August 2, 2023

To our peer review clients:

Annually we make an effort to highlight recent changes in professional standards for our peer review clients. We hope what follows is helpful in your accounting and auditing practice.

New Standards for Quality Control

The new Quality Management (QM) Standards, which will replace the current quality control standards, require a significant revision to the quality control systems for any CPA firm performing audits, reviews, compilations, or other attest engagements. The new QM standards will require you to consider how you manage risk in your practice and based on those considerations you will need to prepare properly tailored written policies and procedures. The new standards will take effect December 15, 2025. Here is an AICPA checklist to guide you in implementing the new QM standards:

https://www.aicpa-cima.com/resources/download/firm-checklist-to-guide-your-quality-management-system

The AICPA will be issuing an extensive practice aid later this year. The practice aid will be downloadable with practical examples. Two versions of the practice aid will be provided, one for sole proprietors, and another for small to medium sized partnerships. The AICPA has summarized the various resources available for implementing the QM Standards at:

https://www.aicpa-cima.com/topic/audit-assurance/quality-management

SALT Cap

Twenty states, including Oregon, have SALT cap (the $10,000 ceiling on personal itemized deductions for state and local taxes) workarounds in effect, allowing partners or shareholders in pass-through entities to claim a refundable credit for the state taxes paid by the partnership or S-Corporation on their behalf. At the company level, we recommend you account for these payments as owner draws in most cases.

Auditing Standards

As we have noted in prior update letters, under SAS No. 134 – 140, the language for audit reports and other audit client communications, such as engagement letters, has undergone major revision. Be sure you are using all of the new language, which is effective for the years ended after December 15, 2021. During peer reviews, we frequently see that the new requirement contained in SAS No. 134 to communicate significant risks identified during planning to those charged with governance is not complied with or, if the communication is happening, it is not documented. This communication could be made in the engagement letter if the engagement letter is circulated among board members, or the communication could be in a separate letter to the board members. On most audits, significant risks would include at a minimum management override of controls and risk of fraud with respect to revenue recognition, but there would normally be additional significant risks to communicate unique to each audit. If you use PPC, the significant risks can be found at CX-7.1. If CX-7.1 has not been completed prior to making the required preliminary communication to those charged with governance, you might communicate the significant risks identified in the prior audit that you believe are still applicable.

If you use PPC to audit you may be familiar with the table listing the “required” practice aids (at CX-0.1). These are the practice aids the PPC authors believe you should use to comply with the auditing standards unless you have developed your own alternative. The PPC authors have generated new required practice aids, as described starting in the next paragraph, in response to two new auditing standards: SAS 143 and 145. These standards are not effective until years ending on or after December 15, 2023, but may be early implemented.

Under SAS 143, you need to obtain an understanding of the controls over management estimates, then assess the risk of material misstatement, both inherent and control risk, relating to each material accounting estimate. If you decide the management estimate represents a significant risk, you must conduct control walkthroughs and perform additional substantive tests (when using a PPC audit program, those are the relevant "expanded" procedures). The PPC required practice aid for documenting assessment of risk of material misstatement for material estimates is CX-3.6 (first introduced in the 2021 edition of PPC). The new PPC required practice aid for documenting tests of management estimates is found at CX-11.3 for audits of governments and at CX-11.4 for nonprofit industry audits.

SAS 145 is the new standard on risk assessment. When you are determining risk of material misstatement, this standard requires you to separately assess inherent risk and control risk (which most auditors do already) and says that risk of material misstatement is the same as inherent risk if controls are not tested, which suggests you may want to use more care in assessing inherent risk, perhaps completing CX-7.2 if you are a PPC user.

SAS 145 revises the definition of "significant risk" to mean those risks for which the inherent risk is "close to the upper end of the spectrum of inherent risk." Using the PPC system, this would not be all of the assertions with high inherent risk, but only those with particularly high inherent risk. SAS 145 requires enhancements to your internal control documentation, with an emphasis on the risk arising from the use of Information Technology (IT). When a control addresses a significant risk, SAS 145 requires you to evaluate its design and determine whether the control has been implemented by performing control walkthroughs and to identify related IT applications, the risks related to the use of those applications, as well as IT controls that address such risks. Note that under the prior standards there was an apparent requirement to perform control walkthroughs for all material balances and transaction classes, while SAS 145, for the most part, requires control walkthroughs only on the controls that address significant risks. The new PPC required practice aid used in performing the evaluation of controls addressing a significant risk is at CX-4.2.3.

Government Auditing Standards

The 2018 Yellow Book clarifies that when the auditor prepares the financial statements for an audit client, this nonattest service is always a significant threat to independence requiring safeguards. Perhaps the best safeguard to apply is a second partner review or equivalent. Note that this second review can be limited to the financial statements and related disclosures. Review of the working papers is not necessary. The second reviewer is not deemed part of the audit team and therefore does not need to meet the same CPE requirements. Even so, sole proprietors and small partnerships have difficulty arranging for independent second reviews of the financial statements. The 2018 Yellow Book doesn't provide examples of effective safeguards other than independent review or preparation of the financial statements. Last year the AICPA provided relief to these smaller practice units, in a publication entitled "Evaluation of a Firm's Compliance with 2018 Yellow Book Independence Requirements Related to Nonattest Services." This guidance has recently been updated and is available online at:

https://us.aicpa.org/content/dam/aicpa/interestareas/peerreview/resources/peerreviewprogrammanual/downloadabledocuments/yb-compliance-peer-review.pdf

Per the guidance in this publication, rather than obtaining an independent review of the financial statements as the safeguard, a sole proprietor might apply multiple (more than one) other safeguards. An example included in the publication (Example 15.1) involves a sole proprietor who documents "their own CPE and their own cold review" as potentially sufficient safeguards. According to the AICPA publication, "how much time elapsed" between the financial statement preparation and the cold review could be key to applying cold review as an acceptable safeguard. An effective "cold review" might be performed seven to 14 days after completing the financial statements and might include the use a different checklist than the one used when performing the engagement. For example, the practitioner might complete a peer review checklist during the "cold review" instead of completing the PPC disclosure checklist a second time.

New Lease Standard

The new lease standard at ASC 842 is effective for years beginning after December 15, 2021. Leases need to be analyzed to determine whether they should be classified as financing leases (similar to capital leases under legacy GAAP), or operating leases. The following example concerns operating leases. Operating leases now have an impact on the balance sheet. This can get extremely complicated but here are the basics for operating leases:

- You start by computing the lease liability, which is the present value of the future lease payments at commencement of the lease. You should use the rate implicit in the lease, if known. If this rate is not determinable, you can use the company's incremental borrowing rate or make an election to use a risk-free rate of return (by class of underlying asset) to compute the present value. You cannot use a credit line rate unless the lease is for the same term as the credit line. Practically speaking, you will be using the risk-free rate of return (i.e., US Bond rates) most of the time.

- Then you set the Right of Use (ROU) asset equal to the lease liability so that your opening entry will be a debit to ROU with a corresponding and equal credit to lease liability.

- <u>This is key:</u> Going forward, the ROU asset is a plug account.

- Typically leases require monthly payments, of course, but for the purposes of this example we are going to use annual payments and have the lease commence January 1st. In the most basic scenario possible, cash payments on the lease are the same amount annually, such as a lease requiring annual payments of $50,000 per year over two years, for a total of $100,000 paid out over the lease term of two years. For this lease, the annual payment and the annual lease expense are both $50,000.

- What if the cash payments are not the same amount each year? Then you add all the payments over the term of the lease and divide by the lease term and the result is annual lease expense. This is legacy GAAP. For example, on a two-year lease if the payment in the first year is $50,000 and the payment in the second year is $70,000, the annual lease expense is $60,000.

- <u>This is also key:</u> Under ASC 842 for operating leases, the lease expense is a constant. It is the same dollar amount for each full year period during the lease's term.

- To start, let's keep this simple. We have a two-year lease with annual payments of $50,000 so that over two years the payments add up to $100,000. In that case both the annual cash payment and the annual lease expense are $50,000.

- If the company's borrowing rate is 4 percent, the present value of this lease is approximately $94,000 (rounding to nearest thousand). Therefore your opening journal entry is:

▪ Debit ROU asset	$94,000	
▪ Credit lease liability		$94,000

- The difference between the $100,000 of scheduled lease payments and $94,000 is $6,000. The $6,000 represents the interest expense incurred over two years on the $94,000 lease liability. Of the total, $4000 is incurred in the first year, and $2000 is incurred in the second year (rounding to the nearest thousand).

- For the first year of the lease, your journal entry is as follows:

▪ Debit Lease expense (a constant)	$50,000	
▪ Debit Lease liability (principal)	$46,000	
▪ Credit Cash		$50,000
▪ Credit ROU asset (the plug)		$46,000

The lease expense of $50,000 is composed of two components: $4,000 of interest on the lease liability and $46,000 of amortization on the ROU asset. The principal portion of the debt service, which is also $46,000 in this case, is equal to the difference between the $50,000 cash paid and the $4,000 interest expense. Neither the interest expense on the lease liability nor the amortization expense on the ROU asset appear as captioned amounts on the statement of income. The combination of these two amounts ($46,000 + $4,000) is the lease expense of $50,000, which is what appears captioned "operating lease expense" on the statement of income. The plug of $46,000 credited to the ROU asset is computed by subtracting the $4,000 interest expense from the $50,000 lease expense.

- For the second year of the lease, your journal entry is as follows:

▪ Debit Lease expense (a constant)	$50,000	
▪ Debit Lease liability (principal)	$48,000	
▪ Credit Cash		$50,000
▪ Credit ROU asset (the plug)		$48,000

The lease expense of $50,000 is composed of two components: $2,000 of interest on the lease liability and $48,000 of amortization on the ROU asset. The principal portion paid on the lease liability is also $48,000, equal to the difference between the $50,000 cash paid and the $2,000 interest expense. The plug of $48,000 credited to the ROU asset is computed by subtracting the $2,000 interest expense from the $50,000 lease expense.

- Note that if the annual cash payments on the lease equal the annual lease expense, as they do in this example, then the ROU asset and the lease liability will be the same amount. In the example above, both the ROU asset and the lease liability are $48,000 at the end of the first year. This might be the outcome for copier leases when they are sufficiently material to be booked under ASC 842.

- Now let's look at what happens when the cash payments on the lease are different each year because the tenant received a rent abatement for several months in the first year of the lease. On a two-year lease, what if the payments in the first year add to $50,000 and the payments in the second year add to $70,000? The total of the annual amounts paid is $120,000 and dividing the $120,000 by two years results in an annual lease expense of $60,000.

- If the company's borrowing rate is 4 percent, the present value of this lease is approximately $113,000 (rounding to nearest thousand). Therefore your opening journal entry is:

▪ Debit ROU asset	$113,000	
▪ Credit lease liability		$113,000

- The difference between the $120,000 of scheduled lease payments and $113,000 is $7,000. The $7,000 represents the interest expense incurred over two years on the $113,000 lease liability. Of the total interest expense, $4500 is incurred in the first year, and $2500 is incurred in the second year. The amounts have been rounded.

- For the first year of the lease, your journal entry is as follows:

▪ Debit Lease expense (a constant)	$60,000	
▪ Debit Lease liability (principal)	$45,500	
▪ Credit Cash		$50,000
▪ Credit ROU asset (the plug)		$55,500

The lease expense of $60,000 is composed of two components: $4,500 of interest on the lease liability and $55,500 of amortization on the ROU asset. The debit to lease liability is the difference between the $50,000 cash paid and the $4,500 interest expense. The plug of $55,500 credited to the ROU asset is computed by subtracting the $4,500 interest expense from the $60,000 lease expense.

- For the second year of the lease, your journal entry is as follows:

▪ Debit Lease expense (a constant)	$60,000	
▪ Debit Lease liability (principal)	$67,500	
▪ Credit Cash		$70,000
▪ Credit ROU asset (the plug)		$57,500

The lease expense of $60,000 is composed of two components: $2,500 of interest on the lease liability and $57,500 of amortization on the ROU asset. The debit to lease liability is the difference between the $70,000 cash paid and the $2,500 interest expense. The plug of $57,500 credited to the ROU asset is computed by subtracting the $2,500 interest expense from the $60,000 lease expense.

In the real world, the lease calculations get more complex than the above examples. Although you initially set the ROU asset equal to the lease liability at the commencement of the lease, the ROU asset is subject to additional adjustments at commencement. For example, the ROU asset balance increases for any lease payments made to the lessor before commencement date of the lease. In our example above, if there had been a prepayment of rent for $5,000, the opening entry would be:

- Debit ROU asset $118,000
- Credit lease liability $113,000
- Credit cash $ 5,000

Other complicating factors: treatment of renewal options, initial direct costs incurred by tenant, existing deferred rent at adoption date of ASC 842, and lease incentives paid by landlord to tenant. Also your client will usually have more than one lease. Lease software can be the solution. A discussion on lease software and other implementation issues regarding the new lease standard follows:

Lease Software: There are several software companies offering a product that will generate the adjusting journal entries as well as the footnote disclosures you will need for the financial statements, although they tend to charge significant annual subscription fees. We recommend the following:

- **EZLease** is free if there are fewer than 10 leases involved. According to **EZLease**, your clients with fewer than 10 leases can acquire the subscription directly, and up to two users are allowed (such as yourself and the company bookkeeper). Therefore, if none of your clients has more than nine leases, there would be no cost for the software for either your firm or the client. In addition to doing the computations required under ASC 842, **EZLease** can perform the calculations required under GASB 87 and GASB 96 for your governmental clients.
- **Sikich LLP** is a CPA firm with an Excel based application that you may obtain for a one-time fee. The one-time fee is $300 per client with a minimum cost of $3,000 (i.e., you have to pay for a minimum of ten clients even if you have fewer). What is different about Sikich LLC is that the fee is paid only once. Similar to tax software companies, most of the other lease software providers charge an annual subscription fee.

Emphasis on Statement of Cash Flows: We have seen firms struggle to properly present Topic 842 entries on the statement of cash flows. Here are some things to watch for:

- Using the example immediately above for the second year of the lease, the net income used as the starting point on the statement of cash flows (indirect method) would be net the $60,000 of lease expense. However, cash actually disbursed is $70,000. There is a $10,000 difference that needs to be reconciled. Given this is an operating lease, the reconciliation should be recorded entirely in the operating section of the statement of cash flows. This can be done by recording the $57,500 in amortization on the ROU asset as a non-cash adjustment (addition) to net income (appearing on the statement of cash flows near the non-cash adjustment for depreciation) and by recording the reduction in the lease liability of $67,500 (subtraction) as a change in operating assets and liabilities (grouped with increases and decreases in such accounts as prepaid expenses and accounts payable). The $57,500 could be captioned “Non-cash operating leases” and the $67,500 could be presented under the heading “Increase (decrease) in” and captioned “Operating lease liabilities.” It is also acceptable to record the $10,000 net adjustment on a single line in the operating section of the statement of cash flows.

- The example covered in our update letter is for an operating lease, but if this had been a financing lease, the reconciliation on the statement of cash flows would be done by recording a use of cash for $67,500 in the financing section and a noncash adjustment (an addition) of $57,500 in the operating section of the statement of cash flows.

- In the supplementary information section, along the lower edge of the statement of cash flows, where you report cash paid for interest and income taxes, include a new separately captioned line “Non-cash investing and financing activities: Right-of-use assets obtained in exchange for lease obligations.” In the example immediately above, the amount disclosed opposite this caption would be $113,000. If not disclosed here, this amount should be disclosed in the footnotes.

Emphasis on Footnotes: This is an area we believe peer reviewers will focus on. Please review the sample footnotes in your practice aids and carefully complete the relevant steps on your disclosure checklists. There are a number of footnote disclosures required. One disclosure that is easy to miss is the disclosure for short-term leases, which are leases that have a lease term of 12 months or less, when the company elects not to apply the recognition requirements of Topic 842. Such a footnote disclosure might read: "The Company elects to apply the short-term lease measurement and recognition exemption to its equipment leases."

"Month-to-Month" Leases: If not enforceable, month-to-month leases may fall under the short-term lease exception, which would allow you to continue to account for them as you have in the past under legacy GAAP rather than recognize a lease asset and lease liability. A lease is not enforceable if both the lessee and lessor have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. The loss by the lessee of material leasehold improvements upon termination of the lease would be significant, however. If there is a significant penalty to the lessee, such as loss of material leasehold improvements, the lessee has to determine the period that it is reasonably certain it will not exercise its termination option. If that period exceeds one year, the ROU asset and lease liability would have to be recognized. In that circumstance, the solution for maintaining the short-term lease exception may be for the lessor and lessee, typically related parties, to annually enter into a new 12-month lease.

Common Control Arrangements: Issued in March 2023, ASU 2023-01 establishes a practical expedient for leases between a company and its owners or other related parties, which are termed "common control arrangements." As initially issued, Topic 842 required that related party leases be applied on the basis of legally enforceable terms and conditions of the lease agreement. There was a question as to whether such leases are legally enforceable since one party or group is effectively both the lessor and the lessee. The practical expedient allows the common control group to account for such related party leases using the written terms and conditions in the lease document even when the terms and conditions are not legally enforceable. Only if there is no written lease will management have to evaluate whether or not the verbal understanding contains legally enforceable terms and conditions. If that evaluation determines there are not any legally enforceable terms and conditions, the verbal agreement will not meet the definition of a lease and would not fall within the scope of ASC 842. Fortunately, under ASU 2023-01, if the company documents the existing unwritten terms and conditions of the lease agreement prior to issuing the financial statements for the first period after the effective date of ASC 842, then the practical expedient will apply. That documentation may be informal, such as a memo.

Finance Leases: The above examples are for an operating lease. The treatment of a finance lease under Topic 842 is different. For example, the ROU asset is amortized on a straight-line basis over the lease term, rather than operating as the plug, as you saw in the above examples, and rather than reporting a combined "operating lease expense" on the income statement, you report amortization of the ROU asset separately from the interest expense incurred on the lease liability. The ROU assets and lease liabilities for operating and finance leases should be reported separately on the balance sheet. Take care to segregate your disclosures between finance leases (previously known as "capital leases") and operating leases.

Alternative to Implementing Revenue Standard (ASC 606) and Lease Standard (ASC 842)

We had the opportunity to hear David Pesce speak at the 2023 National Peer Review Conference. David Pesce is Head of Surety for Munich Re Specialty Insurance and, in that capacity, he reviews many financial statements from construction contractors applying for surety bond insurance. According to him, 20% to 25% of the reviews and compilations he sees are prepared under the Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs) rather than under GAAP and he is happy to accept such presentations, although GAAP may be required for companies with revenues exceeding $50 million or smaller companies that have significant borrowing. He says the FRF for SMEs presentations are "basically done using the pre-ASC 606 approach," and, again, he will accept such presentations. He does not tend to see GAAP presentations where there are GAAP departures noted in the accountant's report for failure to adopt ASC 606 or ASC 842. The AICPA standards for FRF for SMEs, along with sample reports and financial statements and other tools for implementing FRF for SMEs can be found here:

https://us.aicpa.org/interestareas/frc/accountingfinancialreporting/pcfr/frf-smes-cpafirms

Please do not hesitate to contact us if you have any questions. We appreciate your business.

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