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Helping Attest Clients Adopt the Lease Accounting Standard

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Financial Accounting Standards Board (FASB) Accounting Standard Codification (ASC) 842, *Leases,* represents a seismic shift in accounting for leases by lessees, whether public, private, or not-for-profit. Companies may look to their auditors to help them understand, plan for, and implement new accounting standards. This article provides a high-level overview of the AICPA independence rules for performing nonattest services for attest clients. It also analyzes brief case studies to illustrate when and how firms may help their attest clients implement ASC 842 under AICPA independence rules.

Evaluating Independence

The AICPA *Code of Professional Conduct* (the Code), Rule 1.200, *Independence*, applies when a practitioner provides attest services to a client. The Code also notes that additional independence requirements may imposed. For example, the Government Auditing Standards (also known as "GAS" or the "Yellow Book") independence standards apply to "Single Audits" and other audits of federal, state, and local governmental bodies and other entities (such as not-for-profit entities) that receive federal funding or are required by law or regulation to comply with GAS. If a firm audits or provides other attestation services to a broker-dealer, public company, or larger insured depository institution (among other entities), Securities and Exchange Commission (SEC) and/or Public Company Accounting Oversight Board (PCAOB) independence rules also apply.

Conceptual Framework Approach

The Code requires a practitioner to be independent in fact and appearance when performing attest services for a company. The interpretations under ET 1.295, *Nonattest Services,* guide practitioners on how they may provide nonattest services to an attest client and maintain their independence by identifying which services and activities compromise independence and which may be provided; in some instances, requiring the firm to apply specific safeguards. If an interpretation in the Code does not specifically address a service, practitioners should evaluate threats to independence using the *Conceptual Framework for Independence* (Conceptual Framework), which requires practitioners to evaluate whether a reasonable and informed third party would conclude that a threat to compliance with the rules is *not* at an acceptable level.

The rules for performing nonattest services caution against self-review, management participation, and advocacy threats to independence. Each of these threats is described below.

Self-review threat. Threat that practitioner will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the practitioner or a colleague, which the practitioner relies on in forming a judgment when performing attest services.

Management participation threat. Threat that a practitioner will take on the role of attest client management or otherwise assume management responsibilities for an attest client.

Advocacy threat. Threat that a practitioner will promote an attest client's interests or position to the point that his or her independence is compromised.

Other terms used in the Conceptual Framework include:

Acceptable level. A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a practitioner's independence is not impaired.

Impair(ed). In connection with independence, to effectively extinguish independence. When a practitioner's independence is impaired, the practitioner is not independent.

Safeguards. Actions or other measures that may eliminate a threat or reduce a threat to an acceptable level.

Threats. Relationships or circumstances that could impair independence.

In some cases, a practitioner may apply safeguards to eliminate or reduce threats to an acceptable level, while in others, applying safeguards will not be effective and performing the service would impair independence.

Evaluating Threats to Independence

If a client asks their auditor to assist in implementing a new accounting standard, the firm must evaluate possible threats to independence. One consideration would be the significance of the new accounting standard to the client's financial statements. Practitioners should always consider whether nonattest services being performed for the client *in the aggregate* create threats. It is not sufficient to examine the impact of the services individually. If significant threats to independence exist, the firm must apply safeguards to reduce those threats to an acceptable level.

Examples of safeguards include the following:

- Audit team members will not participate in or influence the nonattest engagement.
- A partner in the firm who is not associated with the client will review samples of the nonattest team's work product.
- Before performing the engagement, the audit team will discuss their independence evaluation and the safeguards they have agreed to implement with the client's board of directors or other governance body.

In addition, the firm should document their evaluation of the significance of threats to independence and the safeguards they applied.

General Requirements

Before performing nonattest services for an attest client, your firm must comply with the *General Requirements for Performing Nonattest Services* (ET 1.295.040). You must be assured that the client understands the scope and objectives of the nonattest services and can evaluate the services, accept responsibility for them, and make informed judgments on the results. To fulfill this requirement, the client should designate a person with suitable skill, knowledge, and/or experience (SKE). Preferably from senior management, this person will serve as your "go-to" person when your services require management to make a decision or judgment.

Your firm must avoid performing activities that are management's responsibilities, including for example, setting policy or strategic direction for the client, or exercising authority on the client's behalf. Though auditors are closely associated with their clients' financial statements, management must own their financial statements, including the related internal controls. *Management Responsibilities* (ET 1.295.030) provides other examples of activities your firm should avoid.

Affiliates

If you perform a *financial statement attest engagement,* defined as an audit or review of financial statements or a financial statement compilation that does not disclose an independence impairment, the rules also apply to nonattest services you provide to your client's affiliates. For example, if your firm audits Company X, affiliates of Company X may include (among others) X's parents, investees, benefit plans, and sister companies. The relationship between X and its affiliates generally involve some form of control or significant influence (as defined in the FASB accounting standards) and certain relationships will be exempted if not material. An exception to the affiliate rule allows the firm to provide prohibited nonattest services to certain affiliates of a financial statement attest client if the firm applies the Conceptual Framework and concludes that threats to independence are at an acceptable level, which may require the application of safeguards.

Timeframe

The independence rules for performing nonattest services apply during two periods, which are described below:

Period of the professional engagement - starts when your firm signs an initial engagement letter to perform attest services or begins to perform attest services, whichever comes first, and lasts throughout the entirety of the attest relationship, which may span for years. The period ends when the firm or client terminate the attest relationship or the final report issued, whichever comes later.

Period covered by the financial statements (or other subject matter of the engagement) - the specific timeframe related to the subject matter of the attest engagement.

The following case studies illustrate the application of 1.295 to engagements where the client seeks the auditor's assistance in implementing the new accounting standard on leases.

Case Studies

D9 Corporation

D9 Corporation (D9) is a small software developer your firm has audited for two years. The CEO is concerned about implementing the new lease accounting standard as her company's accounting department runs on a very tight budget. She asks you to help them implement the new standard and assigns Darren, the Controller, to be your point person. AICPA independence standards require you to assess Darren's ability to oversee your services. Your experience with Darren has not been good; despite his title, you do not consider him competent to make the types of management decisions and judgments to implement the leases standard. What should you do?

You should tell the CEO that unfortunately you cannot accept the engagement because it would impair your independence. The leases standard is complex and unless D9 appoints someone with sufficient SKE, your firm will invariably make decisions and judgments on management's behalf during the planning and implementation process. This may be a difficult conversation to have with your client, but your firm cannot implement the new accounting standard for the client, which is management's responsibility, and then audit its own work. This situation would create both self-review and management participation threats that impair your firm's independence. Unless your firm is willing to give up the audit, your assistance should be limited to providing general education, information, and advice to help the client understand the new standard. More likely than not, the client will need to engage another firm to help with the actual planning and implementation of ASC 842.

Alphe Corporation

Alphe, Corp., a clothing manufacturer, contacts you to help plan for and implement the new leases standard. Three (3) years ago, the company contracted Natalie, a highly competent CPA with years of experience, as an outsourced Chief Financial Officer (CFO). You are comfortable that Natalie's skills, background, and knowledge will easily provide the management input and support your firm needs to move forward with the project. The fact that she is contracted to serve as the CFO of Alphe is not relevant. If she meets the SKE requirement, the client may designate her to oversee the services.

Your team initiates the engagement but soon learns that Natalie does not consider the project a high priority since the effective date is months away. The first time she delegates your meeting request to her staff, you figure she is just busy. You emphasize the importance of her involvement in the project. When it happens again, you realize that to continue in this manner puts the firm's independence at risk because Natalie's staff lacks the skill, background, and experience required under the independence rules. You call the CEO and explain that if Natalie continues to delegate responsibility for the engagement to her staff, you will be unable to proceed with the engagement. The CEO discusses the matter with Natalie, and things change quickly. Now you can proceed.

Proceeding with the Project

Each aspect of the project is described in the following sections, along with the relevant independence considerations.

Project Management

On its face, this aspect of the service is a non-starter due to the obvious management participation threat. However, your firm can help Natalie manage the project, but she must oversee the project, take full responsibility for the team's actions, and make all decisions about strategies pursued and resources allocated (among other things). Further, Natalie, and not your firm, should provide reports and status updates about the project to the board of directors. You may assist Natalie by compiling data and performing other activities to support her when she prepares to report to the board. You may also accompany her to meetings if you attend solely as an advisor.

Determining Models and Assumptions

Early on, your firm starts the education process, drawing in all the relevant participants who will be instrumental in the process. You explain to Natalie that implementing the "package of three" expedients can help reduce the amount of time and analysis required to adopt and implement the leases standard. You provide information about the pros and cons and what your firm has seen in practice. Natalie confers with her colleagues and decides that Alphe will adopt the practical expedients.

Data Collection

Your firm guides the company through the data collection process to identify the company's leases. Locating and organizing all the relevant documents for making the assessment is quite an undertaking, so you urge them to start the process as early as possible. You spend significant time educating Natalie and others (e.g., accounts payable and supply chain department) on the relevant FASB implementation guidance and illustrations for Topic 842. During this phase, you begin to suggest the updates to Alphe's systems and controls that may be needed to identify any embedded leases in new contracts or other arrangements going forward. Natalie works with the project team to consider your proposals and determine an action plan.

Software Considerations

Alphe has many documents to assess under Topic 842, so you provide information about software products designed to abstract legal documents. Such software—using machine learning or artificial intelligence—can substantially reduce the time and cost involved. You recommend several software solutions that you believe would be beneficial and communicate the pros and cons of each. You strongly recommend that Alphe test-drive these software solutions to see how well they work and interface with their current accounting software before purchasing.

Review of Processes, Procedures, and Internal Controls

You advise Natalie on the possible changes to the company's processes, procedures, and internal controls relating to the implementation process, lease document retention, and organization and quality control over the input of lease information into the lease accounting software. Mindful that she and her team must determine the appropriate course of action for each of these, you counsel the team on the various options available to them.

Lease Analysis and Classification

Once Alphe's leases are identified, they need to be classified in accordance with ASC 842. You work with Natalie and others on the project team to do this, carefully maintaining your advisory role. You educate and advise the team, drawing on your knowledge and experience with other clients and public company filings. Natalie makes the final decisions on classification.

Accounting and Disclosures

Natalie should draft the initial journal entries and footnote disclosures to implement the new standard although your firm can work with her and provide advice and assistance during the process. For example, you may review her initial draft and provide comments for her consideration.

Summary

Adopting new accounting standards like ASC 842 can present real challenges to companies. As the company's auditor, your firm may be able to assist the client, but you should first perform a comprehensive review of the possible independence ramifications. This requires adherence to the *General Requirements for Performing Nonattest Services* and evaluation using the Conceptual Framework to determine whether threats to independence are at an acceptable level. Your firm should also ensure that the client's designee is both willing *and* able to perform all management responsibilities, which enables you to maintain an independent advisory role.