

Agenda Item 1



Proposed Revisions to SSARs – Compliance Frameworks

Discussion Memo

Objective of Agenda Item

To consider revisions to AR-C sections 60, 70, 80, and 90 to incorporate the concept of *compliance frameworks* and to vote to expose the proposed revisions for public comment.

Background

At its meeting in August 2018, the ARSC considered revisions that the ASB's Auditor Reporting Task Force has proposed to AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, to introduce the concept of a compliance framework, which is included in ISA 800 (Revised) *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*. The ARSC directed revisions be developed to SSARs that would be consistent with the proposed revisions to AU-C section 800 and, if determined to be appropriate by the ARSC, that such proposed revisions be included in the exposure draft of the proposed revisions to further converge the requirements for reviews performed in accordance with SSARs with ISRE 2400 (Revised). That exposure draft was approved for issuance by the ARSC at its meeting in August 2018.

The ASB's Auditor Reporting Task Force is expected to present its proposed revisions to AU-C section 800 to the ASB at the ASB's meeting in January 2019 with a request that the ASB vote to expose such proposed revisions for public comment at that time.

Agenda item 1A represents the exposure draft approved by the ARSC at its meeting in August 2018 marked to show additional revisions necessary to incorporate the concept of *compliance frameworks* and certain other revisions. Agenda item 1B represents the approved wrap document marked to include discussion of the additional proposed revisions.

Issues for ARSC Consideration

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Issue #1 - Definition of compliance framework

Paragraph .07 of AR-C section 60 includes a definition of *financial reporting framework* – which incorporates a discussion of the concept of a *fair presentation framework*. That definition states that a framework that requires compliance with the requirements of the framework but does not do one of the following:

- a. Acknowledge explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework.
- b. Acknowledge explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in rare circumstances.

is not a fair presentation framework.

The proposed revision would revise the definition of *financial reporting framework* to state instead that such a framework is a *compliance framework*.

Additionally, to clarify that the cash- and tax-bases of accounting are *fair presentation frameworks*, the proposed revision would include the following new application paragraph hanging off the discussion of *fair presentation framework* included in the definition of *financial reporting framework*:

.A12 Many entities use the cash or tax basis of accounting in preparing their financial statements. Such financial statements are widely recognized and accepted by banks and other stakeholders. In addition, guidance on the preparation of such financial statements has been available and prevalent for many years. For these reasons, the cash and tax bases of accounting are considered fair presentation frameworks.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with the revisions proposed to the definition of *financial reporting framework* to incorporate the concept of a *compliance framework*.

Issue #2 – Definition of special purpose framework

Special purpose framework is defined in paragraphs .07 of AR-C section 70, .05 of AR-C section 80, and .05 of AR-C section 90 as follows:

Special purpose framework. A financial reporting framework other than GAAP that is one of the following bases of accounting:

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- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as other comprehensive bases of accounting (OCBOA).

The document approved by the ARSC at its meeting in August 2018 proposed to add the same definition to AR-C section 60. The result would be that this definition is in all four primary sections of SSARs.

The revised proposal is that this definition (and also the definition of *applicable financial reporting framework*) be included only in AR-C section 60. Further, the definition would be revised so that it is consistent with the corresponding definition proposed by the Auditor Reporting Task Force. The revised definition is as follows:

Special purpose framework. A financial reporting framework other than GAAP designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework. See definition of financial reporting framework.

The listing of types of *special purpose frameworks* would be included in an application paragraph, as follows:

.A14 The following are examples of special purpose frameworks:

- a. **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).

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- b. **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- c. **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- d. **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- e. **Other-basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash-basis, tax-basis, regulatory-basis, and other-basis of accounting are commonly referred to as other comprehensive bases of accounting.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with the additional proposed revised definition of *special purpose framework*.

Issue #3 – GAAP-like disclosures in financial statements prepared in accordance with a special purpose framework

If financial statements are prepared in accordance with a *fair presentation framework*, the extant requirement for the accountant to consider whether *special purpose financial statements* includes informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP and to modify the accountant’s compilation or review report when such informative disclosures are not included would be retained. However, the requirement would not be retained if the financial statements are prepared in accordance with a *compliance framework*.

The underlying presumption of a *fair presentation framework* is that in certain circumstances it may be necessary to provide disclosures in addition to those required by the applicable financial reporting framework in order to achieve fair presentation. This “stand back” assessment recognizes that the financial reporting framework cannot anticipate the particular facts and circumstances of an entity, and that judgment is needed to evaluate whether additional disclosures are needed to enable users of the financial statements to understand the effect of transactions, events, or conditions on the entity’s financial position, results of operations, and cash flows.

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On the other hand, the underlying presumption of a *compliance framework* is that the developers of the framework intend for such financial statements to be prepared in a manner that meets the requirements of only that framework, and that users are interested in knowing whether only those requirements have been met. Therefore, it would be inappropriate to override or supplement the requirements of that framework (e.g., provide additional disclosures) because doing so could lead to a lack of comparability and be contrary to the intent of meeting the financial information needs of users of financial statements prepared in accordance with that framework.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with the removal of the requirement for the accountant to modify the accountant’s compilation or review report when *special purpose financial statements* prepared in accordance with a *compliance framework* do not include informative disclosures similar to those required by GAAP when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP.

Issue #4 – Reporting on financial statements prepared in accordance with a special purpose framework

Extant SSARs require that the accountant’s compilation or review report include a separate paragraph (referred to as an emphasis-of-matter paragraph in a review report) that

- a. indicates that the financial statements are prepared in accordance with the applicable special purpose framework,
- b. refers to the note to the financial statements that describes the framework, if applicable, and
- c. states that the special purpose framework is a basis of accounting other than GAAP.

It is proposed that in a compilation or review report on financial statements prepared in accordance with *a contractual basis of accounting* the separate paragraph also state that, as a result, the financial statements may not be suitable for another purpose.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with the proposed additional reporting language when financial statements are prepared in accordance with *a contractual basis of accounting*? Should the requirement also apply when financial statements are prepared in accordance with *a regulatory basis of accounting*?

Issue #5 – Required restriction on use of the accountant’s review report

Extant AR-C section 90 requires that the accountant’s review report on financial statements prepared in accordance with a *special purpose framework* include an alert that restricts the

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use of the accountant’s report when the financial statements are prepared in accordance with *a contractual basis of accounting* or *a regulatory basis of accounting*.

The proposed revision would require that the accountant’s review report include an alert that restricts the use of the accountant’s report only when the financial statements are prepared in accordance with *a contractual basis of accounting* (i.e., *the accountant could issue an unrestricted report on financial statements prepared in accordance with a regulatory basis of accounting*).

The proposed revision would not preclude the accountant from restricting the use of any report he or she determines is appropriate to restrict. In addition, the accountant would still be required to restrict the use of the accountant’s review report if the financial statements are based on measurement or disclosure criteria that are:

- a. determined by the accountant to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria or
- b. available only to the specified parties

Extant AR-C section 80 does not include any requirements for the accountant to restrict the use of the accountant’s compilation report.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with the proposed revised requirements with respect to including an alert that restricts the use of the accountant’s review report.

Issue #6 - Other Proposed Revisions to SSARs

In addition to the revisions proposed to SSARs to introduce the concept of a *compliance framework*, the following additional revisions are proposed:

- 1) Revision of the definition of *financial statements* in paragraph .07 of AR-C section 60 for consistency with the proposed definition included in the exposure draft of the proposed Statements on Auditing Standards – Auditor Reporting (the Auditor Reporting ED).
- 2) Inclusion of definitions in AR-C section 90 of *modified conclusion* and *pervasive* consistent with definitions included in the Auditor Reporting ED.

Action Requested of ARSC

The ARSC is asked to consider whether it agrees with these additional proposed revisions to SSARs.

Overall Action Requested of ARSC

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The ARSC is asked to vote to expose the proposed revisions to SSARs. The vote to expose would be contingent on the ASB not making substantive changes to its proposed revisions at its meeting in January 2019. The exposure draft would be expected to be issued in late January 2019 (at the same time as the proposed revisions to the auditing standards).

Agenda Items Presented:

- Agenda item 1A Proposed revised AR-C sections 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*; 70, *Preparation of Financial Statements*; 80, *Compilation Engagements*; and 90, *Review of Financial Statements* marked to show changes from exposure draft approved by the ARSC at its meeting in August 2018
- Agenda item 1B Proposed revised wrap document to same exposure draft marked to show changes from document approved by the ARSC at its meeting in August 2018