

To the Point

AICPA – final standard

AICPA issues new guidance that is intended to expand the use of examination reports

The new standard will allow more smaller and early stage companies to obtain examination reports.

What you need to know

- ▶ The AICPA's Auditing Standards Board issued a new attestation standard that allows entities to engage independent accountants to measure or evaluate underlying subject matter without having to (1) evaluate whether an underlying subject matter complies with criteria, (2) prepare the subject matter information or (3) make an assertion.
- ▶ The entity is still responsible for the underlying subject matter and the suitability and appropriateness of the criteria.
- ▶ The new direct examination standard allows an entity's independent accountant to measure or evaluate the subject matter in accordance with criteria, express an opinion about the outcome of that measurement or evaluation, and, as appropriate, present the results of that measurement or evaluation.
- ▶ The standard is effective for reports dated on or after 15 June 2022. Early implementation is permitted.

Overview

The Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued a **new attestation standard**¹ (AT-C 206) that creates a new form of examination that allows independent accountants to perform direct examinations of the underlying subject matter in addition to the assertion-based examinations already permitted. In doing so, the ASB responded to feedback from stakeholders that assertion-based examination engagements are not possible when an entity has chosen not to perform the

measurement of the subject matter (e.g., when doing so is challenging due to a lack of appropriate personnel or systems). In a new direct examination, an independent accountant will measure and evaluate underlying subject matter.

The change is expected to allow more small entities and early-stage entities to engage independent accountants to perform examination engagements to assess compliance with contractual terms or regulatory requirements, reported revenue, sales, investment returns or other matters and opine on whether an underlying subject matter complies with (or is based on) criteria or whether an entity's assertion that the subject matter complies with (or is based on) the criteria is fairly stated. Until now, many entities seeking such a report had to engage an accountant to perform another type of service (e.g., an agreed-upon procedure engagement, a consulting service) that may not address all relevant criteria or forgo the report entirely.

The ASB also wanted to align certain aspects of examination and review engagements conducted in accordance with the attestation guidance with international standards that already have the direct examination concept.

The revisions to the AICPA's attestation standards are part of a broader effort by the ASB to revisit the 2017 Clarified Attestation Standards. The ASB has already made changes to the agreed-upon procedures (AUP) standard (AT-C 215) and is expected to make changes to standards governing other types of engagements, including reviews (AT-C 210) and AUP engagements addressed by the AICPA subject-matter standards (AT-C 300 series), such as compliance with laws and regulations.

The new standard cannot be applied to certain subject matters covered by the subject-matter attestation standards, including examinations of prospective financial information (AT-C 305), pro forma financial information (AT-C 310), service organization controls (AT-C 320) and compliance attestations (AT-C 315).

Key considerations

The new guidance allows independent accountants to perform examinations and offer opinions, even if the party that engages the accountant to perform the examination has not first measured or evaluated the subject matter.

In an assertion-based examination, the entity is responsible for both the underlying subject matter (e.g., an entity's investment transactions during the year) and the subject-matter information (e.g., schedule of investment returns of a company during the year). An assertion about whether the underlying subject matter is in accordance with the criteria is a form of subject-matter information. In examinations conducted under the new standard, only the underlying subject matter remains the entity's responsibility.

An independent accountant's objective in both an assertion-based examination engagement and a direct examination engagement is to obtain reasonable assurance. However, in an assertion-based examination, the accountant obtains reasonable assurance about whether the subject matter that has already been measured or evaluated against the criteria is free from material misstatement, whereas in a direct examination an accountant obtains reasonable assurance by actually measuring or evaluating the underlying subject matter against the criteria.

Consequently, an accountant performing a direct examination will express an opinion in its report that conveys the results of the accountant's measurement or evaluation rather than an opinion on the entity's assertion or on the compliance of the subject matter with the specified criteria.

In all examinations, the company remains responsible for the specified criteria, including their suitability and appropriateness for the purposes of the engagement.

The new standard may be especially helpful for licensors of intellectual property that engage independent accountants to perform what are called royalty audits to verify that licensees comply with various terms in licensing agreements. Entities in the pharmaceutical, technology and entertainment industries often engage accountants to perform these audits under the AUP standard.

A licensing agreement may include both quantitative and qualitative terms. For example, it may stipulate that the licensor is entitled to a percentage of the licensee's sales of a particular drug (a quantitative criterion) but may contemplate a higher rate for sales to licensee's related parties, if such sales are not conducted at arm's length (a combination of quantitative and qualitative criteria).

Under the AUP guidance, the independent accountant's report to the licensor would likely not include an assessment of the qualitative criteria, because that assessment would require judgment not permitted under the AUP standards. Furthermore, the AUP report would be in the form of findings about each of the specified criteria developed by the licensor, rather than an easy-to-interpret opinion about whether the payments made by the licensee are in accordance with the contract.

The new direct examination engagement standard will allow an independent auditor to issue a report that could be more useful to the licensor because it can report on both quantitative and qualitative criteria and deliver an easy-to-interpret conclusion.

How we see it

- ▶ Entities and stakeholders should assess whether they could benefit from direct examination engagements in situations where obtaining assurance over entities' transactions and practices was not previously possible or feasible.
- ▶ Entities that engage independent accountants to perform recurring attestation services should evaluate whether direct examinations offer a more effective and meaningful alternative to such services.

Effective date

The new guidance is effective for reports dated on or after 15 June 2022. Early implementation is allowed.

Endnote:

¹ AICPA Statement on Standards for Attestation Engagements No. 21 supersedes AT-C section 205, *Examination Engagements*; adds AT-C section 206, *Direct Examination Engagements*; and amends AT-C section 105, *Concepts Common to All Attestation Engagements*.

About EY

EY is a global leader in assurance, tax, strategy, transaction and consulting services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.