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Accounting and Financial Reporting Update

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Outline

1. Accounting Update
2. Overview of the New Leasing Standard
3. Pension/ERISA Update
4. Audits, Reviews, Compilations & Preparation of Financial Statements

1. ACCOUNTING UPDATE

Newly Issued Accounting Standards Updates

ASU 2021-08 – Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers

- Requires entities to apply Topic 606 to recognize and measure contract assets and contract liabilities in a business combination.
- Improves comparability after the business combination by providing consistent recognition and measurement guidance for revenue contracts with customers acquired in a business combination and revenue contracts with customers not acquired in a business combination.

ASU 2021-09 – Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities

- Provides lessees that are not public business entities with a practical expedient that allows them to make an accounting policy election to use a risk-free rate as the discount rate for all leases.

Newly Issued Accounting Standards Updates

ASU 2021-10—Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance

- Requires certain disclosures about transaction with a government accounted for as a government grant (i.e. PPP Loans)
    - Information about the transactions and accounting policies
    - Line items in balance sheets and income statements affected by the transactions
    - Terms and conditions of the transactions

Newly Issued Accounting Standards Updates

ASU 2022-02—Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings (TDR) and Vintage Disclosures

- Eliminates the TDR recognition and measurement guidance and, instead, requires that an entity evaluate whether the modification represents a new loan or a continuation of an existing loan.
- Vintage Disclosures – Public business entities are required to disclose current period gross write offs by year of origination for financing receivables and net investments.

ASU 2022-03—Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

- A contractual restriction on the sale of equity security is not considered part of the unit account of equity security (not considered fair value). Also, an entity cannot recognize and measure a contractual sale restriction.

Newly Issued Accounting Standards Updates

ASU 2022-04—Liabilities—Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations

- Requires a buyer in a supplier finance program disclose sufficient information of the program's nature so users can understand the activity and potential magnitude.
- Key terms, including a description of payments and assets pledge as security or other guarantees provided for the committed payment. Buyer also needs to confirm the amount outstanding by the buyer, a description of where the obligations are on the Balance sheet, and a roll forward of those obligations during the period.

2. OVERVIEW OF THE NEW LEASING STANDARD

Leases

ASU 2016-02 – Leases

- Issued on February 25, 2016.
- **Required to be implemented for private companies for years beginning after December 15, 2021 (2022 calendar years)**.
- Implementation ***NOT*** required for interim financial statements.
- All leases will be capitalized. It is estimated that $2 trillion in liabilities will be added to balance sheets when the standard becomes effective!

Leases

What is a lease under ASC 842?

- An identified asset:
  - May be explicitly or implicitly specified
  - No practical ability or economic incentive to substitute the asset
- The right to control the use of the asset during the term:
  - Decision-making authority held by lessee
  - Lessee obtains substantially all economic benefits
- Consideration must transfer from lessee to lessor.
- Month to month leases – often a related party lease. Need to consider if there is economic incentive/disincentive that make an extension reasonably certain, due to:
  - Costs of relocation / disruption to business
  - Significant investments in Leasehold Improvements
  - Regulatory approvals needed for location

Leases

What is a lease under ASC 842?

- **Includes** subleases, "embedded leases" and **related party leases.**
  - If related parties are consolidated for financial statements, leasing activity should be eliminated consistent with current standards.
  - Embedded leases are leases included in larger contracts or agreements (IT Contracts with server leases included).
- **Excludes** leases of all intangible assets, biological assets (e.g. timber), inventory and leases to explore for use of mineral oil and natural gas.
- **Excludes leases with a maximum possible term of 12 months or less**, expense on a straight-line basis.
  - Must consider legally enforceable terms.
  - Must consider expected outcome if unilateral option to cancel or renew.

Leases

How will leases be accounted for under the new guidance?

- Lessees will recognize a **“right-of-use”** asset (non-current) and a liability (current and non-current portions) for their obligation to make lease payments for ***all*** leases.

- Asset and liability are initially measured using the **present value (PV)** of the lease payments using a **discount rate**.

- Use an **expected-outcome approach:**
  - Contingent rentals and residual value guarantees are part of the right-of-use asset and lease liability if expected to be incurred.
  - Lessee bases its inclusion of rentals for renewal periods in the lease liability on the longest possible term that is more likely than not to occur.

- Initial direct costs are added to the cost of the asset, such as commissions to a broker or costs to prior lessees. Legal and accounting costs are expensed.

Leases

Two elements form basis for PV of lease payments:

1) Lease Term

Noncancellable period for which a lessee has the right to use an underlying asset.

+

Any periods covered by an option to:

EXTEND THE LEASE If the lessee is reasonably certain to exercise that option.

TERMINATE THE LEASE If the lessee is reasonably certain they will not exercise that option.

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - INCLUDED

Fixed Payments
Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.

Transaction Fees
Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

Amounts Owed
Amounts it's probable the lessee will owe under residual-value guarantees.

Purchase Option
The exercise price of an option to purchase the underlying asset, if the lessee is reasonably certain to exercise that option.

Penalty Payments
Penalty payments for terminating the lease, when the lease term reflects the lessee exercising an option to terminate the lease.

Some Variable Payments
Variable lease payments that depend on an index or a rate (i.e. CPI).

Leases

Two elements form basis for PV of lease payments:

2) Lease Payments - EXCLUDED

Certain Other Variable Lease Payments

- Real estate taxes
- Building insurance
- Lease payments determined based on a percentage of sales

Amounts Allocated to Non-lease Components

- Common area charges
- Service agreements

Lessees

Lease Classification for Lessees

- Two approaches based on the "lease classification test"
  - ✓ Approach A – Financing Type (Current "Capital Lease")
  - ✓ Approach B – Operating Type

The only difference is how you charge the lease asset and payments to operations

Lessees

Approach A – Financing Type (Capitalized)

- 5-part test – Financing lease if any of the 5 is met
  1. Lease transfers ownership
  2. Lease grants the lessee option to purchase and exercise of the option is reasonably certain
  3. Lease term is for major part of the remaining economic life (~75% or more)
  4. Present value of future payments plus guaranteed residual value equals or exceeds substantially all of the fair value of the underlying asset (~90% or more)
  5. Asset is specialized in nature and has no alternative use to the lessor

Lessees

Approach A – Financing Type (Capitalized)

- Separately reflected in P&L
- Present value the lease liability with interest expense
- Amortize right of use asset on a straight-line basis
- Amortize over shorter of the estimated lease term or underlying asset's useful life
- If significant economic incentive to exercise a purchase option, amortize asset to end of useful life of underlying asset

Lessees

Approach B – Operating Type, Straight-line Approach

- For all leases **not** meeting the financing criteria above
- Amortize the "right-of-use" asset each period as a balancing figure such that the total lease expense would be recognized on a straight-line basis regardless of timing of lease payments
- Recognize lease expense **as a single cost in the income statement**
- Combine effective interest on lease liability with amortization of ROU asset so that the remaining cost of lease is allocated over remaining lease term equally on a straight-line basis

Lessees

Approach A – Financing Type (Capitalized)

- To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate

Finance Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 17,345	$ 23,416
2	20,600	5,096	15,504	57,294	17,345	22,441
3	21,218	4,011	17,207	40,086	17,345	21,356
4	21,855	2,806	19,049	21,038	17,345	20,151
5	22,510	1,473	21,038	-	17,345	18,818
	106,183	19,456	86,727		86,727	106,183

- Note that the **asset amortization is static** from year to year.

Lessees

<u>Approach B</u> – Operating Type, Straight-line Approach

To amortize a 5-year lease at $20,000 / year with a 3% escalation ($106,183 total payments) using a 6% incremental borrowing rate

Operating Lease						
	A	B	C	D	E - B	E
Year	Payment	Interest	Principal	Remaining	Asset Amortization	Total Expense
				$ 86,727		
1	$ 20,000	$ 6,071	$ 13,929	72,798	$ 15,166	$ 21,237
2	20,600	5,096	15,504	57,294	16,141	21,237
3	21,218	4,011	17,207	40,086	17,226	21,237
4	21,855	2,806	19,049	21,038	18,431	21,237
5	22,510	1,473	21,038	-	19,764	21,237
	106,183	19,456	86,727		86,727	106,183

- Note that the **total expense is static** from year to year.

Lessees

Presentation for Lessees

Balance sheet

- Either present separately or combine with appropriate class of assets and liabilities with proper disclosure
- No co-mingling of Approach A (financing) and Approach B (operating) leases, either present separately or disclose separately

Income statement

- No change to how capital leases and operating leases are currently being charged to expense

Side by Side Comparison
Balance Sheet

	Old Standard	New Standard
Assets		
Cash	$ 2,000,000	$ 2,000,000
Accounting receivable	11,500,000	11,500,000
Contract asset	1,500,000	1,500,000
Prepaid expenses and other current assets	500,000	500,000
Total Current Assets	15,500,000	15,500,000
Property and Equipment	10,279,000	10,000,000
Operating Lease Right of Use Asset	--	5,805,000
Financing Lease Right of Use Asset	--	279,000
Total Assets	$ 25,779,000	$ 31,584,000
Liabilities and Stockholder's Equity		
Line of credit	$ 3,500,000	$ 3,500,000
Current portion of operating lease liability	--	510,000
Current portion of financing lease liability	--	92,000
Current portion of capital lease obligations	92,000	--
Accounts payable and accrued expenses	7,000,000	7,000,000
Contract liability	2,000,000	2,000,000
Total Current Liabilities	12,592,000	13,102,000
Operating Lease Liability, less current portion	--	5,295,000
Financing Lease Liability, less current portion	--	191,000
Capital Lease Obligations, less current portion	191,000	--
Total Liabilities	12,783,000	18,588,000
Stockholder's Equity	12,996,000	12,996,000
Total Liabilities and Stockholder's Equity	$ 25,779,000	$ 31,584,000

	Old Standard	New Standard
Debt to Equity Ratio		
Total Liabilities	$ 12,783,000	$ 18,588,000
Total Equity	12,996,000	12,996,000
Debt to Equity Ratio	0.98	1.43

	Old Standard	New Standard
Current Ratio		
Current Assets	$ 15,500,000	$ 15,500,000
Current Liabilities	12,592,000	13,102,000
Current Ratio	1.23	1.18

	Old Standard	New Standard
Working Capital		
Current Assets	$ 15,500,000	$ 15,500,000
Current Liabilities	12,592,000	13,102,000
Working Capital	$ 2,908,000	$ 2,398,000

Side by Side Comparison
Income Statement

	Old Standard	New Standard
Revenues Earned	$ 40,000,000	$ 40,000,000
Cost of Revenues Earned	35,000,000	35,000,000
Gross Profit	5,000,000	5,000,000
General and Administrative Expenses		
Office salaries, payroll taxes and benefits	3,400,000	3,400,000
Rent	595,000	--
Operating lease	--	595,000
Travel and entertainment	300,000	300,000
Depreciation and amortization	248,850	248,850
Office expense	200,000	200,000
Total General and Administrative Expenses	4,743,850	4,743,850
Income from Operations	256,150	256,150
Other Expense		
Interest expense	11,150	11,150
State Income Tax Expense	50,000	50,000
Net Income	$ 195,000	$ 195,000

	Old Standard	New Standard
Debt Coverage Ratio		
Net Income	195,000	195,000
Plus: Interest expense	11,150	11,150
Plus: Taxes	50,000	50,000
Plus: Depreciation and amortization	248,850	248,850
Plus: Operating lease expense	--	--
EBITA	505,000	505,000
Current debt and capital/financing leases	92,000	602,000
Interest expense	11,150	11,150
Debt Service	103,150	613,150
Debt Coverage Ratio	4.90	0.82

Leases

Adoption and Implementation

- Classification, measurement, and recognition are all done at adoption.
  - Not required to re-assess classification for existing leases
- Measurement is done using remaining lease payments as of the date of application
- 2 optional modified retrospective methods of adoption:
  1) Comparative Date Method:
     - Date of initial application is at the beginning of the earliest comparative period (ex: 1/1/21 for a 2022 calendar year-end private entity)
     - Restate comparative periods presented
     - ASC 842 disclosures required for all periods presented

Leases

Adoption and Implementation

- 2 optional methods of adoption (continued):
  2) Effective Date Method:
     - Date of initial application is the effective date (ex: 1/1/22 for a 2022 calendar year-end private entity)
     - No requirement to adjust comparative periods or provide comparative period disclosures
     - Make disclosures under ASC 840 for comparative period and ASC 842 disclosures for post-adoption period
- Full retrospective method is **not** allowed (i.e., going back to beginning of each lease)

Leases

Disclosures

- Information about lease assets by class of asset, including cash flows
- Maturity analysis of lease liabilities
- Description of extension and termination options
- Basis on which variable lease payments are determined
- Quantitative table of lease cost, cash flows, and remaining balances for finance leases and separately for operating leases
- Cumulative effect of the change on retained earnings, if any
- Nature & reason for the change
- Effect on income from continuing operations, net income, or any other line item
- Lease descriptions & terms

Leases

Disclosures

	Year Ending December 31,	
	20X2	20X1
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX

	Year Ending December 31,	
	20X2	20X1
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating	X.X%	X.X%

Consider using tabular format similar to current debt disclosures!

Leases

<u>**Significant Challenges**</u>

- Lease discovery and identification.
- Determining lease term.
- Segregating non-lease components.
- Segregating embedded leases from contracts.
- Accounting for related party leases.
- Data mining and organization for completing note disclosures.
- Master lease agreements.

Leases

Early Adopters and Public Companies – What Have We Seen?

- Significant judgments made in applying the guidance such as in determining the discount rate, whether the contract contains a lease
- Transition Approach – Effective date method much more popular than comparative method
- Utilization of lease software
- Expanded footnote disclosures

Leases

What Should Companies Be Doing Now?

- Review and evaluate now.
- Take inventory & gather documentation for all leases – centralized location.
- Assign "champion" or lead personnel for the project.
- Maintain written policies on the thresholds to be used & any "reasonable" approaches to be used.
- Determine accounting treatment for each lease.
- Start reviewing impact to covenants and KPI's.
- Talk to bankers, sureties, stockholders, lenders.
- Review lease software options – Find what is right for you / your client.
  - There are over 30 different lease software solutions in the market today – various price points, industry focuses, implementation difficulties, features & benefits.
- Apply the policies consistently for all leases.

3. ERISA/PENSION UPDATE

2022 Pension Update

- 2023 Pension Limits
- SECURE Act, CARES Act, Cycle 3 Amendments

2023 Pension Limits

	2023	2022	2021
401k Elective Deferrals (Section 402g)	$ 22,500	$ 20,500	$ 19,500
Catch-Up Contribution Limit (Section 414v)	$ 7,500	$ 6,500	$ 6,500
Annual Defined Contribution Limit (Section 415)	$ 66,000	$ 61,000	$ 58,000
Annual Compensation Limit (Sections 401, 404, 408)	$ 330,000	$ 305,000	$ 290,000
FICA Wage Limit	$ 160,200	$ 147,000	$ 142,800
SIMPLE Employee Deferrals	$ 15,500	$ 14,000	$ 13,500
SIMPLE Catch-Up Deferrals	$ 3,500	$ 3,000	$ 3,000

Required Plan Amendments

CARES Act and SECURE Act Provisions

- Formal amendments required by **December 31, 2025** (extended from December 31, 2022).

Cycle 3 Restatements

- Pre-approved plans were required to be restated to incorporate certain laws and regulations by **July 31, 2022**.
- Missed the deadline? Plan converts to a self-designed plan. Plan sponsor can no longer rely on the IRS determination letter for qualification status.
- Legal counsel may be required to obtain IRS compliance as a self-designed plan.
- Once in compliance as self-designed plan, can re-adopt a pre-approved plan document.

4. AUDITS, REVIEWS, COMPILATIONS & PREPARATION OF FINANCIAL STATEMENTS

Introduction

- On the surface, CPA financial statements may look similar.
- However, the underlying statements can be impacted by a number of factors that can more or less be evident in those statements, including:
  - Basis of accounting – GAAP or something different
  - Type of service – Audit, Review, Compilation or Preparation
  - Type of opinion:
    - Unqualified
    - Qualified due to GAAP departures, scope limitations
    - Disclaimer or adverse
  - CPA firm performing work

Basis of Accounting

- Audit, review and compilation services can be done on any basis of accounting.
- Traditional basis of accounting including:
  - Generally Accepted Accounting Principles or "GAAP"
  - Tax basis
  - Cash basis
- New options including FASB Private Company Council (PCC)
- Departures from GAAP or other basis of accounting

What is GAAP?

- The common set of accounting principles, standards and procedures that companies use to prepare their financial statements
- GAAP is the highest level of principles set by the Financial Accounting Standards Board (FASB) and the commonly accepted ways of recording and reporting accounting information:
  - Accrual method of accounting
  - GAAP rules tend to delay recognition of gains and revenue when compared to other methods
  - Significant and complex disclosure requirements
  - Increased use of fair value accounting and disclosure

GAAP Departures

- When financial statements are materially affected by a departure from GAAP, the auditor should express a qualified or adverse opinion:
  - Inadequate disclosure
  - Inappropriate accounting principles
  - Unreasonable accounting estimates
- In determining the type of opinion, the CPA must consider the pervasiveness of the misstatement and the effect on the financial statements as a whole:
  - If GAAP departures are material, a Qualified Opinion is required
  - If GAAP departures are material and pervasive, require an Adverse Opinion
- Had GAAP been properly applied, the financial position and operating results of the company would almost always be worse – Otherwise why would they have taken the departure!!!

GAAP Departures

- GAAP departures frequently seen in private company financial statements:
  - **Not adopting the new lease standard!!!**
  - Not consolidating Variable Interest Entities
  - Not properly recording liabilities for defined benefit pension plans, other post retirement plans, or deferred compensation liabilities
  - Not accounting for interest rate swap liabilities
  - Not recording inventory at lower of cost or market
- If the effects of the GAAP departure are known, disclosure of these effects is required or the opinion must indicate that the affect is not known.
- Users should consider the actual or estimated amounts under GAAP when analyzing a company's financials.

Tax Basis

- The income tax basis of accounting involves preparing financial statements based on the methods and principles that are used by a company to file its income tax return.
- Entities that typically use the income tax basis of accounting include:
  - Small businesses for which conversion to GAAP is costly
  - Partnerships for which income tax-basis financial statements provide the most useful information to the financial statement users
- Evaluating the profitability and financial health of a company using tax basis financial statements can be problematic due to the many things reflected differently from GAAP

Cash Basis

- The cash basis of accounting consists of recording transactions on the basis of cash receipts and disbursements.
- Using this method of accounting, certain revenues are recognized when the cash is received rather than when the revenues are earned, and certain expenses are recognized when they are paid rather then when the obligations are incurred.
- Entities typically use the cash basis of accounting when conversion to GAAP is costly and income tax returns are filed on a cash basis.
- Since many assets and liabilities are omitted and revenues and expenses are only recorded when settled in cash, the cash basis is also not appropriate for analyzing a company's financial health.

Cash vs. Tax Basis

	Advantages	Disadvantages
Cash Basis	• Can be simpler to prepare than tax basis • Not affected by changes in tax laws • Interim financial statements are easy to prepare	• Recognition and measurement principles are not well-defined • Not well-suited for entities that have inventory or complex operations
Tax Basis	• Well-suited for entities with inventory or complex operations • Well-defined recognition and measurement criteria	• Decisions made for tax reporting purposes may have unintended financial reporting effects • Time-consuming to prepare interim financial statements

Comparing Types of CPA Service

- Users of financial statements associate Certified Public Accountants (CPAs) with **audit** reports on a company's financial statements.
- However, CPAs have also historically provided two other levels of service for unaudited financial statements – **reviews** and **compilations**.
- There is now an even lower fourth standard for **preparation** of financial statements by a CPA.
- The purpose of these engagements is to add credibility to and enhance the reliability of the company's financial statements.
- Who chooses what type of service is required?
  - Sometimes regulatory bodies
  - Possibly non-management owners
  - **Usually banks that provide loans**

Audits, Reviews & Compilations Comparison

	Compilation	Review	Audit
Assurance that the financial statements are not materially misstated.	Accountant does not obtain or provide any assurance.	Accountant obtains limited assurance.	The auditor obtains a high, but not absolute, level of assurance.
Objective.	To assist management in presenting financial information in the form of financial statements.	To obtain limited assurance that there are no material modifications that should be made to the financial statements.	To obtain a high level of assurance about whether the financial statements as a whole are free from material misstatement.
Assurance provided to user of the financial statements.	Report states no assurance is provided.	None – The accountant is not aware of any material modifications.	None – the auditor provides an opinion as to whether the financial statements present fairly, in all material respects, the company's financial position, results of operations and cash flows.

Audits, Reviews & Compilations Comparison

	Compilation	Review	Audit
Understanding of internal controls and assess fraud risk.	No	No	Yes
Perform inquiry and analytical procedures.	No	Yes	Yes
Situations requiring different levels of service.	Generally provided for privately held companies and are prepared in simple situations.	Often provided for privately held companies because of requirements outside of third parties.	Often prepared for companies because outside third parties require an auditor's opinion.
Difference in costs.	Lowest amount of work – far less cost.	More costly than a compilation but substantially lower in cost than an audit.	Involves the most work and therefore cost is substantially higher than a review or compilation.

Audit Engagements

- The audit engagement provides the highest level of assurance on a company's financial statements.
- Thus, the audited statements take the most time to complete and are therefore the most costly.
- Audited financial statements provide the user with the auditor's opinion that the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.
- There are many important audit procedures that are not required for compilations or reviews including:
  - Consideration and evaluation of the internal control system of the company, which may include testing the effectiveness of the system;
  - Tests of the underlying documentation to support account balances;
  - Observation of the physical inventory counts (if any); and
  - Outside confirmation of account receivable balances

Audit Engagements

- In addition, the auditor is specifically required to obtain reasonable assurance that the financial statements are not materially misstated due to **fraud**.
- In a compilation or review engagement, the accountant is not required to document any assessment of fraud risk, nor are they required to consider fraud or search for fraud in the course of the engagement!
- Rather, in a compilation or review, the CPA must only inform management of any material errors, fraud or illegal acts that come to his or her attention during the course of the engagement.

Audit Engagements

- An audit engagement also includes certain required communications to those charged with governance, including:
  - Planned scope and timing for the audit
  - Significant findings
  - Difficulties during the audit
  - Uncorrected misstatements
- In addition, required communications include the traditional "management letter" or "internal control letter" that presents material weakness and significant control deficiencies.
- Financial statement users should request copies of these communications!!!

Sample Audit Opinion

Independent Auditor's Report

March XX, 2023

To the Board of Directors and Stockholders of
XYZ Corporation

Opinion

We have audited the financial statements of XYZ Corporation, which comprise the balance sheets as of December 31, 2022 and 2021, and the related statements of income, changes in retained earnings, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Corporation as of December 31, 2022 and 2021, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described **in the Auditor's Responsibilities for the Audit of the Financial Statements** section of our report. We are required to be independent of XYZ Corporation and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Corporation's ability to continue as a going concern for one year after the date that the financial statements are issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of XYZ Corporation's internal control. Accordingly, no such opinion is expressed.4
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Corporation's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.

Types of Audit Opinions

- An audit opinion can be either an **Unqualified Opinion** or one of three types of **Modified Opinions** as follows:
  - Qualified Opinion
  - Adverse Opinion
  - Disclaimer Opinion
- A modified opinion indicates that there is some area of concern that must be evaluated when considering the amounts presented in the financial statements.
- Similar logic applies to non-standard review and compilation opinions, which also may provide evidence of increased risk.
- An emphasis of paragraph may also be added to opinions to address situations such as going concern disclosures.

Types of Financial Statement Opinions

- Unqualified audit opinion:
  - The results of an audit can be an unqualified opinion meaning the CPA says yes, in my opinion, the statements do present fairly…
  - Unqualified doesn't mean the CPA is not qualified, although sometimes that could be true!

Opinion

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Corporation as of December 31, 2022 and 2021, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Types of Modified Audit Opinions

- The type of modified opinion is determined based on the nature of the matter and the possible effects on the financial statements.

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

Modified Audit Opinions

- An Adverse Opinion concludes the financial statements **do not present fairly** the results of operations and financial position:
  - In practice, you will rarely see this type of opinion.
  - Instead, the company is more likely to change the presentation in their financial statements or change CPA's!
- Disclaimer of Opinion indicates that the auditor basically provides no opinion, since information was not provided to support an opinion.
- Qualified opinions may be the result of the inability to obtain sufficient audit evidence in a specific area.
- Qualified opinions are most often seen for GAAP departures.

Review Engagements

- The **review** is in between a compilation and an audit; in time, fees and assurances.
- Reviewed financial statements provide the user with comfort that, based on the accountant's review, the accountant is not aware of any material modifications that should be made to the financial statements for the statements to be in conformity with the applicable financial reporting framework.
- A review engagement requires all of the procedures necessary for a compilation engagement, plus other procedures that enable the accountant to provide limited assurance on the financial statements.

Review Engagements

- These additional requirements include inquiries of client management and analytical procedures.
- Analytical procedures include:
  – Comparison of current-period financial statements with statements of prior periods or with current-period budgets or forecasts;
  – Study of the financial statements to identify items or relationships between items that do not conform to expectations based on earlier reports or other information; and
  – Review and consideration of adjustments made to the financial statements of prior periods

Review Engagements

- The purpose of analytical procedures is to identify account balances or relationships that appear unusual so that additional inquiries can be made to determine the cause of the unexpected patterns.
- Based on these inquiries, any necessary adjustments to the financial statements may be made.
- The standard accountant's report that accompanies the reviewed financial statements states that:
  - The review engagement is substantially less in scope than an audit engagement, and
  - No opinion can be expressed on the financial statements taken as a whole.
- It also concludes that the CPA is not aware of any material modifications to the financial statements.

Updated Standard - Review Engagements SSAE No.22

- Effective for Review reports dated on or after June 15, 2022
- Provides a description of the procedures a practitioner may perform in a review engagement
- Inquiry procedures are required
- Other procedures might be needed to obtain review evidence, including analytical procedures, inspection, observation, confirmation, recalculation and reperformance.
- Requires that the report include an informative summary of the work preformed as a basis for conclusion.
  - The description may be as brief as "the procedures we performed were based on or professional judgment and consisted primarily of analytical procedures and inquiries" .
  - However, additional details can also be added.
- Requires the practitioner to express an adverse conclusion when there is a conclusion that misstatements, individually or in the aggregate, are both material and pervasive to the subject matter

Review Engagements – Sample Report

Independent Accountant's Review Report

March 12, 2023

To the Stockholders of
XYZ Corporation

We have reviewed the accompanying financial statements of XYZ Corporation (the "Company"), which comprise the balance sheets as of December 31, 2022 and 2021, and the related statements of income and stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Review Engagements – Sample Report

Accountant's Responsibility

Our responsibility is to conduct the review engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. We believe that the results of our procedures provide a reasonable basis for our conclusion.

We are required to be independent of the Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our reviews.

Accountant's Conclusion

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Compilation Engagements

- The compilation has historically been the most basic level of service that a CPA can provide with respect to financial statements.
- A compilation engagement requires less time than a review or audit engagement because fewer procedures are required.
- The **compilation** is putting into the form of financial statements the information provided by the client - without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.
- The compilation standards require the CPA to possess an adequate level of knowledge about the accounting principles and practices of the client's industry and have a general understanding about the nature of the client's business.

Compilation Engagements

- The accountant is required to read the compiled financial statements and consider whether they are in appropriate form and free from obvious material errors.
- Compilation standards do **not** require the accountant to perform any procedures to verify or corroborate the financial statement information provided by the client.
- Glaring irregularities might be noticed, but the CPA is not checking facts or tracing transactions through the system.
- If the accountant has reason to believe the information supplied by the client is inaccurate, incomplete or otherwise unsatisfactory, the accountant is required to obtain revised or corrected information before reporting on the financial statements.
- Because of the limited scope of compilation procedures, the standard compilation report disclaims any degree of assurance on the financial statements.

Compilation Engagements – Sample Report

Independent Accountant's Compilation Report

March 12, 2023

To the Stockholders of
XYZ Corporation

Management is responsible for the accompanying financial statements of XYZ Corporation (the "Company"), which comprise the balance sheets as of December 31, 2022 and 2021, and the related statements of income and retained earnings, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. We have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements, nor were we required to perform any procedures to verify the accuracy or the completeness of the information provided by management. We do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Preparation of Financial Statements

- The financial statement preparation is the lowest level of service that a CPA can provide on historic or prospective financial statements.
- This level of service can also be applied to other historical financial information.
- An engagement to prepare financial statements is a non-attest service and does not require documentation about whether the accountant is independent to the entity.
- However, the accountant needs to be aware that independence for future attest services could be impaired unless appropriate safeguards are put in place.

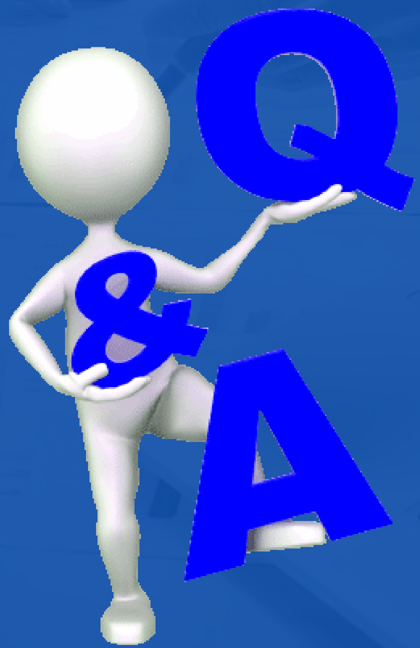
Preparation of Financial Statements

- An understanding should be obtained of the financial reporting framework and the significant accounting policies intended to be used in the preparation of the financial statements.
- The accountant should prepare the financial statements using the records, documents, explanations, and other information provided by management.
- No specific testing is required. However, if the accountant has reason to believe the information supplied by the client is inaccurate, incomplete or otherwise unsatisfactory, the accountant is required to obtain revised or corrected information before reporting on the financial statements.
- If management fails to provide such additional or corrected information, the accountant should disclose a material misstatement or misstatements in the financial statements or withdraw from the engagement.

Preparation of Financial Statements

- There is no accountant’s opinion on prepared financial statements.
- Instead, prepared financial statements should include on each page a statement such as the following:
  - No assurance is provided on these financial statements.
  - These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them.
- The statement is made at management's discretion, and the accountant or the accountant’s firm name is not required to be included.
- A disclaimer by the accountant may also be issued generally at the end of the prepared financial statements that would include the name of the CPA, accountant’s city and state, the date, and a signature.

Questions



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Circular 230

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