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Obtaining an Understanding of Internal Control

During every audit performed in accordance with AICPA auditing standards, you are required to perform risk assessment procedures, which include—

- Obtaining an understanding of the entity, including its internal control.
- Identifying and assessing the risks of material misstatement of the financial statements, whether due to fraud or error. This includes an evaluation of both inherent risk and control risk at the relevant assertion level.
- Evaluating risks at the financial statement level and identifying risks that affect only specific assertions.

Obtaining an understanding of internal control is an important part of performing risk assessment procedures.

Deficiencies Noted in Obtaining an Understanding of Internal Control

During the AICPA Peer Review Board's most recent review cycle, approximately 10% of firms were not properly assessing risk or linking their assessments to further audit procedures planned and performed. A staggering 40% of identified issues related to failure to gain an understanding of internal control when identifying an entity's risks. Without understanding the nature of the entity's controls, you can't identify related risks or design appropriate audit procedures to respond to the risks. In 13% of identified issues, there was an assessment of control risk as less than high without applying tests of controls. You can only reduce control risk below maximum when you have tested controls and are relying on their operating effectiveness.

Practical Consideration:

This study and several other risk-assessment-related resources are available at **www.aicpa.org/eaq/aicpa-risk-assessment-resources.html**.

Requirements for Obtaining an Understanding

Obtaining an understanding of internal control relevant to the audit that is sufficient to assess the risks of material misstatement necessitates that you develop a thorough and robust knowledge of all five components of internal control. Additionally, you

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- Big Change for Divorcing Clients Is Now in Effect
- Transition Guidance for Credit Losses Standard

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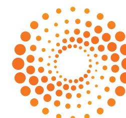

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are required to evaluate the *design* of those controls and determine whether they have been *implemented*.

To evaluate the design of controls, you consider whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. You also need to determine if the control, as documented or described, exists and the entity is using it.

Determining whether a control has been implemented confirms your understanding of control design and helps ensure that the risk assessment is based on accurate information. Implementation means that the controls exist and are being used. Generally, procedures such as observation or inspection, along with inquiries, are used to verify implementation. Inquiry alone cannot provide a sufficient understanding of internal control.

Tests of Operating Effectiveness

Tests of operating effectiveness of controls aren't required in every audit. You may conclude that controls are appropriately designed and implemented but decide that additional tests of operating effectiveness are not warranted. Among other reasons, this decision might be based on the following:

- Materiality and inherent risk considerations.
- Feasibility of performing tests.
- Audit efficiency considerations.

However, if you wish to assess internal control risk at a level of less than high, control testing should be performed.

Practical Consideration:

It is important to understand that even if you decide not to test controls to reduce internal control risk assessment, you still are required to obtain an understanding of the five components of internal control, evaluate the design of those controls, and determine whether they have been implemented. You aren't permitted to simply default to high control risk assessment.

Big Change for Divorcing Clients

Many aspects of the Tax Code were significantly altered when the Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017. Most of the tax changes became effective for tax years beginning after December 31, 2017. However, one very significant change did not.

Effective for divorce decrees, marital settlements, and separation agreements entered into after December 31, 2018, the landscape of divorce has been fundamentally changed by the elimination of both the deduction of alimony payments by payors of alimony (governed by IRC Sec. 215) and the inclusion of alimony payments in income by the recipients of alimony (governed by IRC Sec. 71). The TCJA also repealed the section of the Internal Revenue Code that deals with alimony trusts (governed by IRC Sec. 682), so using those instruments in lieu of the alimony deduction is also no longer an option.

There is yet another big distinction about this tax law change. Unlike other TCJA provisions that apply to individual taxpayers and which are mostly effective only from 2018 through 2025, the new alimony tax rules are a *permanent* change! Most taxpayers, and certainly CPAs, have become used to tax law changes occurring routinely, because in the past decade, the IRC has undergone significant revision almost every year. However, the sections of the IRC that governed alimony have been basically unchanged since the mid-1980s, and alimony has been taxable and deductible since 1942. This really is a big deal for the individuals (and their CPAs) that will be affected by it.

Effect of Alimony Repeal on New Divorces

Due to the elimination of alimony for tax purposes, spousal support payments for divorces entered into after December 31, 2018, will be paid out with after-tax dollars and will be received tax-free by the recipient. For new divorces then, payments of alimony and child support (which has never been deductible from, or includable in, income) will be treated the same for tax purposes.

On the surface, it may seem that such a change would make divorces easier because alimony is now no more complicated than child support. In reality, and certainly in the short term, the change is expected to complicate the divorce process. Some family law attorneys believe this change in tax law could make divorce more acrimonious because now the spouse paying alimony receives no tax benefit for doing so, which may result in divorce negotiations taking longer to resolve. Additionally, because typically the spouse with the higher income is the one that pays spousal support, the repeal of the ali-

mony provisions will tend to increase the total amount of combined tax paid to the federal government by couples entering into divorce or separation agreements in 2019 and after.

The repeal of alimony may also have lasting consequences for child support because those two payments are often calculated in tandem. The payor of alimony and child support for new divorces must now make those payments using all after-tax dollars and, thus, will have fewer dollars available to pay with.

On the other hand, some family law attorneys believe the repeal of the alimony tax provisions could make new divorces easier because alimony will no longer be something for a divorcing couple to fight about. As previously mentioned, all payments within the context of divorce will be the same: alimony, child support, and property tax settlements.

Given that the repeal of alimony has just become effective, no one knows for certain how all the effects of the change will play out. One thing is certain: the repeal of alimony is a major game-changer for how divorce and separation agreements will be structured going forward.

Effect of Alimony Repeal on Divorces Already in Place as of January 1, 2019

For divorce decrees and separation agreements that were already in place on December 31, 2018, alimony will continue to be deductible by the paying spouse and includable by the recipient spouse for federal tax purposes. However, if a couple no longer wishes to be governed by the pre-TCJA alimony rules, they may modify their agreement to include a provision that expressly provides that the alimony amendments made by the TCJA apply to the modification.

Practical Consideration:

PPC's Guide to Divorce Engagements includes both tax and non-tax guidance and provides answers and solutions to many of the questions and issues that commonly arise when a CPA performs divorce-related services.

Transition Guidance for Credit Losses Standard

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*. The ASU, when effective, will change the method for recognizing credit impairments of financial assets. Under the new guidance, impairment would be based on the current expected credit loss (CECL) impairment model, which is the current estimate (based on a broad range of reasonable and supportable information) of contractual cash flows not expected to be collected on financial assets that are held as of the reporting date.

Financial institutions in recent months have been pressuring the FASB to either change the standard or delay the date by which they must comply. In response to this, as discussed in a previous AAU article, the FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses*, that, among other things, delayed the effective date.

Practical Consideration:

For nonpublic business entities, the amended effective date for ASU 2016-13 is fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The effective date for public business entities was not changed. For PBEs that are SEC filers and for other PBEs, the effective dates are for fiscal years beginning after December 15, 2019, and December 15, 2020, respectively, including interim periods within those fiscal years.

Round Table Discussions

Also in response to this resistance, the FASB held a round table discussion with bankers, auditors, and investors to talk about the standard.

The round table discussion revealed divisions among bankers about whether and how the FASB should change the sweeping credit loss standard ahead of when publicly traded banks must follow it in 2020. The discussion underscored the challenges of a one-size-fits-all accounting standard for such a complex industry.

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Topics discussed at the round table included a proposal several banks submitted to the FASB in November 2018 to tweak key pieces of the standard, as well as how to assess charge-offs and recoveries. Representatives from the regional banks pushed the FASB for changes, while large banks and community banks expressed skepticism about the proposal as outlined. Large banks told the FASB they were deep in the process to follow CECL by 2020, while community banks, which said they were less prepared, said any tweaks to it would hinder their progress.

Proposed ASU

The FASB has also recently issued a proposed ASU, *Targeted Transition Relief for Topic 326, Financial Instruments—Credit Losses*, that would offer transition relief for financial statement preparers following the new credit losses standard. The proposal would allow businesses to irrevocably elect the fair value option for certain financial assets previously measured at amortized cost basis.

The FASB is asking for comments on this proposed ASU by March 8, 2019.

FASB Staff Q&A

Questions have been posed to the FASB staff on acceptable, practical methods that may be relevant and appropriate for smaller, less complex banks. The FASB issued informal guidance, via a FASB Staff Q&A, on the acceptable ways these banks can estimate the losses they expect. Specifically, the FASB has received questions about whether the weighted average remaining maturity (WARM) method is an acceptable method to estimate expected credit losses. And the answer is yes. But the Q&A also reiterates the flexibility of the credit losses standard, which sets no specific method.

AICPA Guide

The July 2018 edition of *Audit and Accounting Guide: Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* (AICPA Guide-DEP) considers ASU No. 2016-13, and notes that it has a significant impact on the content of the guide. However, the credit loss standard will not be fully incorporated into the guide until the 2019 or 2020 edition.