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National Venture Capital Association

Audit Results Presentation
August 15, 2023

Agenda

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Audit Results

Auditor's Responsibility Under GAAS

+ Performing an audit in accordance with GAAS
+ Forming and expressing an opinion about whether the consolidated financial statements prepared by management with the oversight of those charged with governance are presented fairly in all material respects in conformity with GAAP
+ Communicating significant matters related to the consolidated financial statement audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process

The audit of the consolidated financial statements does not relieve management or those charged with governance of their responsibilities

2022 Audit Results

- Issued unmodified (clean) audit opinion over GAAP consolidated financial statements
- Written Communications:
  - Board Communication Letter (this presentation)
    - Management representation letter attached
  - Internal Control Letter
    - We are not required (nor had we been engaged) to perform an audit of the Association's internal control over financial reporting
    - No material weaknesses in internal controls identified

Internal Controls

We considered the Association's internal control over financial reporting (internal control) as a basis for designing auditing procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control. Accordingly, we do not express an opinion on the effectiveness of the Association's internal control.

Our consideration of internal control was for the limited purpose described and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that were not identified.

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Board Communications

Significant Accounting Policies and Their Application

Management is responsible for the selection and use of appropriate accounting policies

- The Association has available alternative accounting policies from which to choose
- Significant accounting policies are described in Note A
- The accounting policies selected and applied are appropriate under the circumstances and consistent with those used by other similar organizations
- A new accounting policy adopted (see next slide)
- There were no other significant accounting policies that were initially selected and no changes in significant accounting policies or their application during the year
- We noted no transactions entered into for which there is lack of authoritative guidance or consensus
- We noted no significant transactions recognized in the consolidated financial statements in a different period than when the transaction occurred

New Accounting Policy Adopted

The Associated adopted the FASB's Accounting Standards Update 2016-02 and subsequent amendments, *Leases (Topic 842)* effective January 1, 2022.

+ Lessees are required to classify leases as either operating or finance and recognize a lease liability and a right-of-use asset for all leases (except short-term leases)
+ The impact of the adoption is disclosed in Note I to the consolidated financial statements

Significant Risks Identified

A significant risk is a risk of material misstatement that in the auditor's professional judgment requires special audit consideration.

We have identified the following significant risks :

+ **Revenue recognition** – *presumed significant risk*
+ **Management override of controls** – *presumed significant risk*

Management's Judgments & Sensitive Accounting Estimates

- Accounting estimates are an integral part of the consolidated financial statements and are based upon management's current judgments and assumptions
- Certain estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments
- The consolidated financial statements contain the following sensitive estimates:
  - Expense allocation – Certain costs have been allocated among the programs and supporting services benefited. Allocable costs, such as salaries and benefits, have been allocated among the program and supporting services benefited based on estimated level of effort. We evaluated the key factors and assumptions used to develop the allocation of expenses and determined that the allocation of expenses was reasonable. We gathered sufficient appropriate audit evidence to support the reasonableness of management's estimate.

Audit Adjustments and Uncorrected Misstatements

+ No audit adjustments were recorded
+ We are not aware of any uncorrected misstatements other than misstatements that are clearly trivial
+ Uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period consolidated financial statements to be materially misstated, even though the uncorrected misstatements are immaterial to the consolidated financial statements currently under audit

Matters Affecting Form and Content of Auditor Report

We are required to communicate circumstances that affect the form and content of our auditor's report:

- **Emphasis-of-Matter**
  - The following circumstances lead to the inclusion of an emphasis-of-matter paragraph the auditor's report:
    - Adoption of New Accounting Standard - We included an emphasis-of-matter paragraph in our auditor's report indicating that the Association adopted Financial Accounting Standards Board Accounting Standards Update 2016-02 and subsequent amendments, Leases (Topic 842). Our opinion on the consolidated financial statements was not modified with respect to this matter.

Observations About the Audit Process

- Management Representations
  - Included as an exhibit to this presentation
- Disagreements with Management
  - None
- Significant Difficulties Performing the Audit
  - None
- Significant Issues Discussed
  - Adoption of ASC 842 - Leases
- Management’s Consultations with Other Accountants
  - None

Other Required Communications

Significant Unusual Transactions

Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.

+ We did not identify any significant unusual transactions.

Financial Statement Disclosures

+ The consolidated financial statement disclosures are neutral, consistent and clear.

Independence

+ We have complied with all relevant ethical requirements regarding independence.

Demonstrating Value

To truly be your business partner, we are committed to adding value beyond the scope of the audit engagement. The following demonstrates additional services or support we had the pleasure of providing:

Audit Value-Adds

- Provided proactive guidance throughout the year to ensure improved efficiency and accuracy with financial reporting

Upcoming Accounting & Auditing Standards

Upcoming Accounting Standards – Credit Losses (Topic 326)

+ The current expected credit loss (CECL) model applies to financial assets measured at amortized cost (e.g. trade receivables, loans and promissory notes receivable, net investment in leases recognized for lessors and off-balance sheet credit exposures)
+ Contribution (pledge) receivables and receivables between entities under common control are not in scope
+ Entities will pool assets with similar risk characteristics and establish an allowance for credit losses based on historical information, the current environment and future expectations over the contractual term of the instrument
+ Changes in the allowance are recorded through the income statement
+ Amendments should be applied using a modified retrospective approach by recording a cumulative effect adjustment to retained earnings as of the beginning of the period of adoption
+ Johnson Lambert has developed a guide to assist in the adoption of the standard (attached)
+ A practice aid will be available in Q3 of 2023, available upon request

Effective for: Fiscal years beginning after 12.15.22. Early adoption is permitted.

Upcoming Changes in Auditing Standards

SAS 143 – Auditing Accounting Estimates and Related Disclosures	Describes attributes the auditor's assessment of an estimate should include and clarifies auditor responsibilities for evaluating accounting estimates, including fair value accounting estimates
SAS 144 – Use of Specialists and Use of Pricing Information Obtained from External Sources	Enhancements to guidance for evaluation of management's use of an external specialist to develop an accounting estimate and the use of an auditor's specialist; New appendix for the use of an external pricing service
SAS 145 – Understanding the Entity and Assessing the Risk of Material Misstatement	Enhances requirements for obtaining an understanding of an entity's system of internal control, including revisions to evaluation of IT general controls; New requirement for auditors to separately assess inherent and control risks

We have attached a white paper further detailing the new requirements.

Effective for: Fiscal years ending after 12.15.23.

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Technical Resources

Technical Resources

We are committed to leveraging our professional and industry leadership experience to provide regular communications regarding changes to accounting principles, industry-specific developments and the related financial reporting impacts relevant to your organization so that Management may make timely, informed decisions.

Webinars: Free interactive sessions addressing industry hot topics. Attendees receive CPE credits.
JohnsonLambert.com/Webinars/

Newsletter: Join our mailing list for all the latest industry news, webinar invitations, & updates.
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About Johnson Lambert

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Partners + Principals

180+ professionals firmwide

250+ nonprofit clients

founded in **1986**

AN INDEPENDENT MEMBER FIRM OF DFK INTERNATIONAL/USA

Nationwide Presence

clients in **40+** states

complimentary nonprofit webinars

Industry Involvement

FAR The nonprofit business leaders' network.

Association Forum

Forefront Engaging for impact

asae® The Center for Association Leadership

AICPA®

Johnson Lambert's Business Advisory Services

Internal Audit Services – Outsourcing, co-sourcing

Cybersecurity Assessments – NYDFS or NAIC Data Security Model Law

Risk Assessment and Gap Analysis

System (Pre/Post) Implementation Reviews

COSO Implementation

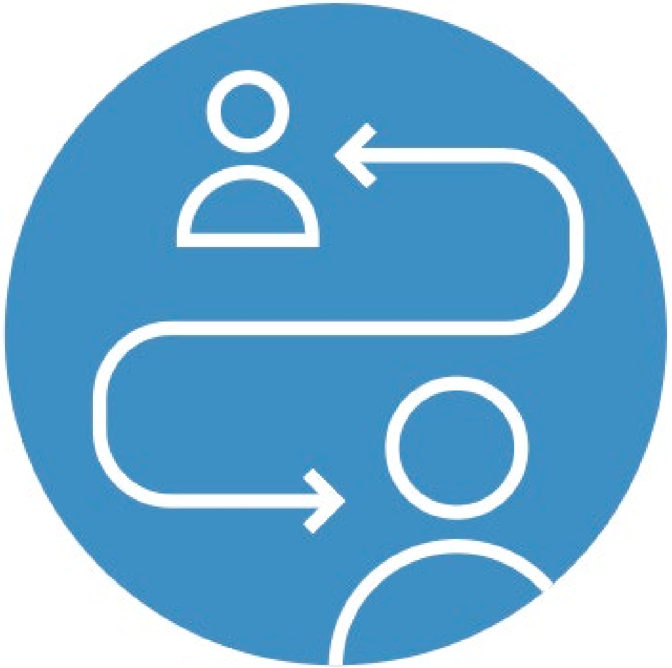
Fraud Risk Assessment

CFO Support Solutions

IPO, SOX 404, MAR Readiness

Mergers & Acquisitions

Data Analytics – helping evaluate client data



Thank you for the opportunity to serve your organization!

Restricted Use

This communication is intended solely for the information and use of the Board of Directors and Management and is not intended and should not be used by anyone other than those specified parties.

August 14, 2023

Johnson Lambert LLP
2650 Park Tower Drive, Suite 801
Vienna, Virginia 22180

This representation letter is provided in connection with your audit of the consolidated financial statements of National Venture Capital Association and Affiliates (the Association), which comprise the consolidated statements of financial position as of December 31, 2022 and 2021, and the related consolidated statements of activities, functional expenses, and cash flows for the years then ended, and the related notes to the consolidated financial statements, for the purpose of expressing an opinion on whether the consolidated financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information such that, in the light of surrounding circumstances, there is substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

We confirm that, to the best of our knowledge and belief, as of the date of this letter, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

Financial Statements

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated October 21, 2022 for the preparation and fair presentation of the consolidated financial statements in accordance with U.S. GAAP.

2. We acknowledge our responsibility for the design, implementation, and maintenance of internal controls and programs relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

3. We acknowledge our responsibility to ensure that the Association's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts in the Association's consolidated financial statements.

4. We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.

5. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.

6. All liabilities resulting from retirement obligations, deferred compensation agreements, and severance packages have been recorded in the consolidated financial statements and disclosed in the notes to the consolidated financial statements.

7. All related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.

8. In regards to the fact that your firm's tax department provided certain tax services to us, we have:
    a. Made all management decisions and performed all management functions;
    b. Established and maintained appropriate internal controls;
    c. Designated a competent employee, Bobby Franklin, to evaluate and accept responsibility for the results of the tax services performed by your firm's tax department.

9. All events subsequent to the date of the consolidated financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed.

10. We are not aware of any uncorrected misstatements, other than those that are clearly trivial.

11. The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with U.S. GAAP.

12. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements have been properly disclosed.

13. The Association has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

14. Guarantees, whether written or oral, under which the Association is contingently liable have been properly reported or disclosed in the consolidated financial statements.

15. Material concentrations known to management have been properly disclosed in accordance with GAAP. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.

16. We have evaluated the Association’s ability to meet its obligations as they become due, and have not identified any conditions or events, individually or in the aggregate, that raise substantial doubt about the Association’s ability to continue as a going concern.

17. The methods and significant assumptions as disclosed in the consolidated financial statements were used to determine fair values of financial instruments and result in a measure of fair value appropriate for financial statement measurement and disclosure purposes. The categorization of the Association's investments into the hierarchical levels as defined by ASC 820, Fair Value Measurements, is based on the lowest level of significant input to the securities' valuation.

18. In regards to the fact that your firm assisted us by drafting the consolidated financial statements and supplementary information, including appropriate disclosures required by U.S. GAAP, we have:
    a. Made all management decisions and performed all management functions.
    b. Designated an individual, MiChele Solomon, who possesses suitable skill, knowledge or experience to oversee the services.
    c. Evaluated the adequacy and results of the draft preparation by reviewing and accepting the consolidated financial statements as complete and accurate.
    d. Accepted responsibility for the consolidated financial statements and supplementary information.

19. In regards to the supplemental information we:
    a. Note the methods of measurement or presentation have not changed from those used in the prior period.
    b. Have notified you of any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information; and
    c. Agree that when the supplementary information is not presented with the audited consolidated financial statements, management will make the audited consolidated financial statements readily available to the intended users of the supplementary information and the auditor's report thereon.

20. For any tools or practice aids you have provided us, we have evaluated and accepted responsibility for the inputs and assumptions. We have sufficient information to understand the calculations and the results generated from the use of these materials.

21. The Association has satisfactory title to all owned assets. We understand that it is our responsibility to report any liens, encumbrances and/or pledged assets in the Association's consolidated financial statements. As of and for the years December 31, 2022 and 2021 we are not aware of any liens, encumbrances or pledged assets.

22. The National Venture Capital Association is an exempt organization under 501(c)(6) of the Internal Revenue Code. The Venture Capital Foundation, is an exempt organization under 501(c)(3) of the Internal Revenue Code. The VenturePAC is a separate segregated fund as defined under 527(f) of the Internal Revenue Code. We are not aware of any activities that would jeopardize the organizations' tax exempt status and all activities subject to tax on unrelated business income or excise tax or other tax have been properly reported. All required filings with tax authorities are up to date. We have not been informed of any tax reviews by federal or state taxing authorities. There is no tax position considered to be uncertain if it was to undergo an inspection by the IRS or state authorities.

23. We have made you aware of all changes in the Association's positions that could cause a lease reassessment in accordance with ASC 842, including changes in the assessment of what contract terms or obligations are considered reasonably certain to be exercised. Any impact of these changes has been properly recorded in accordance with ASC 842.

24. We have made you aware of all modifications/amendments made to our lease contracts. Any impact of these changes has been properly recorded in accordance with ASC 842.

25. We have performed an impairment analysis of the Association's right-of-use assets and have concluded that the assets are fully realizable as of December 31, 2022.

26. We have made available all relevant information about leases as defined by ASC 842 Leases (ASC 842), including copies of all lease agreements, sublease agreements, modifications, endorsements and contracts that may contain an embedded lease. We believe all leases have been identified, classified and properly accounted for in accordance with ASC 842.

27. We have reviewed our service and intercompany contracts for potential embedded leases and we do not believe the Association has any embedded leases.

Information Provided

1. We have provided you with:
    a. Access to all information, of which we are aware that is relevant to the preparation and fair presentation of the consolidated financial statements such as records, documentation and other matters;
    b. Additional information that you have requested from us for the purpose of the audit;
    c. Unrestricted access to persons within the Association and others from whom you determined it necessary to obtain audit evidence.

2. All transactions have been recorded in the accounting records and are reflected in the consolidated financial statements.

3. We have disclosed to you the results of our risk assessment as to how and where the consolidated financial statements may be materially misstated as a result of fraud.

4. Management has examined cash balances in excess of amounts insured or not insured by the Federal Deposit Insurance Corporation and believes that the Association is not exposed to any significant credit risk for these excess amounts.

5. We have no knowledge of any fraud or suspected fraud that affects the Association and involves:
    a. Management;
    b. Employees who have significant roles in internal control; or
    c. Others when the fraud could have a material effect on the consolidated financial statements.

6. We have no knowledge of any allegations of fraud, or suspected fraud, affecting the Association's consolidated financial statements communicated by employees, former employees, analysts, regulators or others.

7. We are not aware of any undisclosed known instances of non-compliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing the consolidated financial statements.

8. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting that could have a material effect on the consolidated financial statements.

9. We are not aware of any pending or threatened litigation and claims whose effects should be considered when preparing the consolidated financial statements.

10. We have not consulted legal counsel concerning pending or threatened litigation or claims.

11. Service organizations have not reported to us any fraud, noncompliance with laws and regulations, or uncorrected misstatements.

12. We have disclosed to you the identity of all the Association's related parties and the nature of all the related party relationships and transactions of which we are aware.

13. We have provided you information concerning monetary related party transactions and amounts receivable or payable from related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arms-length transaction. There are no material related party transactions in the consolidated financial statements.

DocuSigned by:

Bobby Franklin

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Bobby Franklin, President and CEO
bfranklin@nvca.org

DocuSigned by:

MiChele Solomon

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MiChele Solomon, Senior Director of Administration
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MARCH 2023

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Estimates, Specialists, and Risk Assessment

Upcoming Changes in Auditing Standards

Author:

Melanie Barthel

Johnson Lambert LLP is dedicated to keeping you informed on the impact of upcoming auditing standards. The American Institute of Certified Public Accountants (AICPA) has issued Statements on Auditing Standards (SAS) 143-145, which address estimates, the use of specialists, and the risk assessment process for audits of financial statements for periods ending on or after December 15, 2023.

Background and Overview

Following the release of several auditing standards effective in 2021 (SAS 134-141) which brought significant changes to the auditor's report, and the release of SAS 142 effective in 2022 related to audit evidence, the AICPA has released further updates applicable to audits of financial statements for periods ending on or after December 15, 2023 as follows:

- **SAS 143** *Auditing Accounting Estimates and Related Disclosures*
- **SAS 144** *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*
- **SAS 145** *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

The impetus for such changes comes from a variety of factors including:

- Changes in accounting standards,
- Recent changes in Public Company Accounting Oversight Board (PCAOB) and international auditing standards,
- Observations from AICPA peer reviews, and
- The need for modernization in the standards.

SAS 143: Accounting Estimates and Disclosures

What's Changing?

SAS 143 (Estimates) clarifies the auditor's responsibilities for evaluating accounting estimates, including fair value accounting estimates and related disclosures. The standard is designed to be scalable for all types of estimates, from the simple to the increasingly complex. The standard also provides guidance for determining whether the evaluation of accounting estimates requires specialized skills or knowledge, including the use of an auditor's specialist, as further discussed in SAS 144 (Specialists).

The standard requires the auditor to separately assess the inherent risk[1] and control risk[2] related to accounting estimates to determine the associated risk of material misstatement (ROMM). The auditor then develops procedures in response to the associated ROMM using one or more of the approaches in the diagram below.

Taking the evidence obtained from the approach(es) used into account, the auditor is able to conclude on whether estimates are reasonable in the context of the applicable financial reporting framework and whether sufficient appropriate evidence has been obtained in response to the associated ROMM.

The standard also provides considerations for when the engagement team requires specialized skills or knowledge to perform risk assessment procedures, identify and assess the risks of material misstatement, design and perform audit procedures in response to those risks, or evaluate the audit evidence obtained. Matters affecting this determination include the nature of the estimates for a business or industry (e.g. complex financial instruments, insurance contract liabilities, or retirement plan obligations), the degree of estimation uncertainty, and the complexity of the underlying methods, models, and applicable financial reporting framework.

1. Inherent Risk – susceptibility to a material misstatement before consideration of any related controls

2. Control Risk – risk that a material misstatement will not be prevented, or detected and corrected, by the entity's system of internal control

What to Expect

Risk Assessment and Fieldwork

Management can anticipate audit procedures and inquiries focused on obtaining an understanding of the entity, its environment, and its system of internal control in order to identify and assess the ROMM related to estimates and to understand the underlying data, methodology, and assumptions used in the estimation process. To the extent that management utilizes a specialist in the estimation process, the new procedures will require an increased collaboration between the auditor and the specialist. The scope of the auditor's procedures is also highly dependent on the volume and complexity of significant accounting estimates applicable to the entity.

Communications with Those Charged with Governance

The auditor has certain communication requirements with those charged with governance, including the auditor's views about the qualitative aspects of the entity's significant accounting policies and sensitive accounting estimates. SAS 143 provides that the auditor needs to consider certain matters regarding accounting estimates as part of this communication.

Additional matters specific to accounting estimates that the auditor may consider communicating with those charged with governance at the conclusion of the audit include:

- Risks of material misstatement,
- Relative materiality of the estimates to the financial statements as a whole,
- Whether management has applied appropriate specialized skills or knowledge,
- Auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements, and
- Indicators of possible management bias.

Written Representations

At the conclusion of the audit, the auditor requests certain written representations from management. Under SAS 143, such representations will include whether the methods, significant assumptions, and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement, or disclosure that is in accordance with the applicable financial reporting framework. The auditor may also need to obtain additional representations about specific accounting estimates.

SAS 144: Use of Specialists and Pricing Information

What's Changing?

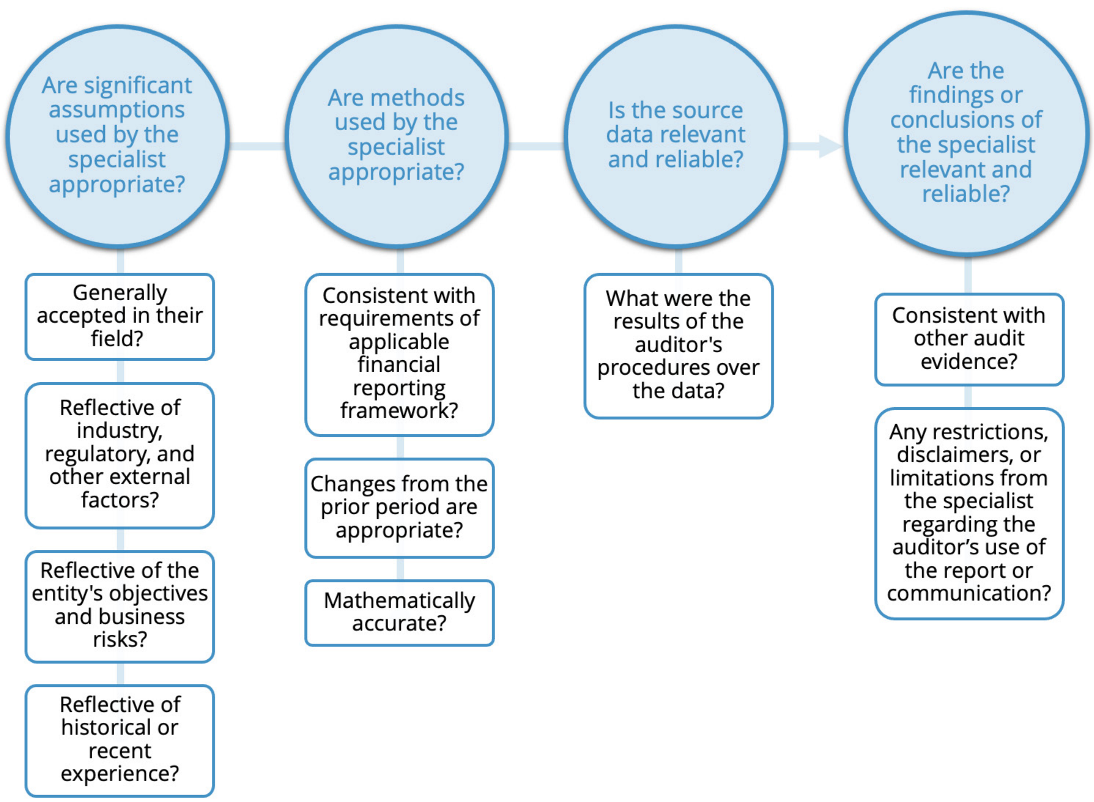
Specialists

SAS 144 (Specialists & Pricing Information) enhances the guidance for (1) the auditor's evaluation of management's use of an external specialist to develop an accounting estimate and (2) the use of an auditor's specialist.

As it relates to the use of a management specialist to develop an accounting estimate, the standard adds applicable material from PCAOB Auditing Standards (AS) 1105, Audit Evidence, intended to enhance audit quality for private companies. Consistent with the extant standards, when a management specialist has prepared information that is used as audit evidence, the auditor needs to evaluate their competency and objectivity and obtain an understanding of their work and its appropriateness.

The additional application material in the diagram below provides further guidance on relevant considerations for this evaluation.

The level of audit evidence needed to satisfy the requirements increases with the increase in significance to the financial statements of the specialist's work, the associated ROMM, and the ability of management to affect the specialist's judgments and with the decrease in the competence, capability, and objectivity of the specialist. When complex or proprietary modeling is used, additional evidence will also be required.



When a management specialist is used by management in preparing the financial statements, the auditor must also determine the need for the use of an auditor's specialist. This is affected by factors including:

- The nature, scope, and objectives of the work of management's specialist,
- Whether management's specialist is employed by the entity or is a party engaged by it to provide relevant services,
- The extent to which management can exercise control or influence over management's specialist (including, when applicable, the organization that employs the individual specialist), thereby influencing the work of management's specialist,
- The competence and capabilities of management's specialist,
- Whether management's specialist is subject to technical performance standards or other professional or industry requirements,
- Any controls within the entity over the work of management's specialist, and
- The auditor's ability to evaluate the work and findings of management's specialist without the assistance of an auditor's specialist.

When an auditor's specialist is used, the auditor must similarly evaluate their competence, capability, and objectivity, the appropriateness of assumptions and methods used, and adequacy of their work for its desired purpose.

Fair Value Pricing Information

SAS 144 also enhances guidance on the use of pricing information from external information sources related to fair value estimates. It adds a new appendix to AU-C 540, Auditing Accounting Estimates and Related Disclosures, taking into account previously released PCAOB guidance. The guidance defines a **pricing service** as:

> An organization that routinely provides uniform pricing information to users, generally on a subscription basis.

When a pricing service is engaged to individually develop a price for a specific financial instrument not routinely priced for its subscribers, the requirements relating to management's and/or the auditor's specialist apply.

What to Expect

The changes from SAS 144 impact primarily the auditor's procedures rather than the deliverables that will be issued as a result of the audit. While the changes are not outward facing, management should expect more detailed inquiries of management and its specialists from the auditors. Management should ensure they have procedures in place to evaluate the competency of its specialists and the quality of source data provided to them.

Furthermore, entities with more complex investment portfolios (i.e. entities for which all investments are not Level 1 in the fair value hierarchy) can expect increased procedures to comply with the guidance surrounding the use of pricing services. In such cases, the auditor may need to rely on an auditor specialist to provide independent fair value estimates. Management should also ensure that they have an understanding of their pricing sources and whether they are pricing services and specialists. This should include an understanding of the pricing sources used by an investment manager or custodian.

SAS 145: Risk Assessment

What's Changing?

SAS 145 (Risk Assessment) supersedes AU-C 315 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement. The standard focuses on enhanced risk assessments as a driver of audit quality and defines the auditor's responsibilities for understanding the entity's system of internal control, including general information technology (IT) controls, and determining risks of material misstatement, including significant risks.

As part of the revised risk assessment process, the standard introduces new key terms and revises the definition of a **significant risk** as follows:

An identified risk of material misstatement

for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur

or

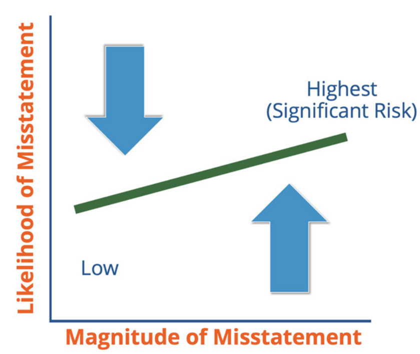
that is to be treated as a significant risk in accordance with the requirements of other AU-C sections[3]:

- Management override of controls
- Revenue recognition
- Related party transactions that are also significant unusual transactions.

As previously defined, the definition of a significant risk focused the auditor on the response to an identified risk (a risk that requires special audit consideration). The revised definition focuses the auditor on the inherent risk assessment, with new terms inherent risk factors and spectrum of inherent risk.

Inherent risk factors are characteristics of an account or disclosure assertion that affect its susceptibility to misstatement, before the consideration of controls. Such factors include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias.

Based on these factors, inherent risk is evaluated on the spectrum of inherent risk, considering both the likelihood and magnitude of a misstatement, as illustrated below:



The guidance in SAS 145 is intended to be scalable based on the complexity of the entity and to modernize the standard for changes in the evolving business environment. The standard also incorporates a significant amount of explanatory guidance in the form of appendices that the auditor may use to understand the entity's system of internal control, including the entity's use of IT. With regard to IT in particular, the guidance clearly defines relevant terms and is more detailed than IT guidance from other standard setters.

3. AU-C 240, *Consideration of Fraud in a Financial Statement Audit* and AU-C 550, *Related Parties*

What To Expect

As part of planning procedures, the auditor:

- Performs risk assessment procedures,
- Obtains an understanding of the entity and its environment and its system of internal control, and
- Identifies and assesses the risk of material misstatement.

These concepts have not fundamentally changed under SAS 145. However, within these concepts, several principles have changed and management should expect an increased emphasis on the risk assessment phase of the audit and the performance of audit procedures that are responsive to the risks identified, including an understanding of controls in place that address such risks. Under SAS 145, the auditor must identify and assess:

- Controls that address significant risks,
- Controls over journal entries,
- Controls for which the auditor plans to test the operating effectiveness, and
- Other controls based on the auditor's judgment.

Based on these controls, the auditor should identify the related IT applications and risks and the general IT controls that address such risks. The auditor must then evaluate the design and evidence the implementation of the identified controls.

Management remains responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management can best prepare for the upcoming standard by reviewing key controls in place related to significant accounts in preparation for the annual audit.

Conclusion

SAS 143-145 will have a significant impact on upcoming audits beginning with those with 2023 calendar year ends. While the changes primarily affect the auditor's procedures versus the auditor's report, the changes serve to increase audit quality and ensure the auditing standards are modernized with changes in the economic and accounting standard-setting environment. Your Johnson Lambert team is available for further discussion of and preparation for the upcoming standards to ensure you and your organization are prepared.

Are You and Your Organization Ready?	
☐	Understand the underlying data, methodology, and assumptions used in making significant accounting estimates, including when those are developed by a specialist
☐	Understand the source of pricing information for fair value estimates and whether the pricing service is a specialist
☐	Understand controls in place at your organization over the work of management's specialist(s)
☐	Communicate with management's specialist(s) regarding new requirements and the need for enhanced collaboration with the auditor
☐	Review and document key internal controls in place over significant accounts, journal entries, and related IT applications

Author: Melanie Barthel

FEBRUARY 2023

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Credit Losses for Nonprofit Organizations

Your Accounting Guide to Adopting Topic 326

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Johnson Lambert LLP is dedicated to keeping you current on the impact of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 326 - Financial Instruments – Credit Losses. This white paper presents the most significant changes related to applying ASC Topic 326 to nonprofit organizations.

Background

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses, the first of several ASUs that created and amended ASC Topic 326. The standard requires entities to record the current expected credit loss (CECL) on certain financial assets and other commitments to extend credit that are not recorded at fair value, taking into consideration historical information, current losses and, for the first time, reasonable and supportable forecasts to project expected future losses.

The CECL model addresses perceived shortcomings of the previous incurred loss impairment model by taking into consideration future economic changes (allowing credit losses to be recognized earlier). The model also permits recognition of potential improvements in estimated losses in the statement of activities in future periods, rather than the one-way "permanent impairment" model used prior to this standard.

The standard is effective for calendar years beginning after December 15, 2022 for nonpublic companies.

Financial Assets in Scope

Several financial assets commonly held by nonprofit organizations are subject to the CECL reporting model, including:

CECL Reporting Model

- Trade receivables arising from exchange transaction revenue such as:
  - Tuition income
  - Membership dues
  - Merchandise sales
  - Conference and exhibit registration fees
- Promissory notes receivable
- Loans receivable, including loans to employees, officers and directors
- Contract assets recognized under Topic 606, Revenue from Contracts with Customers (grants receivable following the exchange transaction model)
- Lease receivables resulting from sales-type or direct financing leases
- Off-balance-sheet credit exposures such as loan commitments and financial guarantees

Scope Exceptions

- Financial assets measured at fair value with changes in fair value recorded through the statement of activities
- Contributions (pledges) receivable
- Grants receivable following the contribution model
- **Loans and receivables between entities under common control**
- Receivables arising from operating leases under Topic 842

The CECL model excludes related party loans and receivables between entities under common control based on feedback received during the exposure process. The term common control is mentioned in several codification topics and generally is present when an organization or individual (including immediate family members) controls more than 50% of the voting interest of an organization.

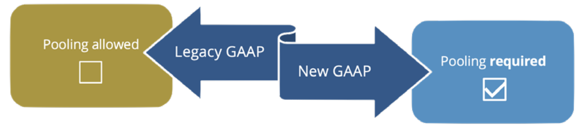
Contracts between entities under common control may include shared service agreements between related parties under common control or loans issued to an affiliate organization. These transactions and related receivables between entities under common control are not subject to the CECL model.

CECL Reporting Model

ASC 326-20 introduces a model for estimating credit losses that generally accelerates the recognition of impairment on financial assets. An organization must estimate expected future credit losses on financial assets in scope and record an allowance, with an offsetting charge through the statement of activities. The allowance (contra-asset) can increase or decrease over time, which is expected to increase volatility in the statement of activities.

Under the CECL model, assets with similar risk profiles are required to be pooled and analyzed collectively to arrive at a lifetime estimated loss rather than waiting for a specific asset to be probable of impairment under the previous incurred loss impairment model.

Under CECL, entities will report financial assets at the net amount the organization ultimately expects to collect over the life of the asset.



Financial Asset Pooling

Financial assets with similar risk characteristics are required to be reviewed collectively as a pool to determine the credit allowance. Similar risk characteristics may include:

- Past due status
- Asset type, size, or term
- Geographic location
- Industry of borrower
- Effective interest rate
- Credit quality or rating
- Year of origination

When a pooled asset ceases to share similar risk characteristics, the asset must be removed from the pool and assessed either with another pool or separately, when no other pools share similar risk characteristics. The organization must review asset pool(s) for similar risk characteristics at each reporting period.

Measurement

Organizations are required to estimate and record a credit allowance against financial assets (or asset pools) in scope at each reporting period. Changes in expected credit losses are recorded each year through the statement of activities. The following information and data may be used in management's analysis:

- Historical data
- Characteristics of the financial assets
- Current economic conditions
- **Reasonable and supportable forecasts**

Qualitative and quantitative aspects of the data are required to be considered. Management should also consider expected recoveries of amounts previously written off or expected to be written off. The expected recoveries cannot exceed the aggregate of amounts previously written off and expected to be written off.

Estimation Methods

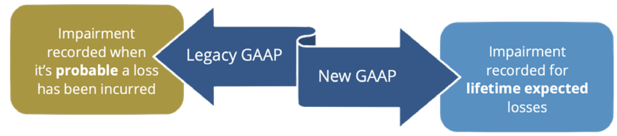
While the guidance does not prescribe a method to estimate the current expected credit losses; it requires management to use a reasonable estimation method. This provides entities the flexibility to choose an estimation method for each financial asset that works for their organization and the available data. Judgment is involved in determining estimation methods that are appropriate under the circumstances.

Management can leverage the same estimation methods used under previous guidance to develop the credit allowance, which may include some or all of the following:

- Aging schedule - considers the length of time an asset has been outstanding; commonly associated with trade receivables
- Discounted cash flow method - projects future principal and interest cash flows
- Loss rate method - calculates the average lifetime rate of loss on a pool of financial assets
- Roll-rate method (or migration analysis) - calculates ultimate losses based on the frequency of assets transitioning from one delinquent stage to another
- Probability-of-default method - estimates the probability a loan in the pool will default based on total exposure

Trade receivables are common financial assets of nonprofit organizations. Many nonprofit organizations may currently use a historical aging schedule to estimate expected losses. Aging schedules may continue to be used to support historical payment patterns, however, management will need to add consideration for current conditions and future expectations.

New inputs into the estimation methods need to be incorporated to reflect the use of reasonable and supportable forecasts in accordance with the CECL model. Organizations are required to consider prospective forecasts for a reasonable period of time that is reasonably available without undue cost or effort. When prospective forecasts cannot be evaluated for the life of the asset, an organization may revert back to historical loss information.



Collateral

An organization is required to consider the effects of a collateral agreement when measuring the credit allowance including the nature of the collateral, potential future changes in the collateral values and historical loss information for financial assets secured with similar collateral.

An organization may elect a practical expedient to measure the allowance for credit losses using the fair value of the collateral at the measurement date without consideration of future changes in the fair value of the collateral. This election is permitted provided the borrower is expected ***to replenish the collateral on a continual basis***. No allowance is required if the fair value of the collateral held and estimated costs to draw upon the collateral exceeds the amortized cost. If the fair value of the collateral is less than amortized cost, the CECL model is applied only to the difference between the fair value of the collateral and amortized cost.

Credit Enhancements

The allowance for credit losses should take into account non-freestanding credit enhancements that mitigate expected credit losses. To be non-freestanding, the credit enhancement must be embedded in the financial asset and cannot be legally detachable or separately exercisable. A freestanding credit enhancement is accounted for as a separate asset.

Disclosures

Appendix A includes a disclosure checklist summary for financial assets subject to the CECL model.

CECL Considerations for Common Financial Assets

The table below lists common financial asset holdings for nonprofit organizations that are subject to the CECL model, and allowance considerations for each:

Trade Receivables

- Required to pool trade receivables provided similar risk characteristics are present, which may include customer credit rating, aging category, the industry of the customer, geographic location of the customer and the product line.
- Historical aging analysis may be used as a starting point to evaluate the allowance for credit losses on trade receivables, adjusted for current conditions and reasonable and supportable forecasts.

Contract Assets

- Required to pool contract assets provided similar risk characteristics are present, which may include type of contract asset, geographic concentration of business and credit ratings.
- Contract assets represent a conditional right to consideration for services transferred when the condition is due to the requirement of satisfying future conditions. Contract assets are recorded when collection of the transaction price is probable.
- Consider credit risk of pools of related receivables when evaluating the allowance for credit losses on contract assets.

Loans Receivable

- Required to pool loans receivable provided similar risk characteristics are present, which may include credit scores, risk ratings, financial asset type, collateral type, size, effective interest rate, term, geographic location, the industry of the borrower and vintage.
- Collateral (ex: house, car) and non-freestanding credit enhancements (ex: co-signer) are considered in the allowance.

Other Considerations

The following items may also apply to financial assets under the CECL model.

Accrued Interest

An organization may make an accounting policy election to exclude accrued interest from the measurement of the allowance for credit losses provided it writes off the uncollectible accrued interest receivable balance in a timely manner.

Zero Allowance

If management deems there is a low risk (or no risk) of credit loss on a specific financial asset, an evaluation must still be performed to support the conclusion. For these cases, it may be reasonable to recognize a zero credit loss.

Financial Assets with Purchased Credit Deterioration

The standard eliminates the legacy model in ASC 310-304 for purchased credit impaired assets for loans. In lieu, a Day 1 accounting model for financial assets with purchased credit deterioration (PCD) was created. The organization recognizes the initial expected credit loss on the asset with PCD through an adjustment to increase the asset's amortized cost and to increase the allowance for credit losses contra-asset account.

Subsequent changes to the allowance for credit losses of PCD assets are the same as for non-PCD assets, with increases or decreases to the allowance for credit losses recorded in changes in net assets.

ASC 326 also clarifies that only non-credit related discounts or premiums may be accreted or amortized to interest income.

Transition

The guidance is required to be adopted using a modified retrospective approach for most financial assets (exception noted below). Nonpublic entities are required to make the following disclosures in the year of adoption:

+ Adoption of the standard
+ Recognize a cumulative effect adjustment to the opening balance of net assets
+ The effect of the change on impacted financial statement line items in the current reporting period and an explanation of significant changes

For PCD assets, entities are required to use the prospective approach. This will result in an adjustment to the amortized cost basis to reflect the addition of the allowance for credit losses at the date of adoption.

Implementation Best Practices

Implementing ASC 326 requires a shift in thinking. The FASB expects organizations to adopt forward-looking forecasts in addition to looking back in time. Additionally, the allowance for credit losses must be revisited at each reporting period which will require organizations to implement tracking mechanisms and additional oversight over the credit loss estimate since it impacts the statement of financial position.

Estimation methods used and policies and practices will vary and can be entity specific. An organization should look at the information available to estimate the credit allowance and determine its appropriateness under the guidance. The CECL model provides flexibility over estimation methods and forecasting data, as long as it is reasonable and supportable.

Regulators, auditors and other users of the financial statements will expect to see consistency of the estimation methods used (including forecasting inputs) from one reporting period to the next.

When judgment is involved and management needs to support consistent application, management is responsible to maintain sufficient, appropriate documentation to support its conclusions.

Documentation should include:

+ Internal controls around gathering the data and inputs in the analysis
+ Risk assessment and characteristics of each asset pool
+ Selection and rationale for estimation methods used
+ Inputs and data (including quantitative and qualitative factors considered)
+ Selection and rationale for forecasts used, specifically how they are reasonable and supportable
+ Calculation of reported credit loss
+ Consistency and/or changes as compared to prior assessments

Additionally, management may need to revisit the organization's impairment policies for its financial assets.

Finally, start on implementation early. It will take additional time in the first year to establish internal controls around the new data sources and forecasting inputs to the impairment model. Once management develops a plan, share it with the auditors early. Expect additional inquiries in the initial year as the auditors gain comfort over the new data sources and forecasts.

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For more information or to contact us, visit our website: JohnsonLambert.com

Appendix A: CECL Model Disclosure Checklist Summary

Credit Quality Information

- ☐ Quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets, including all of the following: credit quality indicators, amortized cost basis by credit quality indicator, and for each credit quality indicator, the date the information was last updated for that credit quality indicator
- ☐ If internal risk ratings are disclosed, provide qualitative information on how those internal risk ratings relate to the likelihood of loss

Allowance for Credit Losses

- ☐ Accounting policy and methodology to estimate the allowance for credit losses by asset pool and major security type, and a discussion of factors that influenced management's current estimate of expected credit losses including: past events, current conditions, reasonable and supportable forecasts about the future
- ☐ Risk characteristics relevant to asset pooling
- ☐ Changes in the factors that influenced management's current estimate of expected credit losses and reasons for those changes
- ☐ Changes to the entity's accounting policies and changes to the methodology from the prior period, its rationale for changes and quantitative effect of changes
- ☐ Reasons for significant changes in writeoff amounts
- ☐ Reversion method is applied for periods beyond the reasonable and supportable forecast period, if applicable
- ☐ Amount of significant purchases of financial assets during each reporting period
- ☐ Amount of significant sales of financial assets or reclassifications of loans held for sale during each reporting period
- ☐ Rollforward of the allowance for credit losses

Other Disclosures

- ☐ For past due amounts, the nature and amount of past due status, disaggregated by class of financial assets and major security type
- ☐ For financial assets on nonaccrual status, amortized cost basis at the beginning of the reporting period and the end of the reporting period, amount of interest income recognized during the period, amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date, and the amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses at the reporting date, disaggregated by class of financial assets and major security type
- ☐ For collateral-dependent financial assets when repayment is expected through the operation or sale of the collateral, describe the type of collateral by class of financing receivable and major security type, the extent to which collateral secures its collateral dependent financial assets, and significant changes in the extent to which collateral secures its collateral dependent financial assets
- ☐ For off-balance-sheet credit exposures, the accounting policy, and related methodology the entity used to estimate its liability for off-balance-sheet credit exposures and related charges. Identify factors that influenced management's judgment and the risk elements relevant to particular categories of financial assets.
- ☐ For contracts with customers, credit losses recorded on receivables or contract assets arising from contracts with customers, which the entity shall disclose separately from credit losses from other contracts
- ☐ For purchased assets with credit deterioration, a reconciliation of the difference between the purchase price of the financial assets and the par value of the assets
- ☐ Policy election to exclude the accrued interest from the disclosed amortized cost basis, including time period considered timely, by class of financing receivable or major security-type level