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Targeted Improvements to Related Party Guidance for VIEs

In October 2018 the FASB issued ASU 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, to change how—

- the variable interest entity (VIE) guidance is applied to certain private companies, and
- indirect interest held through related parties is considered when determining whether certain fees are variable interests.

Change in How Guidance is Applied

Currently, FASB ASC 810-10-15 permits private company lessees to elect to not apply the VIE guidance to a lessor entity if both the lessee and lessor are under common control and substantially all the activities between the entities are related to leasing activities. ASU 2018-17 expands the election for private companies to not apply the VIE guidance if *all* the following criteria are met:

- The reporting entity and legal entity are under common control.
- The reporting entity and legal entity aren't under common control of a public business entity.
- The legal entity under common control is, itself, not a public business entity.
- The reporting entity doesn't directly or indirectly have a controlling financial interest in the legal entity.

This accounting alternative election applies to all qualifying current and future legal entities under common control and can't be selectively applied. In addition, the ASU requires detailed disclosures by the private company reporting entity about the involvement and exposure to the legal entity under common control. Because this election has been expanded to all private company common control arrangements that meet certain criteria, the ASU supersedes the prior accounting alternative that began at FASB ASC 810-10-15-17AA.

Indirect Interests

The ASU also amends the guidance on indirect interests held through related parties in common control arrangements

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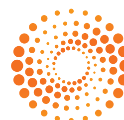

by requiring that such interests be considered on a proportional basis when determining if fees paid to decision makers and service providers are variable interests. This treatment is consistent with the existing guidance on how indirect interests held through related parties under common control are considered for determining if a VIE must be consolidated.

The amendments in the ASU also provide that indirect interests held through related parties under common control will be considered on a proportional basis when determining whether fees paid to decision makers and service providers are variable interests. Such indirect interests were previously treated the same as direct interests. The consideration of whether a decision-making fee is a variable interest is now consistent with determining whether a reporting entity within a related party group is the primary beneficiary of a VIE.

Effective Dates

For public companies, the new guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For private companies, the new guidance is effective for fiscal years after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is allowed.

The ASU requires retrospective adoption with a cumulative effect adjustment to retained earnings at the beginning of the earliest period presented.

Practical Consideration:

ASU 2018-17 will likely result in more private companies opting out of applying the VIE guidance.

FASB Delays the Credit Losses Effective Date for Private Entities

In November 2018, the FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*. The FASB has an ongoing project on its agenda to improve the FASB Codification or correct any unintended consequences. Those Codification improvements generally aren't expected to have a significant impact on current accounting practice or create significant administrative costs for most entities. ASU 2018-19 is similar to the general Codification improvements, but it is solely focused on a couple of issues related to ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, which were brought to the FASB's attention through stakeholder comments.

For nonpublic business entities, ASU 2016-13 (as issued) is effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. The ASU also includes transition guidance in FASB ASC 326-10-65-1(c) that requires an entity to make a cumulative-effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the amendments are effective. Stakeholders questioned whether it was the FASB's intent to require nonpublic business entities to effectively adopt the amendments as of January 1, 2021, because of the cumulative-effect adjustment as of that date. This would essentially require nonpublic business entities to have the same effective date as public business entities. ASU 2018-19 addresses this issue for nonpublic business entities by delaying the effective date for the amendments in ASU 2016-13 to fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The effective date for public business entities isn't changed, and is for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

The other issue involves the scope of FASB ASC 326-20, *Financial Instruments—Credit Losses—Measured at Amortized Cost*, which includes financial assets that are measured at amortized cost. While the scope includes net investments in leases arising from sales-type and direct financing leases, stakeholders noted that the scope doesn't specifically address receivables arising from operating leases. ASU 2018-19 addresses this issue, clarifying that receivables arising from operating leases aren't within the scope of FASB ASC 326-20. Rather, impairment of receivables originating from operating leases should be accounted for in accordance with FASB ASC 842-30, *Leases—Lessor*.

Practical Consideration:

The ASU is available at **www.fasb.org** and on Checkpoint at **checkpoint.riag.com**.

Common Deficiencies in Audit Representation Letters

Auditing standards require that the auditor obtain written representations from management with appropriate responsibilities for the financial statements. Written representations are necessary information that the auditor requires in connection with the audit of the financial statements. Accordingly, written representations are an important source of audit evidence.

Auditing standards require the auditor to request of management specific representations that it has fulfilled its responsibilities concerning the terms of the audit engagement for—

- Preparing and fairly presenting the financial statements.
- Designing, implementing, and maintaining internal control relevant to preparation and presentation of financial statements that are free of material misstatements due to error or fraud.
- Providing all relevant information and access.
- Recording and reflecting all transactions in the financial statements.

Other required written representations also include representations about fraud, laws and regulations, uncorrected misstatements, litigation and claims, estimates, related party transactions, subsequent events, and additional written representations about the financial statements.

Practical Consideration:

AU-C 580 discusses the audit written representation requirements.

Common Deficiencies

The following are common deficiencies regarding management representation letters:

- Failure to obtain a representation letter at all or to retain a signed representation letter in the audit file.
- Failure to include all elements required by the auditing standards.
- A representation letter is used as a substitute for the application of auditing procedures.
- A representation letter is dated and signed earlier than the audit report date.
- A representation letter refers to GAAP, but the engagement relates to financial statements prepared in accordance with a special purpose framework.
- A representation letter doesn't cover all periods covered by the financial statements.
- Titles of the financial statements in the representation letter don't coincide with the descriptions or titles as presented on the financial statements.
- Failure to include representations to support specific assertions within the financial statements or other audit evidence relevant to specific situations within the financial statements.
- Failure to document the inspection of board of director minutes.
- Failure to include and evaluate "passed" adjustments or omitted/incomplete/inaccurate disclosures in the representation letter.
- Failure to include supplementary information in the representation letter even though it is a part of the financial statements.
- A representation letter isn't signed by an appropriate member of management. For instance, a representation letter isn't signed by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) or other equivalent persons in entities that don't use such titles.

PEEC Approves Issuance of *Leases* Interpretation

During the November 2018 meeting of the AICPA's Professional Ethics Executive Committee (PEEC), the committee unanimously agreed to issue its proposed revised *Leases* interpretation (ET 1.260.040). The initially proposed revisions to the interpretation were exposed in October 2017. Changes to the independence interpretation were deemed necessary following issuance of the FASB's updated standard on leases (ASU 2016-02). Comment letters received on the ethics exposure draft resulted in additional revisions to the proposal. Those revisions were discussed at the May and August 2018 PEEC meetings, and a further revised draft of the proposal was presented and approved for issuance at the November 2018 PEEC meeting.

The following items represent some of the significant points of the approved *Leases* interpretation:

- Entering into a lease with an attest client may create self-interest, familiarity, and undue influence threats

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to complying with the *Independence Rule*. Accordingly, a threats and safeguards approach to considering independence impairment replaces the extant consideration of whether a lease is an operating lease or a capital lease.

- The ethics guidance applies to all leases between covered members and attest clients *except for* automobile leases with lending institution clients (as they are addressed in the *Loans and Leases with Lending Institutions* interpretation).
- Maintaining independence when entering into a lease with an attest client is also determined based on whether the lease is (1) a new or renegotiated lease, or (2) an existing lease. Existing leases include leases that were in place prior to an event that triggers the requirement for independence.
- If, during the period of the professional engagement, lease amounts aren't paid in accordance with the terms of the lease, independence would be impaired and couldn't be reduced to an acceptable level.
- Additionally, depending on the type of lease (new or renegotiated or existing), certain other minimum safeguards detailed in the revised interpretation must exist or independence would be impaired and couldn't be reduced to an acceptable level.
- The *Client Affiliates* interpretation (ET 1.224.010) has also been revised by specifying that a subset of covered members addressed by the *Leases* interpretation may have leases with certain sister and parent affiliates that don't comply with the *Leases* interpretation. In that situation, the member should follow a threats and safeguards approach to evaluate whether any threats created by the lease are at an acceptable level.

Effective Date

The final approved revisions made to the *Leases* interpretation delayed the initially proposed effective date to allow firms additional time to implement appropriate identification, evaluation, and monitoring procedures. The interpretation is now effective for fiscal years beginning after December 15, 2019, with early implementation allowed. The revision to the *Client Affiliates* interpretation is effective on the last day of the month it is published in the *Journal of Accountancy*.

Practical Consideration:

The official release of the Leases interpretation is available on the AICPA's website at **www.aicpa.org/interestareas/professionalethics/community/exposuredrafts.html.**