August 28, 2024

To our peer review clients:

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

**New Standards for Quality Control**

The new Quality Management (QM) Standards, which will replace the current quality control standards (SQCS No. 8), require a significant revision to the quality control systems for any CPA firm performing audits, reviews, compilations, or other attest engagements. The QM Standards will require you to consider how you manage risk in your practice and based on those considerations you will need to prepare properly tailored policies and procedures. The QM standards will take effect December 15, 2025. Although you have until December 15, 2025, to implement the standard, we recommend you implement the QM Standards at the start of your peer review fiscal year. Otherwise, you will have a split year, with your firm under the existing quality control standards for the first part of its peer review year.

The AICPA issued a practice aid to help you design your System of Quality Management (SOQM). Two versions of the practice aid are provided, one for sole proprietors, and another for small to medium sized partnerships. The AICPA practice aid is here:

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

The new standards require that when establishing your policies and procedures you take these steps:

- Establish quality objectives
- Identify quality risks, given the conditions in your firm
- Assess quality risks
- Design responses that address the quality risks

The QM standards require your SOQM have eight components. Most of these components carry over from the old quality control standards, but the first one is new and requires special attention. This is the risk assessment process.

The QM standards require the firm to apply a risk-based approach in designing, implementing, and operating the components of its SOQM. Included in its practice aid, the AICPA has an Excel template for assessing risk and formulating responses that includes sample firm policies you might implement. However, if you are looking for a ready-made quality management document, the AICPA has not provided one so far. This actually makes sense because of the eight components required for your SOQM under the QM standards, the first one is risk assessment. If you simply adopt a ready-made quality QM document, you may not have performed the risk assessment required under the standard.

The AICPA Excel template, when completed, cannot be deemed your Quality Management Document (or "Quality Control Document" using the old terminology). Once completed, the AICPA Excel template on its own provides only partial documentation of your SOQM. The AICPA practice aid addresses six of the eight elements required under the new QM Standards. The two missing components are 1) the policies and procedures for risk assessment and 2) those for monitoring and remediation.

One source for sample Quality Management documents is PPC's Guide to Quality Control (2/24 edition), but the PPC authors say their sample QM documents should only serve as a "starting point" for drafting a firm's own policies and procedures. The PPC authors have included a "response number reference" after each sample policy or procedure to cross-reference to a risk assessment template, which presumedly was previously completed. PPC's risk assessment template is on an Excel spreadsheet and bears a strong resemblance to the template provided in the AICPA practice aid, including omission of the policies and procedures for risk assessment and for monitoring and remediation.

Although the PPC sample QM documents include policies and procedures for risk assessment, the policies and procedures for the monitoring and remediation component are not included. The PPC authors say: "Firms will not perform the related monitoring activities until the first year their new SQM is operational (which will be 2026 unless a firm implements the QM standards early). Accordingly this form will be updated for the monitoring and remediation component in next year's edition of the Guide." If you are using one of PPC's sample QM documents, you will have to revise your QM document again in the following year once the PPC authors have addressed the monitoring element.

**Credit Loss Standard**

ASC 326 is possibly the most important change in standards this year. This new standard is effective for years ending after December 15, 2023. You may hear it referred to as "CECL," which is an acronym standing for the Current Expected Credit Loss methodology. The peer review checklists will focus peer reviewers on this change in accounting for what we in the profession have historically called the "allowance for bad debts." If your clients have accounts receivable trade this applies to you. Here are some areas where you will want to exercise care:

- The terminology changes. Instead of "allowance for bad debts" use "allowance for credit losses." Instead of "bad debt expense" use "credit loss expense."

- Under legacy GAAP, a bad debt was not recognized until it was probable based on historical experience and current conditions. ASC 326 requires you to also consider "reasonable and supportable" forecasts. For example, if the economy is going into a recession, you should factor in higher future write-offs than the historical norm when computing the allowance for credit losses.

- Although ASC 326 suggests new methodologies for computing the portion of the allowance for credit losses that is based on historical experience, you can continue to use traditional approaches, and develop an allowance based on the trend of write-offs incurred over the past several years and taking into consideration the days outstanding for the account (e.g., 31-60, 61-90 and over 90) at year end. You may have a different loss rate for the outstanding balance within each aging category. You may evaluate individually specific older accounts receivable.

- We recommend you disclose that you have implemented the new standard. This tells the peer reviewer you are aware of ASC 326. The impact on the financial statements of implementing the standard may be immaterial but you are better off disclosing you have taken it into consideration. If the impact is immaterial, your footnote disclosure might say:

    > Effective January 1, 2023, the Company adopted ASU 2016-13 (Topic 326) on credit losses, which modifies the measurement of expected credit losses on accounts receivable trade and certain other financial instruments. The Company adopted this new guidance using the modified retrospective transition method. The most significant change under Topic 326 compared to existing standards for computing credit losses is a shift from the incurred loss model to the expected loss model. The adoption of this ASU was not material to the financial statements and primarily resulted in enhanced disclosures.

- In the year of implementation, use the new methodology for computing credit losses on both the opening and closing balances. You may have a prior period adjustment to post for opening balance.

- Disclosure would typically include the type of industries in which your client operates (e.g., retail and wholesale) and the type of customer generating the accounts receivable (e.g., wholesale customers); that the company recognizes an expected allowance for credit losses; any changes in credit risk since the account receivable was initially recorded; that the estimate for the allowance is calculated on a pooled basis where similar risk characteristics exist; and that the company writes off receivables when there is no possibility of recovery apparent and that if recoveries are made from accounts previously written off, the recoveries will be recognized in income in the year of recovery. The dollar amount of the write-offs during the year should be disclosed and the amount recorded in the allowance at year end should be disclosed.

- If the allowance for credit losses is material at year end, you should disclose the methodology used to compute the historical component of the allowance (e.g., loss-rate method or aging schedule method). If a forward-looking adjustment to the allowance was made, disclose the reasons (e.g., high unemployment rates, or changes in borrowing rates) and the impact on the allowance (e.g., "increased by 2% across all aging categories"). You should include a table showing the opening balance, the additions to the allowance, the write-offs during the year, and the closing balance.

- Take a look at your client's history with collectability of its accounts receivable trade. If your client does not have write-offs or if the write-offs are only for trivial amounts, ASC 326 may not apply to that client. As with any professional standard, ASC 326 only applies if the amounts involved are material to the financial statements.

- Note ASC 326 does not apply to receivables from commonly controlled companies or to pledges receivable in a nonprofit organization.

**Risk and Uncertainties Disclosure**

If you have clients that own commercial property, you may want to include a footnote on the currently negative prospects for refinancing mortgage debt on commercial buildings, similar to the Covid 19 footnote used in prior years, such as:

> The current commercial lending environment is challenging and banks are tightening credit standards. An increase in interest rates for commercial loans could adversely impact the Company's ability to refinance existing debt on attractive terms, or at all. Management is carefully monitoring the situation. No adjustments have been made to these financial statements as a result of this uncertainty.

In addition, you may need to consider whether the value of the commercial building has been impaired such that a write down to the lower fair value is required.

**CAT Tax and SALT Cap**

Oregon has had the CAT tax in place for several years, which we believe is a form of gross receipts tax even though the CAT tax allows a 35 percent subtraction for certain business expenses. In addition, beginning in 2022, Oregon allows partners or shareholders in pass-through entities to claim a refundable credit for the state taxes paid by the partnership or S-Corporation on their behalf under the PTE-E program. In the financial statements, we recommend reporting the CAT tax much as you would the Washington B&O tax, as an operating expense rather than a provision for income taxes. Regarding the PTE-E, even though it is computed on net income at the company level, we recommend you treat these payments as owner draws rather than as an income tax provision because the tax is incurred by the owners personally. Here is an example footnote for the PTE-E for a limited liability company:

> The Company elected to pay the Oregon Pass-Through Entity Elective (PTE-E) Tax, which was effective in 2022, on behalf of its members. This tax is assessed at 9% on the first $250,000 of distributive proceeds and 9.9% on any amount exceeding $250,000. It is applied to reduce each member's proportionate share of federal taxable income reportable on that member's personal income tax return. Accordingly, each member recognizes a federal income tax benefit as if the member's Oregon income tax were fully deductible on the member's personal federal income tax return. Since the income tax benefits associated with the PTE-E tax exclusively benefit the members, each member's proportionate share of the tax is recognized as a distribution to that member.

**Revision to Income Tax Disclosures**

ASC 740 on income taxes is revised, effective for annual periods beginning after December 15, 2025, to include the following new disclosures:

- The amount of income taxes paid disaggregated by federal and state, and further disaggregated to disclose the amount paid to each individual taxing jurisdiction for which payments are equal to or greater than 5% of total income taxes paid.
- Qualitative (not quantitative) disclosure about specific categories of reconciling items, those categories including, among others, the effect of changes in tax laws, and changes in valuation allowances. Also, qualitative disclosure is required for individual taxing jurisdictions where there is a significant difference between the statutory tax rate and the effective tax rate.

**Lease Standard Update**

Our letter last year included an in-depth discussion of ASC 842, the lease standard that went into effect with the 2022 calendar year. We find in peer review that many firms struggle to fully implement the standard.

One area where firms have difficulty concerns operating leases where the client is the lessor rather than the more common scenario where the client is the lessee. Although there is no impact under ASC 842 on the lessor's balance sheet, there are required footnote disclosures, including information about the nature and terms of the lease and options to extend or terminate the lease, including the judgments made in applying ASC 842, and including disclosure of undiscounted cash flows to be received annually for each of the next five years and a total of the amounts for the remaining years. Usually the lessor will elect the practical expedient on not separating out non-lease components, which requires footnote disclosure. Here is a sample footnote if the practical expedient is elected:

> The Company's lease contracts include services for maintenance to common areas on behalf of the lessees. The Company has elected to apply the practical expedient for combining the nonlease components of the contract with the lease components. The Company has determined that the apartment lease is the predominant component and accordingly recognizes revenue for the combined apartment lease and maintenance services under ASC 842. As a result, the Company presented apartment lease revenue and maintenance service revenue opposite the same caption on the statement of income for the year ended December 31, 2023.

Another area where firms have difficulty with the footnote disclosure for operating leases under ASC 842 is for short-term leases. You do not have to capitalize short-term leases, and that includes month-to-month leases if properly structured, but you have to disclose this election. Here is a sample footnote:

> Company policy is to not recognize right-of-use assets and lease liabilities arising from short-term leases for any class of underlying asset. Operating leases with an initial term of 12 months or less and the lack of a purchase option that the Company is reasonably certain to exercise are considered short-term leases. Amounts paid toward short-term leases are included in rent expense as payments are made.

When computing the right-of-use asset and the lease liability under ASC 842, you will frequently be using the "risk free rate of return," which is the rate on US bonds for a term that corresponds to the lease term. You can find these rates on the treasury yield curve tables at treasury.gov. Here is a link:

https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics

**PPC Practice Aid**

If you use PPC to audit you may be familiar with the table listing the "required" practice aids (at CX-0.1). These are the practice aids the PPC authors believe you should use to comply with the auditing standards unless you have developed your own alternative. The PPC authors have generated new required practice aids in response to two new auditing standards: SAS 143 and 145. These standards are effective for years ending on or after December 15, 2023. Here are the new PPC forms you need to complete:

- The PPC required practice aid for documenting assessment of risk of material misstatement for material estimates is CX-3.6 (first introduced in the 2021 edition of PPC).

- The new PPC required practice aid for documenting tests of management estimates is found at CX-11.3 for audits of governments and at CX-11.4 for nonprofit industry audits.

- The new PPC required practice aid used in performing the evaluation of controls addressing a significant audit risk is at CX-4.2.3.

**Oregon Municipal Auditors**

In the past smaller local governments in Oregon qualified for a review of their financial statements rather than an audit. Starting this year, local governmental units with between $250,000 and $1,000,000 of annual expenditures will need to engage a licensed Oregon Municipal Auditor to perform certain agreed-upon procedures on their records as described in the Oregon Administrative Rules. In addition, these local governments will typically engage the Oregon Municipal Auditor to compile their annual financial statements.

Over the years, conducting peer review, we continue to see firms struggle to comply with professional standards when performing agreed-upon procedures engagements. Firms typically have a limited understanding of what the attestation standards require of them for this kind of engagement. This is because there are not good practice aids available for agreed-upon services and the continuing education options on the topic are minimal. (There is a chapter in the PPC Guide to Nontraditional Engagements that is helpful.)

To be clear, an agreed-upon procedure engagement requires:

- An engagement letter in accordance with the samples in the attestation standards (not a SSARS engagement letter).
- A representation letter including the representations that are required in the attestation standards.
- A correctly worded accountant's report in accordance with the latest attestation standards, which have changed frequently in recent years.
- A work program.

If you have access to the AICPA standards, we recommend you review AT-C Section 215 on "Agreed-Upon Procedures Engagements."

The OSCPA Governmental Accounting and Auditing Strategic Committee is providing resources to help you conduct these agreed-upon procedures engagements, which you will find at:

https://www.orcpa.org/gov-resources

**Auditing Standards**

SAS 145 is effective for your audits of years ended December 31, 2023. If you remember nothing else about SAS 145, remember this: "The Relevant Assertion (RA) is king."

Before, when planning an audit, we would identify material audit areas (such as cash, debt, revenues, etc.) first, then determine which assertions within those audit areas were relevant. No longer. Under SAS 145, we first determine which assertions represent a reasonable possibility of a misstatement occurring and, if the misstatement were to occur, whether there is a reasonable possibility of the misstatement being material. Those are Relevant Assertions (RA). An RA

represents "an identified risk of material misstatement." Other assertions are not relevant (NR) and have no impact on your audit program. In order for an audit area (such as receivables, property, expense, etc.) to be deemed significant, there have to be RAs connected to that area. Therefore, you can have material audit areas that are not deemed significant.

We had the opportunity to hear Tom Groskopf speak at the 2024 National Peer Review Conference. Tom Groskopf is the Technical Director for the AICPA's Center for Plain English Accounting. He believes that SAS 145 represents an opportunity for the profession to audit smarter. He says that our approach to auditing as a profession has been to "beat up the balance sheet," which is a safe approach if you do not feel comfortable exercising professional judgment when planning your audit, but which results in less effective auditing. As auditors, we lose sight of what is important and spend too much time on immaterial accounts and insignificant audit areas.

Most firms are using PPC for their audit practice aid, and the PPC approach is to "beat up the balance sheet." When you attempt to apply Tom Groskopf's approach for SAS 145 to PPC, the practice aid is fighting you at every step.

Remember: "The Relevant Assertion (RA) is king." However, the PPC authors state in their *Guide to Audits of Nonprofit Organizations*, at paragraph 405.7, that even "a low level of inherent risk is a risk level that indicates a reasonable possibility of being material as described in AU-C 315." In other words, the PPC authors believe even a low inherent risk level for an assertion can result in an RA. This does not seem to be consistent with the spirit of SAS 145. To be fair to the PPC authors, the sample in the AICPA *Guide to Assessing and Responding to Audit Risk in a Financial Statement Audit* has an example, in Appendix K-5, that suggests a low inherent risk level for an assertion can result in an RA.

SAS 145 introduces the concept of a spectrum of risk. Under the approach used at PPC, even at the lowest point on this spectrum, you will have a RA that results in a significant audit area. Now that we have the concept of a spectrum of risk, the PPC approach with only three categories for risk (Low, Moderate, High) seems limiting. Using a scale of from 1 to 10 seems to be more meaningful. On a spectrum of risk from 1 to 10, you might say that the Low would be a 1,2 or 3; the Moderate would be a 4,5 or 6; and the High would be a 7,8,9 or 10. SAS 145 introduces the concept of very high inherent risk (which is the kind that results in a significant audit risk). This very high risk might be a 9 or 10 on the spectrum.

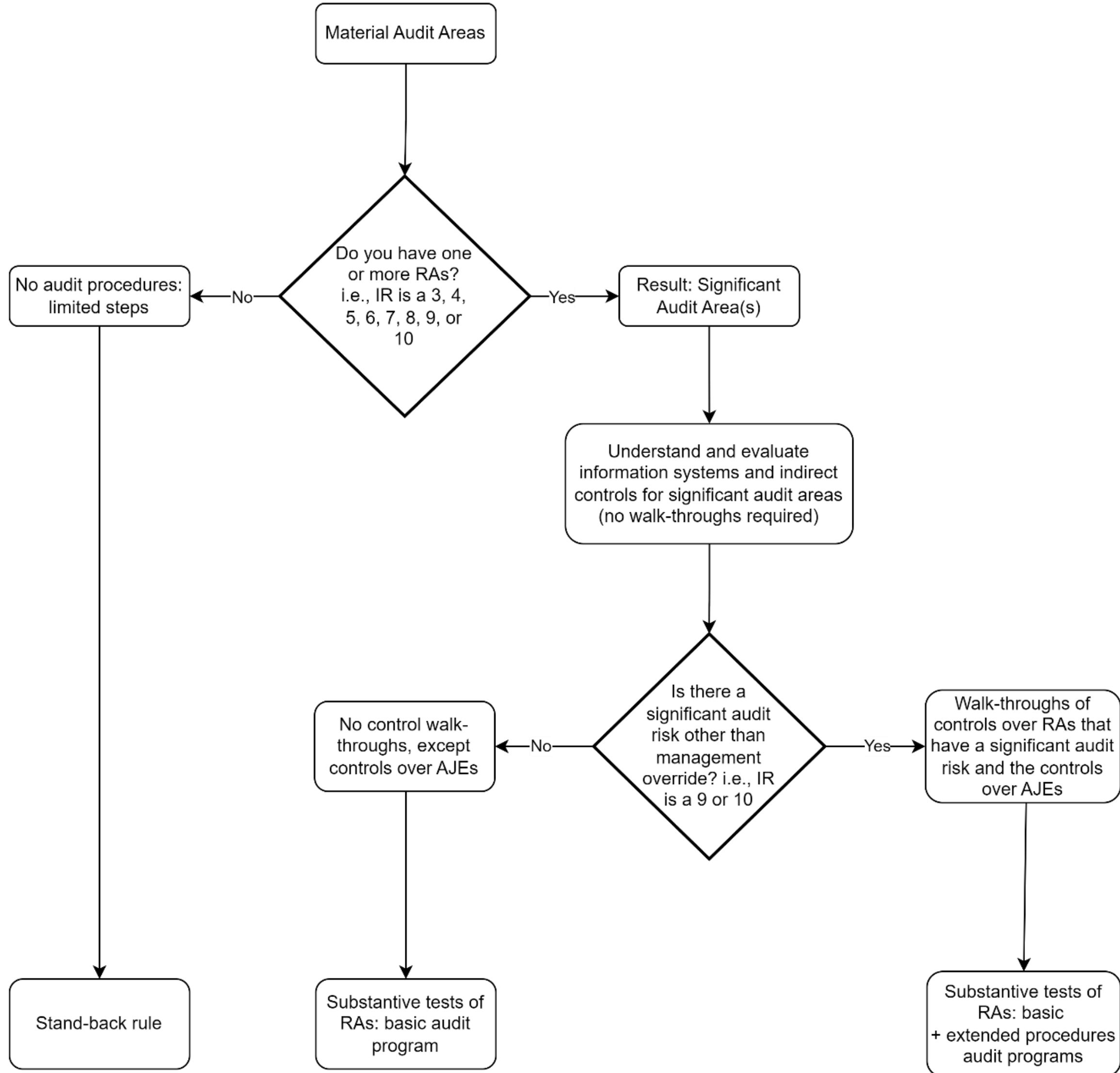
In our firm, we are considering re-evaluating the low risk (L) assertions we have entered on the PPC form CX-7.1 for our clients. The standards allow us to exercise judgment in this determination. If the available L assertions are a 1,2, or 3 we believe that the 1 and 2 levels should be converted to Not Relevant (NR). As we re-evaluate, we may decide that even some of the Moderate (M) assertions belonged in the L category and have a rating of 1 or 2, which would move them to the NR bucket.

In addition, because the PPC approach to distinguishing high risk (a 7 or 8) from very high risk (a 9 or 10) does not impact the audit program steps generated when using the PPC SMART practice aid (as discussed in more detail later), we will tend not in identify the risk for a RA as high (H) unless we have also identified it as a significant audit risk (i.e., very high risk).

A flowchart summarizing these concepts appears on the following page.

# SAS 145 Audit Planning

**Material Audit Areas**
**Control Risk at Maximum**




| Acronyms | |
|---|---|
| RAs | Relevant assertion |
| IR | Inherent risk |
| AJEs | Adjusting Journal Entries |

**Definition of walk-through for purposes of this flowchart:** "Procedures to determine whether controls have been implemented."

| Spectrum of IR | |
|---|---|
| 1-3 | Low |
| 4-6 | Moderate |
| 7-8 | High |
| 9-10 | Very High |

The “stand-back” rule referred to in the flow chart above requires you to take a break after you think you have determined all of the significant audit areas, then re-evaluate the areas that are material but that were not deemed significant. You may decide some of these audit areas are actually significant.

The new targeted approach in SAS 145 sounds good, but how does it work in practice if you are a PPC user?

What is the impact on the length of the audit program from the new standard? Let’s look at the audit program for cash, and take an aggressive approach, setting all assertions to NR except for the “existence or occurrence (E/O)” assertion. What happens?:

- If you set IR for E/O to Moderate (M), with all other assertions NR, there are two fewer steps on the basic audit program, but neither of them is time consuming to perform. You haven’t achieved much in the way of audit efficiency.
- We think that the more NR assertions you have, there will be a tendency on the part of practitioners to set remaining RAs to high. If you set IR for E/O to High (H) for the cash audit program, then PPC generates the same basic audit program as above, with the two fewer steps, but also generates an extended procedures audit program. You will have to exercise judgment in selecting at least some of these extended procedures to perform. The result is even less audit efficiency than you had before.

Some of the other issues with using PPC SMART after the implementation of SAS 145 that we identified are:

- The SMART practice aid, in determining what audit areas (such as receivables, property or expense, etc.) are significant, does not distinguish among the Low, Moderate or High settings for IR. Any entry for IR other than NR results in a conclusion that the audit area is significant.
- SMART generates the same audit program for a given significant audit area regardless of whether the risk ratings for the associated RAs are Low or Moderate. An RA with a High risk rating (whether or not a significant audit risk) does generate “extended procedures” but even in this circumstance the “basic” audit program does not change.
- The PPC audit program steps are designed to address more than one assertion. Two assertions in particular will appear opposite most of the audit steps on the various audit programs. If you identify only one RA but that assertion is either “existence or occurrence (E/O)” or “accuracy, classification, or presentation (A/CL/P)” it is likely that the audit program generated will not differ much from the program you generated in the past prior to implementing SAS 145. As before with PPC, you have the ability to delete audit program steps manually after the program is generated. After SAS 145, you could be more aggressive about deleting steps that, based on your judgment, primarily address assertions other than E/O and A/CL/P (if those are the only two RAs). Note that the PPC authors put the assertions appearing on the audit programs in the lefthand column in brackets if they are deemed less significant (e.g., “[E/O]”).
- PPC’s approach to audit programs is to have a “basic” program supplemented with “extended procedures”. Following SAS 145, as you convert more of your assertions to NR, you may have a tendency to set the remaining relevant assertions to H for inherent risk. On SMART, if you enter an assertion as H that makes the “extended procedures” program generate.

- If you have already set an RA to High, indicating a Significant Audit Risk for that assertion on SMART has no impact on the audit program generated. In other words, it doesn't matter if IR is high or very high, the same extended audit program results in either case. As noted in the flow chart above, a significant audit risk (i.e., very high IR), does require you to do a control walk-through, but if you were challenged by a regulator, how would you explain that your audit program for substantive procedures is the same when there are significant audit risks as when there aren't? It is incumbent on you to ensure that you are selecting more steps from the extended program generated by SMART when IR is very high (i.e., when there is a significant audit risk).
- Under SAS 145, you clearly cannot enter S for "significant risk" on PPC's risk table without also entering H for high inherent risk. The entry of S increases an already high risk to a very high risk. Using a risk spectrum from 1 to 10, the entry of the S on PPC's risk table rachets up the risk from a 7 or 8 to a 9 or 10.

The AICPA intends SAS 145 to result in more efficient audits with fewer, more targeted steps on the audit program. However, if you ask one of your staff to implement SAS 145 using SMART, the "basic" audit program generated will frequently not be significantly shorter than under the old standard, and because as more of your assertions are moved to the NR category, there will be a tendency to move the remaining assertions to High, it is more likely than before that an "extended program" will be generated and the staff will have to make judgments about which steps on the extended program to implement. In other words, if you are using PPC, you may end up with a less efficient audit under SAS 145 than you had under the old standard.

In conclusion, there is at least a little good news here:

- SAS 145 does not require walk-throughs to determine that controls are implemented unless there is an RA with significant audit risk (i.e., very high risk).

- More frequent use of NR is possible under SAS 145 and if every assertion within an audit area is marked NR, then the audit area, even though material, is not deemed significant and a limited approach can be taken (i.e., PPC does not generate an audit program). Although there isn't an audit program generated, you would perform preliminary and final analytical review on the account, and possibly other selected procedures. Two audit areas where setting all assertions to NR is possible in our opinion, are:

    1. Property if no material additions and cumulative repair expense immaterial
    2. For a nonprofit organization, net assets without restrictions

**Single Audits**

Effective October 2, 2023, single audit submissions to the Federal Audit Clearing House (FAC) go to the General Services Administration (GSA) rather than to the U.S. Census Bureau. This impacts single audits with earlier fiscal years not submitted to the Census Bureau before October 1, 2023. You cannot use your old Census FAC credentials to access the new GSA system. GSA is using Login.gov and you will have to set up a secure user account there.

The Office of Management and Budget (OBM) issued revisions to the Uniform Guidance on April 22, 2024, that will be effective for all federal awards issued on or after October 1, 2024. The threshold for single audits will increase from $750,000 to $1 million. There are a number of other changes, such as raising the de minimis indirect cost rate from 10% to 15% and increasing the

equipment capitalization threshold from $5,000 to $10,000. The latter change could have ripple effects on capitalization thresholds overall for governmental units.

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

Very truly yours,

The RBH Group, LLC