Comprehensive Updates from CalCPA’s AP&AS Committee

Standards Rundown

plus
Audit Mgmt. | Leg. Update | Tax Relief Signed
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– Cantor Forensic Accounting, PLLC

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¹ Savings info based on 2020 CA Dept. of Insurance rate comparison 255B. Individual savings may vary. ² Discounts subject to qualification requirements. ³ Repairs guaranteed for as long as you own your vehicle when repairs are completed at a Mercury authorized direct repair facility.

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“Auditor independence is not merely an obstacle to overcome, it is the bedrock foundation that supports the integrity, transparency and reliability of financial reporting.”

—Charles Cain, chief of the SEC Enforcement Division’s FCPA Unit

$500K
The amount of retirement savings people say is enough to feel financially secure.

—Transamerica Center for Retirement Studies

716
The average FICO credit score, setting a new high.

—FICO

$3.6T
The value of completed or pending M&As worldwide this year, topping the $3.59T total for all of 2020.

—Refinitiv

70%
The number of workers who would quit if another employer offered better policies to reduce burnout.

—Visier

$4.24M
The average cost of a security breach to a company.

—IBM Security

24%
The increase in average 401(k) balances from a year ago.

—Fidelity Investments

LOOKING AHEAD
What are CEOs thinking about these days? A survey found:

77% Expect their organization’s growth to be “very strong” or “strong” over the next 12 months.

75% Undergoing or preparing for digital transformation.

66% Cybersecurity is “highly relevant” to their agenda.

61% Diversity, equity and inclusion has been built into their strategic priorities/goals as CEO.

54% Innovation/new products will be a significant driver of business success over the next 12 months.

—Fortune/Deloitte CEO Survey
Two new tax credits will be available for taxpayers in the next few months:

- **Main Street Small Business Tax Credit II**: This will be available for taxpayers who were impacted by the economic disturbances in 2020 and 2021. The credit can be applied against sales and use taxes or income and franchise taxes. The credit requires taxpayers to get a tentative credit reservation from the California Department of Tax and Fee Administration (CDTFA), and to elect at that time whether to apply the credit to sales and use taxes, or to income and franchise taxes. You must apply for the credit reservation from Nov. 1–30 (or sooner, if the money available for the credit is fully allocated). More information on this credit can be found on the CDTFA’s webpage, cdtfa.ca.gov/industry/main-street-small-business-tax-credit-II-AB150.htm.

- **Homeless Hiring Tax Credit**: This is a newly enacted credit available to qualifying taxpayers who hire new employees deemed to be eligible homeless individuals (as defined by RTC Sec. 17053.80 and RTC Sec. 23629). The credit amount is based on the number of hours the eligible individual (employee) works during the taxable year and will be available for the 2022 through 2026 taxable years. To claim the credit, qualifying taxpayers must obtain an eligible individual certification, an eligible individual certification and receive a tentative credit reservation for each eligible individual from the FTB. More info is available at ftb.ca.gov.

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**Wildfire Tax Relief**

Tax Relief for Californians Affected by Wildfires

The FTB announced taxpayers and businesses in presidentially declared disaster areas are granted an extension to Nov. 15 to file California tax returns on 2020 income and make any tax payments that would have been due between July 14–Nov. 15.

Taxpayers should write the name of the disaster (for example, “Dixie Fire”) in blue or black ink at the top of their tax return to alert the FTB. If taxpayers are filing electronically, they should follow the software instructions to enter disaster information. If an affected taxpayer receives a late filing or late payment penalty notice related to the postponement period, the taxpayer should call the number on the notice to have the penalty abated.

Taxpayers who are victims of wildfires may claim a deduction for a disaster loss sustained in an area proclaimed by the governor to be in a state of emergency. For a complete list of all disasters declared by the governor, see the “List of Disasters” chart on FTB’s disaster loss webpage. Additional information and instructions are available in FTB Publication 1034, 2020 Disaster Loss: How to Claim a State Tax Deduction.

Taxpayers may claim their disaster loss in one of two ways: They may claim the disaster loss for the 2021 tax year when they file their return next spring, or they may claim the loss against 2020 income on this year’s return. An amended return may be filed by those who already have filed this year. The advantage of claiming the disaster loss in the prior tax year is that the FTB can issue a refund sooner.

Disaster victims also may receive free copies of their state returns to replace those lost or damaged. Taxpayers may complete form FTB 3516 and write the name of the disaster in blue or black ink at the top of the request.

Find more info at ftb.ca.gov.

The IRS previously announced tax relief for victims of wildfires in California. Information can be found at irs.gov/newsroom/irs-announces-tax-relief-for-victims-of-wildfires-in-california.

A roundup of disaster recovery resources also can be found at calcpa.org/sitecore/content/Sites/Public/home/public-resources/financial-literacy/disaster-recovery/2021-california-wildfire-relief.

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CalCPA Names Denise LeDuc Froemming President & CEO

CalCPA recently named Denise LeDuc Froemming, CPA, CAE, MBA as president and CEO of CalCPA and the CalCPA Education Foundation, effective Oct. 18.

“This is a tremendous opportunity to join CalCPA at such a momentous time for the profession, including the CPA Evolution project, the forthcoming development of sustainability standards and other trends that positively impact the value CPAs bring to the market,” said Froemming. “As a CPA myself, I can appreciate the changes our members are facing and will focus on delivering resources and programs that help CPAs take advantage of opportunities and overcome challenges.”

The announcement comes after a nationwide search by the CalCPA Board. Froemming will step in for Rich Simitian, CPA, who has been interim CEO since May.

“Denise brings deep association leadership to CalCPA and a fresh perspective from the real estate and health care sectors. She will be instrumental in leading our organization as we innovate, grow and nurture the CPA profession in California,” said CalCPA Chair Christie Simons.

Froemming was most recently CEO and executive vice president of the Chicago-based Institute of Real Estate Management. There, she led a team of association professionals serving more than 20,000 individual IREM members and more than 550 member firms worldwide.

Look for more on Froemming in a future issue of California CPA.

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How to Respond to Subpoenas

CPA firms are often uncertain about whether or how to respond to a subpoena, as they also need to comply with a number of rules and regulations that are intended to protect client confidentiality.

CPAs in receipt of a subpoena should consider the information in their client files, along with any recent communications with the client or any parties involved, and then contact the CPA's professional liability risk adviser or attorney before responding to the subpoena.

Typically, an attorney or other party will issue a subpoena because they believe the CPA has information that will establish facts relevant to the underlying case. However, sometimes a subpoena may indicate the CPA is a target in the underlying case by seeking information that could implicate the CPA as possibly liable for the matter being investigated or litigated.

If the CPA has received an order signed by a judge, or a subpoena from a government agency, in most cases the CPA must comply. Government subpoenas generally require compliance, even without client consent or a court order.

However, most subpoenas are preprinted forms that attorneys or other parties fill out to request information. In these cases, accountants are bound by a number of rules and regulations that are intended to protect clients, including IRC Sec. 7216. Under most circumstances, these rules and regulations prohibit the accountant from complying with the subpoena, unless the accountant has undertaken specific measures to protect client confidentiality, including obtaining the client’s consent.

Again, CPAs should contact their risk adviser regarding all subpoenas to evaluate the underlying litigation and the obligation to comply. Regardless of how much or how little information a CPA may have pertaining to the client or former client, it’s always important to promptly report the matter to the CPA’s professional liability insurance carrier.

For more, visit camico.com.
AUDIT & ACCOUNTING DELAYS EVERYWHERE

In case you missed it, several effective dates were delayed due to the pandemic. Here’s a quick summary:

- **Revenue Recognition**: ASC 606 was to be implemented for calendar 2019 for non-public clients. After the national emergency was declared, FASB provided an election for entities that had not yet issued their 2019 financial statements to delay the implementation of ASC 606 until 2020. However, if the 2019 financial statements had been issued, there was no going back.
- **Leases**: ASC 842 (for non-public companies) requiring capitalization of most leases was delayed to accounting years beginning after Dec. 15 unless it was early implemented. In other words, entities must implement ASC 842 for their calendar 2022 financial statements.
- **Credit losses rules**: ASC 326 is now delayed to years beginning after Dec. 15, 2022. In other words, calendar 2023 financial statements.
- **New Audit Report Standards**: SAS 134-140 is becoming effective this year. If you perform audits, then you will need to get to a class to understand the reasoning and implementation. These SAS are effective for all audit reports issued after Dec. 15. In other words, calendar 2021 financial statements.
- **New ERISA Audit Report and Procedures**: SAS 136. The ERISA audit report will be completely different for calendar 2021 audits. While ERISA still uses the term “Limited- Scope audit,” our professional literature is changing the nomenclature to “ERISA Sec. 103(a)(3)(C) audit.” If you audit ERISA financial statements, get to a CPE class, stat!

For more updates from CalCPA’s Accounting Principles and Auditing Standards Committee, see Page 12.

—CalCPA AP&AS Committee Member Mark F. Wille

**Statement of Ownership, Management and Circulation**

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<td>17. Signature and Title of Editor, Publisher, Business Manager, or Owner:</td>
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Accounting Standards

Codification (ASC) 842, Leases, is effective for private companies and other not-for-profit entities that have not issued (or made available for issuance) financial statements that reflect the new standard as of June 3, 2020, are required to adopt the new leases standard for annual periods beginning after Dec. 15 and interim periods in annual periods beginning after Dec. 15, 2022. Early adoption is permitted for all entities.

This is expected to have a significant impact on most entities’ balance sheets, considering how prevalent and routine leasing is to most businesses.

The FASB issued the new standard to increase transparency and comparability among entities by recognizing leases on the balance sheet and providing more information about leasing arrangements so that users can assess the amount, timing and uncertainty of cash flows from leases.

ASC 842 allows for two transition methods upon adoption:

- **Modified retrospective transition approach**: ASC 842 is applied to any leases existing at the beginning of the earliest comparative period presented in the financial statements, as well those commencing after that date, but prior to the effective date, with prior periods being restated; or
- **Prospective transition approach**: ASC 842 is applied only in the year of adoption, whereby the company would not need to apply the new guidance to its leases in the prior comparative periods. Public companies have already adopted the new standard and, based on the feedback and discussions in the past two years, it’s understood that adopting the new lease standard can be quite complex and time consuming, with many important nuances that can impact the amounts initially recorded.

What follows are updates on a variety of topics from CalCPA’s Accounting Principles and Assurance Services Committee. For more information on the committee, visit calcpa.org/apascommittee.
Definitions
The new standard defines a lease as “A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration.” The keys are whether there is an identified asset and whether the arrangement conveys control of the identified asset.

ASC 842-10-15-9 defines identified asset as “An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.”

ASC 842-10-15-16 also states: “A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.”

**ASC 842** provides several practical expedients and policy elections to make it easier to apply the new guidance.

**Lease Identification**
It’s more important to determine whether a contract is a lease or contains a lease under the new leases standard than it was under ASC 840, as an incomplete population of leases (as discussed later in this article) could materially misstate financial results. Under ASC 842, lessees must recognize a right-of-use asset (ROU) and lease liability on their balance sheets for most leases.

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**MATERIAL CHANGES TO THE REVIEW**

By Gail H. Anikouchine, CPA

In early 2020, the AICPA, in conjunction with the Accounting and Review Services Committee (ARSC), issued Statement on Standards for Accounting and Review Services (SSARS) No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*. SSARS 25 primarily amends AR-C Sec. 90, which relates to review services.

The issuance of SSARS 25 aligns with an overarching goal of minimizing differences with the International Standard for Review Engagements (ISRE) 2400, which has been part of a decades-long convergence project. In addition, SSARS 25 aligns some review practices with audit principles to provide consistency in areas that should apply equally regardless of the level of assurance provided.

What follows are the three significant changes to review services in SSARS 25.

**Determining Materiality**
For a long time, the review report has included a statement in the conclusion paragraph “not aware of any material modifications”; however, the accountant performing the review had no explicit requirement to calculate a threshold of materiality. To support the statement in the review report, many practitioners did calculate the threshold in a manner similar to that used for auditing financial standards. Now, such a calculation will be required and aid in providing evidence to support the review conclusion.

Further, the accountant needs to apply materiality to design the procedures and to evaluate the results of those procedures. The accountant is required to design and perform analytical procedures and inquiries of all material items on the financial statements, including the disclosures. During the review, the accountant will need to assess the need to recalculate materiality if the accountant becomes aware of information obtained during the review process that would have changed the initial calculation had such information been known.

**Independence**
The desire for the accountant performing a review engagement to be independent was reaffirmed with SSARS 21. While the requirement to use the word “independent” in the report title remains, effective with SSARS 25, within the Accountant’s Responsibility section, the accountant needs to include a statement of independence from the entity and that other ethical requirements relative to the review have been met.

**Adverse Review Conclusion**
Prior to SSARS 25, the accountant could issue a modified review report in somewhat limited circumstances, such as a framework departure that was material, but not pervasive. SSARS 25 expands the use of modified reports. The accountant should alter the Accountant’s Conclusion paragraph heading with either the words “qualified” or “adverse” and include a reference to the immediately preceding paragraph headed “Basis for Qualified (or Adverse) Conclusion.”

The Basis paragraph will contain the description of the matter(s) giving rise to the modification. A Qualified conclusion indicates that the modification is material, but not pervasive, to the financial statements, while an Adverse conclusion is both material and pervasive to the financial statements.

For further information or to see the illustrative review reports, see SSARS 25 at tinyurl.com/AICPASSARS25 or see AR-C 90 at tinyurl.com/AICPAARC90. These amendments within SSARS 25 are effective for engagements performed in accordance with SSARS on financial statements for periods ending on or after Dec. 15, with early implementation permitted.

Gail H. Anikouchine, CPA is the owner of Anikouchine & Associates and a member of the CalCPA Accounting Principles and Assurance Services Committee. You can reach her at gail@CPAGHA.com.
MANAGING THE HANDOFF: NOCLAR
By Gary Krausz, CPA

Much like passing the baton during the 100-meter relay race, the rules for handing off audit clients are complicated—and changing fast. One of the issues that successor auditor’s face is the required communications with the predecessor auditor: how this needs to be authorized, what to ask and what to do when there are barriers to open communication between predecessor and successor auditor.

No one wants to drop the baton, especially when it comes to the required inquiries about noncompliance with laws and regulations (NOCLAR).

To help clarify our responsibilities and align the U.S. GAAS rules with the international auditing standards, the AICPA’s Auditing Standards Board (ASB) exposed for public comment the Statement on Auditing Standards (SAS), Communication with Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations. The overall objective of the proposed standard is to help auditors properly understand potential issues in determining whether to accept an engagement.

This exposure draft has its roots in the International Ethics Standards Board for Accountants (IESBA). The IESBA code requires a predecessor auditor to “provide all relevant facts and other information concerning the identified or suspected non-compliance (with laws and regulations) to the proposed accountant. The predecessor accountant shall do so even ... where the client fails or refuses to grant the predecessor accountant permission to discuss the client’s affairs with the proposed accountant, unless prohibited by law or regulation.”

The Professional Ethics Executive Committee believes that certain differences are necessary to make them relevant to CPAs in the United States. Most notably, the IESBA provisions permitting disclosure to an outside authority under certain conditions were not included in the AICPA proposals, as they would be incompatible with most state laws and regulations on client and employer confidentiality.

The proposed revision to AU-C Sec. 210 would “require a prospective successor auditor, once management authorizes the predecessor auditor to respond to inquiries from the predecessor, to inquire of the predecessor auditor regarding identified or suspected fraud or NOCLAR.”

Furthermore, the absence or limitation of authorization by management for an auditor to make inquiries of a predecessor auditor should alert the successor auditor to carefully consider engagement acceptance.

The successor auditor will need to document the reasons for a client’s limitation or refusal to authorize the predecessor auditor to respond fully to the auditor’s inquiries and to consider the implications of that refusal or limitation in deciding whether to accept the engagement. A limitation or refusal to consent by the client would be a significant red flag that the successor would need to consider in determining whether to accept the engagement.

Finally, the predecessor auditor may limit or refuse to respond to inquiries due to impending, threatened or potential litigation; disciplinary proceedings; or other unusual circumstances.

Under the proposed standards, the predecessor auditor should clearly state their responses are limited. Thereafter, the successor auditor should evaluate the predecessor’s limited responses in determining whether to accept the engagement.

The flowchart available in the Exposure Draft at tinyurl.com/AICPANOCLAR illustrates the proposed revision to existing auditing standards.

If issued as final, the proposed amendment to AU-C Sec. 210 will be effective for audits of financial statements for periods ending on or after Dec. 15, 2022. Early implementation would be permitted.

CalCPA’s Accounting Principles and Assurance Services Committee submitted a comment letter (calcpa.org/members/committees-sections/apas-committee-information/2015-apas-committee-comment-letters) to the AICPA in support of these revisions to AU-C Sec. 210. The ASB will review all comment letters at their September meeting. We hope this will be a smooth hand-off.

Gary Krausz, CPA/CFF is a partner at Gursey | Schneider LLP and a member of the CalCPA Accounting Principles and Assurance Services Committee. You can reach him at garyk@gursey.com.

Entities will need to apply judgment to determine whether the contract includes an identified asset and whether the customer has the right to control the identified asset for a period in exchange for consideration. When determining whether an arrangement is or contains a lease, lessees evaluate, among other things, whether the customer has the right to control the use of the identified asset.

Once an arrangement is determined to be a lease or a contract containing a lease, you will need to determine the commencement date, lease term, lease payments and the discount rate, as you will need this information to determine lease classification and calculate the amounts initially recognized on the balance sheet.

Lease Classification

Lease classification is important because the pattern of expense recognition is different for finance vs. operating leases. The lessee will follow the same process for classifying the lease as under the existing standard ASC-840.

While the criteria to determine whether a lease is a finance lease are similar to those for capital leases under ASC 840, there are two changes lessees need to be aware of:

1. The addition of a fifth criterion related to the specialized nature of the underlying asset; and
2. The removal of ASC 840’s bright lines and the introduction of judgment when determining whether a lease meets the economic life (the 75 percent test under ASC 840) or fair value (the 90 percent test under ASC 840) criterion. The FASB stated that “one reasonable approach” would be to conclude that “ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset, and that 75 percent of remaining useful life is still an acceptable benchmark.”

Initial Recognition & Measurement

Lessees initially recognize a lease liability for the obligation to make lease payments and a ROU asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments over the lease term. The ROU asset is measured at the lease liability amount, adjusted for lease prepayments, lease incentives received and the lessee’s initial direct costs (e.g., commissions).

ASC 842 provides several practical expedients and policy elections to make it easier to apply the new guidance. Listed in Figure 1 are various policy elections available to entities on adoption and related considerations.

Note 1: As of the writing of this article, the
FASB is working on Exposure Draft 2021-003, *Leases—Discount Rates for Lessees that Are not Public Business Entities*. This draft intends to clarify use of risk-free rate, by asset class and if implicit rate not available for lease accounting.

**Subsequent Measurement**

For operating leases, lessees measure the lease liability at the present value of the remaining lease payments, which results in the same subsequent measurement as the liability for a finance lease. They subsequently measure the ROU asset at the amount of the remeasured lease liability, adjusted for cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term, unamortized lease incentives, unamortized initial direct costs and any impairment of the ROU asset.

---

**TABLE 1**

<table>
<thead>
<tr>
<th>ELECTION</th>
<th>DESCRIPTION</th>
<th>CONSIDERATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Package of practical expedients (lessee and lessor)</td>
<td>Allows a private company not to reassess: - Whether any expired or existing contracts are or contain leases - Lease classification for any expired or existing leases - Initial direct costs for any expired or existing leases</td>
<td>Most private companies are expected to elect this package of expedients because doing so reduces the cost and complexity of transitioning to ASC 842. It is important to keep in mind that this election does not grandfather incorrect conclusions under ASC 840.</td>
</tr>
<tr>
<td>Hindsight practical expedient (lessee and lessor)</td>
<td>Permits private companies to revisit the determination of the lease term for existing leases by considering the effect of changes in facts and circumstances through the effective date.</td>
<td>Lessees are more likely to elect this expedient if the facts and circumstances indicate that lease terms may be shorter than originally anticipated and, therefore, the ROU asset and lease liability would be lower. Electing this practical expedient is generally expected to make implementation more complex.</td>
</tr>
<tr>
<td>Short-term lease policy election (by class of underlying asset to which the right of use relates—lessee only)</td>
<td>Permits lessees to not recognize an ROU asset and a lease liability for leases with a term of 12 months or less at lease commencement and to recognize expense related to lease payments on a straight-line basis over the lease term as an operating lease under ASC 840. A qualifying lease cannot include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.</td>
<td>This expedient is expected to reduce the cost of applying ASC 842. However, private companies still need to appropriately evaluate the lease term, including the likelihood that they will exercise extension and/or termination options, and provide certain disclosures.</td>
</tr>
<tr>
<td>Lessee practical expedient to not separate lease and non-lease components (by class of underlying asset)</td>
<td>Permits lessees to account for each separate lease component of a contract and its associated non-lease components as a single lease component, i.e., all of the contract consideration is allocated to the lease component. Multiple lease components cannot be combined into a single lease component.</td>
<td>Using this expedient will reduce the cost and complexity of applying ASC 842, but it will increase the likelihood that a lease will be classified as a finance lease (i.e., it’s more likely that the lease would meet the fair value criterion because all consideration is allocated to the lease component) and it will increase the initial measurement of it.</td>
</tr>
<tr>
<td>Risk-free-rate policy election</td>
<td>Permits private company lessees to use a risk-free rate as the discount rate for classifying and measuring leases. Private company lessees will need to obtain the rate for risk-free borrowings for a term comparable to each lease. The risk-free rate cannot be less than zero. If this election is made, it must be applied to all existing leases as of the effective date and to new or modified leases after the effective date. (Also refer Note 1)</td>
<td>Using a risk-free rate will reduce complexity, but it will increase the likelihood that a lease will be classified as a finance lease, and it will increase the initial measurement of the lease liability and ROU asset. Also, private companies that are considering going public may not want to make this election because they will have to retrospectively apply the public entity accounting and reporting requirements to all prior periods presented if they go public.</td>
</tr>
<tr>
<td>Easements practical expedient (lessee only)</td>
<td>Permits lessees to continue applying their current policy for accounting for land easements that existed as of, or expired before, the effective date. This expedient is available for transition only.</td>
<td>Lessees will still need to evaluate whether land easements they enter into or modify on or after the effective date meet the definition of a lease under ASC 842.</td>
</tr>
</tbody>
</table>

(Source: EY publication- The Private Angle- Navigating the new lease standard- August 2020)
Lessees recognize lease expense for these leases on a straight-line basis, which is similar to what is done under ASC 840. ROU assets for both lease types are subject to impairment testing under ASC 360, Property, Plant, and Equipment.

For finance leases, lessees increase the lease liability to reflect interest and reduce the liability for lease payments made. The related ROU asset is amortized on a straight-line basis unless another systematic basis is more representative of the pattern in which the lessee expects to consume the asset’s future economic benefits.

Effects on Balance Sheet & Income Statement
Under ASC 842, the entity recognizes all leases, including operating leases, on the balance sheet. Both financing leases and operating leases create an ROU asset and a lease liability, initially measured at the present value of the future lease payments, to be reflected on the balance sheet.

For operating leases, the entity recognizes a single total lease expense and a gross up on the balance sheet related to the ROU asset and lease liability. For financing leases, the entity recognizes amortization expense of the ROU asset separately from interest expense on the lease liability.

Disclosures
ASC 842 expands the disclosure requirements for both lessees and lessors. ASC 842-20-50-1 (lessee disclosure) states, “The objective of these expanded disclosures is to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases.”

ASC 842 requires both lessees and lessors to disclose quantitative and qualitative information about their leases, the significant judgments and assumptions made in applying ASC 842 and the amounts recognized in the financial statements related to those leases.

ASC 842 Implementation Practical Tips & Steps to Consider
Based on my prior experience, entities that have adopted the new leases standard required more effort than initially anticipated by the management. Entities experienced difficulty in determining whether their lease population is complete, and collecting the data needed to account for and disclose information about their leases under the new standard.

Therefore, it’s important for entities to start planning now, even though the FASB has deferred the effective date to next year.

For Operating Leases, lessees measure the lease liability at the present value of the remaining lease payments, which results in the same subsequent measurement as the liability for a finance lease.

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As entities prepare for adoption of the standard and related year-end reporting, they may want to consider the following steps related to ASC 842 implementation.

**Project plan (including need for resources):** The first step is understanding the requirements of ASC 842, establishing a project team and preparing a project plan. Entities also might need to engage consultants/advisers to help in both the project planning, accounting and monitoring the project progress for accurate implementation of ASC 842. Also, entities will need to plan for this additional cost of consultants/advisors in their annual budgeting process.

**Existing process and controls:** One of the key challenges that many public companies faced was ensuring that their population of lease contracts was complete. The identification of a complete population of leases may require more coordination between finance/accounting personnel, real estate, procurement, operations and corporate development. Entities will need to consider their existing processes and controls for identifying new leases or contracts that contain leases.

**Service contracts or embedded leases:** During review of the contracts, entities also need to consider the fact that a contract being labeled a “service contract” or a lease does not mean the arrangement is or is not a lease. While companies have often accounted for many

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**Example: Lessee Accounting for an Operating Lease**

Entity L (lessee) makes a payment of $5,000 to an existing tenant to obtain a lease and enters into a three-year lease of the same office space that it concludes is an operating lease. The lease commences at the beginning of Year 1. Entity L agrees to make the following annual payments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. Entity L concludes that the $5,000 payment to the former tenant qualifies as an initial direct cost (IDC).

For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, variable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is $12,000 per year \([($10,000 + $12,000 + $14,000) ÷ 3]\).

**Analysis:** At lease commencement, Entity L would recognize the right-of-use asset and lease liability:

<table>
<thead>
<tr>
<th>Asset/Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>$38,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$33,000</td>
</tr>
<tr>
<td>Cash</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*To initially recognize the right-of-use asset, lease liability and the payment that qualifies as an IDC.*

The following journal entries would be recorded in Year 1:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>$12,000</td>
</tr>
<tr>
<td>Right-of-use asset (accrued rent)</td>
<td>$2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
</tbody>
</table>

*To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent).*

Lease expense (amortization of IDC) $1,667
Right-of-use asset (amortization of IDC) $1,667

*To record amortization of the IDC ($5,000 ÷ 3 years = $1,667).*

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>$8,602</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>$8,602</td>
</tr>
</tbody>
</table>

*To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.*

A summary of the lease contract’s accounting (assuming no changes due to reassessment, lease modification or impairment) is as follows:

Immaterial differences may arise in the recompilation of amounts in the example above due to rounding.

*Source: EY publication - Financial Reporting Development - Lease Accounting - December 2020*
arrangements as service agreements with no balance sheet liability, companies now must assess and identify those arrangements that meet the criteria for a “lease.”

System implementation or implement a checklist: Another challenging step in lease implementation is to ensure that lease assets and liabilities are accurately calculated and reported in the financial statements after adoption of the new standard. Today, many entities use Excel spreadsheets for their lease tracking, calculation and accounting. As such, entities may consider developing new or updated systems and controls to identify any embedded leases at the execution of all new contracts or arrangements.

Alternatively, entities not using any software solutions may consider a checklist of key areas to be addressed for adoption of ASC 842.

If entities decide to implement a new IT system, it should be done with an approach that is right for them. A few of those key decisions include determining whether the system:

- Should be centralized or decentralized,
- Should be developed in-house or outsourced to a third party; and
- Can be interfaced with the company’s current enterprise resource planning system.

Develop new accounting policies: As per transition provisions of ASC 842, you can choose to apply the transition provisions at the beginning of the earliest comparative period presented in your financial statements or these provisions can be applied at the date of adoption (i.e., the effective date). The latter option effectively allows entities to continue to apply the guidance in ASC 840, including its disclosure requirements, in the comparative periods. This will make the transition accounting easier to apply, because you would not need to recast numbers for periods before adoption.

Debt covenants: Needed to consider impact of ASC 842 adoption on its EBITDA sensitive amounts, and to have discussions with lending institutions about the pro forma effect on debt covenants. As there may be a need to modify existing debt arrangements or proactively address the new covenants required post-ASC 842 adoption.

Auditor involvement: Consider reading additional guidance from the large independent accounting firms and discussing the timing of the auditing of the ASC 842 adoption process with your independent auditors to ensure that there is time for timely remediation or consideration of timely feedback, if needed.

ASC 842 COVID Considerations
Entities that receive or provide lease-related concessions to mitigate the economic effects of COVID-19 on lessees need to consider whether to elect to not evaluate whether certain concessions provided by a lessor related to the effects of COVID-19 are a modification of the lease.

Refer to the Question and Answer document issued by staff of FASB posted on FASB website, tinyurl.com/leaseconcessionsFAQ.

Ravi Malhotra, CPA is a member of the CalCPA Accounting Principles and Assurance Services Committee. You can reach him at rmalhotra1981@gmail.com.

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Quality Management

The times are changing for firms that conduct audits—and they will likely affect the willingness of many to perform such engagements.

The Auditing Standards Board (ASB) has issued an exposure draft to address audit quality concerns. It has also continued its effort of convergence with the standards of the International Auditing Standards and Assurance Standards Board.

There are three new standards for quality management at the firm and engagement levels that will need to be implemented by Dec. 15, 2023, so each firm’s first annual evaluation of their system will be performed by Dec. 15, 2024:

- Proposed Statement on Quality Management Standards (SQMS 1), A Firm’s System of Quality Management
- Proposed SQMS 2, Engagement Quality Reviews
- Proposed Statement on Audit Standards Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards

A Firm’s Quality Management System

Of the following eight components under SQMS 1, some are the same as Quality Control standards in place, but there are new ones:

1. The firm’s risk assessment process (new)
2. Governance and leadership
3. Relevant ethical requirements
4. Acceptance and continuance of client relationships and specific engagements
5. Engagement performance
6. Resources
7. Information and communication (new)
8. The monitoring and remediation process

The new risk assessment process requires a firm to establish quality objectives, identify and assess risks to achievement of the quality objectives, and design and implement responses to address the quality risks.

The other new component underscores the importance of a continuous flow of information and communication by linking the exchange of information to the firm’s culture, so it is driven from top leadership.

While the other components may not be new, there are nuances to improve the firm’s quality management system.

Engagement Quality (EQ) Reviews

There are requirements for policies and procedures addressing the appointment of engagement quality reviewers and performance of EQ reviews. According to the ASB, the EQ review was put into a separate standard to make it a point of emphasis for the firm’s overall quality management.

Appointment, Eligibility of Reviewers

Requirements and application material have been added to address:

- The eligibility of the individuals within the firm responsible for the appointment of EQ reviewers.
- The eligibility of individuals to assist the EQ reviewer in performing the engagement quality review.
- The authority, competence and capability, including sufficient time to perform the EQ review, of the EQ reviewer.

- The EQ reviewer taking responsibility for the performance of the engagement quality review, including that the work of individuals assisting in the review is appropriate.

Review Performance, Documentation

The proposed standard provides guidance on the EQ reviewer’s attention on significant judgements and matters, the timing of the review and documentation requirements.

Proposed QM SAS

The proposed QM SAS makes clear that the engagement partner has overall responsibility for managing and achieving quality and outlines the engagement partner’s need to be sufficiently and appropriately involved throughout the engagement. The overall responsibilities include:

- Fulfilling leadership responsibility;
- Supporting engagement performance; and
- A “stand-back” requirement.

The new stand-back requirement is to determine whether the engagement partner has taken overall responsibility for managing and achieving quality, including determining that the engagement partner’s involvement has been sufficient and appropriate throughout the engagement and that the nature and circumstance of the engagement have been taken into account. The standard also outlines guidance on group audits, covering relevant ethical requirements and engagement resources, and clarifying what engagement partners need to review.

As firms implement these proposed standards, it will tap into resources that will likely pose challenges for smaller firms and may be the deciding factors for them to cease doing these types of services.

David Chavez, CPA is partner at Chavez Accountancy Corp. and a member of the CalCPA Accounting Principles and Assurance Services Committee. You can reach him at davchavezcpa@gmail.com.
Mid-September marked the end of the first year of the 2021-22 legislative session. The flurry of late session activity sent a number of bills to the governor for action. He will have until Oct. 10 to act.

For CalCPA, the legislative session was largely successful and CalCPA was able to address a number of important issues on behalf of the CPA profession.

**Paycheck Protection Program Loans**

Early in the year, CalCPA was heavily engaged in the advocacy of state action to determine how Paycheck Protection Program (PPP) loans should be treated for state tax purposes. The delay in state guidance led to confusion and challenges for CPAs and their clients that had received a PPP loan.

CalCPA’s grassroots advocacy and position letters helped spur action on a policy that will allow most taxpayers to apply the more favorable federal PPP tax rule for state tax purposes. While the ultimate policy that was outlined by the state will not benefit clients that had received a PPP loan.

**School Audits**

Additionally, CalCPA worked with legislative staff and other stakeholders to address proposed legislation that would have placed additional regulatory burdens on CPAs who provide audit services to schools.

To increase financial oversight and audit requirements for local education agencies, namely charter schools, the proposal would place additional CPE and peer review requirements on CPAs that serve this industry. These additional requirements would have been inconsistent with the current licensing framework and would have created significant challenges for CPAs working in the education space.

**Changes to Licensure Process**

Last month, the Legislature passed and sent to the governor’s desk for action AB 298, legislation sponsored by the California Board of Accountancy (CBA) and supported by CalCPA that makes thoughtful adjustment to the current CPA licensure process to provide increased flexibility and efficiency for applicants as they work toward their license and entry into the profession.

First, the bill makes changes allowing candidates to apply and sit for the CPA Exam prior to their official degree conferral. Second, the bill updates the current ethics education requirements for licensure to allow additional flexibility in how candidates can meet the ethics education requirements for licensure. More specifics about this bill were highlighted in the June issue of California CPA.

The governor has until Oct. 10 to act on the bill and is expected to sign it. Following the governor’s approval, the CBA will be working with CalCPA and the academic community to outreach to candidates about the changes to the licensure process.

**Governor Defeats Recall**

Last month California voters decided not to recall Gov. Newsom. While he will remain in office for the remainder of his term, the politics and campaigns surrounding the recall election are likely to transition to the next gubernatorial election in November 2022.

The governor will be up for re-election, where many of the same issues debated in recall will be debated in a more traditional campaign cycle. Additionally, most legislative seats are likely to be up for election under newly drawn legislative district lines.

The politics of another high-stakes gubernatorial campaign and a more contentious legislative election is likely to significantly shape the policy discussions for the second year of the 2021-22 legislative session. CalCPA’s government relations team will continue to follow these political developments and how they may shape the policy issues of importance to the CPA profession and their clients.

Jason Fox is CalCPA’s vice president of government relations. You can reach him at jason.fox@calcpa.org.
What’s Bezosism?

Is it the Future of Management?

Christopher Mims, a technology columnist for The Wall Street Journal, recently coined the term Bezosism. What is Bezosism? It may become the standard of workplace efficiency soon—including at your firm.

CPA firms tend to manage their overall productivity by utilization rates. What do your local Amazon warehouse, let’s call it SFO1, and your own CPA firm have in common? Both SFO1 and your firm use people and technology to fulfill a customer’s order. There are five key criteria to fill that order: workflow, roles, collaboration, technology and continuous improvement.

It’s often said that the value of your firm are the people sitting at your desks producing something valuable every day. That value is quantified in your revenues, your EBITDA, your utilization rates, and your client and employee retention rates. It’s a bit more complex the higher up the knowledge ladder you go, but at the end of the day, if your people are not efficient compared to your industry, you will fall behind.

Bezosism Benevolence?

OK, now back to Bezos. Jeff Bezos, of course, is the oft-quoted and studied billionaire who built Amazon—and now wants to win the private citizen space race—on worker efficiency. The pandemic only grew his wealth and expanded the Amazon empire.

How did that package of floss arrive so quickly in a box so comically large? Bezosism. Its journey started in an Amazon warehouse, and the order was fulfilled by an assembly line of workers and processes in an Amazon fulfillment center. Austin Morreale, who took a job at an Amazon fulfillment center as a stower to supplement his own income, said most people he trained with quit within their first two weeks. They couldn’t make “rate,” which is the Bezosism term for keeping up with the pace of work.

Bezosism does not involve managers walking the warehouse floors, hovering down from above and shouting expletives as workers frantically run around filling boxes. Rather, warehouse managers hold stand-up meetings twice a day, where they report on making rate—the metric for evaluating worker efficiency and performance.

Amazon has fitted their warehouses with sensors that track employees moves, and those moves are then analyzed in software, real-time and reported back to the warehouse employees regularly throughout the day. The rate is the output of this complex algorithm.

Per Mims, “It’s a mix of surveillance, measurement, psychological tricks, targets, incentives slogans, Jeff Bezos’ trademark hard-charging attitude toward work, and an ever-growing array of clever and often proprietary technologies. Taken as a whole, this system is novel enough in the history of work that it deserves its own name: Bezosism. The Bezosism algorithm carries the torch started from Henry Ford assembly line and later, Toyota’s just-in-time approach to production and efficiency.”

As Mims points out, Bezosism is catching on quickly through the global world of work. And, depending on its incarnation, it may be benevolent, a benevolent dictator, sinister or all the above.

Rate’s Ramifications

That rate we talked about earlier is susceptible to bias. The overall rate at which workers must complete a task—organizing, gathering or packing or items—is the aggregate efficiency of everyone doing those same tasks in each facility, according to Amazon. Amazon may see this rate as fair because it’s similar to what the average warehouse worker is already doing. But is that average? Amazon fulfillment workers and its drivers have long raised workplace issues. A replaceable workforce whose only value is their “rate” may either quit, if they have other options, or stay the course and grind until the end. Bias will inevitably creep into those numbers.

States, like our great state of California, have taken notice, as legislators here recently have advanced a bill to regulate companies that use quotas and algorithm-based practices in their factories and warehouses. This may be too late, though. As consumers, we have voted with our pocketbooks that this form of commerce and efficiency is preferable to the alternative, which involves spending your spare time dealing with humans in a store.

Amazon has recently announced they’re planning its own cashier-less, automated grocery stores. That explains the Whole Foods acquisition. I’m glad that I became a CPA, but I’m not sitting carefree now. It’s a matter of time when Bezosism infiltrates our profession. Those close to retiring won’t care, but those like me with 25 plus years left before retirement sure do.

Consolidation is on the rise. So are private equity investments. The commoditization, and Bezosism, of our profession is approaching. What will the CPA firm of the future look like? Otherworldly utilization rates and revenue per employee? What skills and technologies do we need to leverage to make rate with a non-CPA algorithmic manager? Intellectual property—the core of our professional value—kicks off cashflows. IP cashflows are tracked. And what is tracked is managed. And keep in mind there are many accounting workflows already out there: CCH Axcess Workstream and SmartSheet, to name a few.

Trevor Gilmore, CPA/ABV, MST is CFO of the The Menke Group. You can reach him at tgilmore@menke.com.
Rescue Legislation

2021 American Rescue Plan Act Provides Tax Relief

Advance Payments
The Treasury Department and the IRS will disburse monthly advance payments for 50 percent of this credit, beginning July 1 through Dec. 31. The remaining unpaid 50 percent will be received when 2021 returns are filed as the full amount of this credit is claimed on those returns but after reduction for amounts received in advance.

If a taxpayer received erroneous payments (for example a 2019 or 2020 return indicated a dependent child who is not a dependent in 2021), the ARPA contains a safe harbor, protecting taxpayers from repaying overpayments of up to $2,000 per child.

This safe harbor is available for:
- Joint return filers with MAGI of $120,000 or less.
- Head of household filers with MAGI of $100,000 or less.
- Single taxpayers with MAGI of $80,000, or less.

The Treasury Department and the IRS are directed to create a website for taxpayers to opt out of receiving advance payments or to provide information on status changes that would affect the amount of the credit.

For additional information, see Rev. Proc. 2021-23 and irs.gov/childtaxcredit2021.

Earned Income Tax Credit
For 2021 only, the ARPA makes these changes for taxpayers without children:
- The credit increases to $1,502 from $534 (per the 2020 Form 1040 instructions, Page 50);
- Increases the income at which this credit is maximized to $9,820 from $7,100;
- Increases the phaseout threshold for non-joint filers to $11,610 from $8,880; and
- Reduces the minimum age for claimants to 19 from 25 (except full-time students).

The ARPA also permits taxpayers to substitute 2019 earned income for 2021 earned income in claiming this credit on 2021 returns if 2021 earned income is less than 2019 earned income.

A similar provision was contained in the 2021 Consolidated Appropriations Act (CAA), P.L. 116-260, permitting lower-income taxpayers to compute their 2020 earned income credit by using their 2019 earned income instead of their 2020 earned income if this earned income was less than their 2019 earned income (See the March/April 2021 California CPA, Page 23).

There are other changes to the earned income credit, which are permanent, including the following:
- Eliminating the prohibition against taxpayers claiming the childless credit solely because they cannot claim the earned income credit for taxpayers with children due to the lack of identification requirements;
- A married, but separated, individual can claim the earned income credit as an unmarried individual if certain requirements, pertaining to children, are satisfied; and
- The amount of disqualifying investment income, for purposes of the earned income credit, is increased to $10,000—adjusted for inflation after 2021. The disqualifying investment income was $3,650 for 2021.

Child & Dependent Care Assistance Credit
Under the old law, this credit was equal to 35 percent of qualified expenses for care of a qualifying individual—up to $3,000 for one qualifying individual or $6,000 for two or more qualifying individuals. These amounts are reduced by the total amount excludable from gross income under Sec. 129 dealing with exclusions from gross income for dependent care assistance programs described in Sec. 129(d) [Sec. 21(c)]. However, this 35 percent was reduced by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income (AGI) exceeding $15,000—but not below 20 percent.

For 2021 only, the ARPA makes the following changes:
- This credit is based on 50 percent of qualified expenses, instead of 35 percent;
- The 50 percent is reduced by 1 percentage point for each $2,000
(or fraction thereof) of AGI exceeding $125,000. This credit percentage is then not further reduced below 20 percent until AGI reaches $400,000, when the reduction of the credit percentage continues until it is zero;

• The amount of eligible expenses qualifying for this credit are increased to $8,000 for one qualifying individual and $16,000 for two or more qualifying individuals; and

• This credit is fully refundable.

In addition, the maximum exclusion under Sec. 129(a)(2)(A) for employer-provided dependent care could not exceed $5,000 ($2,500 for married filing separately).

For 2021, the ARPA increases these limitations to $10,500 (or $5,250 for a married individual filing a separate return). For further information, see irs.gov/newsroom/child-and-dependent-care-credit-faqs.

Forgiven Student Loans Exclusion

Under the old law, forgiven student loans were excluded from gross income only under certain conditions—such as the borrower’s death or disability.

However, for loans discharged after 2020 and before 2026, the ARPA provides that this exclusion applies to any discharge of student loans for any reason during this period.

The exclusion also will apply to private student loans, if there is no required provision of services to the discharging lender.

Recovery Rebates

The Coronavirus Aid, Relief and Economic Security (CARES) Act, P.L. 116-136, enacted March 27, 2020, provided the first round of these rebates—with $1,200 for individuals and $500 for qualifying children (see the June, August, October and December 2020 issues of California CPA, at Pages 12, 19, 24 and 28, respectively).

The 2021 CAA provided an additional $600 stimulus payment—for individuals and children (see the March/April and June 2021 California CPA, at Pages 23 and 21 respectively).

The ARPA contains a third round of direct stimulus payments for taxpayers in the amount of a $1,400 payment. These payments are credits against 2021 income taxes but are fully refundable and payable in advance (similar to the previous payments).

But, like the prior payments, this third round is subject to income limitations. The payment is phased out ratably if AGI exceeds the following amounts:

• $150,000 for joint return filers
• $112,500 for head of household return filers
• $75,000 for single return filers

This stimulus payment phases down to zero if AGI reaches the following levels:

• $160,000 for joint return filers
• $120,000 for head of household return filers

$80,000 for single return filers

2020 AGI is used to compute the phaseout, but 2019 AGI is substituted if 2020 returns have not yet been filed. Comparable to the last two stimulus payments, amounts to which taxpayers would be entitled, but did not receive, will be creditable on 2021 income tax returns filed in 2022. Also, payments received that were based on 2019 or 2020 returns, but would be lower based on 2021 returns, do not have to be repaid.

This $1,400 stimulus payment is for all individuals who have a Social Security number and applies to taxpayers, their children and non-child dependents.

The Treasury Department and the IRS are granted authority to make stimulus payments to non-filers based on available information.

Stuart R. Josephs, CPA has a San Diego-based Tax Assistance Practice that specializes in assisting practitioners in resolving their clients’ tax questions and problems. Josephs, immediate past chair of the Federal Subcommittee of CalCPA’s Committee on Taxation, can be reached at (619) 469-6999 or stuartrjosephs@yahoo.com.

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**FEATURED EVENTS**

**OCT. 21**

**@ Temblor BrewingCo**

**Bakersfield Chapter**

**Attorneys, Bankers and CPAs (ABC) Mixer**

Come mix and mingle with fellow Attorneys, Bankers and CPAs from Bakersfield! Enjoy drinks and hors d’oeuvres while expanding your network and socializing.

[calcpa.org/BKABC](http://calcpa.org/BKABC)

**OCT. 28**

**@ Subpar Miniature Golf**

**San Francisco Chapter**

**Halloween Ghouls, Ghosts and Mini Golf Mixer**

Fore! Sink a few balls and brush up on your MINI-golf game at Subpar Mini-Golf. Take a break and join in on the fun and spend an evening with your fellow emerging professionals. Casual food and 2 drink tickets included. See you there.

[calcpa.org/SFMiniGolf](http://calcpa.org/SFMiniGolf)

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