 is not conclusive as to whether an explanatory paragraph is required in the auditor's report.

In an audit conducted under PCAOB auditing standards, the auditor makes a qualitative assessment based on the relevant conditions and events and other considerations set forth in AS 2415. However, it is expected that the conclusions under PCAOB auditing standards and U.S. GAAP will be consistent.

Substantial Doubt

If substantial doubt is raised but alleviated by management's plans, the auditor may consider including an emphasis-of-matter paragraph in the auditor's report. Such a paragraph highlights the liquidity issues related to the entity's disclosures without affecting the auditor's opinion.

If substantial doubt is raised but not alleviated by management's plans and the auditor concludes that the disclosures are adequate, the auditor's report will reflect that conclusion in either:

- An explanatory paragraph (for audits conducted under PCAOB auditing standards); or
- An emphasis-of-matter paragraph (for audits conducted under AICPA auditing standards).

The PCAOB uses different terms for paragraphs included in the auditor's report when matters are required to be reported (explanatory paragraph) and when they are optional (emphasis-of-matter paragraph). The AICPA directs auditors to use only emphasis-of-matter paragraphs to communicate matters regardless of whether they are required to be reported or are optional. These paragraphs do not affect the auditor's opinion under either PCAOB or AICPA auditing standards.

If the auditor determines the going concern disclosures are inadequate, the auditor may issue a qualified or adverse opinion due to the departure from U.S. GAAP. There could be circumstances when multiple uncertainties exist that make it impossible to form an opinion on the financial statements as a whole due to the interaction and possible cumulative effects of the uncertainties resulting in a disclaimer of opinion (i.e., the auditor does not express any opinion).

Going Concern Conditions or Events

Many issues can create going concern conditions or events. The following lists outline many of these by category.

- Customer demand
  - — Loss of a principal customer or major market
  - — Significant decline in customer demand or adverse changes in consumption behavior
  - — Adverse changes in pricing
  - — Emergence of a highly successful competitor
- Supply chain
  - — Loss of a principal supplier
  - — Production delays or product shortages
  - — Supply chain shortages or restrictions in import/export of machinery, components, or raw materials
  - — Adverse changes in the price of significant product inputs, such as commodities
- People
  - — Loss of key management or a key person without replacement
  - — Unexpected management changes
  - — Staffing shortages or other labor difficulties
  - — Adverse changes in labor laws and regulations
- Operations
  - — Intentions to liquidate the entity or cease operations
  - — Plant, store, office, or other facility closures
  - — Loss of a major franchise, license, or patent
  - — Lack of success in a project critical to the entity (e.g., failure to obtain Food and Drug Administration approval on the entity's main new drug candidate)
  - — Significant uneconomic long-term commitments
  - — Need to significantly revise operations
  - — Unexpected organizational changes
  - — Fundamental and significant changes in the industry in which the entity operates
  - — Economical and geopolitical instability in regions where the entity operates (e.g., significant currency devaluation, economy becoming highly inflationary)
- Markets
  - — Significant exposure to volatile markets, such as: exchange rates, commodities (like crude oil prices), stocks, and interest rates
- Liquidity and Overall Financial Condition
  - — Debt becoming due or callable (e.g., debt covenant violation)
  - — Net liability or net current liability position (e.g., working capital deficiency)
  - — Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment

- — Excessive reliance on short-term borrowings to finance long-term assets
- — Indications of withdrawal of financial support by debtors and other creditors
- — Negative operating cash flows or substantial operating losses
- — Adverse key financial ratios
- — Significant deterioration in the value of assets used to generate cash flows
- — Arrears or discontinuance of dividends
- — Inability to pay creditors on due dates
- — Inability to comply with the terms of loan agreements
- — Change from credit to cash-on-delivery transactions with suppliers
- — Inability to obtain financing for essential new product development or other essential investments
- — Debt restructuring (other than refinancing)
- — Need to seek new sources or methods of financing or dispose of substantial assets
- — Changes in trade terms, including availability of trade credit
- — Greater reliance on nontraditional financing arrangements
- — Greater restrictions on access to necessary capital and credit
- — Downward revisions to the entity's credit agency ratings
- — Significant increase in the level of bad debts or insolvency of significant customers or other debtors
- — Adverse changes in the credit risk ascribed to transaction counterparties

- Other Conditions/Events
  - — Noncompliance with capital or other statutory, regulatory, or reserve requirements, such as solvency or liquidity requirements for financial institutions
  - — Pending tax, legal, or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
  - — Adverse changes in law, regulation, or government policy
  - — Unstable or changing regulatory environments, including more proactive regulatory oversight
  - — Regulatory inquiries into the entity's operations or financial reporting
  - — Catastrophe, such as drought, earthquake, or flood, for which the entity is uninsured or underinsured

Differences: Management versus Auditors

ASU 2014-15 defines substantial doubt about the entity's ability to continue as a going concern when aggregate conditions and events indicate that it is probable that the entity will be unable to meet obligations when due within one year of the date that the financial statements are issued or are available to be issued. The auditor's evaluation of whether substantial doubt exists is qualitative and based on the relevant events and conditions outlined in AS 2014-15.

Time period of evaluation. ASU 2014-15 requires management to evaluate whether the entity will be unable to meet its obligations due within one year of the date the financial statements are issued or are available to be issued.

Meanwhile, the auditors are required as part of their annual audit to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the annual financial statements being audited. This may result in situations where the auditor's going concern evaluation is for a period of time that is less than management's evaluation period.

Interim financial statement requirements. ASU 2014-15 requires management to assess an entity's ability as a going concern for each interim reporting period. For interim reviews performed in accordance with AS 4105, auditors are required to inquire of management and to consider the adequacy of management's disclosures if they become aware of conditions or events that might be indicative of the entity's possible inability to continue as a going concern.

AS 4105 states that for an interim review "It ordinarily is not necessary for the [auditor] to obtain evidence in support of the information that mitigates the effects of the conditions and events."

¶ 406 COVID-19 ISSUES

As a result of the COVID-19 pandemic and the resulting economic uncertainty, several companies may face challenges that could impact their ability to continue operating as a going concern. Those challenges may include, among others, work stoppages, restrictions and/or regulations, supply chain disruptions, and reduced consumer spending.

To determine the effect of these challenges on the business, management may need to invest significant effort to prepare supportable future cash flow projections for the next 12 months that will be utilized in going concern evaluations.

- This may result in increased judgments by management and corresponding increases in skepticism from auditors with respect to going concern evaluations.
- In this environment, it becomes even more critical that management, the auditors, and those relying on the financial statements have a clear understanding of each party's responsibilities as it relates to going concern with respect to both the interim and annual financial statements.

¶ 407 TIPS FOR AUDITORS AND MANAGEMENT

Auditor reporting and transparency about the entity's financial condition is information critical to our turbulent economy. Amid the economic turmoil related to the coronavirus pandemic, going concern is one of the topics that auditors are most frequently asking about in their contacts with the AICPA. Auditors and management may need refreshers on what the auditing standards say about going concern and how they interact with the accounting requirements.

In FASB's standards, management is responsible for determining whether preparing the financial statements on a going concern basis is appropriate for the entity. FASB's standards require that management look out for a reasonable period of time, which is 12 months beyond the date when the financial statements are issued. Management needs to assess whether there is substantial doubt about the entity's ability to continue as a going concern for that 12-month period. Management then concludes whether preparation of the financial statements as a going concern is appropriate. It should also be pointed out that that is the standard issued by FASB for nongovernmental entities.

There are also governmental accounting standards (specifically, for going concern, GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*). The reasonable period of

time for this assessment by management is 12 months from the financial statement date, for example, the balance sheet date.

Some special-purpose frameworks may address this evaluation of a reasonable period of time. For instance, the financial reporting framework for small and medium-size entities also has the period defined as 12 months from the financial statement date, for example, the balance sheet date.

For this reasonable period of time, management is required to identify whether any conditions or events are present when they are making this evaluation that may cause significant doubt with respect to the ability to continue as a going concern. And management's evaluation is made based on the conditions or events that are known at the time they are making that evaluation or are reasonably knowable as of that date—in other words, at the date of that evaluation, what do they know and what is their conclusion about that?

This is important because it actually says that conditions that arise or events that occur subsequent to that evaluation, or subsequent to the date that the financial statements are issued, may result in a different outcome or a difference that does not reflect management's evaluation.

Substantial doubt from the perspective of management is defined by FASB as a "probable" threshold, which means "likely to occur." Note, however, that AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, does not define *substantial doubt*.

The auditing standards direct the auditors to consider whatever the accounting framework uses. In this case, whatever U.S. GAAP (either FASB or GASB) requires is what the auditor would use. The auditor is required to consider the evaluation that has been performed by management and then to come to his or her own conclusion on whether the use of the going concern basis is appropriate for preparation of those financial statements.

Another requirement is for the auditor to consider the adequacy and the appropriateness of the disclosures around the conditions and events relative to going concern. Those requirements for disclosure are essentially in the accounting framework, so they are embedded in U.S. GAAP (either FASB or GASB).

Auditors should drill down on those basic objectives and consider the steps the auditor goes through in achieving those objectives. The first one to consider, from the auditor's perspective, is whether there are any conditions or events that cause or raise substantial doubt about the ability to continue as a going concern.

Certainly, it is hard to deny that the COVID-19 pandemic has created events and conditions that may cause doubt about an organization's ability to continue as a going concern. However, that is not a blanket, absolute rule in today's environment. Depending on the sector in which the entity operates, the pandemic-related events and conditions may or may not cause significant doubt.

A frequently used example is that if your business happens to manufacture toilet paper, the environment is probably not leading you to question your ability to continue as a going concern. On the other hand, if you are operating a business in the hospitality industry—such as restaurant, bar, airline, or cruise ship—obviously the conditions and events give rise to going concern matters.

Once the auditor establishes whether conditions and events warrant a going concern evaluation, the next step for the auditor is to ask whether management has performed the evaluation they are required to perform under the accounting framework

as described earlier. If management has performed that evaluation, then the next step would be for the auditor to look at, consider, and discuss management's evaluation with them.

In today's environment, certainly with smaller businesses, management has their hands full just keeping the operations going and the doors open, that they may not have spent a lot of time with a going concern evaluation. If management has not performed that evaluation, then the auditor is obligated to ask management to perform the evaluation required by the accounting framework.

The next step then is to consider the evaluation that management has performed. The first question, of course, is do you agree as an auditor that management has identified all the appropriate conditions and events that need to be considered? Also, have they extended that evaluation period to the reasonable period of time? Have they included all relevant information that is available at that date?

Auditors must remember that management's evaluation is valid at the point at which they make that evaluation based on known information.

The Plan

When conditions and events have been identified and management has concluded there is substantial doubt about their ability to continue as a going concern, the next step is for the auditor to evaluate management's plans to effectively mitigate those conditions and events to less than a probable chance of occurring. In other words, the auditor would be asking, "Can management execute these plans, and if executed, would it mitigate substantial doubt about going concern to less than probable?" This is a key process for auditors.

Often management uses cash flow forecasts in that evaluation, and that is a significant factor in helping them determine whether their plans can alleviate substantial doubt.

When management needs to use cash flow projections to make their evaluation, then the auditor certainly has to consider those projections and evaluate the underlying data. The auditor has to make sure the underlying data used in the projections is reliable and that management has the appropriate support for the assumptions they are using in making the projections.

Often, the last piece of the puzzle for management plans involves the entity's ability to access funding from an external third party, a parent entity, an owner-manager, or some other source. That circumstance is directly addressed in GAAS (AU-C Section 570). If that is part of management's plans, then the auditor must assess whether those third parties have both the intent and the ability to provide that support if need be.

If the intent and ability are present, there is a requirement for the auditor to obtain written evidence about the intent, preferably from the third party. And if that is all present, it may very well lead to a conclusion that the going concern has been alleviated for a reasonable period of time.

COVID-19 Considerations

When management needs to do projections, auditors must consider the reliability of the underlying data involved in those projections and the reasonableness of management assumptions. Generally, in today's environment with the COVID-19 pandemic, there is a heightened degree of uncertainty associated with trying to do projections for a 12-month period into the future.

Auditors understand that in this environment, it is inevitable that the degree of uncertainty is elevated from what it would be in other cases. Because of this, we need to look at those projections with a degree of judgment to assess whether management has done the best they can in making those projections or assessments, based on the information available to them today.

Auditors also need to ask whether management's assumptions are reasonable. That requires a lot of judgment, but auditors must appreciate that the robustness and the rigor of elaborate cash flow projections, for example, just may not be possible in the current environment. Those requirements have to be met the best they can with the information that is available at the time the evaluation is made.

The important point is that when a going concern evaluation involves projections and uncertainty is involved, the types of disclosures in the financial statements that highlight the uncertainty, especially as it relates to uncertainty associated with estimates and projections, should be made in the notes to the financial statements in the risks and uncertainty area or some general footnote.

Another aspect for auditors to consider is that the conditions and events we are facing should not be considered to be an automatic going concern report for any company. It is likely that auditors may see more going concern conclusions, but it is not automatic.

For example, many businesses have very strong financial statements, for example. Clients with very strong balance sheets may not have significant doubt about being able to operate as a going concern for a 12-month period just based on the strength of their financials. This is not an automatic rule of thumb or conclusion to be drawn. Auditors must look at each circumstance individually and make that assessment.

The AICPA has received questions from members about whether it would be prudent for management to delay the issuance of its financial statements until some of this pandemic-related uncertainty is resolved. First of all, this would be contingent on whether management has the flexibility to delay issuance of its financial statements.

Certainly, auditors must always think about who the users of the financial statements are and whether a delay in the issuance of the financial statements would be acceptable or would be viewed as unacceptable by users of the financial statements. If the issuance of the financial statements is delayed unreasonably, that simply means the users of the financial statements will be deprived of the information they need during that extended period. That may not be in the best interests of the users, and that is something management and auditors need to be taking into account.

Another aspect to keep in mind is that as of this writing, nobody can come up with a consensus estimate of when this pandemic will resolve itself, or when social distancing and travel restrictions will be relaxed.

Although going concern is one of the top three areas the AICPA gets questions about, the requirements are not actually that complex. Everybody should be familiar with them and the process involved. Certainly, as alluded to, there are probably a handful of unique considerations that require the auditor to use professional judgment when applying the requirements of the standards. There may very well be an increase in the number of emphasis-of-matter paragraphs and more disclosure in the financial statements about the risks and uncertainties.

An entity's financial statements will not look substantially different from everyone else's financial statements if they are done appropriately, because there will be many in that category.

STUDY QUESTIONS

4. Which of the following statements is correct regarding SAS No. 132?

- **a.** It reflects revisions related to the convergence with the IAASB's other auditor reporting standards.
- **b.** It was written to be biased toward U.S. accounting frameworks.
- **c.** The ASB did not retain any of the concepts from SAS No. 126.
- **d.** In developing SAS No. 132, the ASB used ISA 570 as the base.

5. In issuing SAS No. 132, the ASB also amended interim financial information standard included within which of the following AU-C Sections?

- **a.** AU-C Section 210
- **b.** AU-C Section 260
- **c.** AU-C Section 315
- **d.** AU-C Section 930

6. Which of the following is ***not*** one of the three disclosure outcomes with respect to management's going concern assessment?

- **a.** No disclosure
- **b.** Disclosures when potential substantial doubt is remote
- **c.** Disclosures when substantial doubt raised but alleviated
- **d.** Disclosures when substantial doubt exists

MODULE 2: TOP AUDITING ISSUES—CHAPTER 5: Accounting and Auditing Under the New Leasing Standard

¶ 501 WELCOME

This chapter is designed to provide external auditors with practical and insightful perspectives on how to audit transactions under the Financial Accounting Standards Board's (FASB) new leasing standard, Accounting Standards Codification (ASC) Topic 842, *Leases*. It discusses the new accounting and financial reporting requirements and how to substantively and analytically test them in accordance with *Professional Standards*.

¶ 502 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Recognize the FASB's new leasing standard requirements
- Identify the new accounting and reporting requirements of leases
- Identify which audit procedures to perform
- Recognize how to properly audit the transition requirements and initial adoption of the new standard
- Recognize the types of transactions that fall within the scope of ASC Topic 842
- Identify the first question to be considered when determining whether an arrangement contains a lease
- Identify an example of an initial direct cost (IDC) of a lease

¶ 503 OVERVIEW OF FASB ASC TOPIC 842

Accounting Standards Update (ASU) 2016-02 introduces a lessee model that brings most leases onto the balance sheet. It aligns many of the underlying principles of the new lessor model with those in ASC Topic 606, the new revenue recognition standard (e.g., those related to evaluating when profit can be recognized). It also addresses other concerns related to the current leases model, such as eliminating the requirement in current U.S. generally accepted accounting principles (GAAP) for a company to use "bright line" tests in determining lease classification.

The new standard requires lessors to increase the transparency of their exposure to changes in value of their residual assets and how they manage that exposure. The new model represents a wholesale change to lease accounting. Approximately $3 trillion of right-of-use (RoU) assets and lease payment liabilities will be added on by U.S. companies' balance sheets. Industries such as retail, telecommunications, and real estate will be greatly affected, and all other businesses that participate in leasing transactions will be impacted to some degree.

Management will now face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and estimating
- Managing the complexities of data collection, storage, and maintenance

- Enhancing information technology (IT) systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements
- Refining internal controls and other business processes related to leases
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations
- Addressing any income tax implications

In addition, lessees' financial risk metrics will change, as debt to equity will increase and interest coverage will decrease. A lessee's financial performance metrics will change in the following ways: EBITDA (earnings before interest, taxes, depreciation, and amortization) will increase, return on assets will decrease, and the current ratio will decrease.

Loan covenants and other long-term arrangements may be violated based on additional RoU assets and lease payment liabilities on the balance sheet. Accounting policies and business implications will also need to be addressed. These considerations include the budgeting and planning processes, lease versus buy decisions, and internal controls over leasing transactions.

Effective Date

FASB ASC Topic 842 was effective for private companies with annual periods beginning after December 15, 2019 (e.g., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption was permitted.

However, on June 3, 2020, the FASB issued ASU 2020-05, which amended the effective date of the new leasing standard to give immediate relief to private entities as a result of the widespread adverse economic effects and business disruptions caused by the COVID-19 pandemic. The FASB deferred the effective date to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The deferral applies if those private entities had not yet issued their financial statements (or made their financial statements available for issuance) as of June 3, 2020.

Note that the guidance in ASC Topic 842 does *not* apply to the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas, and similar assets
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

Organization

FASB ASC Topic 842 is organized into the following sections in the Codification:

- 10 – Overall
- 20 – Lessee
- 30 – Lessor
- 40 – Sale and Leaseback Transactions
- 50 – Leveraged Lease Arrangements

Note that the new standard is structured around the type of participant in the lease, as compared to current standard, which is based on lease type.

What Is a Lease?

The new standard contains a new definition. A *lease* is defined as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration." The prior definition was "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time."

To determine whether a contract contains a lease, consider the following questions:

- Is there an identified asset?
- Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of time?
- Does the customer/supplier have the right to direct how and for what purpose the identified asset is used throughout the period of time?
- Does the customer have the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions?
- Did the customer design the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use?

¶ 504 ACCOUNTING UNDER ASC TOPIC 842

Service Contracts versus Leases

Service contracts give rise to different rights and obligations compared to those of a lease contract and therefore result in different accounting. In a service contract, the customer obtains economic benefit from the service only as the supplier performs the service prescribed within the contract. The vendor has a remaining obligation to perform until it has provided all of the service to the customer. The customer typically has an obligation to pay only for the services provided to date.

New Lessee Lease Classification

Lessees must now recognize both a RoU asset and an associated lease liability on the balance sheet. The FASB's view is that the lessee's right to use the underlying asset meets the definition of an asset.

The New Capital Lease—Finance Lease

A lessee is required to classify a lease as a finance lease when it meets any one of the following conditions:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

The New Operating Lease

ASC Topic 842 now states that if a lease is not a finance lease, then it is an operating lease. There is, however, a short-term lease exception: a lease that, at the commencement date has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise, will not be recorded on the balance sheet.

Lease versus Non-Lease Components

After a lessee has made the determination that a contract contains a lease, management is required to identify separate lease components within the contract and consider the right to use an underlying asset to be a separate lease component if both of the following conditions are met:

- The lessee can benefit from the RoU either on its own or together with other resources that are readily available to the lessee, and
- The RoU is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract.

Not all lease contracts contain multiple lease components. When a contract does contain more than one lease component, management is required to allocate consideration in the contract to each separate lease component and non-lease component. The following are not considered lease components and should not receive an allocation of the consideration:

- Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee
- Reimbursement or payment of the lessor's costs

Lessee Lease Recognition and Measurement

The commencement date of a lease is the date on which the lessor makes an underlying asset available for use by a lessee. Calculate the payment stream over the lease term to determine the present value of future minimum lease payments.

The following should be included in the lease payments relating to an underlying asset over its lease term:

- Fixed payments less any lease incentives paid or payable to the lessee
- Variable lease payments
- Exercise price of a reasonably certain option to purchase the underlying asset
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts being owed under a residual value guarantee

The following components should *not* be included within the lease payments:

- Certain other variable lease payments
- Guarantee by the lessee of the lessor's debt
- Amounts allocated to non-lease components

The lease term is an important concept to understand. It is the sum of the non-cancellable period of the lease along with any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option as well as any options to extend that would be controlled by a lessor.

Lease term reassessment. Some situations, such as the following, call for a lease term reassessment:

- A significant event or change in circumstances that is within the control of the lessee directly affects whether the lessee is reasonably certain to exercise—or not exercise—an option to extend or terminate the lease or to purchase the underlying asset.
- An event written into the contract obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
- The lessee elects to exercise an option even though the company had previously determined that the lessee was not reasonably certain to do so.
- The lessee elects not to exercise an option even though the company had previously determined that the lessee was reasonably certain to do so.

Initial measurement—RoU asset and lease liability. The lessee is required to measure and record both of the following:

- The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease
- The RoU asset, which consists of the following:
  - — The amount of the measurement of the initial lease liability
  - — Any lease payments made to the lessor at or before the commencement date, less any lease incentives received
  - — Any IDCs incurred by the lessee

Management should use the rate implicit in the lease if it is readily determinable; if not, then management should use its incremental borrowing rate. A lessee that is a private company is permitted to use a risk-free discount rate for a comparable lease term; however, the private company must make this election for all of its leases.

IDCs are types of costs that would not have been incurred if the lease had not been obtained, for example, commissions or payments made to an existing tenant to terminate the lease. Examples of costs not identified as IDCs include:

- General overheads such as depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities
- Costs related to activities that occur before the lease is obtained, such as tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition

Impairment considerations. The current lease guidance has no consideration of impairments as they relate to operating leases because there was not an asset on a lessee's balance sheet to test for impairment. Under the new guidance, a lessee will apply the ASC Topic 360 impairment guidance for its RoU assets.

After applying the impairment guidance and recording an impairment loss, the RoU asset should be measured as its carrying value less any accumulated amortization and should continue to be amortized from the date of the impairment to the earlier of its useful life or the end of the lease term.

STUDY QUESTIONS

1. Which of the following ASUs introduced a new lessee model that brings most leases onto the balance sheet?

a. ASU 2016-01
b. ASU 2016-02
c. ASU 2016-04
d. ASU 2016-09

2. Which of the following types of transactions is within the scope of ASC Topic 842?

a. Leases of buildings
b. Leases of intangible assets
c. Leases to explore for or use minerals
d. Leases of biological assets

3. Which of the following identifies the first question to be considered when determining whether an arrangement contains a lease?

a. Does the customer have rights to operate the asset?
b. Did the customer design the asset?
c. Is there an asset identified in the contract?
d. Does the customer obtain substantially all of the economic benefits from the arrangement?

Lease Modification

Because the current guidance under ASC Topic 840 has generally been considered complex, the new guidance under ASC Topic 842 was designed to be easier to understand and apply.

Lease modification is defined as "a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease." When a lease modification occurs, the lessee or lessor has to determine whether the modification will be accounted for as a separate contract or as a change to the existing contract. The lessee or lessor is required to account for a modification as a separate contract when both of the following conditions exist:

- The modification grants the lessee an additional RoU not included in the original lease; and
- The lease payments increase commensurate with the stand-alone price for the additional RoU, adjusted for the circumstances of the particular contract.

If the lease modification is not accounted for as a separate contract, management is required to reassess the classification of the lease as of the effective date of the modification based on the modified terms and conditions.

Remeasurement is required under the following circumstances:

- Grants the lessee an additional RoU not included in the original contract
- Extends or reduces the terms of an existing lease other than through the exercise of a contractual option to extend or terminate the lease
- Changes the consideration in the contract only
- Fully or partially terminates an existing lease

Presentation, Disclosures, and Transition Requirements

The new lease guidance includes requirements for presentation, disclosures, and transition. Presentation requirements for lessees and lessors include the following:

- **Balance sheet.** ASC Topic 842 requires that lessees present both finance lease RoU assets and operating lease RoU assets separately from other assets on the statement and in the footnotes. The accounting requirements for lessors have remained substantially the same as current guidance. Lessors are required to present lease assets separately from other assets. They must present a single net investment in both sales-type and direct financing leases instead of separately presenting the respective components.
- **Income statement.** Lessees should include operating leases in income from continuing operations as a single lease cost, consistent with existing guidance. Components of a finance lease are disclosed in a manner consistent with how the company presents depreciation and amortization of similar assets and other interest expense. Lessors have the option of presenting lease income (for all three different types of leases) separately or disclosing in the notes which line items in the statement include lease income. The presentation should reflect the lessor's business model.
- **Statement of cash flows.** For lessees, the presentation requirements for cash outflows are aligned to the presentation of expenses arising from a lease in the income statement (e.g., payments arising from operating leases should be disclosed in Cash Flows from Operating Activities). For lessors, the presentation requirements for cash inflows is simple. Regardless of whether a lease is a sale-type lease, direct financing lease, or an operating lease, all cash receipts should be classified as operating activities.

With respect to disclosures, lessees and lessors are required to present both qualitative and quantitative information about their leases, the significant judgments made, and the amounts recognized in the financial statements. They must consider the level of detail necessary to satisfy disclosure objectives and appropriately aggregate and disaggregate disclosures in order to ensure the information will be useful to investors and third parties. The following charts list qualitative and quantitative disclosures for lessees and for lessors.

Disclosures—Lessees	
Qualitative Disclosures	**Quantitative Disclosures**
• Narrative disclosure about the options recognized and not recognized as part of its RoU assets and liabilities • Existence of any residual value guarantees along with the related terms and conditions • Restrictions or covenants imposed by leases • Significant leases that have not yet commenced to include any construction or design involvement • Determination of the discount rate • Election of the practical expedient for not separating lease components from non-lease components	• Finance lease cost, segregated between amortization of the RoU assets and interest on the lease liabilities • Operating lease cost • Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less • Variable lease costs • Sub-lease income, disclosed on a gross basis, separate from finance or operating lease expense • Net gain or loss recognized on sale and leaseback transactions • The following amounts segregated between each type of lease: —Cash paid for amounts included in the measurement of lease liabilities —Supplemental non-cash information on lease liabilities arising from obtaining RoU assets —Weighted average remaining lease term and discount rate • Maturity analysis separately for both finance and operating leases

Disclosures—Lessors	
Qualitative Disclosures	**Quantitative Disclosures**
• Options for a lessee to purchase the leased asset including terms and conditions • Determination of the amount the company expects to derive from the leased asset following the end of the lease term • Information on how it manages its risk associated with the residual value of its leased assets, including risk management strategy, carrying amount of residual assets covered by residual value guarantees, and other means by which it reduces its residual asset risk • For sales-type and direct finance leases only: Significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases and maturity analysis of its lease receivables • For operating leases only, maturity analysis of lease payments	• Lease income recognized in each annual and interim period, in a tabular format, to include the following: —Sales-type and direct finance leases: Profit or loss recognized at the commencement date and interest income either in aggregate or separated by components of the net investment in the lease —Operating lease, including lease income related lease payments as well as variable lease payments not included in the measurement of the lease receivable • Components of its aggregate net investment in sales-type and direct financing leases

Previous operating leases should be recognized as a RoU asset at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease. The lessee should measure lease liability at present value of the sum of the following using an appropriate discount rate: (a) the remaining minimum rental payments and (b) any amounts probable of being owed by the lessee under a residual value guarantee.

Similarly, a lessee is required to measure a RoU asset as this calculated lease liability, adjusted for the following: prepaid or accrued lease payments, remaining balance of any lease incentives received, unamortized initial direct costs, and impairment of the RoU asset, if applicable.

There are two methods for transition requirements; management must choose one:

- Retrospectively to each prior reporting period presented in the financials with the cumulative effect of initially applying the new guidance at the beginning of the earliest comparative period presented.
  - — Following this method, the application date will be the later of the beginning of the earliest period presented in the financials and the commencement date of the lease. When using this approach, management applies the guidance to all periods presented in the financials.
  - — This approach will require adjustment of previously issued financials. It will be required to consider its reporting impact for all comparable periods presented in the financial statements issued during the year of adoption.
- Retrospectively at the beginning of the period of adoption through a cumulative effect adjustment. Following this transition method, the application date will be the beginning of the reporting period in which the reporting entity first applies ASC Topic 842.

The retrospective approach includes five optional practical expedients an entity may elect to apply:

1. A reporting entity will not have to reassess whether any expired or existing contracts are or contain a lease.

2. A reporting entity will not have to reassess the lease classifications for any expired or existing leases—capital are finance, and operating are operating.
3. A reporting entity will not have to reassess IDCs for any existing leases.
4. A reporting entity may also elect to use hindsight in determining the lease term when considering lease options to extend or terminate the lease and to purchase the underlying asset as well as assessing impairment of RoU assets.
5. Land easements are required to be assessed under Topic 842 to determine whether the arrangements are or contain a lease. Reporting entities can elect to not apply Topic 842 to land easements that exist or expired before the effective date of Topic 842 and that were not previously assessed under Topic 840 (ASU 2018-01).

Practical expedients 1 through 3 must be elected as a package, whereas practical expedients 4 and 5 may be elected to be applied separately.

Sample Journal Entries

Existing operating lease with practical expedients elected. To transition to ASC Topic 842, you would record the following journal entry at January 1, 2022.

Account	Debit	Credit
RoU Asset	XXXX	
Accrued Rent	XXXX	
Lease Liability		XXXX
Unamortized IDCs		XXXX

You would record the following journal entry at December 31, 2022 (with similar entries throughout the term of the lease).

Account	Debit	Credit
Lease Liability	XXXX	
Lease Expense	XXXX	
ROU Asset		XXXX
Cash		XXXX

Existing finance lease with practical expedients elected. To transition to ASC Topic 842, you would record the following journal entry at January 1, 2022, in order to add the unamortized IDCs to the initial RoU asset.

Account	Debit	Credit
RoU Asset	XXXX	
Capital Lease Asset		XXXX
Unamortized IDCs		XXXX

Existing operating lease with practical expedients elected. You would record the following journal entry at December 31, 2022 (with similar entries throughout the term of the lease).

Account	Debit	Credit
Lease Liability	XXXX	
Amortization Expense	XXXX	
Interest Expense	XXXX	
RoU Asset		XXXX
Cash		XXXX

At the end of the lease term, you would record the following journal entries.

Account	Debit	Credit
Lease Liability	XXXX	
Amortization Expense	XXXX	
Interest Expense	XXXX	
RoU Asset		XXXX
Cash		XXXX
Lease Liability	XXXX	
RoU Asset		XXXX
Cash		XXXX

Initial measurement of RoU asset and lease liability under ASC Topic 842. You would record the following journal entry at January 1, 2022.

Account	Debit	Credit
RoU Asset	XXXX	
Lease Liability		XXXX
Cash		XXXX

You would record the following journal entry at December 31, 2022 (with similar entries throughout the term of the lease).

Account	Debit	Credit
Lease Liability	XXXX	
Lease Expense	XXXX	
RoU Asset		XXXX
Cash		XXXX

Accounting for a finance lease under ASC Topic 842. You would record the following journal entry at January 1, 2022.

Account	Debit	Credit
RoU Asset	XXXX	
Lease Liability		XXXX
Cash		XXXX

You would record the following journal entry at December 31, 2022 (with similar entries throughout the term of the lease).

Account	Debit	Credit
Lease Liability	XXXX	
Amortization Expense	XXXX	
Interest Expense	XXXX	
RoU Asset		XXXX
Cash		XXXX

Inquiry With Management Regarding Transition

The extent of the engagement team's inquiry and discussion with management concerning the transition to ASC Topic 842 will depend on the nature and volume of the client's contracts related to property, including service agreements.

The engagement team will need to discuss with management the accounting requirements of the new guidance to assess whether the client is adequately planning for the transition, including the use of the practical expedients and accounting policy elections that are available. The team may also want to discuss the associated business and tax implications.

A threshold issue is the capability of management personnel to plan and execute the transition to ASC Topic 842. Consider the following:

- Is it realistic to expect someone among accounting personnel to function as an in-house lease specialist?
- Can that person, or another member of management, head the effort to identify all agreements that are or contain leases, and collect the information that will be needed for implementation of the new requirements?
- Will it be necessary to engage outside expertise or otherwise outsource some of the necessary activities?

Management should review existing arrangements to identify leases or embedded leases and collect the data that will be needed on each one, including counterparty information, lease term and renewal and termination options, payment terms, and details of the property explicit or implicit in the agreement. Management will also need to make decisions about establishing a central depository for the data and the extent to which new technology may be necessary to properly accumulate and analyze the information.

The engagement team will need to discuss with management the implications of the available elections possible in the transition to the new guidance. For example, electing to not separate lease and non-lease components or use the risk-free rate as the discount rate will make the transition easier and less time-consuming but will result in larger asset and liability balances.

Using hindsight to determine lease terms and impairment avoids estimates and judgments, but must be applied consistently to all expired or existing leases and may interfere with the election for short-term leases. If one or more 12-month leases had renewal options that were not reasonably certain to be exercised at inception, but were in fact exercised, they could not be treated as short-term leases.

The engagement team should also discuss business and tax implications, including the effects of ASC Topic 842 on loan covenants, buy-or-lease decisions, and structuring of lease contracts that may point toward revising agreements.

Because prior guidance resulted in operating leases being off–balance sheet, the change to all leases being on the balance sheet may result in loan covenant violations, may change the economics of deciding to lease rather than buy, or may change previous decisions to structure an agreement to obtain classification as an operating lease.

Although ASC Topic 842 does not change lease characterization for federal income tax purposes, it may result in recording new—or adjusting existing—deferred tax assets and deferred tax liabilities. Common book-tax differences are a lessee expensing rent on a straight-line basis for book purposes but expensing rent payments as made for tax purposes; or depreciating a RoU asset on a straight-line basis for book purposes but differently for tax purposes.

¶ 505 AUDITING UNDER ASC TOPIC 842 FOR LESSEE CLIENTS

The audit engagement team should obtain from the client an analysis of lease contracts separated by class of asset, including those that existed at the end of the prior year and any new lease contracts, showing the balance of RoU lease assets and lease liabilities at the beginning and end of the period, and the related amortization and interest expense. The engagement team should also do the following:

- Test the clerical accuracy of the analysis.
- Trace the opening balances to the adjusted prior-year working trial balance and the ending balances to the current-year working trial balance.
- Review any reconciliation to the general ledger and investigate any unusual reconciling items.
- Compare and document (including the auditor's expectations) balances in the lease liability accounts and related interest expense with those of the preceding years or other expectations.
- Compare and document (including the auditor's expectations) balances in the RoU asset accounts and related amortization with those of the preceding years or other expectations.
- Investigate any unexpected results (ratios or variations different from what would be expected), considering known changes in client operations.

For any leases that were not tested in a prior audit or were significantly modified in the current period, the engagement team should perform the following procedures:

- Obtain and review lease contracts and other applicable documents and review abstracts or copies of significant lease contracts analyzed in prior years.
- Based on the auditor's knowledge of the client's business and industry, inquire whether outsourcing, service, supply, or other similar contracts give the client the right to control an identified asset (i.e., embedded lease).
- Determine that the contracts contain a lease as defined and that the client has identified the separate lease components (or multiple lease components) and non-lease components, if any, within each contract and has allocated the consideration in the contracts to each separate lease and non-lease component of the contract.
- Consider whether to confirm significant lease obligations and related lease provisions.
- Based on the terms of the contracts, determine that leases are appropriately classified as either finance or operating leases and that initial measurement of the RoU asset and lease liability are in accordance with ASC Topic 842.
- Inquire about whether any major sales of fixed assets were sale-leaseback transactions. If so, determine the propriety of accounting for those transactions.
- Determine that significant related-party leases are classified and accounted for on the basis of the legally enforceable terms and conditions of the lease in the same manner as leases between unrelated parties.
- Evaluate whether (1) any modifications to the lease during the period are appropriately accounted for as either changes to an existing lease contract or as a separate lease contract and (2) any other circumstances have occurred that require the lessee to remeasure the lease liability.
- Considering information obtained in performing other procedures and knowledge of client operations and business conditions, evaluate whether the remaining useful lives of RoU assets are reasonable and the net carrying values of RoU assets are recoverable in the ordinary course of business.
- Considering the procedures previously performed related to RoU assets and lease liabilities, including lease modifications, if any, perform the following procedures:

— Evaluate the reasonableness of interest expense for the period and any related accrued amount at the balance sheet date.

— Test the adequacy of amortization for the period and related accumulated amortization.

- Evaluate whether the balance sheet presentation of RoU assets and lease liabilities is consistent with the requirements and that expenses related to leased assets are appropriately presented in the statement of comprehensive income.
- Summarize the financial statement disclosures in the workpapers for both finance and operating leases.

STUDY QUESTIONS

4. Which of the following is a criterion for a lease meeting the definition of a finance lease?

a. Ownership is transferred at the conclusion of the lease term.

b. The lease term is for the major part of the remaining economic life of the underlying asset.

c. The present value of future lease payments equals or exceeds substantially all of the fair value of the asset.

d. The asset is of a specialized nature so that it will not have alternative use to the lessor.

5. Which of the following statements is correct regarding presentation, disclosure, and transition requirements?

a. Previous operating leases should be recognized as a right-of-use (RoU) asset at the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

b. Both finance lease RoU assets and operating lease RoU assets should be presented net on the balance sheet.

c. Finance leases should be included in income from continuing operations as a single lease cost.

d. Lessees are required to only present quantitative information about their leases.

6. Which of the following statements is incorrect with respect to auditing under the new lease standard?

a. The auditor should obtain an analysis of lease contracts separated by class of asset.

b. The auditor should compare balances in the lease liability accounts and related interest expense with those of the preceding years or other expectations.

c. The auditor should discuss with management the new lease characterization requirements for federal tax purposes as a result of ASC Topic 842.

d. The auditor should determine that leases are appropriately classified as either finance or operating leases.

MODULE 2: TOP AUDITING ISSUES—CHAPTER 6: How to Audit in a COVID-19 Environment

¶ 601 WELCOME

This chapter provides external auditors with both practical and insightful perspectives on how to navigate an audit engagement of a private company during the global pandemic. Readers will learn which areas of the audit have increased in risk exponentially due to the COVID-19 pandemic and which viable alternative audit procedures are available in circumstances where traditional audit procedures are just not possible. Readers will acquire a deeper understanding of how to fulfill their professional responsibilities in order to perform an audit in this challenging environment in accordance with *Professional Standards*.

¶ 602 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify areas of the audit where risk has gone up significantly due to the COVID-19 pandemic
- Recognize viable alternative audit procedures to perform
- Describe how to address potential reporting implications
- Differentiate FASB ASC Topics and how they apply
- Recognize the specific steps in the order of asset impairment testing

¶ 603 OVERVIEW

On January 30, 2020, the World Health Organization (WHO) announced a global health emergency because of a new strain of coronavirus originating in Wuhan, China (the COVID-19 outbreak), and the risks to the international community as the virus spread globally beyond its point of origin. In March 2020, the WHO classified the COVID-19 outbreak as a pandemic, based on the rapid increase in exposure globally.

The full impact of the COVID-19 outbreak continues to evolve. The magnitude of the effect that the pandemic will have on organizations' financial condition, liquidity, and future results of their operations is uncertain. Organizations' management are actively monitoring the situation and its impact on their financial condition, liquidity, operations, suppliers, industry, and workforce. The COVID-19 pandemic could have a material adverse effect on companies' results of future operations, financial position, and liquidity in fiscal year 2020 and beyond.

As a result of the COVID-19 outbreak, significant financial reporting consequences are a likely possibility in a variety of accounting and disclosure areas. Organizations and their external auditors will need to be on alert for the economic and financial impact of the actions taken by both federal and state governments.

¶ 604 PROPER PLANNING DURING THE PANDEMIC

Due to social distancing and other restrictions related to the COVID-19 crisis, remote working became the "new normal" for many professionals, including external auditors.

To successfully work in a remote environment, all audit engagement team members, as well as their clients, must have access to the Internet. Those who have the ability and the resources to get online, access data, exchange volumes of information, and hold virtual meetings can keep their business moving.

In this environment, planning is just as important as ever. It should still constitute about 20 to 25 percent of the audit budget, with engagement teams investing time upfront to discuss the audit client, its environment, its industry, and its risks. Then the team can devise a game plan for focusing on high-risk areas and gathering the necessary information. Audit engagement teams should discuss the following important topics, as needed, and have substantive conversations with the audit client on engagement risks prior to commencing fieldwork. Topics to be discussed include:

- Assessing independence
- Determining the scope of the engagement
- Communicating with the predecessor auditor (initial audit)
- Communicating with those charged with governance
- Obtaining a signed engagement letter
- Obtaining an understanding of the client
- Performing walkthrough procedures
- Testing internal controls (if elected)
- Calculating planning materiality and performance materiality
- Performing risk assessment procedures
- Performing a fraud risk assessment
- Performing preliminary analytical procedures
- Documenting the audit strategy

¶ 605 CHANGES IN CERTAIN AUDIT PROCEDURES

Many audit procedures have been impacted by the pandemic, including access to client records, enhanced risks and uncertainties, fraud risk procedures, confirmations, subsequent events, and inventory observations. The following sections discuss these areas in more detail.

Challenges in Accessing Client Records

In a remote working environment, accessing records may be a real challenge if some audit clients still maintain them in hard-copy format. Engagement teams may be able to obtain scans of such records but must consider their validity and perform additional procedures to obtain comfort that those records are complete, accurate, and authentic. If the engagement team is unable to obtain access, they may have to inform their audit clients that the audit cannot be completed until the records are available.

Clients who have bank covenant considerations should contact their local bank representatives as soon as possible to obtain waivers or extensions.

Enhanced Risks and Uncertainties

The pandemic has resulted in enhanced risks and uncertainties when dealing with financial reporting considerations. These risks may vary depending on the nature of the client's operations. Auditors must use their judgment about which estimates might be sensitive to COVID-19 implications. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 275 offers guidance about about disclosing and dealing with such risks.

Some vulnerabilities can result from concentrations—volume of business, revenues, material, labor, licenses, specific market, geographic area, political forces, and so forth. Auditors must disclose the concentrations described in ASC 275-10-50-18 if, based on the information known to management before the financial statements are issued (or are available to be issued), all of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the client vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

The following are examples of concentrations that should be disclosed if they meet the preceding criteria:

- Concentrations in the volume of business transacted with key customers, suppliers, lenders, grantors, or contributors. A severe impact can result, for example, from total or partial loss of the business relationship.
- Concentrations in revenue from particular products, services, or fund-raising events.
- Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which the client conducts its operations.

ASC Topic 275 requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the client. Significant estimates can exacerbate a vulnerability due to certain concentrations.

For clients with a year-end that falls after the declaration of the state of emergency, the necessity for and robustness of the disclosures may require additional consideration by the engagement team.

Fraud Risk Procedures

The pandemic has created a perfect storm for fraud. For example, clients that have laid off key personnel and whose remaining workforce has moved out of the typical office environment could experience a major breakdown in internal controls, leading to fraud. Therefore, engagement teams should be on higher alert for fraud risk. They may need to adjust their procedures as necessary to appropriately address any potential fraud risks that could have a material effect on the financial statements.

AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*, lists requirements and procedures that may be more difficult to perform in a remote audit situation.

Teams will still need to hold appropriate discussions in order to understand what fraud risk factors may be affecting the client in this environment. Inquiries of management and others within the client are generally most effective when they involve an in-person discussion. However, due to the pandemic circumstances, these inquiries could be done via videoconferencing. The key is to design the discussion to allow the audit team interviewer to read the facial expressions and body language of the client interviewee.

Confirmations

In cases where a client location is either closed or key personnel are not on-site, confirmations could be a viable alternative. However, there may be situations in which those confirmations are not completed and sent back to the engagement team.

Engagement teams would have to design additional procedures to gain sufficient appropriate evidence related to the relevant assertions for the particular account balance (or class of transaction) for which confirmation was requested. If they are unable to design and perform additional tests, nonreceipt of confirmations in and of itself should not result in the engagement team issuing a scope limitation on their report.

However, if the team is unable to obtain sufficient audit evidence through review of the client records and are relying on receipt of audit confirmations as a key source of audit evidence, the non-receipt of those confirmations could result in the engagement team issuing a scope limitation.

Engagement teams may consider sending electronic confirmations rather than on hard copy. Due to the current environment, they should ask their clients to contact their vendors and suppliers in advance to let them know that because of the pandemic, their auditors may be contacting them or sending them a confirmation for them to prepare, answer, and send back. Teams should note that although oral confirmations may be the fastest and most effective way to obtain evidence about account balances, they will be considered the same as an inquiry of a third party.

Subsequent Events

Audit clients should include a note in their financial statements about the COVID-19 pandemic and how it is (or is not) affecting their business. Any specific impact(s) should be disclosed. The wording of the note will vary depending on the client company's facts and circumstances, but here is a sample footnote disclosure.

Sample Footnote Disclosure

> On January 30, 2020, the World Health Organization ("WHO") announced a global health emergency because of a new strain of coronavirus originating in Wuhan, China (the "COVID-19 outbreak") and the risks to the international community as the virus spreads globally beyond its point of origin. In March 2020, the WHO classified the COVID-19 outbreak as a pandemic, based on the rapid increase in exposure globally.
>
> The full impact of the COVID-19 outbreak continues to evolve as of the date of this report. As such, it is uncertain as to the full magnitude that the pandemic will have on the Company's financial condition, liquidity, and future results of operations. Management is actively monitoring the global situation on its financial condition, liquidity, operations, suppliers, industry, and workforce. Given the daily evolution of the COVID-19 outbreak and the global responses to curb its spread, the Company is not able to estimate the effects of the COVID-19 outbreak on its results of operations, financial condition, or liquidity for fiscal year 202X.
>
> Although the Company cannot estimate the length or gravity of the impact of the COVID-19 outbreak at this time, if the pandemic continues, it [may/will] have a/an [material] adverse effect on the Company's results of future operations, financial position, and liquidity in fiscal year 202X.

Inventory Observations

If clients are unable to perform physical inventory counts at year-end, they might decide to perform them on an alternative date. Engagement teams may be able to observe the

rescheduled counts and perform additional audit procedures on intervening transactions. If the physical inventory counts are rescheduled, engagement teams will have to perform additional procedures, such as reviewing and testing inventory rollforwards. Alternative procedure can be performed if the client is using a cycle count procedure and a perpetual inventory system.

¶ 606 UNDERSTANDING THE INTERNAL CONTROL ENVIRONMENT REMOTELY

In an unstable environment, engagement teams should inquire about any changes in the client system of internal control since the time that preliminary work was performed. Often, those controls may have changed. For example, during the COVID-19 pandemic, procedures may have been changed to accommodate remote workforces. Engagement teams will need to evaluate how much reliance can be placed on those controls that were only in effect for a brief portion of the year. In addition, if client locations are closed, performing walkthroughs and certain tests of internal control will be challenging.

Even when engagement teams have no plans to rely on the operating effectiveness of controls, they still are required to obtain an understanding of internal controls relevant to audits and to determine that those controls have been implemented. Obtaining an understanding of controls may be achieved remotely; however, inquiry alone is not sufficient to determine whether such controls have been implemented. Auditors will need to consider what evidence can be obtained remotely to determine if effectively designed controls have been placed in operation. If they are unable to obtain sufficient appropriate audit evidence, it may result in a scope limitation.

STUDY QUESTIONS

1. Each of the following identifies a proper procedure related to audit planning during the COVID-19 pandemic, ***except:***

a. Determine the scope of the engagement.

b. Test material account balances.

c. Communicate with the predecessor auditor.

d. Perform preliminary analytical procedures.

2. Which Accounting Standards Codification (ASC) Topic requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term of an entity?

a. ASC 275

b. ASC 280

c. ASC 310

d. ASC 606

3. Which of the following statements is correct regarding changes in procedures in response to the COVID-19 pandemic?

a. Accessing records should not be a challenge.

b. An adverse opinion should be issued if the auditor is unable to obtain records.

c. Engagement teams should be on a higher alert for fraud risk.

d. Inquiries of management and others within the client are generally most effective when they occur during a Zoom meeting.

¶ 607 MANAGEMENT REPRESENTATION LETTERS

When tailoring the management representation letter, auditors should be cautious about things that could change due to the COVID-19 pandemic, such as disclosures, valuation of certain investments, or other aspects of a business that might be affected.

For example, with so many businesses experiencing a huge disruption due to COVID-19, the audit team must assess going concern. This means examining the odds that the client will be viable in the next 12 months. Some experts estimate that 40 percent or more organizations will go out of business in the near future as a result of the pandemic. Additional representations will need to be added to the representation letter, related to assumption, subsequent events, risks and uncertainties, fraud, significant estimates, and more.

Obtaining electronic signed management representation letters is fine if the engagement team can obtain appropriate evidence of management's receipt and acknowledgment of the representations. Confirmation that the signatory knowingly and willingly signed the representation letter is needed.

The acceptance of electronic signatures, scanned images of signatures, and other digital information is a matter of risk management practices as well as applicable state laws or regulations addressing legal acceptability of electronic signatures.

The following is a sample representation:

> The extent of the impact and effects of the recent outbreak of the coronavirus (COVID-19) on the operation and financial performance of the Company are unknown. However, the Company does not expect that the outbreak will have a material adverse effect on operations or financial results at this time.

¶ 608 INCREASE IN GOING CONCERN ASSESSMENTS

ASC Topic 205-40 requires management to evaluate an entity's ability to continue as a going concern. It states, "Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued."

Disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or that its plans alleviate that substantial doubt.

The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the entity's ability to obtain financing. The COVID-19 pandemic may cause a deterioration in an entity's operating results and financial position. Engagement teams will need to consider recent critical information related to their assessments of going concern.

Management's evaluation of conditions or events that may have an effect on the entity's ability to continue as a going concern under U.S. generally accepted accounting procedures (GAAP) could be extremely difficult. Management's inability to evaluate going concern issues could cause difficulty in complying with the relevant GAAP requirements. If engagement teams are unable to gain access to information or believe

the supporting documentation supplied by management is inaccurate or incomplete, they must consider a scope limitation or other modification of the opinion.

If the engagement team concludes that substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans, then the team should evaluate whether the financial statements include adequate disclosure of management's plans and, if adequate, an unmodified auditor's report may be appropriate.

If engagement teams conclude that use of the going concern basis of accounting is appropriate, but substantial doubt about the entity's ability to continue as a going concern remains, then the report should be modified to add an emphasis-of-matter (EOM) paragraph in accordance with AU-C 570.

If the financial statements have been prepared on a going concern basis and the engagement team concludes that use of the going concern basis of accounting is inappropriate, then the team should express an adverse opinion.

¶ 609 SOC REPORTS

Engagement teams may face a challenge when a client outsources functions to an independent third party and they are not able to obtain a Service Organization Control (SOC) 1 Type 1 or 2 Report. If a team cannot get the SOC 1 Type 1 or 2, an understanding of the nature of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit may be obtained remotely. For example, the user auditor may be able to obtain and read one or more of the following:

- User manuals, system overviews, technical manuals, etc.
- Contract or service agreement between the user entity and the service organization
- Reports by service organizations, internal auditors, or regulatory authorities on controls at the service organization

Although the engagement team will be able to obtain information about the design of controls from reading many of these documents, that will not provide them with evidence that such controls were suitably designed and implemented at the service organization. If a SOC 1 report is not available and it is significant to the audit, obtaining an understanding of the design and implementation of controls at the service organization may be more challenging in this environment.

The engagement team should discuss with senior management the expected date of receipt of the SOC 1 report and emphasize the need for it. If it is unlikely that the report will be available, the engagement team may consider what other procedures might be performed to obtain evidence about the design and implementation of controls at the service organization.

The engagement team should read the client's prior period SOC 1 report and perform the following procedures during the gap period:

- Contact relevant individuals at the service organization, through the client, and make inquiries (which should be documented) about the following:
  - — Significant changes within the system (including relevant system controls), including procedures or controls that changed to accommodate employees working remotely and process flows
  - — System events that affected the service organization's ability to achieve its service commitments to users.

- Read system documentation and any amendments to contracts or service-level agreements from the service organization to the client that address significant system changes.
- Read communications from the service organization to the client about its COVID-19 responses and the effects on the system.

If, in the engagement team's professional judgment, they have not received sufficient appropriate evidence to determine if effectively designed controls were placed in operation, a scope limitation may be warranted.

¶ 610 SIGNIFICANT FINANCIAL REPORTING AND DISCLOSURE IMPLICATIONS

In light of the COVID-19 pandemic and its effects, auditors face several challenges related to financial reporting and disclosure.

Fair Value of Investments

FASB ASC Topic 820 defines an *active market* as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis." However, it does not provide a rule of thumb for what constitutes an active market.

To assist management with determining fair value in periods of market disruption, ASC Topic 820-10-35 provides guidance on measuring fair value when the volume or level of activity for an asset or a liability has significantly decreased. In circumstances when there has been a significant decrease in the volume or level of activity, it may be appropriate to consider other valuation techniques in estimating the fair value.

Estimating fair value requires significant judgment under normal circumstances. In the pandemic-affected environment with heavy market volatility and an uncertain outlook, applying judgment in determining fair value will be even more difficult.

Goodwill

FASB ASC 350-20-35-3C provides examples of triggering events that may warrant an interim test of goodwill:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets
- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development
- Cost factors such as increase in prices of raw materials, labor, or other costs that have a negative effect on earnings and cash flows
- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets; a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit; the testing for recoverability of

a significant asset group within a reporting unit; or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

- If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)

Indefinite-Lived Intangible Assets

Indefinite-lived intangible assets (e.g., trademarks) may need to be evaluated for possible impairment. ASC Topic 350-30-35 contains guidance on impairment testing of indefinite-lived intangible assets, requiring that they be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. ASC Topic 350-30-35-18B provides examples of such events and circumstances, which are similar to those considered for goodwill.

Long-Lived Assets

Long-lived assets to be held and used (including property, plant, and equipment; finite-lived intangible assets; and right-of-use assets [RoU] recognized under FASB ASC Topic 842, *Leases*) are also tested for impairment. Following are examples of events that can indicate such assets are impaired:

- A significant decrease in the market price of a long-lived asset (asset group)
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

Other Assets

Asset impairment considerations may also include the following:

- Financing receivables (e.g., trade accounts receivables, loans)
  - — FASB ASC Topic 310, *Receivables*
  - — FASB ASC Topic 326, *Financial Instruments—Credit Losses* (if adopted)
- Inventories
  - — FASB ASC Topic 330, *Inventory*
- Contract assets
  - — FASB ASC Topic 310, *Receivables*
- Equity securities
  - — FASB ASC Topic 320, *Investments—Debt and Equity Securities*, or FASB ASC 321, *Investments—Equity Securities*, if ASU No. 2016-01, *Financial Instru-*

ments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, has been adopted

- Debt securities
  - — FASB ASC Topics 320 or 326, if ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, has been adopted
- Other investments
  - — FASB ASC Topic 325, *Investments—Other*
- Deferred tax assets
  - — FASB ASC Topic 740, *Income Taxes*

Order of Impairment Testing

It is important to perform the impairment testing steps in the appropriate order. Per ASC 360-10-35-27, the step-by-step process is as follows:

1. Adjust the carrying amounts of any assets (e.g., accounts receivable and inventory) and liabilities (e.g., accounts payable, long-term debt, and asset retirement obligations) not covered by ASC 360-10 that are included in an asset group in accordance with other applicable GAAP.
2. Test for impairment and adjust carrying amounts of indefinite-lived intangible asset(s) that are included in an asset group under ASC 350-30.
3. Test long-lived assets (asset group) and amortizable intangible assets under ASC 360-10.
4. Test goodwill of a reporting unit (or, for private companies, an entity) that includes the aforementioned assets under ASC 350-20.

NOTE: This sequence is important because it allows the team to make any required adjustments to the carrying amount of the reporting unit (or, for private companies, an entity) prior to the performance of the goodwill impairment test.

Deferred Tax Assets

ASC 740-10-30 requires that a valuation allowance be established for a deferred tax asset (DTA) if it is *more likely than not* that the related tax benefit will not be realized. Realization of DTAs depends on the existence of sufficient taxable income of the appropriate character within the carryback and carryforward period available under the tax law. The guidance lists the following four sources of future taxable income:

- Future reversals of existing taxable temporary differences
- Future taxable income exclusive of reversing temporary differences and carryforwards
- Taxable income in prior carryback year(s) if carryback is permitted under the tax law
- Tax-planning strategies

ASC 740-10-30-17 states the following: "All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years."

Management should consider each source of income incrementally to determine the amount of the valuation allowance needed, if any. ASC 740-10-30-18 also states that

"if one or more sources are sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered." ASC 740-10-30-21 notes that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."

¶ 611 AUDITOR'S REPORT IMPLICATIONS

Engagement teams may conclude that an event has such a material impact on the client that it would be appropriate to include an emphasis of matter (EOM) paragraph in the report. EOM paragraphs are included in the report if the team considers it necessary to present or disclose in the financial statements that, in the auditor's professional judgment, the event is of such importance that it is fundamental to users' understanding of the financial statements.

The AICPA's AU-C Section 706A states that a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position is an example of circumstances when an engagement team may consider it necessary to include an EOM paragraph. The COVID-19 pandemic is considered by many to be a major catastrophe.

AU-C Section 705 contains a chart listing examples of situations where a modified opinion or a disclaimer, or an adverse opinion, is likely in this environment.

STUDY QUESTIONS

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4. Which ASC Topic requires management to evaluate an entity's ability to continue as a going concern?

- **a.** ASC 205-40
- **b.** ASC 275
- **c.** ASC 310
- **d.** ASC 326

5. Management is required to evaluate an entity's ability to continue as a going concern for how many years after the date that the financial statements are issued?

- **a.** One
- **b.** Two
- **c.** Three
- **d.** Five

6. Based on the requirements of ASC 360-10, which of the following identifies the starting point in the order of impairment testing process?

- **a.** Test for impairment and adjust carrying amounts of indefinite-lived intangible assets.
- **b.** Test long-lived assets and amortizable intangible assets under FASB ASC 360-10.
- **c.** Test goodwill of a reporting unit.
- **d.** Adjust the carrying amounts of any assets/liabilities not covered by FASB ASC 360-10.

MODULE 2: TOP AUDITING ISSUES—CHAPTER 7: Major Audit Issues: SAS 141, 142, and 143

¶ 701 WELCOME

This chapter reviews recent issues from the AICPA's Auditing Standards Board (ASB) for private entities, including implementation issues with new effective dates. New and revised audit standards, attestation standards, and other recent pronouncements about auditing will be discussed. Also, the revised auditing standards resulting from the COVID-19 pandemic will be examined for current application.

¶ 702 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Summarize the auditing pronouncements that may impact private companies that come from the Auditing Standards Board (ASB) of the AICPA and review other recent audit releases that affect the non-issuing entities
- Identify the changes in Statement on Auditing Standards (SAS) Nos. 141, 142, and 143
- Recognize changes to attestation in Statement on Standards for Attestation Engagements (SSAE) Nos. 20, 21, and 22
- Understand auditing issues and financial reporting considerations related to the COVID-19 pandemic

¶ 703 AICPA AUDITING STANDARDS UPDATE

As a result of an April 2020 vote by the AICPA ASB, the effective dates of seven private company auditing standards (SASs Nos. 134–140) were delayed for one year. The standards are primarily related to substantial changes to the auditor's report. Delaying the effective dates of these SASs provides relief to audit firms amid the challenges created by the COVID-19 pandemic. The delay is designed to ensure that firms will be able to effectively implement the standards when pandemic-related distractions subside. The titles and issue dates for the SASs are as follows:

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements* (Issued May 2019)
- SAS No. 135, *Omnibus Statement on Auditing Standards—2019* (Issued May 2019)
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (Issued July 2019)
- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (Issued July 2019)
- SAS No. 138, *Amendments to the Description of the Concept of Materiality*, and SSAE No. 20 of the same title (Issued December 2019)
- SAS Number 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes from SAS No. 134* (Issued March 2020)

- SAS Number 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes from SAS Nos. 134 and 137* (Issued April 2020)

SAS Nos. 134–140 now will take effect for audits of financial statements for periods ending on or after December 15, 2021. SASs No. 134–140 are interrelated and, within this group, subsequent SASs amend previously issued SASs. Early implementation is permitted, and the ASB recommends that SAS Nos. 134–140 be implemented at the same time. According to AICPA Chief Auditor Bob Dohrer, firms that already have methods, tools, or plans in place can move forward with those plans despite the change in the effective date.

¶ 704 STATEMENTS ON AUDITING STANDARDS 141, 142, AND 143

SAS No. 141

SAS No. 141, *Amendment to the Effective Dates of SAS Nos. 134–140* (issued May 2020), delays the effective dates of SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, for one year, from December 15, 2020, to December 15, 2021. As mentioned earlier, the extension gives firms more time to implement these SASs in light of the effect of the coronavirus pandemic.

As originally issued, SAS Nos. 134, 136–137, and 139–140 do not permit early implementation. However, SAS No. 141 amends these SASs so that early implementation is permitted; it deletes the sentence "Early implementation is not permitted." SAS Nos. 134 and 136–140 are interrelated because the ASB amended the auditor reporting model adopted in SAS No. 134 with the issuance of the subsequent SASs. The effective dates were aligned so that these SASs would be implemented at the same time, primarily to accommodate the amendments to the auditor reporting model.

To help auditors and firms that do not implement SAS Nos. 134–140 before December 15, 2021, a "Pre-SAS No. 134" edition of the auditing standards (the AU-C sections) in AICPA Professional Standards is now available. It includes SAS Nos. 122–133, as amended, remains effective throughout 2021, and should be followed when SAS Nos. 134–140 have not been implemented. After implementing SAS Nos. 134–140, auditors and firms should no longer use the "Pre-SAS No. 134" edition.

SAS No. 142

SAS No. 142, *Audit Evidence* (issued July 2020), supersedes AU-C section 500, *Audit Evidence*, and amends other sections of SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended. SAS No. 142 explains what constitutes audit evidence in an audit of financial statements and outlines the attributes an auditor should consider when evaluating information to be used as audit evidence. Taking these attributes into account can help auditors maintain professional skepticism.

SAS No. 142 is a principles-based, rather than rules-based, standard. Because of this, there are no step-by-step instructions on what to do next. Prior to SAS No. 142, the objective of audit evidence primarily focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence. With the issuance of SAS No. 142, auditors are to evaluate the sufficiency and appropriateness of the audit evidence itself.

According to Bob Dohrer, the AICPA's chief auditor, "The biggest benefit to audit quality in the near term will simply be getting auditors to focus on some of the fundamentals of sufficient appropriate audit evidence—the accuracy, the completeness,

susceptibility to bias, and authenticity of information to be used as audit evidence, and whether that information contradicts or corroborates management assertions." Furthermore, he stated, "And it's all very critical to audit quality now and in the future."

The revisions to SAS No. 142 address the evolving nature of transacting business as well as the evolution of audit services. Issues addressed include preparers' and auditors' use of emerging technologies and techniques, the application of professional skepticism, the expanding use of external information sources to provide audit evidence, and the relevance and reliability of audit evidence.

Following is a brief description of the key changes in SAS No. 142:

- Expanded guidance on evaluating whether sufficient appropriate audit evidence has been obtained
  - — Expands the existing standard's objective to focus on considering the attributes of information to be used as audit evidence in assessing whether sufficient appropriate audit evidence has been obtained.
  - — Previously, the objective focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence, rather than evaluating the sufficiency and appropriateness of the audit evidence itself.
  - — This change can be accomplished by establishing attributes of information to be used as audit evidence when evaluating if the auditor obtained sufficient appropriate audit evidence.
  - — Attributes of reliable information include its authenticity, accuracy, completeness, and susceptibility to bias.
- Automated tools and techniques
  - — Recognizes the increased use of automated tools and techniques in auditing. The standard includes examples of how auditors can use automation such as audit data analytics, drones, and remote observation tools.
  - — SAS No. 142 states that auditors can use automated tools and techniques to perform both a risk assessment procedure and a substantive procedure at the same time if the goals of both procedures are achieved. This concept is illustrated in an exhibit in the standard.
- Professional skepticism
  - — Incorporates the concept of professional skepticism throughout the standard.
  - — This content includes the auditor's consideration of the information's susceptibility to bias and whether the audit evidence corroborates or contradicts management's assertions.
- Management's specialists
  - — Includes an amendment that moves the content dealing with management's specialists from section 500 to section 501, *Audit Evidence—Specific Considerations for Selected Items*.

SAS No. 142 is effective for periods ending on or after December 15, 2022.

SAS No. 143

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*, issued in July 2020, addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in a financial statement audit. It is designed to help auditors address complex issues that arise from new accounting standards that include estimates.

SAS No. 143 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, and AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. It also amends other AU-C sections in the Codification.

Accounting estimates are monetary amounts whose measurement, in accordance with applicable financial reporting framework requirements, is subject to uncertainty (e.g., depreciation, obsolescence, valuation, etc.) Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition or disclosure. Accounting estimates vary widely and are required when the monetary amounts cannot be observed directly.

Estimation involves applying a method using assumptions and data, which requires management judgment. There is generally inherent subjectivity and variation in the measurement of outcomes.

SAS No. 143 also includes guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias. Whereas AU-C Section 315 requires the auditor to assess the risk of material misstatement at the relevant assertion level, SAS No. 143 requires inherent risk and control risk to be assessed separately for accounting estimates.

The assessment of inherent risk depends on the degree to which the risk factors affect the likelihood or magnitude of misstatement. The degree of estimation uncertainty can vary; some accounting estimates have low estimation uncertainty. Therefore, extensive risk assessment and further audit procedures would not be necessary. When estimation uncertainty, complexity, or subjectivity are higher, the extent of procedures will increase.

SAS No. 143 enhances the auditing standards for auditing accounting estimates and the auditor's focus on factors related to estimation uncertainty and potential management bias. The standard:

- Explains the nature of accounting estimates and the concept of estimation uncertainty
- Provides information about scalability of the SAS for all types of accounting estimates, from the relatively simple to the complex
- Requires a separate assessment of inherent risk and control risk at the assertion level
- Includes an enhanced risk assessment intended to address the challenges auditors face when auditing accounting estimates by providing risk assessment requirements that are more specific to estimates; also addresses the increasingly complex business environment and complexity in financial reporting frameworks
- Emphasizes that the auditor's further audit procedures must be responsive to the reasons for the assessed risks of material misstatement at the relevant assertion level
- Refers to relevant requirements in other AU-C sections and provides related guidance emphasizing the importance of the auditor's decisions about controls relating to accounting estimates
- Addresses the auditor's exercise of professional skepticism when auditing accounting estimates
- Requires the auditor to evaluate whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework

SAS No. 143 is effective for audits of financial statements for periods ending on or after Dec. 15, 2023.

Why is now the time to have a new standard on audit evidence? Looking back in history, one will realize that prior to this new standard, the most recent changes to the audit evidence standard occurred over a decade ago. That standard was developed when audit evidence was obtained primarily from internal sources to the entity. It consisted almost entirely of paper, hard-copy documents.

With the rapid technological advances in the way business is conducted and transactions are undertaken, it was important to modernize the audit evidence standard to recognize those facets. At the last part of the finalization process for SAS No. 143, the COVID-19 pandemic emerged. The task force spends significant time looking at the finished document, "stress-testing" it against the new environment, which was characterized by electronic information and remote audit procedures.

While the previous standard focused on paper documents and evidence that auditors could obtain directly from their clients, the new standard looks at different forms of evidence that auditors receive, third-party evidence, external information sources, and so forth.

It also provides guidance on when auditors might need to be comfortable with the completeness and accuracy of data or whether they may need to assess the reliability of external information. The biggest benefit to audit quality in the near term will simply be getting auditors to focus on the fundamentals—accuracy, completeness, susceptibility to bias, authenticity, and so forth.

The onslaught of nonfinancial information and even some of the highly uncertain economic times during the pandemic have put an onus on auditors to think beyond traditional numbers-based and right-brain thinking and consider issues such as bias and authenticity, and whether information corroborates or contradicts other information.

¶ 705 CHANGES TO ATTESTATION FROM THE ASB: SSAES 20, 21, AND 22

This section discusses three SSAEs with important changes to attestation that were released in 2019 and 2020. Attestation is becoming even more of an issue due to the importance of internal controls and the SOC 1 reports.

SSAE No. 20

SSAE No. 20, *Amendments to the Description of the Concept of Materiality* (issued in December 2019), modified the following sections in SSAE No. 18, *Attestation Standards: Clarification and Recodification*:

- Section 205, Examination Engagements
- Section 210, Review Engagements

It states that, in general, misstatements, including omissions, are considered to be material if there is a substantial likelihood that individually or in the aggregate they would influence a judgment made by intended users based on the subject matter. But what constitutes "substantial likelihood"? Many have indicated that "substantial likelihood" probably means a greater than 50 percent likelihood. SSAE No. 20 goes on to state that "The practitioner's consideration of materiality is a matter of professional judgment and is affected by the practitioner's perception of the common information needs of intended users as a group." The auditor can assume that intended users:

- "have a reasonable knowledge of the subject matter and a willingness to study the subject matter with reasonable diligence,

- understand that the subject matter is measured or evaluated and examined to appropriate levels of materiality and have an understanding of any materiality concepts included in the criteria,
- understand any inherent uncertainties involved in measuring or evaluating the subject matter, and
- make reasonable judgments based on the subject matter."

Note that unless the engagement has been designed to meet the particular information needs of specific users, the possible effect of misstatement on specific users whose information needs may vary widely is not ordinarily considered. SSAE No. 20 is effective for practitioners' examination reports dated on or after December 15, 2020.

SSAE No. 21

The AICPA ASB issued SSAE No. 21, *Direct Examination Engagements*, in September 2020. SSAE No. 21 adds a new AT-C section (AT-C section 206, *Direct Examination Engagements*) to the attestation standards that enables auditors to perform an examination engagement in which they obtain reasonable assurance by measuring or evaluating the underlying subject matter against criteria and expressing an opinion that conveys the results of that measurement or evaluation. SSAE No. 21 also amends AT-C section 105, *Concepts Common to All Attestation Engagements*, and supersedes AT-C section 205, *Examination Engagements*. SSAE No. 21 makes the following changes:

AT-C section 105:

- Defines the terms *underlying subject matter* and *subject matter information* to conform with the definitions in ISAE 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, which provides for direct engagements. It also defines *direct examination engagement* and *assertion-based examination engagement*.

AT-C section 205:

- Supersedes the existing AT-C section 205 and changes the title of that section to *Assertion-Based Examination Engagements*, to differentiate it from AT-C section 206.
- Retains the traditional examination engagement, including the requirement that the auditor request a written assertion from the responsible party.
- Adds a statement to the examination report that the auditor must be independent and meet other ethical responsibilities related to the examination engagement.
- Requires the auditor to determine whether the responsible party has a reasonable basis for making its assertion.
- Acknowledges the auditor's ability to add information to the report that goes beyond the minimum requirements outlined in AT-C section 205.

AT-C section 206:

- Enables entities that do not make an assertion about whether the underlying subject matter meets the criteria to undertake an examination engagement. Entities must acknowledge their responsibility for the underlying subject matter.
- Establishes performance requirements for a direct examination based on AT-C section 205.

SSAE No. 21 is effective for reports dated on or after June 15, 2022.

SSAE No. 22

Issued in December 2020, SSAE No. 22, *Review Engagements*, supersedes AT-C section 210. It revises the attestation review standard for clarity on procedures that may be performed, report transparency, and consistency with other professional standards. SSAE No. 22 includes the following:

- A description of the procedures an auditor may perform in a review engagement
- A requirement that the auditor's report include an informative summary of the work performed as a basis for the auditor's conclusion
- A requirement that the auditor express an adverse review conclusion when concluding that misstatements, individually or together as a group, are both material and pervasive to the subject matter

SSAE No. 22 is effective for review reports dated on or after June 15, 2022. Early implementation is allowed only if the auditor also implements early the amendments to AT-C section 105 included in SSAE No. 21, *Direct Examination Engagements.*

STUDY QUESTIONS

1. Which of the following recently released SASs included amendments to the description of the concept of materiality?

a. SAS No. 132
b. SAS No. 134
c. SAS No. 135
d. SAS No. 138

2. Which of the following AU-C sections was superseded by SAS No. 142?

a. AU-C Section 500
b. AU-C Section 505
c. AU-C Section 530
d. AU-C Section 580

3. Which of the following statements is correct regarding changes from SAS No. 142?

a. SAS No. 142 is more of a rules-based standard.
b. SAS No. 142 includes step-by-step instructions on how to apply audit procedures.
c. The primary focus and the objective of SAS No. 142 is materiality.
d. With SAS No. 142, auditors are to evaluate the sufficiency and appropriateness of the audit evidence itself.

4. Each of the following identifies a change/clarification as a result of SAS No. 143, ***except:***

a. Explains the nature of accounting estimates and the concept of estimation uncertainty
b. Provides information about scalability of the SAS for all types of accounting estimates
c. Addresses the auditor's responsibilities relating to written representations
d. Requires a separate assessment of inherent risk and control risk at the assertion level

¶ 706 COVID-19: GOING CONCERN, EMPHASIS OF MATTER, AND SCOPE LIMITATIONS

The COVID-19 pandemic has brought with it numerous challenges, many of which are still unresolved. Audit issues related to the pandemic include going concern, emphasis-of-matter paragraphs, and scope limitations.

Going Concern

The pandemic has caused the financial position of many organizations to deteriorate. In certain industries (e.g., restaurant, hospitality) and in certain geographical areas, an entity's ability to continue as a going concern may be called into question. The auditor should start by assessing whether there are events or conditions (e.g., the COVID-19 pandemic) that raise substantial doubt that the entity can continue as a going concern. Management also must evaluate the entity's ability to continue as a going concern. The look-forward period is one year from the date the financial statements are issued or available to be issued, unless otherwise specified in the financial reporting framework.

Next, the auditor should ask for that evaluation and consider whether it is complete and accurate. "Substantial doubt" means that, in management's judgment, it is probable that the client will not continue as a going concern. When substantial doubt exists, it must be disclosed in the financial statement notes regardless of whether the doubt is alleviated by management's plans.

After determining whether there is substantial doubt, the auditor should consider management's plans to alleviate that doubt. Then, the auditor should assess the impact on the auditor's report as follows:

- If management's plan alleviates substantial doubt, an unmodified opinion may be issued.
- If the going concern basis of accounting is appropriate but substantial doubt remains, an emphasis-of-matter paragraph is required.
- If the going concern basis of accounting is not appropriate, an adverse opinion should be issued.

Emphasis of Matter

Even if there is no substantial doubt about the entity's ability to continue as a going concern, an auditor may still conclude that an emphasis-of-matter paragraph is necessary. This would be the case if an unusually important subsequent event or major catastrophe is disclosed in the financial statements and, in the auditor's opinion, it is necessary to draw the user's attention to the matter. In determining whether COVID-19 meets this definition for a given client, auditors should consider that particular client's circumstances and exercise their professional judgment.

Scope Limitations

As auditors work with clients throughout the pandemic, there is a real possibility that scope limitations will occur. For example, confirmations that are a key source of evidence may not be returned and alternative procedures may not be considered sufficient, or it may not be possible to evaluate the design and implementation of relevant controls at the client.

When assessing the impact of a scope limitation, auditors should focus on whether they are material and pervasive. "Pervasive" effects are those that, in the auditor's judgment, meet one or more of the following criteria:

- Are not confined to specific elements, accounts, or items of the financial statements
- If they are confined, represent or could represent a substantial proportion of the financial statements
- With regard to disclosures, are fundamental to the users' understanding of the financial statements

Scope limitations that are material but are not pervasive to the financial statements result in a qualified opinion, whereas scope limitations that are both material and pervasive result in a disclaimer of opinion.

Steps for Auditor Consideration and Going Concerns

Step 1: Consider whether there are any conditions or events that cause or raise substantial doubt about the entity's ability to continue as a going concern.

It would be hard to deny that the COVID-19 pandemic has created events and conditions that may cause doubt about an organization's ability to continue as a going concern. However, it is not an absolute rule in today's environment. Depending on the sector in which the entity operates, the pandemic may or may not cause significant doubt. For example, for businesses in the hospitality industry—restaurants, bars, airlines, cruise ships—the conditions and events obviously give rise to going concern matters.

Step 2: Ask whether management has performed the evaluation that they are required to perform under the accounting framework as described earlier.

If management has done that evaluation, then the auditor should review and discuss management's evaluation with them. In today's environment, certainly with smaller businesses, management may have their hands full with so many tasks just to keep the operations going and the doors open, that they may not have spent a lot of time on a going concern evaluation. If management has not performed that evaluation, then the auditor is obligated to ask management to perform the evaluation required by the accounting framework.

Step 3. Consider the evaluation that management has performed.

- Does the auditor agree that management has identified all the appropriate conditions and events that must be considered?
- Has management extended that evaluation period to the reasonable period of time?
- Has management included all relevant information that is available at that date?

Remember that management's evaluation is valid at the point at which they make that evaluation based on known information.

Step 4: Evaluate management's plans to effectively mitigate those conditions and events to less than a probable chance of occurring.

In other words, the auditor should ask, "Can management execute these plans, and if executed, would it mitigate substantial doubt about going concern to less than probable?" This is a key process for auditors. Often management uses cash flow forecasts in that evaluation, and that is a significant factor in helping them determine whether their plans can alleviate substantial doubt.

Final steps include the following:

- If management uses cash flow projections to make an evaluation, then the auditor certainly must consider those projections and evaluate the underlying data.

- The auditor must confirm that the underlying data used in the projections is reliable and that management has the appropriate support for the assumptions they are using in making the projections.
- The last piece of the puzzle involves the entity's ability to access funding from an external third party, a parent entity, an owner-manager, or some other source. That circumstance is directly addressed in AU-C Section 570.
- If that is part of management's plans, then the auditor must assess whether those third parties have both the intent and the ability to provide that support if need be. If the intent and ability are present, there is a requirement for the auditor to obtain written evidence about the intent, preferably from the third party; and if that is all present, it may very well lead to a conclusion that the going concern has been alleviated for a reasonable period of time.

Going concern is one of the top three areas the AICPA receives questions about. Therefore, auditors and management should be familiar with the requirements and the process involved. There likely are some unique considerations that require the auditor to use professional judgment when applying the requirements of the standards. There may very well be an increase in the number of emphasis-of-matter paragraphs, and practitioners should expect more disclosures in the financial statements about the risks and uncertainties.

¶ 707 SUBSEQUENT EVENTS AND COVID-19: PAST, PRESENT, AND FUTURE

For audits of calendar-year-end 2019 financial statements, COVID-19–related subsequent events are likely to be Type II events (i.e., events that provide evidence of conditions that arose after the date of the financial statements). These include declines in the fair value of investments. Although these events would not require recognition in the financial statements, disclosure may be required.

Auditors should assess the appropriateness of the subsequent-event disclosures in the financial statements. If an appropriate disclosure is not made, a modified auditor's opinion may be appropriate

For audits of clients with year-ends that fall in 2020, pandemic-related events may require adjustments to the financial statements or additional disclosures as Type I events (i.e., events that provide evidence of conditions that existed at the date of the financial statements).

Financial Reporting Considerations Related to COVID-19

Entities may need to evaluate whether the consequences of COVID-19 represent subsequent events. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 855, *Subsequent Events*, defines *subsequent events* as events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events:

- The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (i.e., recognized subsequent events).
- The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (i.e., nonrecognized subsequent events).

For calendar year-end 2019 financial statements, any COVID-19–related subsequent events identified likely are to be nonrecognized subsequent events. Some nonrecognized subsequent events may be of such a nature that financial statement disclosure is required to keep the statements from being misleading. In these situations, the financial statements must include disclosure of the following:

- The nature of the event or events
- An estimate of the financial statement effect of the event or events, or a statement that the estimate cannot be made

Occasionally, such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements. Judgment is required, and each entity must carefully evaluate its relevant facts and circumstances to determine the appropriate treatment for events related to COVID-19 and determine whether COVID-19 is viewed as a current-period event based on their financial reporting year-end.

Market-Value Declines

Given the recent stock market volatility, the AICPA offered the following guidance on market-value declines in its technical Q and As. The guidance was for a typical private company, a nonissuing entity.

- *Inquiry:* In light of overall market decline, should the decline in market value of an asset subsequent to the balance sheet date result in the adjustment of the financial statements?
- *Reply:* FASB ASC 855-10-25-1 states that "[a]n entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements."
- FASB ASC 855-10-25-3 states that "[a]n entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued."
- FASB ASC 855-10-55-2 provides a list of examples of nonrecognized subsequent events, including changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before financial statements are issued.

What Auditors Should Keep in Mind Related to Subsequent Events Disclosures and COVID-19

In complying with the requirements of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, the overall objectives of the auditor are as follows:

- Obtain sufficient appropriate audit evidence about whether subsequent events are appropriately recognized and disclosed in the financial statements.
- Respond appropriately to facts that become known after the audit report date that, had they been known to the auditor as of the report date, may have caused the auditor to revise the report.
- For audits of calendar year-end 2019 financial statements, any COVID-19–related subsequent events identified likely will be events that provide evidence of conditions that arose after the date of the financial statements (historically referred to as type II events).

- Although not requiring recognition in the financial statements, subsequent event disclosures may be required.
- If appropriate disclosure of subsequent events is not made in the financial statements, a modified auditor's opinion may be appropriate.

Many entities with year-ends after December 2019 will have pandemic-related events that may require an adjustment to the financial statements or additional disclosures (historically referred to as type I events). Auditors will have to work with clients to ensure any subsequent events have been accurately identified and reflected in the financial statements as required by FASB ASC 855. If management is either unable or unwilling to identify those events and properly reflect them in the financial statements, this could result in a modification to the auditors' opinion.

¶ 708 RISKS AND UNCERTAINTIES PLUS COVID-19

FASB ASC 275, *Risks and Uncertainties*, requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations.

The effects of the COVID-19 pandemic may negatively impact significant estimates and exacerbate a vulnerability due to certain concentrations (e.g., business concentration in a market or geographical area severely affected by COVID-19). Finally, COVID-19 may pose risks to the actual functioning of entities in certain industries (e.g., restaurants, hotels, airlines, etc.).

Due to the effects of COVID-19, for entities with year-ends that fall after the declaration of the state of emergency, the necessity for and robustness of the disclosures may require additional scrutiny by the auditor.

Significant Estimates

FASB ASC 275-10-50-8 states that:

- "Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued . . . indicates that both of the following criteria are met:
  - — It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
  - — The effect of the change would be material to the financial statements."

Current Vulnerabilities Due to Certain Concentrations

FASB ASC 275-10-50-16 states that:

- "Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.
- Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.
- Financial statements shall disclose the concentrations described in paragraph 275-10-50-18 if, based on information known to management before the financial statements are issued or are available to be issued . . . , all of the following criteria are met:

— The concentration exists at the date of the financial statements.
— The concentration makes the entity vulnerable to the risk of a near-term severe impact.
— It is at least reasonably possible that the events that could cause the severe impact will occur in the near term."

FASB ASC 275-10-50-18 provides the following examples of concentrations that should be disclosed if they meet the preceding criteria:

- "Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this Subtopic, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
- Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- Concentrations in the market or geographic area in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this Subtopic, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term."

Examples of concentrations that are likely to be affected by COVID-19 include specific markets or geographical areas in which the entity conducts its operations, diminishing volume of transactions with a particular customer or a supplier, or limited supply of material or availability of labor or services.

STUDY QUESTIONS

5. Which of the following identifies the look-forward period for going concern considerations?

a. 1 year
b. 2 years
c. 3 years
d. 6 years

6. Which ASC Topic provides the reporting and disclosure requirements relating to subsequent events?

a. ASC Topic 280
b. ASC Topic 606
c. ASC Topic 842
d. ASC Topic 855

CPE NOTE: When you have completed your study and review of chapters 4-7, which comprise Module 2, you may wish to take the Final Exam for this Module. Go to **cchcpelink.com/printcpe** to take this Final Exam online.

¶ 10,100 Answers to Study Questions

¶ 10,101 MODULE 1—CHAPTER 1

1. a. ***Correct.*** **The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations.**

b. ***Incorrect.*** ASC Topic 280 does not relate to the disclosures about risk and uncertainties. Instead, this ASC Topic includes accounting and reporting guidance related to segment reporting.

c. ***Incorrect.*** This ASC Topic includes accounting and reporting guidance related to receivables. It does not relate to the disclosures about risk and uncertainties.

d. ***Incorrect.*** ASC Topic 326 does not relate to the disclosures about risk and uncertainties. Instead, this ASC Topic includes accounting and reporting guidance related to credit losses on financial instruments.

2. a. ***Incorrect.*** Entities may need to evaluate whether the consequences of COVID-19 represent subsequent events. Note that there are two types of subsequent events.

b. ***Correct.*** **Also note that some nonrecognized subsequent events may be of such a nature that financial statement disclosure is required to keep the statements from being misleading.**

c. ***Incorrect.*** A recognized subsequent event consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

d. ***Incorrect.*** Although not requiring recognition in the financial statements, subsequent event disclosures may be required. If appropriate disclosure of subsequent events is not made in the financial statements, a modified auditor's opinion may be appropriate (but is not required).

3. a. ***Correct.*** **Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).**

b. ***Incorrect.*** Note that disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or that its plans alleviate that substantial doubt.

c. ***Incorrect.*** The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the accessibility to financing that is available for the entity.

d. ***Incorrect.*** Entities and practitioners may need to consider recent pertinent information related to their assessments of going concern. The consequences of COVID-19 may impact those factors and may cause a deterioration in an entity's operating results and financial position.

4. a. ***Correct.*** **The belief is that the COVID-19 pandemic may be considered a circumstance rendering in-person attendance during physical inventory counting impracticable.**

b. ***Incorrect.*** This section addresses the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C sections 330 and 500. It does not address inquiries regarding litigation, claims, and assessments.

c. ***Incorrect.*** This section addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). It also addresses the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

d. ***Incorrect.*** This section addresses the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. Note that in some cases, clients may be able to perform the usual physical inventory counts, but auditors are unable to attend due to travel restrictions.

5. a. ***Incorrect.*** In this situation, an auditor would not issue an unqualified opinion. This would only be the case if the auditor concluded that the financial statements were not materially misstated and the auditor obtained all the needed evidence.

b. ***Incorrect.*** In this situation, an auditor would not issue an adverse opinion. Instead, if the auditor concluded that the financial statements were in fact materially misstated, then an adverse opinion would be appropriate.

c. ***Correct.*** **In this situation, an auditor should issue a disclaimer of opinion. However, if the auditor believed the impacts to be material but not pervasive, then the auditor should issue a qualified opinion.**

d. ***Incorrect.*** A qualified opinion would be issued if either the financial statements are materially misstated or the auditor could not obtain sufficient audit evidence and the impacts were material but not pervasive.

6. a. ***Incorrect.*** This is not the first step in the impairment testing order. Instead, this is the second step in the impairment testing order.

b. ***Incorrect.*** Testing long-lived assets and amortizable intangible assets under FASB ASC 360-10 is not the first step in the impairment testing order. Instead, this is the third step in the process.

c. ***Incorrect.*** Testing goodwill of a reporting unit is the last step in the impairment testing order. Testing goodwill last is necessary because it allows the auditor to make any required adjustments to the carrying amount of the reporting unit prior to the performance of the goodwill impairment test.

d. ***Correct.*** **This is the first step in the impairment testing order. This sequence is necessary because it allows the auditor to make any required adjustments to the carrying amount of the reporting unit (or, for private companies, an entity) prior to the performance of the goodwill impairment test.**

7. a. ***Incorrect.*** Both types of conferences are relatively easy to record.

b. ***Correct.*** **Video allows the auditor to read the body language of the person to whom the inquiries are directed, whereas audio does not.**

c. ***Incorrect.*** The fact that the auditor might be able to see part of the client's office in the video is irrelevant in preferring videoconferencing to audio-only.

d. ***Incorrect.*** This is not true; the audio quality in an audio-only conference typically is no different from the audio quality during a videoconference.

¶ 10,102 MODULE 1—CHAPTER 2

1. a. ***Incorrect.*** The theory of differential reinforcement was developed by Gabriel Tarde.

b. ***Correct.*** **Dr. Cressey developed the fraud triangle theory.**

c. ***Incorrect.*** Dr. Sutherland developed the theory of differential association.

d. ***Incorrect.*** Ronald Akers developed the social learning theory.

2. a. ***Incorrect.*** Opportunity is part of the fraud triangle; it is not an element of fraud.

b. ***Incorrect.*** Rationalization is part of the fraud triangle; it is not an element of fraud.

c. ***Incorrect.*** Pressure is part of the fraud triangle; it is not an element of fraud.

d. ***Correct.*** **Concealment is one of the elements of fraud, along with the act of theft and concealment.**

3. a. ***Incorrect.*** In 2016, corruption accounted for the second highest volume of fraud cases.

b. ***Incorrect.*** Financial statement fraud occurs the least often of the occupational frauds.

c. ***Incorrect.*** Tax fraud is not a type of occupational fraud.

d. ***Correct.*** **Asset misappropriations are the most frequently occurring occupational fraud.**

4. a. ***Incorrect.*** A government settlement is the result of a legal or regulatory issue.

b. ***Incorrect.*** Damage to reputation is a public relations issue.

c. ***Correct.*** **Using personal devices or connecting with the employee's home Wi-Fi devices is a risk when employees are working from home.**

d. ***Incorrect.*** Home offices rarely have complex IT systems.

5. a. ***Incorrect.*** Social media is not used for phishing attacks.

b. ***Correct.*** **Phishing involves** sending illegitimate emails asking for personal information.

c. ***Incorrect.*** Vishing is done over the phone.

d. ***Incorrect.*** Smishing is done using text messaging.

6. a. ***Incorrect.*** This is an example of skimming, not a data breach.

b. ***Incorrect.*** This is an example of shoulder surfing, which is not a data breach.

c. ***Correct.*** **Stealing information from a computer is an example of a data breach.**

d. ***Incorrect.*** This is an example of criminal identity theft, not a data breach.

7. a. ***Correct.*** **Dr. Donald Cressey referred to the factor of pressure in the fraud triangle as an "unsharable financial need." A person's greed, debt, or desire to "keep up with the Joneses" can all result in pressure to commit fraud.**

b. ***Incorrect.*** Opportunity means the perpetrator has a chance to commit a crime or fraud. Greed does not illustrate the opportunity part of the fraud triangle.

c. ***Incorrect.*** Rationalization refers to a fraudster's ability to convince themselves that it is okay to commit the fraud.

d. ***Incorrect.*** Conversion is not a part of the fraud triangle; rather, it is one of the three basic elements of fraud.

¶ 10,103 MODULE 1—CHAPTER 3

1. a. ***Correct.*** **An indefinite lived asset is an asset where there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of an entity.**

b. ***Incorrect.*** A long-lived asset is an asset that is expected to provide economic benefits over a future period of time (greater than one year).

c. ***Incorrect.*** An impaired asset is an asset (fixed or intangible) for which there has been a reduction in value reflecting a decline in the quality, quantity, or market value of the asset.

d. ***Incorrect.*** A concession is a reduction in price, rent, or other benefit provided to a tenant or buyer as an inducement to buy or lease.

2. a. ***Incorrect.*** The relevant time period exceeds three months.

b. ***Correct.*** **The measurement date is the date that is six months prior to delivery of the notice of such redemption or the date of such purchase.**

c. ***Incorrect.*** The measurement date is not a date nine months prior to delivery of the notice of such redemption or the date of such purchase.

d. ***Incorrect.*** The measurement date is less than 12 months prior to delivery of the notice of redemption or date of purchase.

3. a. ***Incorrect.*** The temporary relief from the troubled debt restructuring rules is not applicable for all loan modifications made after the enactment of the CARES Act.

b. ***Incorrect.*** The temporary relief from the troubled debt restructuring rules is not applicable for all loan modifications made beginning March 20, 2020, until further notice.

c. ***Incorrect.*** The temporary relief from the troubled debt restructuring rules is not applicable for all loan modifications made in the one-year period after the CDC officially declared the COVID-19 outbreak a pandemic.

d. ***Correct.*** **The temporary relief from the troubled debt restructuring rules is applicable for certain loan modifications made in response to COVID-19.**

4. a. ***Incorrect.*** In order to classify the liability as current in the borrower's financial statements, the lender must be given more than six months from the end of the reporting period in which to demand payment.

b. ***Incorrect.*** Nine months is not the appropriate time period with respect to which the lender must be given to demand payment.

c. ***Correct.*** **In order to classify the liability as current in the borrower's financial statements, the lender must be given six months from the end of the reporting period in which to demand payment.**

d. ***Incorrect.*** In order to classify the liability as current in the borrower's financial statements, the lender can be given less than 18 months from the end of the reporting period in which to demand payment.

5. a. ***Correct.*** **If the impacts of COVID-19 result in a significant deterioration of a customer's ability to pay, the entity should reassess collectibility.**

b. ***Incorrect.*** ASC 360 addresses accounting for long-lived assets.

c. ***Incorrect.*** A price concession provided solely as a result of the pandemic may result in a modification that changes the parties' rights and obligations and, if it does, it must be determined whether the contract should be accounted for as a new and separate contract, a continuation of an existing contract, or a combination of contracts.

d. ***Incorrect.*** Because of the significant uncertainty associated with the pandemic's effects on an entity/customer, it may be challenging for the entity to make appropriate estimates of variable consideration.

6. a. ***Incorrect.*** While investors may want to understand how the board of directors is overseeing management's performance, the SEC and Division of Corporate Finance is not specifically encouraging companies to disclose how the board of directors is analyzing management's performance in the pandemic environment and how management's decision-making is impacting the company's cash flow.

b. ***Incorrect.*** Disclosures regarding the opinion of institutional shareholder advisory services may have with respect to the decision-making of a board of directors or management is not a disclosure being encouraged by the SEC and Division of Corporate Finance.

c. ***Incorrect.*** While accurate disclosures in a company's MD&A are of great importance to the SEC and the Division of Corporate Finance, this is not the subject of the new disclosure guidance relating to the pandemic.

d. ***Correct.*** **The SEC and Division of Corporate Finance are encouraging companies to make disclosures that enable investors to understand how management and the board of directors are analyzing the current and expected impact of COVID-19 on the company's financial condition, including liquidity and capital resources.**

7. a. ***Incorrect.*** Under ASC 350, an entity is required to test goodwill for impairment at the reporting-unit level at least annually.

b. ***Correct.*** **As a result of the pandemic, it is expected that more entities will test goodwill for impairment between annual testing dates.**

c. ***Incorrect.*** Entities must test goodwill for impairment regardless of the pandemic and resulting effect on the economy.

d. ***Incorrect.*** Impairment of goodwill testing requirements must be met regardless of whether an entity received pandemic assistance.

¶ 10,104 MODULE 2—CHAPTER 4

1. a. ***Incorrect.*** This SAS provided the requirements related to going concern, but the requirements have been superseded by another SAS.

b. ***Correct.*** **SAS No. 132,** ***The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,*** **supersedes SAS No. 126,** ***The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*** **It is effective for audits of financial statements for periods ending on or after December 15, 2017.**

c. *Incorrect.* This SAS does not relate to going concern. Instead, it relates to auditor reporting and amendments, including amendments addressing disclosures in the audit of financial statements.

d. *Incorrect.* This SAS does not relate to going concern. Instead, SAS No. 142 relates to audit evidence.

2. a. *Correct.* The look-forward period is one year from the date the financial statements are issued (or available to be issued, when applicable). Management is required by U.S. GAAP to determine the appropriateness of preparing its financial statements on the basis of a going concern.

b. *Incorrect.* With circumstances changing rapidly due to the COVID-19 pandemic, management's evaluation of conditions or events that may have an effect on the entity's ability to continue as a going concern could be extremely difficult.

c. *Incorrect.* The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the accessibility to financing that is available for the entity.

d. *Incorrect.* The look-forward period related to going concern is shorter than four years. Note that entities and auditors may need to consider recent pertinent information related to their assessments of going concern.

3. a. *Incorrect.* Entities are not required to prepare their financial statements using the cash basis if liquidation is imminent. The cash basis method is not a method used in accordance with U.S. GAAP.

b. *Incorrect.* Entities are not required to prepare their financial statements using the accrual basis if liquidation is imminent. However, they should use this basis if liquidation is not imminent.

c. *Correct.* Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either plan for liquidation is approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties or plan for liquidation is being imposed by other forces.

d. *Incorrect.* Entities are not required to prepare their financial statements using the accrual basis if liquidation is imminent. However, if liquidation is not imminent, certain items within an entity's financial statement should be measured at fair value.

4. a. *Incorrect.* SAS No. 132 does not reflect any revisions related to the convergence with the IAASB's other auditor reporting standards.

b. *Incorrect.* SAS No. 132 was written to be neutral regarding accounting frameworks so that it can be applied to audits of financial statements prepared under different financial accounting frameworks.

c. *Incorrect.* The ASB retained several concepts from SAS No. 126, including a requirement for the auditor to separately conclude whether there is substantial doubt about an entity's ability to continue as a going concern, among other matters.

d. *Correct.* Overall, respondents to the exposure draft supported the ASB's proposal to update SAS No. 126 in light of the impending effective date of FASB ASU No. 2014-15.

5. a. *Incorrect.* This section addresses the auditor's responsibilities in agreeing upon the terms of the audit engagement with management and, when appropriate, those charged with governance.

b. *Incorrect.* This section addresses the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

c. *Incorrect.* This section addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

d. *Correct.* This section addresses the auditor's responsibilities when engaged to review interim financial information under the conditions specified in this section.

6. a. *Incorrect.* No disclosure is required if management concludes under Step 1 that substantial doubt has not been raised.

b. *Correct.* There are three potential disclosure outcomes from management's going concern assessment. Although management's going concern assessment has no direct effect on an entity's accounting, it can have indirect implications.

c. *Incorrect.* Even when management's plans alleviate substantial doubt (Step 2), the entity needs to disclose certain information about its conclusions regarding the going concern assessment.

d. *Incorrect.* When management's plans do not alleviate substantial doubt, the entity needs to disclose that substantial doubt exists.

¶ 10,105 MODULE 2—CHAPTER 5

1. a. *Incorrect.* This ASU did not introduce a new lessee model. Instead, this ASU provided amendments to the recognition and measurement of financial assets and financial liabilities.

b. *Correct.* It aligns many of the underlying principles of the new lessor model with those in ASC Topic 606, the new revenue recognition standard (e.g., those related to evaluating when profit can be recognized).

c. *Incorrect.* This ASU did not introduce a new lessee model. Instead, this ASU provided amendments related to the recognition of breakage for certain prepaid stored-value products.

d. *Incorrect.* This ASU did not introduce a new lessee model. Instead, this ASU provided improvements to employee share-based payment accounting.

2. a. *Correct.* Leases of buildings are within the scope of ASC Topic 842. By contrast, leases to explore for or use minerals, oil, natural gas, and similar assets are not within the scope of ASC Topic 842.

b. *Incorrect.* Leases of intangible assets are not within the scope of ASC Topic 842. Another transaction not within the scope of ASC 842 is leases of assets under construction.

c. *Incorrect.* Leases to explore for or use minerals are not within the scope of ASC Topic 842. Leases of inventory are also not within the scope of ASC 842.

d. *Incorrect.* Leases of biological assets are not within the scope of ASC Topic 842. Note that certain industries such as retail, telecommunications, and real estate will be severely impacted.

3. a. ***Incorrect.*** Determining whether the customer has rights to operate the asset is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

b. ***Incorrect.*** Determining whether the customer designed the asset is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

c. ***Correct.*** **Whether there is an identified asset is the first determination to be made when determining if a contract contains a lease. It is important to note that identification of an asset within a contract can be made either explicitly or implicitly.**

d. ***Incorrect.*** Whether the customer obtains substantially all of the economic benefits is not the first determination to be made when determining if a contract contains a lease. However, this is an important consideration that must be assessed when concluding whether a contract does in fact contain a lease.

4. a. ***Incorrect.*** The criterion of a transfer of ownership to the lessee at the conclusion of the lease term is not a new criterion for a finance lease.

b. ***Incorrect.*** The lease term accounting for a major part of the remaining economic life of the underlying asset is not a new criterion for a finance lease. In the previous capital lease criteria, though, a 75% bright line test was included in this analysis.

c. ***Incorrect.*** The present value of future lease payments equaling or exceeding substantially all of the fair value of the asset is not a new criterion for a finance lease. In the previous capital lease criteria, though, a 90% bright line test was included in this analysis.

d. ***Correct.*** **The criteria relating to the fact that the underlying assets are of such a specialized nature that when they are returned to the lessor they have no alternative use is a new criterion for a finance lease under the lease accounting standards**.

5. a. ***Correct.*** **There are two transition methods allowed. One of the methods is retrospectively to each prior reporting period presented in the financials with the cumulative effect of initially applying the new guidance at the beginning of the earliest comparative period presented.**

b. ***Incorrect.*** ASC Topic 842 requires that both finance lease RoU assets and operating lease RoU assets be presented separately from other assets on the balance sheet and in the footnotes.

c. ***Incorrect.*** Operating (not finance) leases should be included in income from continuing operations as a single lease cost, consistent with existing guidance.

d. ***Incorrect.*** Lessees are required to present both qualitative and quantitative information about their leases, the significant judgments made, as well as the amounts recognized in the financial statements.

6. a. ***Incorrect.*** This includes those that existed at the end of the prior year and any new lease contracts, showing the balance of RoU lease assets and lease liabilities at the beginning and end of the period, and the related amortization and interest expense.

b. *Incorrect.* Furthermore, the auditor should investigate any unexpected results (ratios or variations different from what would be expected), considering known changes in client operations.

c. *Correct.* This is an incorrect statement. ASC Topic 842 does not change lease characterization for federal income tax purposes but may result in recording new, or adjusting existing, deferred tax assets and deferred tax liabilities.

d. *Incorrect.* The auditor should also inquire about whether any major sales of fixed assets were sale-leaseback transactions. If so, the auditor should determine the propriety of accounting for those transactions.

¶ 10,106 MODULE 2—CHAPTER 6

1. a. *Incorrect.* Determining the scope of the engagement is a proper procedure specific to planning during the pandemic. Another procedure is to communicate with those charged with governance.

b. *Correct.* Testing material account balances is not a planning procedure. This is a procedure that would be performed during the fieldwork phase of the audit. Instead, a proper planning procedure is to test internal controls.

c. *Incorrect.* Communicating with the predecessor auditor is a proper procedure specific to planning during the pandemic. Another procedure is to obtain a signed engagement letter.

d. *Incorrect.* Performing preliminary analytical procedures is a proper procedure specific to planning during the pandemic. Another procedure is to obtain an understanding of the client.

2. a. *Correct.* The risks and uncertainties addressed can stem from the nature of an entity's operations, the use of significant estimates, and current vulnerabilities due to certain concentrations.

b. *Incorrect.* ASC Topic 280 does not relate to the disclosures about risk and uncertainties. Instead, this ASC Topic includes accounting and reporting guidance related to segment reporting.

c. *Incorrect.* This ASC Topic includes accounting and reporting guidance related to receivables. It does not relate to the disclosures about risk and uncertainties.

d. *Incorrect.* ASC Topic 606 does not relate to the disclosures about risk and uncertainties. Instead, this ASC Topic includes accounting and reporting guidance related to revenue with contracts with customers.

3. a. *Incorrect.* Accessing records may be a challenge if some clients still maintain them in hard copy format. Engagement teams may be able to obtain scans of such records but need to consider their validity.

b. *Incorrect.* If an auditor is unable to obtain access to a client's records, the team may have to inform their clients that the audits cannot be completed until records are available.

c. *Correct.* For example, for clients that have laid off key personnel and whose work forces have moved out of the typical office environment, there could be a major breakdown in internal controls.

d. *Incorrect.* Inquiries of management and others within the client are generally most effective when they involve an in-person discussion. However, due to the circumstances surrounding the pandemic, these inquiries could be done via videoconferencing.

4. a. *Correct.* Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued.

b. *Incorrect.* This Topic requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term of the reporting entity.

c. *Incorrect.* This Topic includes accounting and reporting guidance related to receivables. It does not relate to the disclosures about going concern evaluations.

d. *Incorrect.* ASC 326 does not relate to going concern evaluations. Instead, this ASC Topic includes accounting and reporting guidance related to credit losses on financial instruments.

5. a. *Correct.* Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

b. *Incorrect.* Note that disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or that its plans alleviate that substantial doubt.

c. *Incorrect.* The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the financing that is available for the entity.

d. *Incorrect.* Entities and practitioners may need to consider recent pertinent information related to their assessments of going concern. The consequences of COVID-19 may affect those factors and cause a deterioration in an entity's operating results and financial position.

6. a. *Incorrect.* This is not the first step in the impairment testing order. Instead, this is the second step in the impairment testing order.

b. *Incorrect.* Testing long-lived assets and amortizable intangible assets under FASB ASC 360-10 is not the first step in the impairment testing order. Instead, this is the third step in the process.

c. *Incorrect.* Testing goodwill of a reporting unit is the last step in the impairment testing order. Testing goodwill last is necessary because it allows the audit team to make any required adjustments to the carrying amount of the reporting unit prior to the performance of the goodwill impairment test.

d. *Correct.* This is the first step in the impairment testing order. This sequence of steps is necessary because it allows the audit team to make any required adjustments to the carrying amount of the reporting unit (or, for private companies, an entity) prior to the performance of the goodwill impairment test.

¶10,106

¶ 10,107 MODULE 2—CHAPTER 7

1. a. ***Incorrect.*** This SAS addresses the auditor's responsibilities in the audit of financial statements relating to the entity's ability to continue as a going concern and the implications for the auditor's report.

b. ***Incorrect.*** This SAS addresses the auditor's responsibility to form an opinion on the financial statements. It also addresses the form and content of the auditor's report issued as a result of an audit of financial statements.

c. ***Incorrect.*** This SAS is intended to more closely align Auditing Standards Board guidance with the PCAOB's standards by primarily amending AU-C section 260, AU-C section 550, and AU-C section 240.

d. ***Correct.*** **SAS No. 138 amended various AU-Cs in AICPA Professional Standards, to align the materiality concepts discussed in AICPA Professional Standards with the description of materiality used by the U.S. judicial system.**

2. a. ***Correct.*** **This section explains what constitutes audit evidence in an audit of financial statements and addresses the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.**

b. ***Incorrect.*** This section addresses the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C sections 330 and 500. It does not address inquiries regarding litigation, claims, and assessments.

c. ***Incorrect.*** This section applies when the auditor has decided to use audit sampling in performing audit procedures. It addresses the auditor's use of statistical and nonstatistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

d. ***Incorrect.*** This section addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.

3. a. ***Incorrect.*** SAS No. 142 is a principles-based standard, rather than rules-based. Because of this there are no step-by-step instructions on what to do next.

b. ***Incorrect.*** There are no step-by-step instructions included in SAS No. 142. Note that prior to SAS No. 142, the objective of audit evidence primarily focused on the design and performance of audit procedures to obtain sufficient appropriate audit evidence.

c. ***Incorrect.*** The primary focus and the objective of SAS No. 142 is the consideration of the attributes and factors of information that contribute to an assessment of whether sufficient appropriate audit evidence has been obtained.

d. ***Correct.*** **Note that the revisions to SAS No. 142 address the evolving nature of transacting business as well as the evolution of audit services.**

4. a. ***Incorrect.*** SAS No. 143 explains the nature of accounting estimates and the concept of estimation uncertainty. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

b. ***Incorrect.*** This standard enables auditors to appropriately address the increasingly complex scenarios that arise from new accounting standards that include estimates.

c. *Correct.* This is an incorrect statement. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

d. *Incorrect.* SAS No. 143 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification, as amended, section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and amends various other AU-C sections in AICPA Professional Standards.

5. a. *Correct.* The look-forward period is one year from the date the financial statements are issued (or available to be issued, when applicable). Management is required by U.S. GAAP to determine the appropriateness of preparing its financial statements on the basis of a going concern.

b. *Incorrect.* With circumstances changing rapidly due to COVID-19, management's evaluation of conditions or events that may have an effect on the entity's ability to continue as a going concern could be extremely difficult.

c. *Incorrect.* The ability of an entity to continue as a going concern is affected by many factors, including the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the accessibility to financing that is available for the entity.

d. *Incorrect.* The look-forward period related to going concern is shorter than five years. Note that entities and auditors may need to consider recent pertinent information related to their assessments of going concern.

6. a. *Incorrect.* ASC 280 does not relate to subsequent events. Instead, this ASC topic provides the reporting requirements relating to segment reporting.

b. *Incorrect.* ASC 606 does not relate to subsequent events. This ASC topic provides the standards with respect to revenue recognition for contracts with customers.

c. *Incorrect.* ASC 842 does not relate to subsequent events. Instead, this ASC topic provides the accounting, reporting, and disclosure requirements for lease transactions.

d. *Correct.* ASC 855 applies to all reporting entities and applies to subsequent events not addressed in other ASC topics. One of the topics that takes precedence over ASC 855 is ASC 260 related to earnings per share.

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¶ 10,200 Glossary

Active market: Defined by FASB ASC Topic 820 as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis."

American Institute of Certified Public Accountants (AICPA): The national professional association representing certified public accountants in the United States.

Association of Certified Fraud Examiners (ACFE): A professional organization of fraud examiners that offers anti-fraud training, education, and certification.

Auditing Standards Board (ASB): The senior technical committee designated by the American Institute of Certified Public Accountants (AICPA) to issue auditing, attestation, and quality control statements; standards; and guidance to certified public accountants for non-public company audits.

Concession: Any reduction in price, rent, or other benefit provided to a tenant or buyer as an inducement to buy or lease.

Coronavirus Aid, Relief, and Economic Security (CARES) Act: Economic stimulus legislation that was passed in response to the COVID-19 pandemic's effect on the economy in the United States.

Corruption: The misuse of one's position for personal gain.

Covered period: The time period (either eight weeks or 24 weeks) that a business has to use funds received from a Paycheck Protection Program loan.

COVID-19: Abbreviation for *coronavirus disease 2019*. COVID-19 is a disease caused by the SARS-COV-2 coronavirus. First identified in China in December 2019, COVID-19 was declared a pandemic by the World Health Organization in March 2020.

Data breach: The release or taking of data from a secure source to an unsecured third-party location (computer).

Discount rate: For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease.

Discounted cash flows: Cash flows adjusted to incorporate the time value of money.

Economic Injury Disaster Loan (EIDL): A loan program authorized by Congress as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act that allows the Small Business Administration (SBA) to make direct loans to small businesses.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Finance lease: From the perspective of a lessee, a lease that meets one or more of the criteria in FASB ASC paragraph 842-10-25-2.

Financial Accounting Standards Board (FASB): An independent, private-sector, not-for-profit organization that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow generally accepted accounting principles (GAAP).

Fraud: A deception deliberately practiced in order to secure unfair or unlawful gain.

Fraud triangle: The theory developed by Dr. Donald Cressey explaining why individuals commit occupational fraud. The three components of the fraud triangle are opportunity, pressure, and rationalization.

GAAP: Generally accepted accounting principles.

Going concern: A business that is assumed will meet its financial obligations when they fall due. It functions without the threat of liquidation for the foreseeable future, which is usually regarded as at least the next 12 months or the specified accounting period.

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized.

Impairment: The condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value.

Impairment of assets: Describes a reduction in the value of a company asset (fixed or intangible), so as to reflect a decline in the quality, quantity, or market value of the asset.

Indefinite lived asset: Asset for which there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the entity (e.g., certain brands, trademarks, licenses).

Infrequency of occurrence: As defined by the FASB, an underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (FASB ASC 220-20-60-1).

Initial direct costs: Types of costs that would not have been incurred if a lease had not been obtained, for example, commissions or payments made to an existing tenant to terminate the lease.

Inquiry: Consists of seeking information of knowledgeable persons within or outside the entity.

Intangible asset: Assets (not including financial assets) that lack physical substance.

Internal control: The process of ensuring an organization's integrity of information, reliable financial reporting, and compliance with laws, regulations, policies, and procedures.

Lease: A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration.

Lease modification: A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease.

Lease modification accounting: Addresses the subsequent accounting for leases for changes occurring after the commencement date.

Liquidity: The availability of liquid assets to a market or company.

Long-lived asset (LLA): An asset that is expected to provide economic benefits over a future period of time (greater than one year). LLAs may be tangible, intangible, or financial assets.

Look-forward period: A period that spans one year from the assessment date, the date an entity's financial statements are issued or are available to be issued.

Loss contingency: Defined by ASC 450 as: "an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."

Materiality: Magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

Non-occupational frauds: Fraud that are not related to one's employment.

Nonrecognized subsequent event: An event that provides evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date.

Occupational frauds: Crimes an employee commits against the employer.

Operating lease: From the perspective of a lessee, any lease other than a finance lease. From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease.

Orderly transaction: A transaction that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities to take place and to ensure that it is not a forced transaction.

Pandemic: An infectious disease outbreak that spans a wide geographic area, often multiple continents, and affects a significant portion of the population.

Paycheck Protection Program (PPP): A loan program established as part of several COVID-19 stimulus laws that provided forgivable loans to certain small businesses.

Pervasive effects: Effects that, in the auditor's judgment, meet one or more of the following criteria: are not confined to specific elements, accounts, or items of the financial statements; if they are confined, represent or could represent a substantial proportion of the financial statements; with regard to disclosures, are fundamental to the users' understanding of the financial statements.

Phishing: A technique used by fraudsters to obtain personal information for purposes **of identity theft. This theft can include sending illegitimate emails asking for personal information.**

Recognized subsequent event: An event or transaction that provides additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

Recoverability: An asset's fair value less costs to sell, or its value in use. The concept focuses on the greatest value that can be obtained from an asset, by either selling or using it.

Reporting unit: The level of reporting at which goodwill is tested for impairment.

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Short-term lease: A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

Small Business Administration (SBA): An agency of the U.S. government that guarantees loans for small businesses.

Subsequent events: Events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued.

Substantial doubt: Means that in management's judgment, it is probable that the client will not continue as a going concern.

Triggering event: Occurs when there are indicators the fair value of an entity may be below its carrying amount.

Type I event: An event that provides evidence of conditions that existed at the date of the financial statements.

Type II event: An event that provides evidence of conditions that arose after the date of the financial statements.

Undiscounted cash flows: Cash flows not adjusted to include time value of money.

Unusual nature: As defined by the FASB, the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (FASB ASC 220-20-60-1).

Valuation assumption: An assumption/estimate of future events that includes a margin for adverse deviations and is used in calculating the actuarial liabilities.

Virtual private network (VPN): A network that encrypts data being sent over the Internet when employees connect with company systems.

¶ 10,300 Final Exam Instructions

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¶ 10,301 FINAL EXAM QUESTIONS: MODULE 1

1. When _____ doubt exists regarding an entity's ability to continue as a going concern, disclosure in the financial statement notes is required, regardless of whether the doubt is alleviated by management's plans.

a. Substantial

b. Any

c. Limited

d. Moderate

2. If the going concern basis of accounting is appropriate but substantial doubt remains, a(n) _____ paragraph is required.

a. Other-matter

b. Disclaimer

c. Emphasis-of-matter

d. Adverse

3. ASC Topic 275 requires disclosures that focus primarily on _____ and _____ that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity.

a. Risks, uncertainties

b. Hazards, uncertainties

c. Risks, reserves

d. Hazards, reserves

4. For calendar year-end 2019 financial statements, COVID-19–related subsequent events identified are likely to be _____ subsequent events.

a. Recognized

b. Nonrecognized

c. Material

d. Immaterial

5. Which of the following ASC Topics requires management to evaluate an entity's ability to continue as a going concern within one year after the date the financial statements are issued?

a. ASC Topic 125

b. ASC Topic 205

c. ASC Topic 310

d. ASC Topic 450

6. If the physical inventory counts are to take place at a later date than originally scheduled, what must auditors do?

a. Issue an adverse opinion if the inventory balance is material to the entity.

b. Estimate the inventory levels using appropriate analytical procedures.

c. Issue a disclaimer of opinion.

d. Perform additional procedures such as reviewing and testing inventory roll-forwards.

7. Which of the following AU-C Sections lays out several requirements and procedures that may be more challenging in a remote audit as it relates to the consideration of fraud in a financial statement audit?

a. AU-C Section 185

b. AU-C Section 240

c. AU-C Section 350

d. AU-C Section 480

8. Many user auditors rely on a _____ report on the controls at a service organization to obtain the required understanding. However, as a result of the recent COVID-19 pandemic, the issuance of these reports may be delayed or such reports may not be available.

a. SOC 1

b. SOC 2

c. SOC 3

d. SOC 4

9. Typically, if auditors are able to design and perform additional tests of those relevant assertions, non-receipt of external confirmations in and of itself _____ result(s) in a scope limitation.

a. Should

b. Always

c. Should not

d. Often

10. Which of the following identifies the last step in the asset impairment testing order?

a. Test for impairment and adjust carrying amounts of indefinite-lived intangible asset.

b. Test goodwill of a reporting unit.

c. Adjust the carrying amounts of any assets/liabilities not covered by FASB ASC 360-10.

d. Test long-lived assets and amortizable intangible assets under FASB ASC 360-10.

11. Which of the following terms means that in management's judgment, it is probable that the client will ***not*** continue as a going concern?

a. Vulnerability

b. Scope limitation

c. Substantial doubt

d. Substantial risk

12. According to FASB 855, a _____ is a transaction that occurs after the balance sheet date but before financial statements are issued or are available to be issued.

a. Subsequent event

b. Scope limitation

c. Going concern

d. Concentration

13. It is estimated that cyber fraud losses totaled $_____ in 2019.

a. 1.5 billion
b. 2.7 billion
c. 3.5 billion
d. 10.2 billion

14. The sale of fake documents is part of which COVID-19–related scam or fraud?

a. Charity scams
b. Vaccination card scams
c. Financial statement fraud
d. Testing scams

15. Common COVID-19 phishing scams include spoofing emails from all of the following, ***except:***

a. WHO
b. CDC
c. FDA
d. AMA

16. Which of the following organizations announced a data breach for applicants' personal information regarding disaster loan applications?

a. SBA
b. IRS
c. CDC
d. FDA

17. Which of the following government agencies warned consumers about COVID-19 funeral scams?

a. SBA
b. CDC
c. FEMA
d. IRS

18. According to the Association of Certified Fraud Examiners, what percentage of fraud victims make a full recovery of their losses?

a. 100 percent
b. 53 percent
c. 32 percent
d. 15 percent

19. Criminals filed a fraudulent unemployment claim for which U.S. Senator?

a. Mitch McConnell
b. Chuck Schumer
c. Dianne Feinstein
d. Bernie Sanders

20. What is the maximum amount a business could receive from the United States COVID-19 Relief Program?

a. $0
b. $35,700
c. $2,000,000
d. $10,000,000

21. Employees at Chase Bank illegally used customer information to apply for which stimulus program?

a. United States COVID-19 Relief Program
b. Paycheck Protection Program
c. EIDL Grants
d. American Rescue Plan Loans

22. The SBA announced it would audit all Paycheck Protection Program loans over _____.

a. $1,000,000
b. $2,000,000
c. $5,000,000
d. $10,000,000

23. What are the two main cybersecurity risk factors for businesses?

a. Asset misappropriation and corruption
b. Data breaches and phishing
c. Employees and IT systems
d. HR and Marketing departments

24. Which of the following is one of the factors that caused unemployment frauds to skyrocket in 2020 and 2021 during the COVID-19 pandemic?

a. Levels of unemployment were very high before the COVID-19 pandemic began.
b. Throughout the United States, more employees were telecommuting.
c. The number of data breaches was decreasing.
d. Many states had outdated computer systems for unemployment claims.

25. On which date did the SEC issue Disclosure Guidance Topic 9, which provided questions to consider in developing disclosures related to the COVID-19 pandemic's impact?

a. March 13, 2020
b. March 25, 2020
c. March 27, 2020
d. June 23, 2020

26. Which of the following terms applies when there are indicators that the fair value of an entity may be below its carrying amount?

a. Concession
b. Triggering event
c. Lease modification
d. Recoverability

27. Which Accounting Standards Codification (ASC) outlines the process for testing long-lived assets which include the use of assumptions or estimates that may change due to the COVID-19 pandemic?

a. ASC 326
b. ASC 360
c. ASC 840
d. ASC 842

28. Which Accounting Standards Codification (ASC) provides that economic relief that was agreed to or negotiated outside of an original lease agreement most likely represents a lease modification?

a. ASC 321
b. ASC 326
c. ASC 450
d. ASC 840

29. Which of the following is an asset that can be traded or seen as packages of capital that may be traded?

a. Financial asset
b. Contract asset
c. Equity security
d. Financial instrument

30. Entities with market capitalization in what range are more likely to be affected by the COVID-19 pandemic?

a. $300 million to $2 billion
b. $2 billion to $5 billion
c. $5 billion to $100 billion
d. More than $100 billion

31. In accordance with ASC 320, impairment of a debt security is considered other than temporary if the entity intends to sell the security as of a measurement date and has determined it is _____ that it will be required to sell the security before the recovery of its amortized cost basis.

a. Substantially certain
b. More likely than not
c. Beyond a reasonable doubt
d. Guaranteed

32. Per ASC 330, variable production overhead costs should be allocated to each unit of production on the basis of the actual use of the production facilities. The pandemic may affect entities in such a way that may result in an abnormal reduction of an entity's production levels. Which of the following statements is correct?

- **a.** The entity should increase the amount of fixed overhead costs allocated to each inventory item.
- **b.** The decrease in production overhead costs should be ignored.
- **c.** The unallocated fixed overhead costs are recognized in profit or loss in the period in which they are incurred.
- **d.** The unallocated fixed overhead costs should be averaged out and allocated over a period of three years.

33. The impacts of the COVID-19 crisis may result in incurring costs associated with exit or disposal activities, such as involuntary employee termination benefits or costs to consolidate or close facilities and relocate employees. Which of the following ASCs provides guidance on determining when to recognize such costs and information that must be disclosed in the notes to the financial statements?

- **a.** ASC 326
- **b.** ASC 360
- **c.** ASC 420
- **d.** ASC 450

34. Which of the following conditions is evaluated when testing goodwill for impairment in a COVID-19 environment?

- **a.** The extent of operational disruption
- **b.** Contractual obligations due or anticipated within one year
- **c.** Potential liquidity and working capital shortfalls
- **d.** A change in the market for an entity's products or services

35. As a result of the COVID-19 pandemic and its effects, entities need to consider whether they can continue as a going concern within _____ after the date on which the interim or annual financial statements are issued.

- **a.** Six months
- **b.** One year
- **c.** Two years
- **d.** Five years

¶ 10,302 FINAL EXAM QUESTIONS: MODULE 2

1. SAS No. 132 is effective for audits of financial statements for periods ending on or after _____.

a. December 15, 2017

b. December 15, 2018

c. December 15, 2019

d. December 15, 2020

2. Under the going concern basis of accounting, financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for a _____ period of time.

a. Extended

b. Long

c. Reasonable

d. Unlimited

3. Which of the following ASUs issued in 2014 required that management evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued?

a. ASU 2014-02

b. ASU 2014-07

c. ASU 2014-10

d. ASU 2014-15

4. The absence of any reference to substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in an auditor's report _____ be viewed as a guarantee of the entity's ability to continue as a going concern for a reasonable period of time.

a. Can

b. Should

c. Cannot

d. Must

5. Management's assessment is a ____ step process that requires determining whether it is probable the entity will be unable to meet its obligations over a defined period.

a. Two

b. Three

c. Four

d. Five

6. For its plans to alleviate the substantial doubt, management must establish that it is probable the plans will do each of the following, ***except:***

a. Be timely implemented

b. Ensure positive cash flows within 24 months

c. Be approved and feasible

d. Successfully mitigate the conditions and events that raise the substantial doubt

7. When management's plans do ***not*** alleviate substantial doubt, the entity _____ disclose that substantial doubt exists.

a. Should
b. Can
c. Must not
d. Cannot

8. Which of the following identifies the going concern standard issued by the AICPA?

a. ASC 250-40
b. AU-C 570
c. AS 2415
d. ASU 2014-15

9. Which of the following identifies a going concern condition or event related to the supply chain?

a. Loss of a principal customer or major market
b. Adverse changes in pricing
c. Production delays or product shortages
d. Emergence of a highly successful competitor

10. Amid the economic turmoil related to the coronavirus pandemic, _____ is one of the topics that auditors are most frequently asking about in their contacts with the AICPA.

a. Going concern
b. Inventory valuation
c. Supply chain
d. Goodwill amortization

11. Approximately what amount of right-of-use (RoU) assets and lease payment liabilities will be added to the balance sheets of U.S. companies as a result of the new lease standard?

a. $100 billion
b. $900 billion
c. $1 trillion
d. $3 trillion

12. Which of the following is ***not*** a new challenge with respect to applying the new lease standard?

a. Refining internal controls and other business processes related to leases
b. Managing the complexities of data collection
c. Lease classification determination
d. Determining whether debt covenants are likely to be affected

13. Which of the following types of covenants may be violated based on additional RoU assets and lease payment liabilities on the balance sheet?

a. Loan
b. Insurance
c. Going concern
d. Fair value

14. Which of the following Accounting Standards Updates amended the effective date of the new leasing standard to give immediate relief to private entities as a result of the widespread adverse economic effects and business disruptions caused by the COVID-19 pandemic?

a. ASU 2020-01
b. ASU 2020-02
c. ASU 2020-04
d. ASU 2020-05

15. Which of the following identifies an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time?

a. Borrowing
b. Lease
c. Guarantee
d. Conveyance

16. Which of the following identifies the number of criteria that must be assessed with respect to lease classification?

a. Two
b. Five
c. Six
d. Eight

17. A short-term lease is a lease that, at the commencement date has a lease term of _____ months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

a. 12
b. 18
c. 24
d. 36

18. Which of the following identifies an example of an initial direct cost (IDC) of a lease?

a. Costs related to activities that occur before the lease is obtained
b. Commissions or payments made to an existing tenant to terminate the lease
c. General overheads such as depreciation, occupancy, and equipment costs
d. Costs related to activities performed by the lessor for advertising

19. ASC Topic 842 _____ lease characterization for federal income tax purposes.

a. Does change
b. May change
c. Does not change
d. Likely does change

20. Regarding auditing under the new lease standard, you should compare and document (including your expectations) balances in the _____ accounts and related amortization with those of the preceding years or other expectations.

a. Right-of-use
b. Liability
c. Goodwill
d. Equity

21. Which of the following is an audit area/procedure that generally is ***not*** affected by the COVID-19 pandemic?

a. Calculation of planning materiality

b. Accessing client records

c. Subsequent event considerations

d. Inventory observations

22. If an auditor is unable to obtain access to a client's records, the auditor may have to:

a. Issue an adverse opinion.

b. Inform their client that the audit cannot be completed until those records are available.

c. Notify the appropriate regulatory authority.

d. Disclaim an opinion on the prior year financial statements.

23. Which AU-C Section lists requirements and procedures that may be more difficult to perform in a remote audit situation?

a. AU-C Section 210

b. AU-C Section 240

c. AU-C Section 370

d. AU-C Section 450

24. ASC Topic 275 requires disclosures that focus primarily on _____ and _____ that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity.

a. Risks, uncertainties

b. Hazards, uncertainties

c. Risks, reserves

d. Hazards, reserves

25. If an auditor is unable to design and perform additional tests with respect to confirmations not received, this nonreceipt of confirmations in and of itself _____ result in a scope limitation.

a. Should not

b. May

c. Should

d. Must

26. While obtaining an understanding of controls may be achieved remotely, which procedure alone is insufficient to determine whether such controls have been implemented?

a. Reperformance

b. Observation

c. Inquiry

d. Recalculation

27. If an audit engagement team concludes that substantial doubt about an entity's ability to continue as a going concern has been alleviated by management's plans, then the team should:

a. Include a standard unqualified opinion in all situations.

b. Issue a disclaimer of opinion.

c. Evaluate whether the financial statements include adequate disclosure of those plans.

d. Include an additional paragraph in the audit report with an opinion on the plans.

28. If a Service Organization Control (SOC) ____ report is not available and it is significant to the audit, obtaining an understanding of the design and implementation of controls at the service organization may be more challenging in the COVID-19 environment.

a. 1

b. 2

c. 3

d. 4

29. Which type of paragraph may be included in an audit report if the team considers it necessary to address an event that has a material impact on the client?

a. Other matter

b. Concerning event

c. Critical matter

d. Emphasis of matter

30. Which of the following identifies the last step in the asset impairment testing process?

a. Test for impairment and adjust carrying amounts of indefinite-lived intangible assets.

b. Test the carrying amounts of any assets/liabilities not covered by ASC 360-10.

c. Test goodwill of a reporting unit.

d. Test long-lived assets and amortizable intangible assets under ASC 360-10.

31. Based on the issuance of SAS No. 141, SAS No. 134–140 will take effect for audits of financial statements for periods ending on or after _____.

a. December 15, 2021

b. December 15, 2022

c. December 15, 2023

d. December 15, 2024

32. SAS No. 142 explains what constitutes _____ in an audit of financial statements and sets out attributes of information that are taken into account by the auditor when evaluating information to be used.

a. Audit evidence

b. Materiality

c. Errors

d. Internal controls

33. Prior to SAS No. 142, the objective of audit evidence primarily focused on the design and performance of audit procedures to obtain _____ appropriate audit evidence.

a. Significant
b. Sufficient
c. Substantial
d. Satisfactory

34. SAS No. 142 is effective for periods ending on or after which of the following dates?

a. December 15, 2021
b. December 15, 2022
c. December 15, 2023
d. December 15, 2024

35. SAS No. 143 addresses the auditor's responsibilities relating to which of the following?

a. Accounting estimates
b. Going concern
c. Use of specialists
d. Audit sampling

36. SAS No. 143 requires a separate assessment of inherent risk and _____ risk at the assertion level.

a. Control
b. Audit
c. Sampling
d. Misstatement

37. Which of the following Statements on Standards for Attestation Engagements (SSAEs), released in September 2020, relates to direct examination engagements?

a. SSAE No. 20
b. SSAE No. 21
c. SSAE No. 22
d. SSAE No. 23

38. Which of the following types of doubt means, in management's judgment, it is probable that the client will not continue as a going concern?

a. Substantial doubt
b. Limited doubt
c. Possible doubt
d. Sufficient doubt

39. For audits of calendar-year-end 2019 financial statements, COVID-19–related subsequent events were likely to be Type _____ events.

a. I
b. II
c. III
d. IV

40. Which of the following FASB ASC Topics requires disclosures that focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity?

a. ASC Topic 215
b. ASC Topic 275
c. ASC Topic 315
d. ASC Topic 606

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1. ____	10. ____	19. ____	28. ____
2. ____	11. ____	20. ____	29. ____
3. ____	12. ____	21. ____	30. ____
4. ____	13. ____	22. ____	31. ____
5. ____	14. ____	23. ____	32. ____
6. ____	15. ____	24. ____	33. ____
7. ____	16. ____	25. ____	34. ____
8. ____	17. ____	26. ____	35. ____
9. ____	18. ____	27. ____	

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Please answer the questions by indicating the appropriate letter next to the corresponding number.

1. ____	11. ____	21. ____	31. ____
2. ____	12. ____	22. ____	32. ____
3. ____	13. ____	23. ____	33. ____
4. ____	14. ____	24. ____	34. ____
5. ____	15. ____	25. ____	35. ____
6. ____	16. ____	26. ____	36. ____
7. ____	17. ____	27. ____	37. ____
8. ____	18. ____	28. ____	38. ____
9. ____	19. ____	29. ____	39. ____
10. ____	20. ____	30. ____	40. ____

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