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Get Ready for New Quality Management Standards!

The AICPA has issued a suite of quality management (QM) standards that will affect your firm and your assurance engagements. Even though the effective date is a few years in the future, the new QM standards will require significant changes to your quality management system. Therefore, it's important that you understand these new standards and begin making changes now. The new QM standards consist of—

- Statement on Quality Management Standards (SQMS) 1, *A Firm's System of Quality Management*
- SQMS 2, *Engagement Quality Reviews*
- Statement on Auditing Standards (SAS) 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- Statement on Standards for Accounting and Review Services (SSARS) 26, *Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services*

SQMS 1 supersedes SQCS 8, *A Firm's System of Quality Control* (QC 10), and SAS 146 supersedes AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and amends a variety of other auditing standards. The SSARS amends various AR-C sections (AR-C 60, 70, 80, and 90).

SQMS 1

SQMS 1 takes a new approach in addressing the firm's responsibility to design, implement, and operate a system of quality management for its accounting and auditing practice. The approach emphasizes the responsibility of firm leadership for proactively managing quality. The new approach is risk-based and is designed to improve scalability of the standards by requiring a quality management system that is tailored to the nature and circumstances of the firm and its engagements. The new approach requires a firm to customize its system of quality management by considering the quality management

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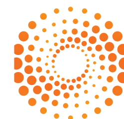

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system as a whole, with a stronger focus on continual remediation and improvement.

Under SQMS 1, the firm's system of quality management is composed of eight components. Under current SQCS 8, the firm's system of quality control is composed of six quality control elements. SQMS 1 adapts the existing six QC elements, renaming three of them, and adds two new components.

Systems of quality management under the SQMS are required to be designed and implemented by December 15, 2025, with an evaluation completed within one year following December 15, 2025.

SQMS 2

SQMS 2 addresses the appointment and eligibility of the engagement quality reviewer, and the performance and documentation of the engagement quality review. The engagement quality reviewer appointment and eligibility requirements are more robust than under current SQCS 8.

SQMS 2 applies to all engagements for which an engagement quality review is required to be performed. The review by the engagement quality reviewer doesn't change the responsibilities of the engagement partner in managing and achieving quality on an engagement or for the direction, supervision, or review of engagement team members.

SQMS 2 is effective for audits or reviews of financial statements for periods beginning on or after December 15, 2025 and other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025.

SAS 146

The QM SAS reinforces that the engagement partner has overall responsibility for managing and achieving quality at the engagement level. Additionally, the QM SAS focuses on how the engagement partner leverages the firm's system of quality management and how the engagement partner, at the engagement level, manages quality.

The engagement partner is responsible for creating an environment that focuses on the firm's culture and the expected behaviors of engagement team members, which includes responsibilities for quality, attitudes and values, professional skepticism, and the importance of professional ethics.

The SAS is effective for engagements under GAAS for periods beginning on or after December 15, 2025.

SSARS 26

The QM SSARS addresses quality management for engagements performed under SSARS. It ensures that quality management concepts are consistent between auditing standards and SSARS, when appropriate. Like the QM SAS, SSARS 26 indicates that the engagement partner has overall responsibility for managing and achieving quality.

SSARS 26 is effective for SSARS engagements for periods ending on or after December 15, 2025.

Practical Consideration:

For AICPA members, the new standards are available at **www.aicpa.org/resources/landing/audit-attest-and-quality-control-standards** and **www.aicpa.org/resources/landing/preparation-compilation-and-review-standards**.

Are Your Clients Starting to Think About Accounting for Credit Losses?

We know that the last few years have been busy for you and your clients with the implementation of new accounting standards, especially those dealing with revenue and leases. But get ready—the implementation of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which introduced the current expected credit loss (CECL) impairment model in FASB ASC Topic 326, *Financial Instruments-Credit Losses*, is just around the corner.

For private entities (as well as certain SEC smaller reporting entities), the effective date is fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Early application is allowed for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Practical Consideration:

After the issuance of ASU 2016-13, the FASB issued eight additional standards which further addressed aspects of credit losses, including extending the original effective date of ASU 2016-13 to the December 15, 2022 date above. For entities that hadn't adopted ASU 2016-13 when those subsequent ASUs were issued, the effective dates and transition requirements of the subsequently issued ASUs are generally the same as the original requirements in ASU 2016-13, as amended. For entities that had already adopted ASU 2016-13 when those ASUs were issued, additional effective date and transition requirements are provided in each of the eight additional standards.

Current GAAP for credit losses is based on an *incurred loss* methodology that delays recognition of a credit loss until it is probable that a loss has been incurred. ASU 2016-13 replaces the incurred loss impairment methodology with one that reflects expected credit losses and doesn't prescribe the method for measuring expected credit losses. All entities with the following assets will apply the CECL model:

- Financial assets measured at amortized cost, including financing receivables (loans), held-to-maturity debt securities, trade receivables, reinsurance recoverables, and receivables related to repurchase and securities lending agreements.
- Net investments in leases recorded by lessors.
- Off-balance sheet credit exposures not accounted for as insurance, including loan commitments, standby letters of credit, and financial guarantees.

In this newsletter, we'll give a brief refresher of some of key accounting and disclosure provisions of ASU 2016-13. Subsequent newsletters will address other important considerations, such as auditing credit losses.

Expected Credit Losses on Financial Instruments Measured at Amortized Cost

Scope. The guidance for measuring expected credit losses on financial instruments measured at amortized cost applies to the following items:

- Financial assets measured at amortized cost, including financing receivables (loans), held-to-maturity debt securities, trade receivables, and receivables related to repurchase and securities lending agreements.
- Net investments in leases recorded by lessors in accordance with FASB ASC 842.
- Off-balance-sheet credit exposures not accounted for as insurance, including loan commitments, standby letters of credit, and financial guarantees.
- Reinsurance recoverables.

Accounting Provisions. The allowance for credit losses is a valuation account that should be deducted from, or added to, the amortized cost basis of a financial asset to present the net amount expected to be collected. The valuation account should include expected recoveries of amounts previously written off and expected to be written off. However, expected recoveries can't exceed the sum of amounts previously written off and expected to be written off. An allowance for credit losses should be recorded at the reporting date to reflect the current estimate of expected credit losses with any adjustment of the amount reflected as a credit loss expense in net income.

Expected credit losses should be measured based on relevant available information about past events, including historical experience, current conditions, and reasonable and supportable forecasts. Various approaches may be used to measure expected credit losses, including a discounted cash flow method, loss-rate method, roll-rate method, probability-of-default method, or an aging schedule.

When estimating expected credit losses, historical credit loss experience for financial assets with similar risk characteristics normally serves as a basis for the assessment. However, entities shouldn't solely rely on historical information when estimating expected credit losses. An entity should consider adjusting historical information when management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed in the historical data.

Credit losses on financial assets should be reassessed at each reporting date, applying a consistent measurement method. Subsequent changes in the allowance for credit losses should be adjusted through earnings by increasing or decreasing the credit loss expense account.

Disclosures. FASB ASC 326 requires a variety of disclosures about—

- Credit quality of financial assets.
- Expected loss estimates and the allowance for credit losses, including activity in the allowance.
- Past due and nonaccrual financial assets.
- Purchased financial assets with credit deterioration.

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- Collateral dependent financial assets.
- Off-balance sheet credit exposures.

Credit Losses on Available-for-Sale Debt Securities

Scope. The guidance for measuring credit losses in the following paragraphs applies to debt securities that are classified as available-for-sale securities, including loans that meet the definition of debt securities and are classified as available-for-sale.

Accounting Provisions. Available-for-sale debt securities whose fair value is below amortized cost are considered impaired. When the fair value of an individual debt security that is classified as available for sale declines below its amortized cost basis, an entity is required to determine whether the decline is attributable to a credit loss or other factors. At each reporting date, impairment due to a credit loss should be recorded through an allowance for credit losses. Impairment due to factors other than credit losses should be recorded through other comprehensive income, net of applicable taxes.

Estimates of credit losses for available-for-sale debt securities should be measured by comparing the present value of expected future cash flows to the amortized cost basis of the security. The entity should make its best estimate of expected future cash flows by considering available information that is relevant to the collectibility of the security, including past events, current conditions, and reasonable and supportable forecasts.

At each reporting period, credit losses should be reassessed whenever there is an allowance for credit losses for available-for-sale debt securities. Subsequent changes in the allowance for credit losses should be charged to credit loss expense on available-for-sale debt securities. An entity may recognize credit-related improvements in expected future cash flows immediately to earnings by reducing the allowance (up to a zero balance), with an offsetting entry to reverse credit loss expense.

Disclosures. Among other things, FASB ASC 326 requires disclosures about:

- Available-for-sale debt securities in unrealized loss positions without an allowance for credit losses.
- The allowance for credit losses.
- Purchased financial assets with credit deterioration.

Practical Consideration:

You can locate ASU 2016-13 and various related subsequent ASUs on the FASB's website at **www.fasb.org**. Certain PPC accounting and audit guides such as *PPC's Guide to GAAP* and *PPC's Guide to Audits of Financial Institutions*, and related disclosure checklists, provide additional coverage of the credit loss standard.