

## Center for Plain English Accounting

AICPA's National A&A Resource Center

### **FASB ASC 842** **Reporting on Consolidating Information**

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Over the last several months, we have received and answered many questions from our members on FASB *Accounting Standards Codification* (FASB ASC) ASC 842, *Leases*, and related party leases. One specific group of questions deal with related party leases and presenting consolidating information.

The questions arise when FASB ASC 842 is not adopted for related party leases in individual entities that are part of a consolidated group, since these leases, even if recorded, would eliminate in consolidation. When this situation occurs, members have inquired about various issues related to lease misstatements in the consolidating entities. While many of our answers have been covered in various past reports, we thought it would be helpful if we compile those inquiries and replies into one spot.

Throughout the inquiries and answers below, assume the following facts:

A consolidated reporting entity has leases among related parties in the group (lessee and lessor). Management of the consolidated group has not adopted FASB ASC 842 for related party leases because any ROU assets and lease liabilities would eliminate in consolidation. Management will be presenting consolidating information.

***Inquiry 1:*** Does the nature of the consolidating information and the auditor's reporting obligation, if any, change depending on whether management includes the consolidating information on the face of their basic financial statements or as separate schedules outside of the basic financial statements?

***Reply:*** As per AICPA *Technical Questions and Answers* 9170, *Supplementary Information*, consolidating information included on the face of the financial statements, would be considered supplementary information, the same as if the information was

presented outside the basic financial statements, as long as such information is clearly differentiated from the financial statements.

As long as the auditor is not engaged to audit and opine on the consolidating information, then the auditor's reporting obligation is the same regardless of whether the consolidating information is included on the face of the financial statements or outside the basic financial statements.

**Inquiry 2:** As the auditor of the consolidated group are we obligated to report on the consolidating information?

**Reply:** Assuming that you have not been engaged to audit and opine on the consolidating information, you need to determine whether:

1. You have been engaged, pursuant to AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, to report on whether supplementary information (e.g., the consolidating information) is fairly stated, in all material respects, in relation to the financial statements as a whole. If the auditor has not been engaged pursuant to AU-C 725, then,
2. The auditor needs to determine whether consolidating information (or any other information other than the consolidated financial statements and the auditor's report thereon) is included in the group's "annual report" (as that term is defined by AU-C 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*). There are specific reporting requirements in AU-C 720 when applicable.

If neither of these sections (AU-C 725 nor AU-C 720) apply, then the auditor is not required to report on the consolidating information. However, nothing precludes the auditor from voluntarily reporting on the other information (See inquiry 8 below).

**Inquiry 3:** Management would like to engage us to apply AU-C 725 and to report on whether the consolidating information is fairly stated, in all material respects, in relation to the financial statements as a whole. What factors should we consider before accepting such an engagement?

**Reply:** Just because an auditor has accepted an engagement to audit the consolidated financial statements of a group, the auditor should not automatically accept an engagement to apply AU-C 725. Like any assurance engagement, an auditor should consider the engagement risks associated with an AU-C 725 engagement and what issues there may be in performing such an engagement.

The auditor should consider, for example:

- Why does management want to present consolidating financial information if such information contains known misstatements (i.e., FASB ASC 842 misstatements)?
- Is the consolidating information likely to be misunderstood or misused by financial statement users who may look at the consolidating information as separate financial statements for each member of the consolidating group?
- Are there outside users, for example bankers, who may be using the consolidating information for decision making purposes?
- What type of nonattest services will need to be provided by the audit firm in preparing the consolidating information and will such services impair the auditor's independence?
- Knowing that related party leases have not been recorded pursuant to FASB ASC 842, will there be issues in applying materiality to these U.S. generally accepted account principles (U.S. GAAP) misstatements?

These and other risks need to be considered before an auditor decides to accept an engagement to apply AU-C 725.

***Inquiry 4:*** In addition to auditing the consolidated group, we also have been engaged, pursuant to AU-C 725, to report on the consolidating information and whether such consolidating (supplementary) information is fairly stated, in all material respects, in relation to the financial statements as a whole. How is materiality applied by the auditor when concluding whether the supplementary information is materially misstated in relation to the financial statements as a whole?

***Reply:*** When applying the requirements of AU-C 725, the auditor should use and apply the same materiality as used in the audit of the consolidated financial statements. Generally, if one or more misstatements in individual consolidating entities would be immaterial to the consolidated financial statements, then the auditor can presume that supplemental information is fairly stated, in all material respects, to the financial statements as a whole. However, it is important to clarify that an auditor is not absolved from reporting a material misstatement on consolidating information in the individual consolidating entities that eliminates in the consolidated entity. AU-C 725.07b requires the auditor to “determine whether the form and content of the supplementary information complies with the applicable criteria [U.S. generally accepted accounting principles (U.S. GAAP) in this context].” As a result, a material misstatement in the consolidating information, even one which eliminates upon consolidation, should be reported as a departure from U.S. GAAP on the consolidating information (see reporting examples in the inquiry responses below)

Example: Management erroneously presents \$50,000,000 in Lease Expense in Subsidiary A and \$50,000,000 in Lease Income in Subsidiary B in consolidating supplementary information that the auditor is engaged to provide an in relation to

report under AU-C 725. The Lease Expense in Subsidiary A and Lease Income in Subsidiary B eliminate upon consolidation. The error is deemed a material misstatement. Based on the requirements in AU-C 725.07b, the auditor reports a departure from U.S. GAAP on the consolidating supplementary information.

Misstatements in the consolidating information, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, those misstatements would influence the judgment made by a reasonable user based on the financial statements (or in this case, the consolidating information). Professional judgments about materiality need to be made considering surrounding circumstances and need to involve both qualitative and quantitative considerations. These professional judgments are affected by the auditor's perception of the needs of users of the financial information, and by the size or nature of a misstatement, or both. See AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, and AU-C 450, *Evaluation of Misstatements Identified During the Audit*, for further information on materiality.

***Inquiry 5:*** In addition to auditing the consolidated group, we also have been engaged, pursuant to AU-C 725, to report on the consolidating information and whether such consolidating (supplementary) information is fairly stated, in all material respects, in relation to the financial statements as a whole. After performing the procedures required by AU-C 725, we have concluded that the consolidating information is not fairly stated in all material respects in relation to the consolidated financial statements as a whole, because management did not implement FASB ASC 842 for material related party leases. However, we cannot find a reporting example in AU-C 725 for this situation. Do you have a report illustration?

***Reply:*** In this circumstance, when the auditor has concluded that the consolidating schedules are materially misstated in relation to the financial statements as a whole, the auditor's opinion on the consolidating information in the separate section of the auditor's report (a separate report on the consolidating schedules is not being issued), should be modified and the misstatement described in the auditor's report. While there is not a specific reporting example included in the standards, we believe that wording for that report section based on illustration 2 of AU-C 725.A17 would be appropriate:

#### Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating information on pages xx to zz is presented for purposes of additional analysis and is not a required

part of the consolidated financial statements<sup>1</sup>. Such information is the responsibility of management and was derived from and related directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information on pages xx to zz has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, except for the matter described below, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

The accompanying consolidating information on pages xx to zz does not include right-to-use lease assets and lease liabilities for material related-party leases that fully eliminate upon consolidation. Management has informed us that they have not determined the effects of not including related-party leases in the consolidating information.

***Inquiry 6:*** In addition to auditing the consolidated group, we have also been engaged, pursuant to AU-C 725, to report on the consolidating information and whether such consolidating (supplementary) information is fairly stated, in all material respects, in relation to the financial statements as a whole. After performing the procedures required by AU-C 725, we have concluded that the consolidating information is not fairly stated in all material respects in relation to the consolidated financial statements as a whole, because management did not implement FASB ASC 842 for material related party leases. May we issue a modified separate report on the consolidating schedules?

***Reply:*** AU-C 725.13 indicates that if the auditor concludes, on the basis of the procedures performed, that the consolidating schedules are materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the consolidating schedules. If management does not revise the consolidating schedules, the auditor should withhold the separate report on the consolidating schedules. Therefore, a modified separate report is not appropriate and should not be issued. Instead, the auditor's opinion on the supplementary information should be included in a separate section in the auditor's report

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<sup>1</sup> An acceptable alternative sentence is "The consolidating information on pages xx to zz is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and is not a required part of the consolidated financial statements." The source for this alternative wording is AICPA TQA 9170, *Supplementary Information*.

on the financial statements with the heading "Supplementary Information," or other appropriate heading.

***Inquiry 7:*** In addition to auditing the consolidated group, we also have been engaged, pursuant to AU-C 725, to report on the supplementary information, which includes consolidating information. After performing the procedures required by AU-C 725, we have concluded that the consolidating information is not fairly stated in all material respects in relation to the consolidated financial statements as a whole, because management did not implement FASB ASC 842 for material related party leases. However, the remaining supplementary information we believe is fairly stated. Do you have a report illustration when some supplementary information is fairly stated but the consolidating information is not?

***Reply:*** While there is not a specific report example included in the standards, we believe that a report based on illustration 2 of AU-C 725.A17 would be appropriate:

#### Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information on pages aa to dd is presented for purposes of additional analysis and is not a required part of the financial statements. Additionally, the consolidating information on pages aa to cc is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual companies. Such information is the responsibility of management and was derived from and related directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information, on pages aa to dd has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, except for the matter described below, the supplementary information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

The accompanying consolidating information on pages aa to cc does not include right-to-use lease assets and lease liabilities for material related-party leases that fully eliminate upon consolidation. Management has informed us that they have not determined the effects of not including related-party leases in the consolidating information.



***Inquiry 8:*** We know from our audit that management did not implement FASB ASC 842 for related party leases and that such leases would be a material misstatement to the consolidating information. While we have not been engaged pursuant to AU-C 725, we are required to apply AU-C 720 because management’s basic financial statements, its consolidating information, and our auditor’s report will be included in the group’s annual report. Do you have a report illustration of how to report these uncorrected material misstatements?

***Reply:*** We believe that a report based on illustration 2 of AU-C 720.A62 would be appropriate.

Other Information [Included in the Annual Report]

Management is responsible for the other information [included in the annual report]. The other information comprises the [information included in the annual report] but does not include the consolidated financial statements and our auditor’s report thereon. Our opinion on the consolidated financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the consolidated financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report. As described below, we have concluded that such an uncorrected material misstatement of the other information exists.

The accompanying consolidating information on pages aa to cc does not include right-to-use lease assets and lease liabilities for material related-party leases that fully eliminate upon consolidation. Management has informed us that they have not determined the effects of not including related-party leases in the consolidating information.

***Inquiry 9:*** We know from our audit that management did not implement FASB ASC 842 for related party leases and that such leases would be a material misstatement to the consolidating information. We have not been engaged pursuant to AU-C 725 and AU-C 720 does not apply because management’s basic financial statements, its consolidating information and our auditor’s report will NOT be contained in an “annual report” as defined by AU-C 720.

Since we know of these misstatements do we have an obligation to report these uncorrected material misstatements in the other information? Is there a report illustration of how we might report if we choose to do so?

**Reply:** As discussed in our March 2022 [report](#), another risk management consideration when dealing with other information is what to do with consolidating schedules or other schedules outside the basic financial statements in a document that includes the auditor's report, but that document is determined to not be an annual report in accordance with AU-C 720 and the auditor is not engaged to report on the information under AU-C 725.

In these situations, AU-C 706.10 indicates in part:

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report, the auditor should include an other-matter paragraph in the auditor's report ....

If the auditor is aware that other information contained in a document along with the auditor's report, is materially misstated or misleading, the CPEA believes it is a best practice for the auditor to voluntarily include an other matter paragraph because the auditor may be deemed associated with such other information through the inclusion of the auditor's report. Further, in many cases, the auditor may have prepared such consolidating information as a nonattest service which also will associate the auditor with the other information that the auditor knows may be materially misstated. When the auditor includes an other-matter paragraph in the auditor's report, the auditor should include the paragraph within a separate section with the heading "Other Matter" or other appropriate heading. In our view, voluntarily including a paragraph in the auditor's report, such as the following, is a best practice that will help an auditor reduce any engagement risk.

#### Other Matter

Management is responsible for the other information included along with their basic financial statements. The other information comprises the consolidating information included on pages aa to cc but does not include the consolidated financial statements and our auditor's report thereon. Our opinion on the consolidated financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the consolidated financial statements, we have read the other information and considered whether a material inconsistency exists between the other information and the financial statements, or whether the other



information otherwise appears to be materially misstated. Based solely on our read of the other information, we have concluded, as described below, that such an uncorrected material misstatement of the other information exists.

The accompanying consolidating information on pages aa to cc does not include right-to-use lease assets and lease liabilities for material related-party leases that fully eliminate upon consolidation. Management has informed us that they have not determined the effects of not including related-party leases in the consolidating information.

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