

CPE

# Accounting and Auditing Supplement No. 4-2016







# ACCOUNTING AND AUDITING SUPPLEMENT NO. 4-2016

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## INTRODUCTION

This update includes the more significant accounting and auditing developments from October through November 2016. Included in this update are standard-setting and project activities of the Auditing Standards Board (ASB), Accounting and Review Services Committee (ARSC), Professional Ethics Executive Committee (PEEC), FASB, PCAOB, and the SEC.

These developments, although believed to be complete at the date at which they were prepared for this course material, may not cover all areas within accounting and auditing relevant to all users of this material. Readers are encouraged to visit the AICPA's Financial Reporting Center for additional resources, including various "Standards Trackers" for the most recent standard-setting activity in the areas of accounting and financial reporting, audit and attest, and compilation, review and preparation.

This update may refer you to other sources of information, in which case you are strongly encouraged to review that information if relevant to your needs.

After completing this course, you should be able to identify some of the more significant accounting and auditing developments from October through November 2016.

# Audit and Accounting Final and Proposed Standards

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## FINAL STANDARDS, INTERPRETATIONS AND REGULATIONS

### AICPA

#### Auditing Standards Board

##### Auditing, Attestation and Quality Control Standards and Interpretations

The Auditing Standards Board (ASB) did not issue any new auditing, attestation, or quality control standards or interpretations in this period.

#### Accounting and Review Standards Committee

##### Statement on Standards for Accounting and Review Services (SSARS) No. 23, *Omnibus Statement on Standards for Accounting and Review Services*

###### Issue Date

October 2016

###### Background

The Accounting and Review Standards Committee (ARSC) issued two proposals, one in December 2015 and another in July 2016, that resulted in the issuance of this Statement on Standards for Accounting and Review Services (SSARS). This omnibus standard achieves several objectives across four sections of the statements, in some cases expanding the scope of the rules, and in others clarifying or revising specific requirements. SSARS No. 23 amends:

- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*)<sup>1</sup>;
- AR-C section 70, *Preparation of Financial Statements*;
- AR-C section 80, *Compilation Engagements*; and
- AR-C section 90, *Review of Financial Statements*.

The new SSARS *Compilation of Prospective Financial Information* results in the requirements and guidance for compilations of prospective financial information moving from Statements on Standards for Attestation Standards (the “attestation standards”) to the SSARSs, expanding the applicability of AR-C section 70 so that it applies to the preparation of prospective financial information. The ASB decided, as part of its project to clarify the attestation standards, to remove the guidance regarding compilations of prospective financial information from the attestation standards. The standards prohibit the review of prospective financial information under the SSARSs.

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<sup>1</sup> All AR-C sections can be found in AICPA *Professional Standards*.

## Main Provisions

AR-C section 60 does the following:

- Revises the applicability so that SSARs apply to engagements performed on subject matter other than financial statements.
- Defines *financial statements* and *prospective financial information*, harmonizes the definitions of *engagement team* and *professional judgment* to those included in the clarified auditing standards, and clarifies the definition of *other preparation, compilation, and review publications*.
- Requires the accountant to document the justification for a departure from a relevant, presumptively mandatory requirement and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of the requirement.
- Revises the requirement for the accountant to obtain the agreement of management that it acknowledges and understands its responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error, so that the requirement does not apply if the accountant decides to accept responsibility for such internal control.
  - Note that if the accountant accepts responsibility for the design, implementation, or maintenance of the client’s internal control, a self-review threat to the accountant’s independence exists and the accountant could not perform attest services for the client during the period of professional engagement or period covered by the financial statements. Refer to the “Nonattest Services” subtopic (AICPA, *Professional Standards*, ET section 1.295) in the AICPA *Code of Professional Conduct*<sup>2</sup>.

AR-C section 70 does the following:

- Expands the subject matter to which the section should be applied to include prospective financial information and to clarify
  - when the section applies,
  - when the section may be applied, and
  - when the section does not apply.
- Clarifies the nature of an engagement letter and sets forth the following:
  - AICPA Guide *Prospective Financial Information* provides comprehensive guidance regarding prospective financial information, including suitable criteria for the preparation and presentation of prospective financial information.
  - The accountant is not prohibited from preparing and presenting prospective financial information in accordance with other suitable criteria.
  - An oral understanding of the terms of the engagement is insufficient.
  - When the accountant is unable to include a statement on each page of the financial statements indicating, at a minimum, that “no assurance is provided” on the financial statements, the accountant may withdraw from the engagement.
- Due to its importance to the reader, precludes the accountant from preparing prospective financial information that excludes disclosure of the summary of significant assumptions or a financial projection that excludes either
  - an identification of the hypothetical assumptions; or
  - a description of the limitations on the usefulness of the presentation.

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<sup>2</sup> All ET section references can be found in AICPA *Professional Standards*.

AR-C section 80 does the following:

- Expands the subject matter to which the section should be applied to include prospective financial information, pro forma financial information, and other historical financial information
- Clarifies the nature of an engagement letter and makes clear the following:
  - That AICPA Guide *Prospective Financial Information* provides comprehensive guidance regarding prospective financial information, including suitable criteria for the preparation and presentation of prospective financial information, and clarifies that the accountant is not prohibited from performing a compilation engagement on prospective financial information prepared and presented in accordance with other suitable criteria
  - That an oral understanding of the terms of the engagement is insufficient
  - That the accountant is required to disclose known departures from the applicable financial reporting framework in the accountant's compilation report
  - That when the accountant becomes aware of a departure from the applicable financial reporting framework that is material to the financial statements and the financial statements are not revised, the accountant is required to consider whether modification of the standard report is adequate to disclose the departure
- Harmonizes guidance with respect to the requirement that the accountant's compilation report include the signature of the accountant or the accountant's firm with that included in AR-C section 90 for an accountant's review report
- Includes requirements when the accountant is issuing a compilation report on prospective financial information.

AR-C section 90 does the following:

- Clarifies the nature of an engagement letter and sets forth that
  - AR-C section 90 applies to reviews of all historical financial information, excluding pro forma financial information and includes the definition of *supplementary information* and
  - an oral understanding of the terms of the engagement is insufficient
- Revises the requirement that the engagement letter or other suitable form of written agreement use language consistent with that used in corresponding paragraphs in AR-C section 70 and AR-C section 80 and be signed by
  - the accountant or the accountant's firm, and
  - management or those charged with governance (as appropriate)
- Harmonizes the requirement that the accountant's review report include the signature of the accountant or the accountant's firm with that included in AR-C section 80 for an accountant's compilation report.
- Revises the accountant's reporting responsibilities when supplementary information accompanies reviewed financial statements and the accountant's review report thereon

### Effective Date

SSARS No. 23 is effective upon issuance except for the amendments to AR-C sections 70 and 80 with respect to prospective financial information. Those amendments are effective for prospective financial information prepared on or after May 1, 2017, and for compilation reports dated on or after May 1, 2017, respectively.

## Professional Ethics Executive Committee

The PEEC did not issue any new or revised ethics interpretations in this period.

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## FASB

### Accounting Standards Updates

#### ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory

##### Issue Date

October 2016

##### Background

FASB issued this ASU to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory pursuant to its ongoing project to reduce complexity in accounting standards (the simplification initiative). The objective of the simplification initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

Current GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. In addition, interpretations of this guidance have developed in practice over the years for transfers of certain intangible and tangible assets. This prohibition on recognition is an exception to the principle of comprehensive recognition of current and deferred income taxes in GAAP.

FASB learned the following from stakeholders:

- The limited amount of authoritative guidance about the exception has led to diversity in practice and is a source of complexity in financial reporting, particularly for an intra-entity transfer of intellectual property.
- The exception results in an unfaithful representation of the economics of an intra-entity asset transfer because the exception requires deferral of the income tax consequences of the transfer, including income taxes payable or paid.

##### Main Provisions

In light of the concerns raised, FASB decided that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs.

Consequently, the amendments in this ASU eliminate the exception for an intra-entity transfer of an asset other than inventory. Two common examples of assets included in the scope of this ASU are intellectual property; and property, plant, and equipment.

On the basis of stakeholders' feedback on the proposed ASU, FASB decided not to change GAAP for an intra-entity transfer of inventory. Excerpts from comment letters appear here:

Pfizer, Inc. commented in part that

[i]n the basis for conclusions in paragraph BC5, the Board notes that an intra-entity sale of inventory involves two unrelated third parties – the selling entity’s taxing authority and the buying entity’s taxing authority. We acknowledge that the intra-entity sale involves the selling entity’s taxing authority; however, we do not believe that this intra-entity sale involves the buying entity’s taxing authority when the asset is still being held by the buying entity - - it has not yet created any receivable or payable or transaction with the taxing authority. In fact, the proposed guidance requires an entity to record a deferred tax asset, which is not the same as a contractual receivable (i.e., no money is owed to the entity by the buyer’s taxing authority as a result of the intra-entity transfer). Rather, a deferred tax asset is an asset required to be recorded under U.S. GAAP in order to achieve “matching” between a reporting entity’s recorded tax expense and the pre-tax book profit reported in the period (by creating a deferred cost/credit for differences between the book profit and tax profit that will ultimately reverse). However, in an intra-entity sale, this deferred tax asset does not achieve the aforementioned purpose for which deferred tax assets are created. In fact, as illustrated in our example in Appendix B, since this deferred tax asset does not originate from a current income tax cost that has to be deferred until the related pre-tax profit is recorded (or the related pre-tax cost becomes tax deductible), the proposed guidance actually distorts the tax rate and tax cost of the reporting entity, as compared to the pre-tax profit.

In the specific instance of intra-entity sales, in order to achieve the matching between the book pre-tax profit and the income tax expense in the income statement, it would be necessary to defer the income taxes payable or paid to the seller’s taxing authority until the sale of the asset to a third party outside the entity occurs. Further, rather than creating a deferred tax asset and reversing it the following period(s) (when the sale to third parties occurs) and thus creating tax expenses for a given period which we believe are distortive and not reflective of the real tax cost to the entity, we believe that it is necessary and useful to continue to match the recognition of income tax effects to the income reported on a consolidated basis. This approach would provide financial statement users with an effective income tax rate for the consolidated entity that is representationally faithful and ‘connected’ to the consolidated pretax results.

The New York State Society of CPAs commented in part that

[i]n the simplest of examples, if one were to consider the transfer of inventory from a U.S. manufacturer to a wholly owned distributor subsidiary in another country, say Australia, the consolidated statement (under the proposed standard) would present that inventory net of a tax adjustment related to Australia. Further, if the final sale of that inventory item occurs not in Australia, but rather in Japan, we question whether the proposed standard would represent a proper completed taxable transaction in the first instance. A multitude of such transactions could create a complex material calculation related not only to the deferred tax calculation, but also to the proposed valuation allowance.

PricewaterhouseCoopers commented in part that

[a]lthough we support the proposal, we recognize the implementation challenges that it might create for enterprises that have developed global supply chains and designed information systems to process transactions pursuant to current GAAP for intercompany transfers of inventory. We also appreciate that the original exception was largely contemplated in the context of recurring intercompany inventory transactions for which the deferral of the tax consequences of intercompany transfers would be relatively short-lived. Thus, we would support a revision to the



proposal to provide a practical expedient that would permit companies to continue to apply the exception for intercompany transfers of inventory.

Although other commenters supported the proposal to apply to all transfers of assets, including inventory, or suggested no change at all (see the following examples), the FASB apparently was compelled by the arguments against removing the exception for inventory transfers.

The Virginia Society of CPAs commented in part that

[w]e support the Board's proposed Update, which would require that an entity recognize the current and deferred income tax consequences of an intra-entity asset transfer when the transfer occurs. Our position is based on the following ideas:

- By eliminating the current exception for recognizing the income tax consequences, the standard diverges from a principles-based approach and issues specific guidance which can be misconstrued and creates diversity in practice. The resulting confusion decreases value to users of financial statements.
- The proposed Update is consistent with other areas of consolidation accounting, for example, the tax consequences can be eliminated at consolidation.
- Tracking the tax consequences between the intra-entity transfer and ultimate recognition, with the existing exception, creates practical bookkeeping issues that do not add value.
- The update would more closely align the accounting for the tax consequences with tax laws in jurisdictions that recognized the individual legal entities within a consolidated entity.
- The improved alignment with IAS 12, Income Taxes, also serves as a benefit of the Update.

KPMG, LLP commented in part

[w]e believe both the current and proposed models of accounting for the income tax consequences of intra-entity asset transfers have merit; however, it is not apparent to us that the proposed model necessarily simplifies or improves the accounting for income taxes. The complexity in the current model primarily resides in recognizing the existence of the exception and evaluating its scope. The proposal does not eliminate this complexity because it creates a new exception to the ASC Topic 810 consolidation model for preparers to identify. It also introduces new complexity in measuring the temporary difference in the buyer's jurisdiction and estimating the effect of intra-entity asset transfers on the already-challenging estimate of the annual effective tax rate.

Previous Boards agreed with these arguments in developing Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS No. 109) and in deliberating short-term convergence opportunities. Given the inherent complexity of any accounting change, particularly one that may result in significant system and process changes for some entities, we do not believe the proposed change would simplify or improve the existing model. The primary benefit of the proposal is that it would converge U.S. GAAP with international financial reporting standards (IFRS). Although we continue to support efforts for further convergence of U.S. GAAP and IFRS to work towards more comparable global accounting standards, it is unclear whether ongoing convergence efforts are a priority of the FASB. If further convergence is no longer a priority for the FASB, we believe that the costs of implementing the change would exceed the benefits.

Note: The amendments in this ASU also do not change GAAP for the pre-tax effects of an intra-entity asset transfer under FASB ASC 810, *Consolidation*.

### Practically Speaking

This ASU does not include new disclosure requirements; however, existing disclosure requirements might be applicable when accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. For example, GAAP requires an entity to disclose a comparison of income tax expense (benefit) with statutory expectations (a rate reconciliation for public entities or a description of the nature of each significant reconciling item for nonpublic entities) and also requires an entity to disclose the types of temporary differences and carryforwards that give rise to a significant portion of deferred income taxes.

### Effective Date and Transition Requirements

**Public Business Entities.** Effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods.

**All Other Entities.** Effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019.

**Early Adoption.** Permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements.

**How to Apply.** Apply on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.

## ASU No. 2016-17, Consolidation (Topic 810): Interests Held through Related Parties That are under Common Control

### Issue Date

October 2016

### Background

In February 2015, FASB issued ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*. Upon the effective date of FASB ASU 2015-02, a single decision-maker of a variable interest entity (VIE) is required to consider indirect economic interests in the entity held through related parties on a proportionate basis when determining whether it is the primary beneficiary of that VIE unless the single decision-maker and its related parties are under common control. If a single decision-maker and its related parties are under common control, the single decision-maker is required to consider indirect interests in the entity held through those related parties to be the equivalent of direct interests in their entirety. Stakeholders noted that by requiring a single decision-maker, in circumstances involving common control, to attribute interests held by certain of its related parties entirely to itself, the single decision-maker may be required to consolidate a VIE, even if it has little to no variable interests in the VIE. As a result, the single decision-maker may provide financial information that is not useful to users of that information.

### Main Provisions

This ASU amends the consolidation guidance on how a reporting entity that is a VIE's single decision-maker ("reporting entity") should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The primary beneficiary of a VIE is the reporting entity that has a controlling financial interest in a VIE and, therefore, consolidates the VIE. A reporting entity has an indirect interest in a VIE if it has a direct interest in a related party that, in turn, has a direct interest in the VIE.

The amendments in this ASU do not change the characteristics of a primary beneficiary in current GAAP. Therefore, a primary beneficiary of a VIE has both of the following characteristics: (1) the power to direct the activities of a VIE that most significantly affect the VIE's economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

If a reporting entity satisfies the first characteristic of a primary beneficiary (such that it is the single decision-maker of a VIE), the amendments in this ASU require that reporting entity, in determining whether it satisfies the second characteristic of a primary beneficiary, to include all of its direct variable interests in a VIE and, on a proportionate basis, its indirect variable interests in a VIE held through related parties, including related parties that are under common control with the reporting entity. That is, instead of considering indirect interests held through related parties that are under common control with the single decision-maker to be the equivalent of the direct interest *in their entirety*, a single decision-maker would include those interests on a proportionate basis consistent with indirect interests held through other related parties.

If, after performing that assessment, the reporting entity does not have the characteristics of a primary beneficiary, the amendments continue to require that reporting entity to evaluate whether it and one or more of its related parties under common control, as a group, have the characteristics of a primary beneficiary. If the single decision-maker and its related parties that are under common control, as a group, have the characteristics of a primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.

The amendments in this ASU improve GAAP because, in situations involving common control, a single decision-maker focuses on the economics to which it is exposed when determining whether it is the primary beneficiary of a VIE before potentially evaluating which party is most closely associated with the VIE.

Note: FASB plans to separately consider whether other changes to the consolidation guidance for common control arrangements are necessary.

### Effective Date and Transition Provisions

**Public Business Entities.** Effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years.

**Other Entities.** Effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.

**Early Adoption.** Permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

**How to Apply.** Entities that have not yet adopted the amendments in FASB ASU No. 2015-02 are required to adopt the amendments in this ASU at the same time they adopt the amendments in FASB ASU No. 2015-02 and should apply the same transition method elected for the application of FASB ASU No. 2015-02. Entities that have already adopted the amendments in FASB ASU No. 2015-02 are required to apply the amendments in this ASU retrospectively to all relevant prior periods beginning with the fiscal year in which the amendments in FASB ASU No. 2015-02 were initially applied.

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## KNOWLEDGE CHECK

1. Which statement best describes a rationale for FASB's issuance of ASU 2016-16, which changes GAAP for intra-entity transfers of assets such as intellectual property?
  - a. Disclosures on liability transfers were inconsistent with FASB's disclosure framework.
  - b. Previous GAAP for these transactions were inconsistent with their economic impact.
  - c. The indirect method for presenting these transfers was no longer relevant.
  - d. Stakeholders believed additional disclosures were needed.

### **ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)**

#### **Issue Date**

November 2016

#### **Background**

This ASU was proposed based on consensus by the FASB Emerging Issues Task Force (EITF) to address the diversity in practice regarding the accounting for restricted cash in the statement of cash flows. Specifically, stakeholders indicated that diversity exists in the classification and presentation of changes in restricted cash on the statement of cash flows under FASB ASC 230, *Statement of Cash Flows*. Entities classify transfers between cash and restricted cash as operating, investing, or financing activities, or as a combination of those activities, in the statement of cash flows. Also, some entities present direct cash receipts into, and direct cash payments made from, a bank account that holds restricted cash as cash inflows and cash outflows, while others disclose those cash flows as noncash investing or financing activities.

Note: On January 29, 2016, FASB separately proposed (also based on consensus of the FASB EITF) to address the diversity in practice regarding the presentation and classification of eight other items in the Statement of Cash Flows. This ASU addresses the ninth issue.

#### **Affected Entities**

The amendments in this ASU apply to all entities that have restricted cash or restricted cash equivalents and are required to present a statement of cash flows under FASB ASC 230. They improve GAAP by providing guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows, thereby reducing the diversity in practice.

#### **Main Provisions**

The amendments in this ASU require that a statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Under this ASU, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows.

GAAP currently does not include specific guidance on the cash flow classification and presentation of changes in restricted cash or restricted cash equivalents other than limited guidance for not-for-profit entities. Specifically, there is no guidance to address how to classify and present changes in restricted cash or restricted cash equivalents that occur when there are transfers between cash, cash equivalents, and restricted cash or restricted cash equivalents and when there are direct cash receipts into restricted cash or restricted cash equivalents or direct cash payments made from restricted cash or restricted cash equivalents.

The amendments in this ASU do not provide a definition of restricted cash or restricted cash equivalents.

Note: Some commenting on FASB's proposal believed the lack of a definition for "restricted cash" or "restricted cash equivalents" would result in continued diversity in practice.

### Effective Date

**Public Business Entities.** Effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

**Other Entities.** Effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

**Early Adoption.** Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

**How to Apply.** The amendments in this ASU should be applied using a retrospective transition method to each period presented.

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## SEC

### Exemptions to Facilitate Intrastate and Regional Securities Offerings

(Release Nos. 33-10238; 34-79161; File No. S7-22-15)

#### Issue Date

October 26, 2016

#### Background

The SEC adopted amendments to Rule 147 under the Securities Act of 1933, which provides a safe harbor for compliance with the Section 3(a)(11) exemption from registration for intrastate securities offerings. The amendments are as follows:

- Modernize the rule and establish a new exemption to facilitate capital formation, including through offerings relying on recently adopted intrastate "crowdfunding" provisions under state securities laws.
- Eliminate the restriction on offers and ease the issuer eligibility requirements.
- Limit the availability of the exemption at the federal level to issuers that comply with certain requirements of state securities laws.

The amendments update Rule 147 to facilitate current business practices but do not change the character of the rule, which is to permit local issuers to raise money from investors within their state without having to register the securities at the federal level. For example, the proposed amendments to Rule 147 eliminate the requirement that issuers need to incorporate in the state where the offering is conducted and revise the current residency requirement to focus on the issuer's "principal place of business" rather than its "principal office."

The SEC further adopted rule amendments to Rule 504 of Regulation D under the Securities Act to facilitate issuers' capital raising efforts and provide additional investor protections. The amendments to Rule 504 are as follows:

- Increase the aggregate amount of securities that may be offered and sold in any 12-month period from \$1 million to \$5 million.
- Disqualify certain bad actors from participating in Rule 504 offerings.

#### **Effective Date**

- Amended Rule 147 and the new Rule 147A are effective 150 days after publication in the Federal Register.
- Amended Rule 504 is effective 60 days after publication in the Federal Register.
- The repeal of Rule 505 is effective 180 days after publication in the Federal Register.

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## **PCAOB**

The PCAOB did not issue any final standards, interpretations, or guidance in this period.

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## **KNOWLEDGE CHECK**

2. Tom Clifford, CPA attends a CPE webinar to learn about the new AICPA omnibus accounting and review services standard SSARS No. 23. Which statement best describes one of the objectives of the omnibus statement?
  - a. The statement expands the scope of the standards to include compilation of prospective financial information.
  - b. The statement adds significant new requirements for practitioners reviewing prospective financial information.
  - c. The statement eliminates most of the requirements for practitioners compiling pro forma information.
  - d. The statement eliminates the requirement to disclose a lack of independence in a compilation report.

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## PROPOSED STANDARDS, INTERPRETATIONS, AND REGULATIONS

### AICPA

#### Proposed Auditing, Attestation or Quality Control Standards

The ASB did not issue any proposed auditing, attestation or quality control standards or interpretations in this period.

#### Accounting and Review Services Committee

The ARSC did not issue any proposed standards or interpretations in this period.

#### Professional Ethics Executive Committee

##### Proposed Revised Definitions of *Client* and *Attest Client*

###### Issue Date

December 15, 2016

###### Comment Deadline

May 15, 2017

###### Background

The AICPA's Professional Ethics Executive Committee (PEEC) proposed revised definitions of the terms *client* and *attest client*, along with related definitions, interpretations, and guidance in the AICPA Code of Professional Conduct (the code). The PEEC formed a task force in 2013 to reevaluate the definition of *client* as it relates to government auditors.

###### Main Provisions

The PEEC's proposal clarifies the existing definitions of *client* and *attest client*, relocates guidance for government auditors in today's *client* definition to a more appropriate location in the code, and answers the following questions when one entity engages the member to perform services on another entity:

- (1) Of which entity is the member required to be independent? (See the following section on "Independence.")
- (2) To which entity does the member owe a duty of confidentiality? (See the following section on "Confidentiality.")
- (3) To whom may the member respond to requests for records and work product? (See the following section on "Records Requests.")

The proposal also addresses the question of when a government auditor is considered to be "independent" of the entity that employs him or her and when a government auditor may perform attest services with respect to that entity. (See the following section on "Government Auditors.")

The PEEC's exposure draft defines *client* as the entity (or person) engaging the member (engaging entity) and the entity (or person) that is subject to the member's services (subject entity). If the engaging entity and the subject entity are not the same person or entity, the member has two separate clients for the engagement.

## Independence

*Attest Client* includes the latter category of *client* only; that is, the person or entity that is subject to the attest services. Thus, the member needn't be independent of the engaging entity (if the engaging entity is not also the subject entity) unless the "Client Affiliate" interpretation (ET sec. 1.224.010) applies to the engaging entity; that is, the engaging entity is the attest client's parent and the attest client is material to the parent. In addition, the engaging party should consider whether conflicts of interest exist under the circumstances.

## Confidentiality

The proposal is premised on the principle that the member owes the duty of confidentiality to the beneficiary of the services. So, if a company (engaging entity) hires a member to perform personal tax services for the company's executives (subject entities and beneficiaries), the member should not disclose information obtained during the tax engagement to the company without first obtaining the executive's permission to do so.

When the engaging party benefits from the services, the PEEC presumed that the engaging entity and subject entity would typically have an agreement in place to share engagement-related information with each other; that is, the member would not need to obtain the subject entity's permission to disclose the results of the services and other relevant information to the engaging entity. The example provided in the proposal was that Company A engaged the member to value certain assets of Company B for A's possible acquisition.

## Records Requests

For client-provided records that the client requests, the PEEC proposed the member should return those records to the party who provided them to the member.

For the member's work product that the client requests, the member should provide that information to the beneficiary of the engagement (similar to confidentiality) unless the member made other arrangements with the client. The following are examples of work product requests:

- A member hired to perform personal tax services for company executives (beneficiaries) should provide the work product (tax returns) to the executives; the member would not be obligated to provide that information to the company that engaged the member.
- A member hired to value Company B's assets for Company A's possible acquisition should provide the work product to Company A (beneficiary), unless the parties came to some other agreement. Without some other form of agreement, the member would not be obligated to provide the work product to Company B.

## Government Auditors

An anomaly of the extant *client* definition in the code (shown in the following excerpt) was its inclusion of an exemption for a member's employer and, more specifically, government auditors whose employment meets certain conditions in order to be considered independent of their employer.

**Client.** Any person or entity, other than the member's employer, that engages a member or member's firm to perform professional services and, if different, the person or entity with respect to which professional services are performed. For purposes of this definition, the term employer does not include the following:

- a. Person or entity engaged in public practice.



- b. Federal, state, and local government or component unit thereof, provided that the member performing professional services with respect to the entity is
  - i. directly elected by voters of the government or component unit thereof with respect to which professional services are performed;
  - ii. an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or
  - iii. appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

In an effort to simplify the definition of *client* but continue to address the government auditor issue—that is, that government auditors meeting certain conditions would be considered independent to perform attest services on their employer—PEEC is proposing to relocate that guidance to a more appropriate place in the code. Specifically, PEEC is proposing the guidance be moved to the “Simultaneous Employment or Association with an Attest Client” interpretation (ET sec. 1.275.005). The substance of the existing three conditions that would render the government auditor independent of his or her employer (cited previously as i–iii) would remain the same. Conforming edits to the “Entities Included in State and Local Government Financial Statements” interpretation (ET sec. 1.224.020) and part 1, “Introduction” (ET sec. 1.000) are also being proposed.

Because the terms *client* and *attest client* are fundamental to the code and appear frequently throughout the interpretations, PEEC is suggesting various conforming edits throughout the code.

#### Effective Date

If adopted, the aforementioned changes to the AICPA Code of Professional Conduct would become effective on the last date in the month in which the revised rules are published in the Journal of Accountancy.

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## FASB

### Technical Correction to Update No. 2016-14, Not-for-Profit Entities (Topic 958)

#### Presentation of Financial Statements of Not-for-Profit Entities

##### Issue Date

October 27, 2016

##### Comment Deadline

November 11, 2016

##### Background

Since FASB *Accounting Standards Codification*® was established in September 2009 as the source of authoritative GAAP to be applied by nongovernmental entities, stakeholders have provided suggestions for minor corrections and clarifications. The ASC’s “About the Codification” describes FASB’s procedure for responding to submissions, which involves the staff analyzing and processing the submissions and including any resulting changes to FASB ASC in maintenance updates or in an ASU.

FASB is issuing this proposed ASU to clarify the minimum requirements for the reconciliation that a not-for-profit entity (NFP) is required to disclose if it has endowment funds. Those requirements appear in ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*,

which FASB issued in August 2016. FASB ASU 2016-14 completed the first phase of FASB’s initiative to improve GAAP for NFPs, which entailed significant FASB outreach and analysis of potential costs and benefits to those entities.

### Affected Entities

The amendments in this proposed ASU would affect NFPs. NFPs generally receive significant contributed resources and operate to further a public purpose rather than to achieve a profit objective, and their stakeholders, unlike those of business entities, generally do not have ownership interests. Those NFPs typically include nongovernmental entities such as charities, foundations, colleges and universities, health care providers, cultural institutions, religious organizations, and trade associations, among others.

### Main Provisions

The proposed amendments would remove the words “that contain no purpose restrictions” from FASB ASC 958-205-50-1B(e)(3), which were added by the amendments in FASB ASU 2016-14, thus clarifying the minimum requirements for the reconciliation that an NFP is required to disclose if it has endowment funds—whether or not any purpose restriction(s) exist.

### Effective Date and Transition Provisions

The proposed amendments would not require transition guidance and would be effective upon the effective date of the amendments in FASU ASU 2016-14. These amendments would be incorporated in the final ASU on technical corrections and improvements, which is expected to be issued in December 2016.

### Proposed ASU

#### **Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services (a consensus of the FASB Emerging Issues Task Force)**

##### Issue Date

November 4, 2016

##### Comment Deadline

January 6, 2017

### Background

Stakeholders have observed that there is diversity in practice in how an operating entity determines the customer of the operation services for transactions within the scope of FASB ASC 853, *Service Concession Arrangements*. This proposed ASU addresses that diversity.

A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity whereby the operating entity will operate the grantor’s infrastructure (for example, airports, roads, bridges, tunnels, prisons, and hospitals) for a specified period of time. The operating entity also may maintain the infrastructure, and it also may be required to provide periodic capital-intensive maintenance (major maintenance) to enhance or extend the life of the infrastructure. The infrastructure already may exist or may be constructed by the operating entity during the period of the service concession arrangement.

In a service concession arrangement within the scope of FASB ASC 853, the operating entity should not account for the infrastructure as a lease or as property, plant, and equipment. An operating entity should refer to other Topics to account for various aspects of a service concession arrangement. For example, an operating entity should account for revenue relating to construction, upgrade, or operation services in accordance with FASB ASC 605, *Revenue Recognition*, or FASB ASC 606, *Revenue from Contracts with*

*Customers*. In applying the revenue guidance under FASB ASC 605, stakeholders have noted that it is not clear who is the customer of the operation services (that is, the grantor or the third-party users) for certain service concession arrangements. In turn, this uncertainty has resulted in diversity in practice when applying certain aspects of FASB ASC 605. Similar issues could also arise under FASB ASC 606.

### Affected Entities

The amendments in this proposed ASU would apply to the accounting by operating entities for service concession arrangements within the scope of FASB ASC 853.

### Main Provisions

In its proposal, FASB provided the following to illustrate the main provisions of this proposed ASU:

- A public-sector entity grantor (government) enters into an arrangement with an operating entity under which the operating entity will provide operation services (which include operation and general maintenance of the infrastructure) for a toll road that will be used by third-party users (drivers).

The amendments in this proposed ASU would clarify that the grantor (government), rather than the third-party drivers, is the customer of the operation services in all cases for service concession arrangements within the scope of FASB ASC 853 and would

- eliminate the diversity in practice that has been observed regarding the customer determination for the operation services, and
- reduce complexity and enable more consistent application of other aspects of the revenue guidance, which are affected by this customer determination.

### Effective Date

**Entity That Has Not Adopted FASB ASC 606.** The effective date and transition requirements for the amendments in this proposed ASU would be the same as the effective date and transition requirements for FASB ASC 606 (and any other topic amended by ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*). ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers the effective date of FASB ASU 2014-09 by one year.

**Entity That Elects to Early Adopt FASB ASC 606 Before the Finalization of the Proposed Amendments.** Apply the amendments using either (1) a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the beginning of the annual reporting period of adoption or (2) a retrospective approach.

**Effective Date.** FASB will determine the effective date of this proposed ASU for entities that early adopt FASB ASC 606, including whether to permit early adoption of the proposed amendments, after it considers stakeholder feedback on this proposed ASU.

### Proposed ASU

#### Compensation—Stock Compensation (Subtopic 718)

#### Scope of Modification Accounting

#### Issue Date

November 17, 2016

#### Comment Deadline

January 6, 2017

## Proposed ASU

### Background

FASB issued this proposed ASU to provide clarity and reduce diversity in practice, as well as to reduce cost and complexity, when applying the guidance in FASB ASC 718, *Compensation—Stock Compensation*, about a change to the terms or conditions of a share-based payment award.

An entity may change the terms or conditions of a share-based payment award for many different reasons, and the nature and effect of the change can vary significantly. The master glossary of FASB ASC defines the term *modification* as “a change in any of the terms or conditions of a share-based payment award.”

Stakeholders have observed that the definition of the term modification is broad and that it results in diversity in practice. Some entities evaluate whether a change to the terms or conditions of an award is substantive. When those entities conclude that a change is substantive, they apply modification accounting in FASB ASC 718. When those entities conclude that a change is not substantive, they do not apply modification accounting. FASB ASC 718 does not contain guidance about what changes are substantive.

Other entities apply modification accounting for any change to an award, except for a change they deem to be purely administrative in nature. However, FASB ASC 718 does not provide guidance about what changes are purely administrative. Still, other entities apply modification accounting when a change to an award changes the fair value, the vesting, or the classification of the award. In such cases, it appears that an evaluation of a change in fair value, vesting, or classification may be used in practice to evaluate whether a change is substantive.

### Affected Entities

The amendments in this proposed ASU would affect any entity that changes the terms or conditions of a share-based payment award and would provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in FASB ASC 718.

### Main Provisions

An entity would account for the effects of a modification unless all the following are the same *immediately before and after* the modification:

- The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the award
- The vesting conditions of the award
- The classification of the award as an equity instrument or a liability instrument

The current disclosure requirements in FASB ASC 718 would apply, regardless of whether an entity is required to apply modification accounting under the amendments in this proposed ASU.

### Effective Date

The effective date will be determined after FASB considers stakeholder feedback on the proposed amendments.

**How to Apply.** The amendments in this proposed ASU would be applied prospectively to awards modified on or after the effective date.

## Proposed ASU

### **Distinguishing Liabilities from Equity (Topic 480): I. Accounting for Certain Financial Instruments with Down Round Features and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception**

#### Issue Date

December 7, 2016

#### Comment Deadline

February 6, 2017

#### Background

FASB decided to undertake this project to address issues identified as a result of the complexity associated with applying GAAP for certain financial instruments with characteristics of liabilities and equity.

Part I of this proposed ASU addresses the complexity of accounting for certain financial instruments with down round features. *Down round features* are features of certain equity-linked instruments (or embedded features) that result in the strike price being reduced on the basis of the pricing of future equity offerings. Current accounting guidance creates cost and complexity for entities that issue financial instruments (such as warrants and convertible instruments) with down round features that require fair value measurement of the entire instrument or conversion option.

Concerns raised that resulted in the ASU are as follows:

- Stakeholders have asserted that accounting for freestanding and embedded instruments with down round features as liabilities subject to fair value measurement on an ongoing basis creates a significant reporting burden and unnecessary income statement volatility associated with changes in value of an entity's own share price.
- Stakeholders also suggest that this accounting does not reflect the economics of the down round feature, which exists to protect certain investors from declines in the issuer's share price. That is, current accounting guidance requires changes in fair value of an instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered and a decrease will only cause an adjustment when an entity engages in a subsequent equity offering.

Part II of this proposed ASU addresses the difficulty of navigating FASB ASC 480-10, *Distinguishing Liabilities from Equity—Overall*, because of the existence of extensive pending content in FASB ASC. This pending content is the result of the indefinite deferral of accounting requirements about mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests.

#### Affected Entities

The amendments in part I of this proposed ASU would affect all entities that issue equity-linked instruments (or embedded features) that include down round features.

The amendments in part II of this proposed ASU will not have an accounting effect.

## Main Provisions

### Part I

The amendments in part I of this proposed ASU would change the accounting for certain equity-linked financial instruments (or embedded features) with down round features. The proposed amendments would require that when determining whether certain financial instruments should be classified as liabilities or equity instruments, an entity would not consider the down round feature when assessing whether the instrument is indexed to its own stock. However, an entity would recognize the effect of the feature when triggered (that is, when the exercise price of the related equity-linked financial instrument is adjusted downward because of the down round feature) as follows:

- For a financial instrument classified as equity, an entity would recognize the value of the effect of the down round feature in equity as a dividend.
- For a financial instrument classified as a liability, an entity would recognize the value of the effect of the down round feature through a charge to net income.

For financial instruments with down round features that have been triggered during the reporting period, an entity would disclose the following:

- That the feature has been triggered
- The value of the effect of the down round feature being triggered
- The financial statement line item in which that effect is recorded

Therefore, the amendments create a model that would apply to certain financial instruments (either freestanding or embedded) with down round features. Under current GAAP, an equity-linked financial instrument with a down round feature that is not otherwise required to be classified as a liability under FASB ASC 480-10 is evaluated under the guidance in FASB ASC 815, *Derivatives and Hedging*, to determine whether it meets the definition of a derivative. If it does meet that definition, the instrument (or embedded feature) is evaluated to determine whether it is indexed to an entity's own stock as part of the analysis of whether it qualifies for a scope exception from derivative accounting. Generally, for warrants and conversion options embedded in financial instruments that are deemed to have a debt host, a down round feature results in an instrument not being considered indexed to an entity's own stock. This results in a requirement that the freestanding financial instrument or the bifurcated conversion option be classified as a liability, which the reporting entity must measure at fair value initially and at each subsequent reporting date.

Benefits of the proposed changes are as follows:

- Would eliminate the requirement to evaluate the down round feature in financial instruments (or embedded features) in determining whether those instruments are indexed to an entity's own stock under the guidance in FASB ASC 815-40, *Derivatives and Hedging—Contracts in Entity's Own Equity*, for purposes of determining whether it qualifies for a scope exception from derivative accounting.
  - An entity would still be required to determine whether instruments would be classified in equity under the guidance in FASB ASC 815-40 in determining whether they qualify for that scope exception. If they do qualify, those instruments would not be classified as liabilities and instead would be subject to the guidance in this proposed ASU.
- Would eliminate an inconsistency under current GAAP for financial instruments with down round features that currently meet the definition of a derivative and are subject to the guidance in FASB ASC 815-40, as well as those for which the down round feature does not currently affect classification and measurement under current GAAP.

- For convertible instruments, the proposed model for financial instruments with down round features would apply only if an entity is not required to apply existing specialized accounting guidance for convertible instruments in FASB ASC 470-20, *Debt—Debt with Conversion and Other Options*.
- Would simplify GAAP by eliminating the consideration of the down round feature for purposes of assessing whether an instrument is indexed to an entity’s own stock under FASB ASC 815; that is, an entity would no longer measure the instrument at fair value at each reporting period or separately account for a bifurcated derivative on the basis of the existence of a down round feature.
- Would better reflect the economics of the transaction by measuring the down round feature only when the feature is triggered.
- Would alleviate the complexity and income statement volatility associated with fair value measurement on an ongoing basis.
- Would simplify the accounting for convertible instruments with down round features, applying specialized guidance such as the model for contingent beneficial conversion features rather than bifurcating an embedded derivative because the issuer would recognize the intrinsic value of the feature only when the feature is triggered.

## Part II

The amendments in part II of this proposed ASU recharacterize the indefinite deferral of certain provisions of FASB ASC 480-10 (currently presented as pending content) to a scope exception. These amendments will not have an accounting effect. Replacing the indefinite deferral of certain guidance in FASB ASC 480-10 with a scope exception will improve readability and reduce the cost and complexity associated with navigation of the guidance in FASB ASC 480-10.

### Effective Date

FASB will determine the effective date of part I of this proposed ASU after considering stakeholders’ feedback on this proposed ASU.

The proposed amendments in part II of this proposed ASU would not require any transition guidance because those amendments do not have an accounting effect.

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## KNOWLEDGE CHECK

3. Other than the proposed ASU to technically correct an issued ASU, which statement best describes the primary reasons for the changes proposed to GAAP this quarter?
  - a. To provide entities greater flexibility in reporting under GAAP.
  - b. To benefit accounting regulators who review corporate disclosures.
  - c. To align the standards to the International Financial Reporting Standards.
  - d. To reduce complexity of applying the standards and diversity in practice.

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## **SEC**

The SEC did not issue any proposed regulations or guidance in this period.

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## **PCAOB**

The PCAOB did not issue any proposed standards, interpretations or guidance in this period.





# **ACCOUNTING AND AUDITING SUPPLEMENT NO. 4-2016**

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**BY CATHERINE R. ALLEN, CPA**

**Solutions**

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# SOLUTIONS

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## CHAPTER 1

### Solutions to Knowledge Check Questions

1.
  - a. Incorrect. Inconsistency with the disclosure framework was not one of the rationales for changing GAAP in this ASU.
  - b. Correct. One of the reasons for the change in GAAP was that stakeholders believed the accounting did not match the economic realities of such transfers.
  - c. Incorrect. There was no mention of an indirect method in this ASU.
  - d. Incorrect. The need for additional disclosures was not a driver in FASB's issuance of this ASU.
  
2.
  - a. Correct. The standard expands the SSARs to address preparation and compilation of prospective financial information.
  - b. Incorrect. As before under the SSAEs, the standard does not permit an accountant to perform a review of prospective financial information. Reviews of historical financial statements is still permitted.
  - c. Incorrect. The standard does not eliminate most of the requirements in the standards applicable to pro forma information. The standard adds guidance for prospective financial information.
  - d. Incorrect. The standard does not eliminate the requirement to disclose a lack of independence in a compilation report when such disclosure is warranted.
  
3.
  - a. Incorrect. Greater flexibility in reporting under GAAP is not the primary rationale that drove changes to GAAP in the fourth quarter. Reducing complexity was one of the primary reasons for the proposed changes.
  - b. Incorrect. Benefiting regulators who review corporate disclosures does not describe FASB's rationale in issuing proposals to change GAAP in this quarter. Reducing diversity in practice was one of the primary reasons for the proposed changes.
  - c. Incorrect. FASB does consider the International Financial Reporting Standards in proposing amendments to standards, but this does not best describe the rationale for most of the amendments in Q4.
  - d. Correct. Reducing complexity and the diversity in practice figured prominently in the rationale for amendments issued this quarter.

