



Agenda Item 1C-1

Estimates – AU-C 501 Analysis and Disposition

This document is for informational purposes and contains excerpts of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* and provides information about the disposition of certain sections of this SAS and the rationale for retaining or removing the content.

AU-C Section 501

Audit Evidence—Specific Considerations for Selected Items

Source: SAS No. 122.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

Introduction

Scope of This Section

- .01 This section addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; section 500, *Audit Evidence*; proposed SAS Auditing Accounting Estimates and Related Disclosures and other relevant AU-C sections, regarding certain aspects of (a) investments in securities and derivative instruments; (b) inventory; (c) litigation, claims, and assessments involving the entity; and (d) segment information in an audit of financial statements.

Task force (TF) Note: TF believes a reference to the proposed estimates SAS should be included in the scope section of section 501.

The task force discussed the underlying premise that level 1 investments (those with RDFV) are considered estimates (they may have a lower estimation uncertainty but they are considered estimates until you have a transaction). This is consistent with ISA 540 (Revised).

Effective Date

.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

Objective

- .03 The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the
- a. valuation of investments in securities and derivative instruments;
 - b. existence and condition of inventory;
 - c. completeness of litigation, claims, and assessments involving the entity; and
 - d. presentation and disclosure of segment information, in accordance with the applicable financial reporting framework.

Investments in Securities and Derivative Instruments (Ref: par. .A1–.A3)

Investments in Securities and Derivative Instruments (Ref: par. .04–.10)

~~.A12~~ This ~~section~~ ~~proposed estimates SAS~~ addresses the auditor’s responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures in an audit of financial statements. This section addresses only certain specific aspects relating to auditing valuation of investments in securities and derivative instruments that are incremental to the proposed SAS Auditing Accounting Estimates and Related Disclosures. Section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures, addresses the auditor’s responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures in an audit of financial statements. The Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities provides additional and more detailed guidance to auditors related to planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities.

~~.A21~~ Evaluating audit evidence for assertions about investments in securities and derivative instruments often may involves professional judgment because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying circumstances. Valuation assertions relating to investments in securities and derivative instruments may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period (for example, default rates or prepayment rates). Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. Professional judgment also may be necessary when evaluating audit evidence for assertions based on features of the security or derivative and the requirements of the applicable financial reporting framework,

including underlying criteria for hedge accounting, which ~~may be are extremely~~ complex. For example, determining the fair value of a structured note may require consideration of a variety of features of the note that react differently to changes in economic conditions. In addition, one or more other derivatives may be designated to hedge changes in cash flows under the note. Evaluating audit evidence about the fair value of the note, the determination of whether the hedge is highly effective, and the allocation of changes in fair value to earnings and other comprehensive income requires professional judgment.

Investments in Securities When Valuations Are Based on Cost

.A3 Procedures to obtain evidence about the valuation of securities that are recorded at cost may include inspection of documentation of the purchase price, confirmation with the issuer or holder of those securities, and testing discount or premium amortization either by recomputation or through the use of analytical procedures.

TF Note: TF recommends paragraph .A2 be moved to be new paragraph .A1 to scope this section appropriately. The reference to AU-C 540 is not needed, as it has been added into paragraph 01. The reference to the Guide has been deleted (to ensure future changes to standard are not needed, if the Guide is not maintained). Minor changes to .A2 for clarity.

Investments in Securities When Valuations Are Based on the Investee's Financial Results (Excluding Investments Accounted for Using the Equity Method of Accounting)

.04 When investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting, the auditor should obtain ~~sufficient appropriate~~ audit evidence in support of the investee's financial results, including as applicable in the circumstances, performing the as-following procedures: (Ref: par. .A4-.A8)

The TF discussed that this might be an area that would need to be enhanced in Phase 2 of the project; for example, the discussion related to valuation based on the investee results is outdated because when applying the proposed estimates SAS, the investee results (for example, net asset value or percent of net assets) is an "input" to valuation. The TF discussed that there is diversity in practice that is evidenced by inconsistencies in how audit guides describe such content.

The TF modified the lead in in Paragraph 04, given that the procedures in a-d might not be all the procedures that need to be performed.

Investments in Securities When Valuations Are Based on the Investee's Financial Results (Excluding Investments Accounted for Using the Equity Method of Accounting) (Ref: par. .04-.05)

.A4. Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses auditing investments accounted for using the equity method of accounting.

.A5 For valuations based on an investee's financial results (excluding investments accounted for using the equity method of accounting), obtaining and reading the financial statements of the investee that have been audited by an auditor whose report is satisfactory may be sufficient for the purpose of obtaining sufficient appropriate audit evidence of the amount used in the estimate. In determining whether the report of another auditor is satisfactory, the auditor may perform procedures such as making inquiries regarding the professional reputation and standing of the other auditor, visiting the other auditor, discussing the audit procedures followed and the results thereof, and reviewing the audit plan and audit documentation of the other auditor.

TF Note: The PCAOB relocated requirements for obtaining audit evidence when the valuation is based on investee results as an appendix B to AS 1105 (Audit Evidence) [located in appendix 2-amendments to PCAOB Release No. 2018-005]. The task force recommends that one of the objectives of Phase 2 of the project should be to better link the use of audited financial statements as audit evidence with the requirements of the proposed estimate.

.A6 After obtaining and reading the audited financial statements of an investee, the auditor may conclude that additional audit procedures are necessary to obtain sufficient appropriate audit evidence. for example, when the date of the audited financial statements is different from the investor's measurement date. Further examples for when ~~For example,~~ the auditor may conclude that additional audit evidence is needed include because of significant differences in fiscal year ends, significant differences in accounting principles, changes in ownership, or the significance of the investment to the investor's financial position or results of operations. Examples of procedures that the auditor may perform are reviewing information in the investor's files that relates to the investee, such as investee minutes and budgets, and investee cash flow information and making inquiries of investor management about the investee's financial results.

TF Note: The TF believes there is a gap in the guidance relating to what the auditor should do when the measurement date differs from that of the audited financial statements, that should be addressed. The dates should be the same or it may not be appropriate to use the information. The TF discussed the need to clarify that further audit procedures are necessary when the measurement date differs from that of the audited financial statements (this change also helps with considering the need to obtain evidence related to the items in Paragraph.A7). The larger the difference in date, the more persuasive audit evidence is needed. The TF believes this may be an area for the AU-C 501 project to be considered at a future date.

The TF proposes changes to paragraph .A6 be made to address timing differences.

.A7 The auditor may need to obtain evidence relating to transactions between the entity and investee to evaluate

- a. the propriety of the elimination of unrealized profits and losses on transactions between the entity and investee, if applicable, and
- b. the adequacy of disclosures about material related party transactions or relationships.

.A8 ~~The proposed estimates SAS Section 540 and paragraphs .06-.08 of this section~~ address auditing fair value accounting estimates. ~~The Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and securities and on procedures that may be performed by the auditor to evaluate management's consideration of the need to recognize impairment losses.~~

TF Note: TF updated references to the proposed SAS and to paragraph .06 and to remove references to old guide.

- a. Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.

TF Note: The task force believes a-d can be retained provided the lead-in for Paragraph .04 clarifies that these are not the only procedures to be performed.

- b. If the investee's financial statements are not audited, or if the audit report on such financial statements is not satisfactory to the auditor, apply, or request that the investor entity arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.
- c. If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, *obtain sufficient appropriate audit evidence in support of such amounts.*

TF Note: For phase 2 of the project, suggest considering changing last phrase to something more generic such as "performing appropriate audit procedures", rather than explicitly stating "in support of such amounts"; but would need to consider this change in light of other changes that may need to be made (hence, no suggested change now).

- d. If the difference between the financial statement period of the entity and the investee has or could have a material effect on the entity's financial statements, determine whether the entity's management has properly considered the lack of comparability and determine the effect, if any, on the auditor's report. (Ref: par. .A9)

.A9 The date of the investor's financial statements and those of the investee may be different. If the difference between the date of the entity's financial statements and those of the investee has or could have a material effect on the entity's financial statements, the auditor is required, in accordance with paragraph .04d, to determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the difference between the financial statement period ends of the entity and investee is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time period between the financial statement period end of the entity and investee. If a change in the difference between the financial statement period end of the entity and investee has a material effect on the investor's financial statements, the auditor may be required, in accordance with section 708, *Consistency of Financial Statements*, to add an emphasis-of-matter paragraph to the auditor's report because the comparability of financial statements between periods has been materially affected by a change in reporting period.

TF Note: The TF recommends Paragraph. A9 be considered as part of the separate 501 project.

If the auditor is not able to obtain sufficient appropriate audit evidence in support of the investee's financial results because of an inability to perform appropriate procedures~~one or more of these procedures~~, the auditor should determine the effect on the auditor's opinion, in accordance with section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

TF Note: TF recommends changes to clarify that this relates to all procedures, not just those listed in section 501.

.05 With respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the auditor's report, the auditor should obtain and read available interim financial statements of the investee and make appropriate inquiries of management of the investor to identify such events and transactions that may be material to the investor's financial statements and that may need to be recognized or disclosed in the investor's financial statements. (Ref: par. .A10)

TF Note: The TF recommends this be further considered as part of the separate project for AU-C section 501.

.A10 Section 560, *Subsequent Events and Subsequently Discovered Facts*, addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements.

Note: The TF spent a considerable amount of time discussion AU-C 501.06-.10 and the related application material. The TF noted that these requirements were mainly related to the audit procedures that should be performed, and not related to evaluating audit evidence. Overall, the TF believes that the requirements noted below are generally duplicative of the requirements in the proposed estimates SAS and should be removed from AU-C 501. The TF believes it will be confusing to practitioners to have similar requirements in two places (i.e., AU-C 501 and the proposed estimates SAS). Furthermore, the TF believes that the risk of a practitioner only using AU-C 501 for the topics covered in paragraphs .06-.10, outweighs the concern of removing these requirements. The TF believes there is benefit in pointing the practitioner to the proposed estimates SAS, rather than letting them continue to use the incomplete requirements and guidance in AU-C 501. The TF also noted that PCAOB Appendix B to AS 1105 does not relate to any of the requirements in AU-C 501.06-.10, or the related guidance. Therefore, any changes to AU-C 501.06-.10 would not impact any further project related to PCAOB Appendix B.

Therefore, the TF overall recommends that the requirements in AU-C 501.06-.10 be removed from AU-C 501, and that any essential guidance in the application material be included in the application material in the proposed estimates SAS, as applicable. The following matrix provides a mapping of where the requirements and guidance in AU-C 501.06-.10 are addressed, as well the proposal for any changes to the proposed estimates SAS to incorporate examples and guidance from AU-C 501.

<i>AU-C 501 Paragraph</i>	<i>Commentary</i>
<p><i>Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value</i></p> <p>.06 With respect to investments in derivative instruments and securities measured or disclosed at fair value, the auditor should</p> <p>a. determine whether the applicable financial reporting framework specifies the method to be used to</p>	<p>Paragraph 13(b) and 33(b) of ISA 540 (Revised) directly address the requirement in .06a and b. Therefore, the TF suggests deleting the requirements in paragraph .06 of extant AU-C section 501.</p> <p>13. When obtaining an understanding of the entity and its environment, including the entity’s internal control, as required by ISA 315 (Revised),⁸ the auditor shall obtain an understanding of the following matters related to the entity’s accounting estimates. The auditor’s procedures to obtain the understanding shall be performed to the extent necessary to provide</p>

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<p>determine the fair value of the entity’s derivative instruments and investments in securities and</p> <p>b. evaluate whether the determination of fair value is consistent with the specified valuation method. (Ref: par. .A11–.A13)</p>	<p>an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.</p> <p>(b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors. (Ref: Para. A24–A25)</p> <p>33. In applying ISA 330 to accounting estimates,¹⁹ the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether:</p> <p>(b) Management’s decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and</p>
<p><i>Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value (Ref: par. .06–.08)</i></p> <p>.A11 The method for determining fair value may be specified by the applicable financial reporting framework and may vary depending on the industry in which the entity operates or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and</p>	<p>The TF noted that the requirement in 13(h)(ii)(a)(i) of the proposed SAS requires that the auditor obtain an understanding of the entity’s information system, including how management selects or designs and applies the methods. Paragraph .A38 then indicates that the method may or may not be prescribed, which corresponds to the first phrase in .A11; therefore, this phrase can be deleted. Further, the second sentence of .A11, is no longer accurate based on current GAAP today.</p> <p>13. When obtaining an understanding of the entity and its environment, including the entity’s internal control, as required by <u>AU-C section ISA-315-(Revised)</u>,⁸ the auditor <u>should</u>shall obtain an understanding of the following matters related to the entity’s accounting estimates. The auditor’s procedures to obtain the understanding <u>should</u>shall be performed</p>

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other costs that would be incurred to dispose of the derivative instrument or security.

to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

(h) The entity's information system as it relates to accounting estimates, including:

(i) The classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures; and (Ref: Para. A34–A35)

(ii) For such accounting estimates and related disclosures, how management:

a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)

i. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)

A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

The TF also noted that the first sentence of paragraph .A11 of extant AU-C 501 is addressed by Paragraph .A25 and .A26 in ISA 540 (Revised). (These two paragraphs are associated with the requirement in paragraph 13(b), to understand the entity.)

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
 - Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates. For example, the method for ;
 - Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
 - Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

A26. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks ~~(for example, regulatory frameworks established by prudential supervisors in the banking or insurance industries)~~ and in determining whether such regulatory framework(s):

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework;

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- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or
- Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

.A12 If the determination of fair value requires the use of accounting estimates, see section 540, which addresses auditing fair value accounting estimates, including requirements and guidance relating to the auditor’s understanding of the applicable financial reporting framework relevant to accounting estimates and the method used in making the estimate^{fn 4} and the auditor’s determination of whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the

The TF notes that the first sentence of Paragraph .A12 of AU-C 501 implies that there may be some fair value determinations that are not estimates; this is not consistent with the proposed SAS, so the TF is suggesting to delete.

The second sentence of AU-C 501 paragraph A12 refers to an Audit Guide, and we do not suggest bringing that sentence over to the proposed SAS; therefore, the TF is also suggesting to delete the second sentence.

^{fn 4} [Paragraphs .08a, .08c, .A12–.A14, and .A23–.A25](#) of section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

accounting estimate.^{fn5} The Audit Guide *Special Considerations in Auditing Financial Instruments* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

.A13 Quoted market prices for derivative instruments and securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. Quoted market prices obtained from those sources generally provide sufficient evidence of the fair value of the derivative instruments and securities.

The TF noted that the definition of estimation uncertainty in the proposed estimates SAS has Paragraph A16 attached to it. This paragraph begins the discussion of active/open markets and the use of quotes as audit evidence.

A16. Not all accounting estimates are subject to a high degree of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

The TF also noted that paragraph A127 in the proposed estimates SAS addresses market quotes. However, the second sentence of AU-C 501.A13 (in yellow highlight) states

^{fn5} [Paragraphs .12a](#) and [.A53–.A57](#) of section 540.

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“quoted market prices obtained from those sources [i.e., financial publications, exchanges, NASDAQ] generally provide sufficient evidence of the fair value”. This “assumption” that certain quoted prices are sufficient audit evidence is not consistent with how the proposed estimates SAS refers to this type of evidence. Relevant and reliability would still need to be considered, and the auditor can’t simply assume that the evidence is appropriate. We did note that the examples in the first sentence of AU-C 501.A13 is helpful and suggest adding that to the proposed SAS (in red/underlined text below). Therefore the TF believes paragraph .A13 can be removed from AU-C 501 and the first sentence included in the proposed estimates SAS.

A127~~A128~~. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and
- (d) When the fair value measurement is based on a broker quote, whether the broker quote:
 - (i) Is from a market maker who transacts in the same type of financial instrument;

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(ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and

(iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

Examples of sources relating to (a) and (b) for derivative instruments and securities listed on national exchanges or over-the-counter markets include financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those.

.07 If estimates of fair value of derivative instruments or securities are obtained from broker-dealers or other third-party sources based on valuation models, the auditor should understand the method used by the broker-dealer or other third-party source in developing the estimate and consider the applicability of section 500.^{fn 1} (Ref: par. .A14-.A15)

The TF noted that paragraph 23(d) of the proposed SAS requires certain actions, if a model is used by management. The TF also noted that the proposed estimates SAS includes information on “external information sources”, and specifically paragraph A126 of the proposed estimates SAS, the last bullet, addresses the requirement in AU-C 501.07. The TF is of the view that the last bullet in the proposed estimates SAS, paragraph A126 is sufficient and that paragraph AU-C 501.07 can be deleted. In addition, the TF noted that AU-C 501.07 instructs the auditor to “consider the applicability of section 500”. As the TF is of the view that AU-C 500 would always be applicable, this further supports deletion of AU-C 501.07.

The TF also noted that paragraph A3 of the proposed SAS indicates that an expert’s assumptions become management’s assumptions; as it’s unclear as to what the reference to

^{fn 1} Paragraph .08 of section 500, *Audit Evidence*, addresses management’s specialists.

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“third party source” in paragraph AU-C 501.07 means, paragraph A3 provides further indication that the auditor needs to understand methods.

The following is an excerpt of paragraph 23d of the proposed SAS:

23. In applying the requirements of paragraph 22, with respect to methods, the auditor’s further audit procedures should address:

(d) When management’s application of the method involves complex modelling, whether judgments have been applied consistently and whether, when applicable: (Ref: Para. A97–A99)

- (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period’s model are appropriate in the circumstances; and
- (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and

The following is an excerpt of paragraph A126 of the proposed SAS:

~~A126. A127.~~ As explained in AU-C section 500,¹ the reliability of information from an

¹ AU-C section 500, Paragraph A32

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external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases professional judgment is also important in considering information about the methods, assumptions or data applied.

- When information obtained from an external information source has been developed by that source using its own model(s) (for example, for a derivative instrument or security, a pricing model or cash flow projection model). Paragraph .09 and .A43 of proposed SAS *Audit Evidence* provides relevant guidance.
- When, for derivative instruments or securities:
 - o A pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product, or
 - o A valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances, the auditor may determine that it is necessary to obtain estimates from more than one pricing source.

The following is an excerpt of paragraph A3 of the proposed SAS:

A3. Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.

.A14 For certain other derivative instruments and securities, quoted market prices may be obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by the National Quotation Bureau may not be based on recent trades and may be only an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative instrument or security.

When looking at AU-C 501.A14, the TF recognized that the information in this paragraph could be useful (highlighted in yellow). Therefore, the TF is suggesting an addition to paragraph A127 of the proposed estimates SAS, after the bullet list. (Note that the grey shaded content is based on AU-C 501.A13, which was discussed previously.)

~~A127. A128.~~For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and
- (d) When the fair value measurement is based on a broker quote, whether the broker quote:
 - (i) Is from a market maker who transacts in the same type of financial instrument;
 - (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and

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(iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

Examples of sources relating to (a) and (b) for derivative instruments and securities listed on national exchanges or over-the-counter markets include financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. For derivative instruments and securities, if quoted market prices are not available, estimates of fair value frequently may be obtained from, for example, broker-dealers or other third-party sources, based on proprietary valuation models, or from the entity, based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model). Examples of broker quotes for certain derivative instruments and securities include quoted market prices obtained from broker-dealers who are market makers in them or through electronic quotation and trading systems for over-the-counter (OTC) securities. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by electronic quotation and trading systems for OTC securities may not be based on recent trades and may be only an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative instrument or security.

.A15 If quoted market prices are not available for the derivative instrument or security, estimates of fair value frequently may be obtained from broker-dealers or other third-party sources, based on proprietary valuation models, or from the entity, based on internally

The TF noted that the first sentence of AU-C 501.A15 (highlighted in yellow) provided useful guidance for when quoted market prices are not available. Therefore, the TF suggest that an edit be made to Paragraph A126 of the proposed SAS.

The TF noted that the second paragraph in AU-C 501.A15, which begins with “Understanding the method...”, essentially provides estimates of methods/models, as well as examples

or externally developed valuation models (for example, the Black-Scholes option pricing model). Understanding the method used by the broker-dealer or other third-party source in developing the estimate may include, for example, understanding whether a pricing model or cash flow projection was used. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. For example, this may be appropriate if either of the following occurs:

- The pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product.
- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

See also [section 540](#).^{fn 6}

of when it may be necessary to obtain estimates from more than one pricing source. The TF believes that this can be added as examples to Paragraph A126 of the Proposed SAS, as a modification to the 4th bullet, and the addition of the 5th bullet.

~~A126.-A127.~~ As explained in AU-C Section 500, the reliability of information from an external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- a. When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- b. When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.

^{fn 6} [Paragraphs .A68–.A89](#) of section 540.

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- c. When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases professional judgment is also important in considering information about the methods, assumptions or data applied.
- d. When information obtained from an external information source has been developed by that source using its own model(s) (for example, for a derivative instrument or security, a pricing model or cash flow projection model). Paragraph .09 and .A43 of proposed SAS Audit Evidence ~~A33f of ISA 500~~ provides relevant guidance.

(In the previous bullet, the reference to Paragraph A33f of ISA 500 has been included in both Paragraph .09 and .A43 in the 500 ED)

- e. When, for derivative instruments or securities:
 - o A pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product, or

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- A valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances,

the auditor may determine that it is necessary to obtain estimates from more than one pricing source.

(Note that the edit to item A128(a) of the Proposed estimates SAS below, that is shaded in grey is based on AU-C 501.A13, and the edit to add the paragraph after the bullets in A128 of the Proposed estimates SAS below is based on AU-C .A14, which were discussed previously.)

A127. A128. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and
- (d) When the fair value measurement is based on a broker quote, whether the broker quote:

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- (i) Is from a market maker who transacts in the same type of financial instrument;
- (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and
- (iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

Examples of sources relating to (a) and (b) above for derivative instruments and securities listed on national exchanges or over-the-counter markets are financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. For derivative instruments and securities, if quoted market prices are not available, estimates of fair value frequently may be obtained from, for example, broker-dealers or other third-party sources, based on proprietary valuation models, or from the entity, based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model) Examples of broker quotes for certain derivative instruments and securities include quoted market prices obtained from broker-dealers who are market makers in them or through electronic quotation trading systems for over-the-counter (OTC) securities the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by electronic quotation and trading systems for OTC securities the National Quotation Bureau may not be based on recent trades and may be only an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative instrument or security.

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.08 If derivative instruments or securities are valued by the entity using a valuation model, the auditor should obtain sufficient appropriate audit evidence supporting management's assertions about fair value determined using the model. (Ref: par. .A16)

The TF noted that the proposed estimates SAS provides three ways in which an estimate can be tested: (1) obtaining audit evidence from events occurring up to the date of the auditor's report; (2) testing how management made the accounting estimate; and (3) developing an auditor's point estimate or range. When testing how management made the accounting estimate, the proposed estimates SAS requires the auditor to perform the procedures in paragraphs 22-25, which are quite fulsome and should result in auditing the accounting estimate. Because paragraphs 22 through 25 of the proposed estimates SAS adequately address the requirement of AU-C 501.08, there is no need to include any specific incremental requirement to address the wording in AU-C 501.08 (i.e., AU-C 501.08 is very high level, and adding it would not result in any incremental activity that is not already going to be performed through the execution of paragraphs 22-25 of the proposed estimates SAS). Therefore, the TF recommends deleting AU-C 501.08.

Testing How Management Made the Estimate

22. When testing how management made the accounting estimate, the auditor's further audit procedures ~~should~~ shall include procedures, designed and performed in accordance with paragraphs 23–26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to the following: (Ref: Para. A94)

- (a) The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and
- (b) How management selected the point estimate and developed related disclosures about estimation uncertainty.

Methods

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23. In applying the requirements of paragraph 22, with respect to methods, the auditor's further audit procedures ~~should~~shall address:

- (a) Whether the method selected is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from the method used in prior periods are appropriate; (Ref: Para. A95, A97)
- (b) Whether judgments made in selecting the method give rise to indicators of possible management bias; (Ref: Para. A96)
- (c) Whether the calculations are applied in accordance with the method and are mathematically accurate;
- (d) When management's application of the method involves complex modelling, whether judgments have been applied consistently and whether, when applicable: (Ref: Para. A98– A100)
 - (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period's model are appropriate in the circumstances; and
 - (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and
- (e) Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: Para. A100)

Significant Assumptions

24. In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures ~~should shall~~ address the following:

- (a) Whether the significant assumptions are appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A102–A103)
- (b) Whether judgments made in selecting the significant assumptions give rise to indicators of possible management bias; (Ref: Para. A96)
- (c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and (Ref: Para. A104)
- (d) When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. (Ref: Para. A105)

Data

25. In applying the requirements of paragraph 22, with respect to data, the auditor's further audit procedures ~~should shall~~ address:

- (a) Whether the data is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate (Ref: Para. A95, A106);

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- (b) Whether judgments made in selecting the data give rise to indicators of possible management bias; (Ref: Para. A96)
- (c) Whether the data is relevant and reliable in the circumstances; and (Ref: Para. A107)
- (d) Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms. (Ref: Para. A108)

.A16 Examples of valuation models include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Refer to section 540 for the auditor's procedures to obtain evidence supporting management's assertions about fair value that are determined using a valuation model.

Paragraph A39 of the proposed estimates SAS discusses the use of models. The TF noted that the examples in the first sentence of AU-C 501.16 may be useful (highlighted in yellow), and so is proposed the following edit to Paragraph A39 of the proposed estimates SAS, indicated in bold/red text below. The TF noted that there is a significant amount of content in the proposed SAS relating to models, and discussion over general concepts related to models, but there are no specific examples of different types of models; therefore, inclusion of these examples may be helpful. The second sentence of AU-C 501 is not necessary to maintain, as it is simply a reference to 540.

A39. A38. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of control activities relevant to the audit include the following:

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- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity; and
 - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model;
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and

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- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Examples of valuation models may include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

Impairment Losses

.09 The auditor should

- a. evaluate management’s conclusion (including the relevance of the information considered) about the need to recognize an impairment loss for a decline in a security’s fair value below its cost or carrying amount and
- b. obtain sufficient appropriate audit evidence supporting the amount of any impairment adjustment recorded, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. .A17–.A18)

The TF noted that the proposed estimates SAS in its entirety is designed to address the auditing of any accounting estimate, including those related to impairment losses. AU-C 501.09 does not include any procedures that are not already encompassed; specifically, AU-C 501.09(a) is addressed by the entirety of the proposed estimates SAS, as well as paragraph 33 of the proposed estimates SAS (see as follows). Additionally, AU-C 501.09(b) is similar to the requirement in AU-C 501.06, which we previously discussed was equivalent to paragraphs 13 and 33 of the proposed estimates SAS. When considering whether it makes sense to include any of the text of AU-C 501.09 into the proposed estimates SAS, the TF noted that it would not be necessary to add any incremental requirement to achieve the objective of AU-C 501.09. Therefore, the TF is suggesting this requirement be deleted.

33. In applying AU-C 330 to accounting estimates, the auditor ~~should shall~~ evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)

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- (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;
- (b) Management’s decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and
- (c) Sufficient appropriate audit evidence has been obtained.

Impairment Losses (Ref: par. .09)

.A17 Regardless of the valuation method used, the applicable financial reporting framework might require recognizing, in earnings or other comprehensive income, an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary may involve estimating the outcome of future events and making judgments in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

The TF recommends removing the guidance in A17 because this content will become outdated upon adoption of the new credit loss accounting standard.

- Fair value is significantly below cost or carrying value and
 - the decline is attributable to adverse conditions specifically related to the security or specific conditions in an industry or a geographic area.
 - the decline has existed for an extended period of time.
 - for an equity security, management has the intent to sell the security or it is more likely than not that it will be required to sell the security before recovery.
 - for a debt security, management has the intent to sell the security or it is more likely than not it will be required to sell the security before the security's anticipated recovery of its amortized cost basis (for example, if the entity's cash or working capital requirements or contractual or regulatory obligations indicate that the debt security will be required to be sold before the forecasted recovery occurs).
- The security has been downgraded by a rating agency.

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- The financial condition of the issuer of those securities has deteriorated.
- Dividends have been reduced or eliminated or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.A18 Evaluating the relevance of the information considered may include obtaining evidence about factors such as those referred to in paragraph .A17 that tend to corroborate or conflict with management's conclusions.

The TF noted that paragraph 30 of the proposed estimates SAS requires that AU-C 500 be complied with. Additionally, paragraph 33 of the proposed estimates SAS requires that the auditor consider corroborative and contradictory evidence. Based on these two paragraphs of the proposed estimates SAS that describe the requirements of the auditor, the TF does not believe that any incremental guidance is needed to address AU-C 501.A18, and therefore suggests deleting.

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor ~~should~~ ~~shall~~ comply with the relevant requirements in AU-C section 500.

33. In applying AU-C section 330 to accounting estimates, the auditor ~~should~~ ~~shall~~ evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)

(a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;

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(b) Management’s decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and

(c) Sufficient appropriate audit evidence has been obtained.

34. In making the evaluation required by paragraph 33(c), the auditor ~~should shall~~ take into account all relevant audit evidence obtained, whether corroborative or contradictory.²⁰ If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor ~~should shall~~ evaluate the implications for the audit or the auditor’s opinion on the financial statements in accordance with AU-C 705 (Revised).

Unrealized Appreciation or Depreciation

.10 The auditor should obtain sufficient appropriate audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. .A19)

The TF noted that the first part of the sentence of AU-C 501.10 (underlined) is related to the topic of ineffective hedging. The TF does not believe there is any incremental requirement that is needed in order to apply the proposed SAS to derivatives (as the proposed SAS already would be required to be used for accounting estimates that are a result of derivatives). Furthermore, the TF believes it would be confusing to include a requirement that is specifically related to the unrealized appreciation or depreciation in the fair value of a derivative, as application of the proposed estimates SAS is sufficient for auditing derivatives.

Additionally, Similar to other requirements, the TF noted that AU-C 501.10 requirement to evaluate whether the requirements of the applicable financial reporting framework have been complied with is similar to the requirement in AU-C 501.06, which we previously discussed was equivalent to paragraphs 13 and 33 of the proposed estimates SAS.

The TF, therefore, suggests deleting this requirement.

Unrealized Appreciation or Depreciation (Ref: par. .10)

.A19 Obtaining audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge may include understanding the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.

The TF noted that the guidance in AU-C 501.A19 (highlighted in yellow) may be helpful when performing audit procedures related to the unrealized appreciation or depreciation in the fair value of a derivative. Therefore, the TF suggests including AU-C 501.A19 in the proposed estimates SAS as part of Paragraph A97.

A97. Relevant considerations for the auditor regarding the appropriateness of the method selected in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Whether management's rationale for the method selected is appropriate;
- Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates;
- When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- Whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias. (see also paragraphs A133–A136)

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An example of a consideration about whether a method is appropriate in the circumstances includes, when auditing the unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge, the auditor may consider the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.