
# Thank you for joining us!

The presentation will begin shortly

# Winning the Financial Game: Your Playbook for SAS 145 and CECL Implementation

***Thursday, September 21, 2023***

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# Presenters

*Meet the instructors*

Susan Colladay
Partner

Mac Lillard
Senior Manager

John McIntosh
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# Housekeeping

*Additional Information*

| | |
|---|---|
| **Learning Objective**<br>To provide attendees with a road map on SAS 145 and CECL implementation. | **Instructional Delivery Methods**<br>Group Internet-based |
| **Recommended CPE**<br>1.0 CPE Credit | **Recommended Fields of Study**<br>Audit |
| **Prerequisites**<br>None required | **Advance Preparation**<br>None |
| **Program Level**<br>Basic | **Course Registration Requirements**<br>None |
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# Exploring SAS 145


John McIntosh
Senior Manager

# SAS No. 145 Introduction

- Statement on Auditing Standards (SAS) No. 145, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- Supersede SAS No. 122
- Issued October 2021
- The SAS becomes effective for audits of financial statements for periods ending on or after December 15, 2023


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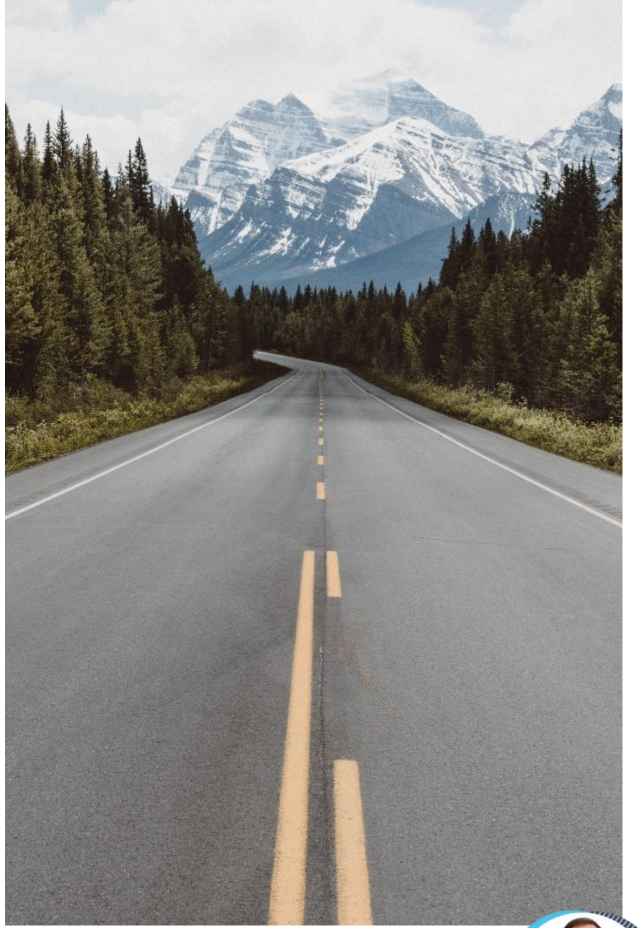
# SAS No. 145 Objective

- Requirements and guidance related to the auditor's risk assessment obtaining an understanding of the entity's system of internal control and assessing control risk
- Guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate
- SAS No. 145 does not fundamentally change the key concepts underpinning audit risk, which is a function of the risks of material misstatement and detection risk. Rather, SAS No. 145 clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments and, therefore, enhance audit quality.





# Reasons for Update?

- **Common Audit Deficiencies:**
    - Deficiencies in the auditor's risk assessment procedures is a common issue identified by practice monitoring programs in the United States and worldwide
- **International Convergence:**
    - SAS No. 145 was developed using ISA 315, *Identifying and Assessing the Risks of Material Misstatement*
- **Modernization for an Evolving Business Environment**




# Points of Discussion

- Revised requirements to evaluate the design of internal controls
- New requirement to separately assess inherent risk and control risk
- New requirements for assessment inherent and control risk
- Revised definition of significant risk
- New guidance on scalability
- New guidance on maintaining professional skepticism
- A new "stand-back" requirement
- Revised requirements relating to audit documentation




# Revised Requirements to Evaluate the Design of Certain Controls

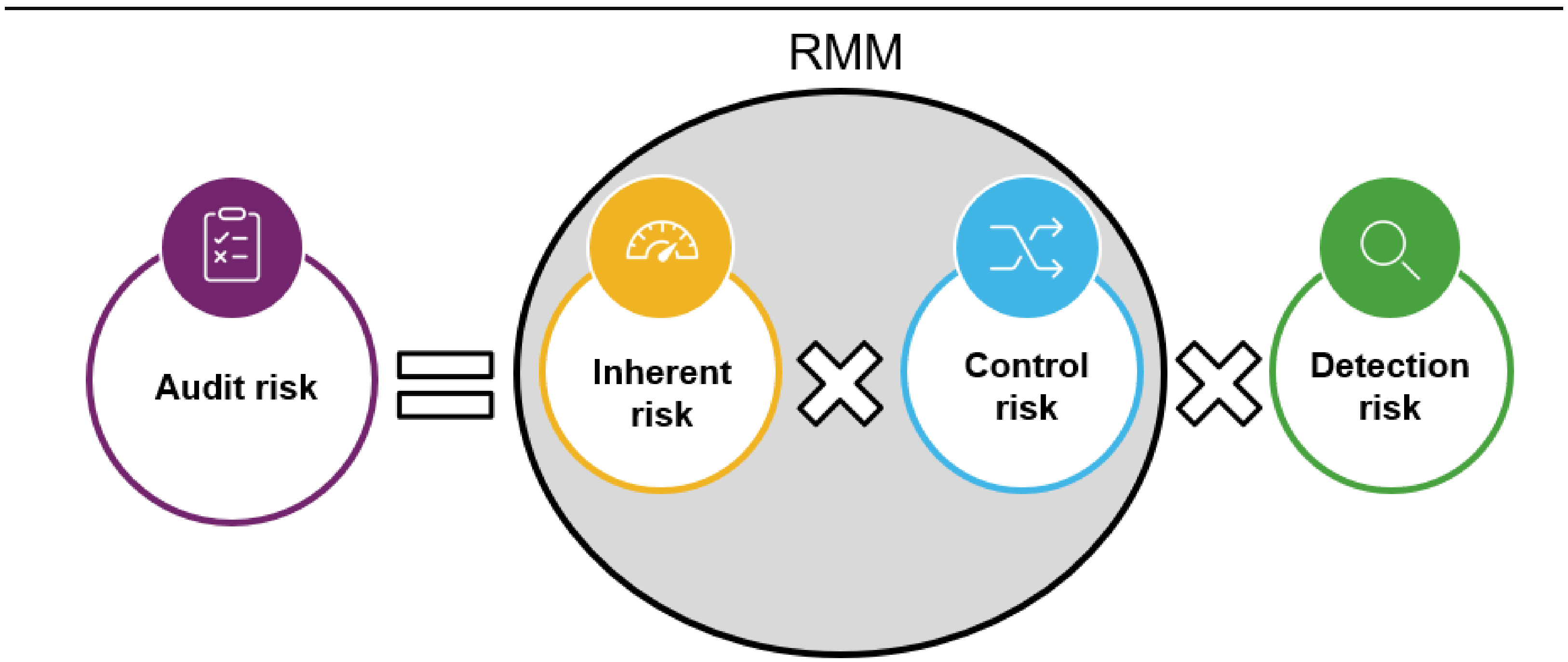
- SAS No. 145 clarifies that the overall understanding of the entity's system of internal control is achieved through understanding, and evaluating certain aspects of, each of the following components of the system of internal control:
  - The control environment
  - The entity's risk assessment process
  - The entity's process to monitor the system of internal control
  - The information system and communication
  - Control activities

# Revised Requirements to Evaluate the Design of Certain Controls


- Revised terminology used to describe aspects of an entity’s internal controls
- The term *internal control* has been changed to *system of internal control*, and the definition has been updated to reflect that it comprises five interrelated components.
- The use of the term *controls* has been clarified and defined as: “Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context



# New Requirement to Separately Assess Inherent Risk and Control Risk




For risks of material misstatement at the assertion level, SAS No. 145 now requires separate assessments of inherent risk and control risk, which is consistent with SAS No. 143, Auditing Accounting Estimates and Related Disclosures.

# New Requirements for Assessment of Control Risk

- New requirement to assess control risk at the maximum level such that, if the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement is the same as the assessment of inherent risk
- When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of controls may still assist in the design of substantive procedures. When identified controls are designed effectively and implemented, risk assessment procedures may influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection, rather than external confirmation, or to perform procedures at an interim date, rather than at period end).



# Polling Question #1

SAS 145 has a new requirement for the assessment of the risk of material misstatement ("RMM") to be the same as the assessment of inherent risk ("IR"). In your opinion, will this change be beneficial for audit efficiency?

A. *Yes*
B. *No*
C. *Unsure*

# Revised Definition of Significant Risk

- Identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur
- The prior significant risk definition focused on the response to the risk, not the risk itself. That guidance said it was a risk that needed special audit consideration




# New Guidance on Scalability

- Complexity of an entity's activities and its environment, including its system of internal control, is the primary driver of scalability
- SAS No. 145 recognizes that, although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex
- Some aspects of the entity's system of internal control may be less formalized but still present and functioning


# New Guidance on Maintaining Professional Skepticism

- Clarifying that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to maintain professional skepticism throughout the audit
- Benefits of the Engagement Team Discussion
- Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.



# New "Stand-Back" Requirement

- Intended to drive an evaluation of the completeness of the auditor's identification of significant classes of transactions, account balances, and disclosures
- Once you have designated all significant classes of transactions, account balances, and disclosures, evaluate all remaining material areas to see if the initial scope determination is appropriate



# Revised Requirements Relating to Audit Documentation

- SAS No. 145 also revises the audit documentation requirements to include the following new requirements:
  - Documentation of the evaluation of the design of identified controls and determination of whether such controls have been implemented
  - The rationale for significant judgments made regarding the identified and assessed risks of material misstatement
- Audit documentation is sufficient to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the risk assessment procedures performed and the results of those procedures.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# SAS 145 and Information Technology

Mac Lillard
Senior Manager

# Polling Question #2

Does SAS 145 require a specific Information Technology framework to be followed?

*A. Yes*
*B. No*
*C. Unsure*

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Mac Lillard
Senior Manager

# SAS 145 and Information Technology

*What does this mean for the audit?*

## SAS 145 Information Technology Reference:

SAS 145 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement Paragraphs A6-A8 (Pages 32-33); Appendix E (Pages 121-128) for information over SAS 145 which becomes effective for fiscal years ended after December 15, 2023.

## High-Level Summary

- Guidance does not require a particular framework but references *COSO 2013 Internal Control - Integrated Framework*
- Auditors will be placing increased emphasis on Information Technology environment as part of the external audit process
- Review of Information Technology General Control documentation (i.e., Information Security Policy)
  - Physical and environmental security, logical security, change management, backup and recovery, incident management, and information security
- Detailed testing of Information Technology controls may be required depending on organization's size/complexity
  - Testing of user access rights (review of current access rights to financial platforms and testing of terminated employees), review of risk assessments (cybersecurity and third party), review of change management logs

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# Cybersecurity Baseline and Best Practices

## *Overview*

- Understand Existing IT infrastructure
    - In-house resources
    - Physical vs hosted vs cloud-based solutions
    - Third Parties
    - Do you follow a framework and have you benchmarked yourself against it?
- Training
    - Onboarding and annual refresher at a minimum
    - Ongoing phishing simulations if feasible

- Formalized Policies and Procedures
    - Access controls (physical and logical)
    - Acceptable Use
    - Backup/storage/retention
    - Incident Response
    - Cybersecurity Risk Management
    - Third-Party Risk Management
    - Privacy
    - Business Continuity and Disaster Recovery
    - Cyber Insurance



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# Communicating IT Items to the Board

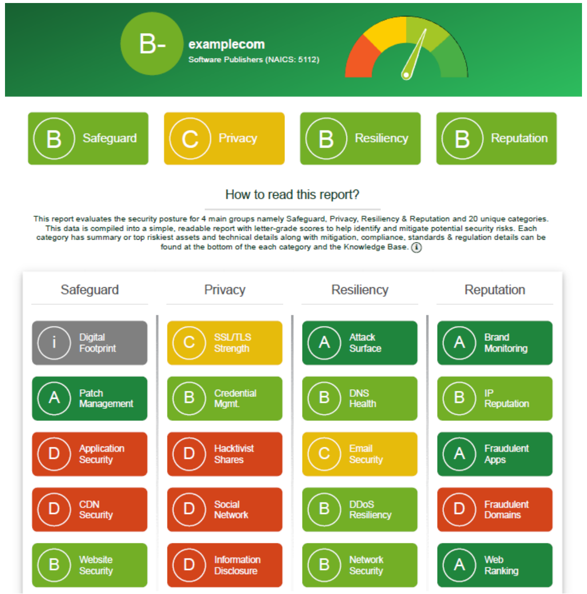
*Education, Monitoring, and Reporting*

## Education:

- SAS 145 and Auditor Comments
- High-level overview of processes implemented by management

## Monitoring and Reporting:

- Leverage existing meetings
- Set as a recurring agenda item
- Top Risks and Mitigation Plans
- Avoid getting too granular
- Break it down in simple terms (avoid technical jargon)
- Review of audits and assessments (executive summary)





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# CECL Implementation

Susan Colladay
Partner

# Current Expected Credit Losses
## ASC Topic 326

- Accounting Standards Update (ASU) 2016-13: *Financial Instruments - Credit Losses (Topic 326)* implementation starts with fiscal years ending December 31, 2023, but the adoption date was January 1, 2023.
- ASU 2016-13 is also known as Current Expected Credit Losses (CECL), and it is not just for banks and for-profit companies. Nonprofits are included in this new standard.
- While the new standard does not apply to contributions, it does apply to programmatic loans and receivables related to exchange transaction revenues that fall under ASC Topic 606.
- Under the old standard, nonprofits recorded an allowance for doubtful accounts based on past experience that represents actual collections or lack thereof.
- CECL removes the probable threshold used in the old incurred loss method and requires recognition of credit losses when such losses are "expected."

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This presentation summarizes the new standard. Please refer to ASC Topic 326 for details.

# What's IN CECL's Scope

Financial assets IN scope include the following:

- Accounts receivable related to exchange transactions under ASC Topic 606.
- Notes or loans receivable with unrelated entities.
- Off balance sheet credit exposure, such as guarantees, commitments or letters of credit (i.e., entity is the recipient of potential assets).
- Assets related to financing leases held by the lessor.
- Any other financial asset not scoped out where the organization has the right to receive cash.



# What's OUT of CECL's Scope

Financial assets OUT of scope include the following:

- Financial assets reported at fair value, such as investments (covered under ASC Topic 820).
- Participant loans receivable reported by a defined contribution plan.
- Contributions receivable (covered under ASC Topic 958).
- Intercompany notes or receivables, including notes or receivables between entities under common control.
- Derivatives and hedging instruments (covered under ASC Topic 815).
- Receivables related to operating leases held by the lessor.

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# Implementation Date Accounting

**On January 1, 2023 (Day 1), what do you need to do?**

1. Determine which financial statement lines (or disclosures) are required to have an allowance for credit losses (ACL).

2. Create an ACL account in your chart of accounts. This new account will be used instead of the allowance for doubtful accounts.

3. Calculate the ACL as of January 1, 2023, using guidance in the accounting standard (ASC Topic 326).

4. Recognize a cumulative-effect adjustment for the ACL in net assets as of January 1, 2023. If the ACL on January 1, 2023, is not material, you may want to discuss not recording the adjustment with your auditors. However, the adjustment should be recorded as of December 31, 2023.

5. If there was an allowance account before the adoption of CECL, the cumulative-effect adjustment on January 1, 2023, will be the difference between the old allowance for doubtful accounts and the new ACL.



# Components of the ACL

The ACL should be based on historical loss experience +/- current conditions +/-  a forecast of future conditions. All nonprofits will now need to determine expected losses rather than incurred losses. CECL requires an expected loss to be recorded upon origination of the asset.

**Historical loss experience**

- Assets should be pooled together if they exhibit similar risk characteristics.
- Document the review of prior year data to provide information on historical losses for each type of asset.

**Current conditions**

- Review qualitative and quantitative factors of current economic conditions to determine if adjustments should be made to the historical loss experience.
- Document the review of current conditions.

**Future conditions**

- Use a reasonable and supportable forecast period.
- Document the rationale and provide evidence supporting the reliability and accuracy of economic scenarios and forecasts of future conditions.

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# Polling Question #3

What is included IN the scope of the new CECL standard?

*A. Contributions receivable (under ASC 958)*

*B. Operating lease receivable*

*C. Accounts receivable (under ASC 606)*

*D. Amounts due from related entities*

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# Potential Ways to Calculate the ACL

- **Loss-rate (aging) method**
- **Discounted cash flows model**
- *Vintage analysis*
- *Probability of default / loss given default*
- *Provision Matrix*
- *Regression Analysis*

Loss-rate (aging) method is good for accounts receivable related to ASC 606 revenue streams.

Discounted cash flows model is good for long-term notes receivable (or programmatic loans).

*Most of the other ways to calculate the ACL are used by financial institutions for their loan portfolios. You are welcome to research these on your own, but we will focus on the first two methods as these are most likely what nonprofits will use.*



# Loss-Rate (Aging) Method

| Customer | Balance | Current | 31-60 | 61-90 | >91 |
|---|---|---|---|---|---|
| Entity A | $ 100,000 | $ 75,000 | $ 25,000 | $ - | $ - |
| Entity B | 200,000 | 50,000 | 50,000 | 50,000 | 50,000 |
| Entity C | 300,000 | 100,000 | 100,000 | 100,000 | - |
| Gross Receivables | 600,000 | 225,000 | 175,000 | 150,000 | 50,000 |
| Less ACL | (133,125) | (7,875) | (19,250) | (64,500) | (41,500) |
| **Net Receivables** | **$ 466,875** | **$ 217,125** | **$ 155,750** | **$ 85,500** | **$ 8,500** |

| | | | | |
|---|---|---|---|---|
| Historical loss rates < | 0.5% | 8.0% | 40.0% | 80.0% |
| Current conditions ^ | 5.0% | 5.0% | 5.0% | 5.0% |
| Future conditions > | -2.0% | -2.0% | -2.0% | -2.0% |
| | 3.5% | 11.0% | 43.0% | 83.0% |

< Historical loss rates are based on the average of actual losses in each category over the past 10 years.

^ Upward adjustment for current conditions because the industry in which customers operate is experiencing challenges.

> Downward adjustment for future conditions because it is expected that the industry will rebound in the next year.

# Discounted Cash Flows Model

| Customer | Loan Balance | Contractual Payments Due after Year End Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|---|
| Loan A (Prime + .25%) | 75,000 | 15,000 | 15,000 | 15,000 | 15,000 | 15,000 |

Contractual payments should be adjusted before discounting to convert contractual cash flows to expected cash flows.
**Three different expected payment scenarios follow:**

| Customer | Total Adjustments | Adjustments to Payments Due after Year End Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|---|---|---|
| 1) Prepayment | - | 7,500 | 3,750 | 3,750 | - | (15,000) | - | - |
| 2) Default | (15,000) | - | - | - | - | (15,000) | - | - |
| 3) Recovery delay | - | - | - | - | - | - | 15,000 | 15,000 |

| Customer | Adjusted Balance | Expected Payments Due after Year End Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|---|---|---|
| 1) Prepayment | 75,000 | 22,500 | 18,750 | 18,750 | 15,000 | - | - | - |
| 2) Default | 60,000 | 15,000 | 15,000 | 15,000 | 15,000 | - | - | - |
| 3) Recovery delay | 75,000 | 15,000 | 15,000 | 15,000 | - | - | 15,000 | 15,000 |

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# Discounted Cash Flows Model (Continued)

The discount rate is equal to the effective interest rate (contractual borrowing rate adjusted for any fees or costs existing at origination of the loan). If the contractual rate varies based on Prime or SOFR, the ACL will change each time it's calculated as the rate changes over the life of the asset.

| | |
|---|---|
| Prime plus .25% | 7.75% |
| Fees at origination | 0.05% |
| Discount rate | 7.80% |

Based on historical experience with Loan A, current economic conditions and a forecast of future conditions, determine which ACL makes the most sense.

| | **Prepayment** | **Default** | **Recovery Delay** |
|---|---|---|---|
| Net Present Value | $ 63,081.64 | $ 49,903.88 | $ 57,221.30 |
| **Discount (ACL)** | **(11,918.36)** | **(25,096.12)** | **(17,778.70)** |

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# CECL Disclosure Requirements

- CECL disclosures should enable financial statement users to understand the following:
  a. credit risk inherent in a portfolio and how credit quality is monitored,
  b. methodology used to estimate the ACL, and
  c. period-over-period changes in the estimation of the ACL.
- The disclosure requirements under the new CECL standard are principles-based and give entities flexibility to determine the nature and extent of the information to be disclosed.
- The accounting policy in the first footnote to the financial statements will need to include information related to the requirements from items a. and b. from above.
- The related asset footnote should include a rollforward chart for the ACL to satisfy the requirement from item c. from above.



# Accounting Policy Disclosures

**Accounts receivable:** Accounts receivable primarily consists of amounts due within one year related to the sales of publications, products, advertising, and meeting registrations. Accounts receivable are presented net of an allowance for credit losses resulting from the inability of customers to make required payments. The allowance for credit losses is based upon historical loss experience in combination with current economic conditions and a forecast of future economic conditions. Any change in the assumptions used in analyzing a specific account receivable might result in an additional allowance for credit losses being recognized in the period in which the change occurs. However, the Organization has historically had insignificant write-offs due to bad debts.

**Notes receivable:** Notes receivable consists of long-term unsecured programmatic loans to other nonprofit organizations (debtors). The loans have various origination dates and maturity dates and are typically repaid over ten years. Notes receivable are presented net of an allowance for credit losses resulting from the inability of debtors to make required payments. The Organization reviews the credit quality of each debtor on a quarterly basis. The Organization uses consumer credit risk scores in conjunction with internal credit risk grades based on collection experience in combination with current economic conditions and a forecast of future economic conditions to determine credit quality. The allowance for credit losses is based upon a discounted cash flows model using the contractual effective interest rate applied to the expected payments, which equal contractual payments adjusted for prepayment rates, probability of default, loss given default, and recovery delay.



*These are sample footnotes and should be adjusted to fit your circumstances.*

# ACL Roll Forward Disclosure

| | 12/31/2023 |
|---|---|
| Allowance for credit losses, beginning of year | $ 100,232 |
| Additions (Charges to Expense) | 57,090 |
| Deductions (Write-offs, net of Recoveries) | (24,197) |
| Allowance for credit losses, end of year | $ 133,125 |

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# Discounted Cash Flows Option Disclosure Requirement

ASC 326-20-45-3 explains that if a creditor calculates the ACL based on a discounted cash flow model, it is permitted to report the entire change in the ACL as credit loss expense (or a reversal of credit loss expense).

However, a creditor may also report the change in the ACL resulting from the passage of time as interest income, but the amount recorded to interest income that represents the change in the ACL due to the passage of time must be disclosed.

# Last Words about CECL

- Even if your nonprofit has never recorded an allowance for doubtful accounts before, your auditors will expect to see an allowance for credit losses recorded on January 1, 2023, and on December 31, 2023.
- To be clear … nonprofits **cannot** use the direct write off method anymore.
- Also, nonprofits will not be able to assert that all receivables are 100% collectible without significant documentation using the CECL framework to support that assertion. Even if the risk of loss is considered highly remote, nonprofits will still be required to estimate the lifetime credit losses related to the financial assets that are IN the scope of the new standard.
- Unlike the previous incurred loss model, the new expected loss model does not specify a threshold for recognizing an ACL.
- Nonprofits will need to document their ACL analysis as of January 1, 2023, using historical data, current conditions, and future conditions.
- **Share the documentation with your auditors** before your audit starts to avoid surprises or significant audit adjustments.




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# Questions?

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