



Agenda Item 1D

EXPOSURE DRAFT

**PROPOSED STATEMENT ON AUDITING
STANDARDS**

***AUDITING ACCOUNTING ESTIMATES AND
RELATED DISCLOSURES***

(Supersedes Statement on Auditing Standards [SAS] No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended, section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures [AICPA, Professional Standards, AU-C sec. 540]; Amends

- *the following sections of SAS No. 122, as amended:*
 - *Section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards [AICPA, Professional Standards, AU-C sec. 200]*
 - *Section 230, Audit Documentation [AICPA, Professional Standards, AU-C sec. 230]*
 - *Section 240, Consideration of Fraud in a Financial Statement Audit [AICPA, Professional Standards, AU-C sec. 240]*
 - *Section 260, The Auditor's Communication With Those Charged With Governance [AICPA, Professional Standards, AU-C sec. 260]*

- **Section 501, Audit Evidence — Specific Considerations for Selected Items** [AICPA, Professional Standards, AU-C sec. 501]
- **Section 580, Written Representations** [AICPA, Professional Standards, AU-C sec. 580]
- **the following sections of SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as amended:**
 - **Section 700, Forming an Opinion and Reporting on Financial Statements** [AICPA, Professional Standards, AU-C sec. 700]
 - **Section 701, Communicating Key Audit Matters in the Independent Auditor’s Report** [AICPA, Professional Standards, AU-C sec. 701]
- **SAS No. 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA** [AICPA, Professional Standards, AU-C sec. 703])

August __, 2019

Comments are requested by November __, 2019

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to Sherry Hazel at sherry.hazel@aicpa-cima.com.



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CONTENTS

	Page
Explanatory Memorandum	
Introduction	5
Background	6
Fundamental Aspects of the Proposed SAS.....	9
Effective Date	11
Issues for Consideration.....	11
Guide for Respondents.....	12
Supplements to the Exposure Draft	13
Comment Period	12
Auditing Standards Board Members.....	14
 Exposure Draft	
Proposed Statement on Auditing Standards <i>Auditing Accounting Estimates and Related Disclosures</i>	

Explanatory Memorandum

Introduction

This memorandum provides background to the proposed Statement on Auditing Standards (SAS) *Auditing Accounting Estimates and Related Disclosures*.

The proposed SAS would supersede SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AU-C section 540).¹

The proposed SAS would also amend the following SASs:

- SAS No. 122, as amended,
 - section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AU-C section 200);
 - section 230, *Audit Documentation* (AU-C section 230);
 - section 240, *Consideration of Fraud in a Financial Statement Audit* (AU-C section 240);
 - section 260, *The Auditor's Communication With Those Charged With Governance* (AU-C section 260);
 - section 501, *Audit Evidence — Specific Considerations for Selected Items* (AU-C section 501);
 - section 580, *Written Representations* (AU-C section 580)
- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, as amended:
 - section 700, *Forming an Opinion and Reporting on Financial Statements* (AU-C section 700);
 - section 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (AU-C section 701)
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (AU-C section 703)

Background

¹ All AU-C sections can be found in AICPA *Professional Standards*.

Auditing Accounting Estimates

The project to enhance the auditing standards relating to auditing accounting estimates is intended to enable auditors to appropriately address the increasingly complex scenarios that arise today from new accounting standards that include estimates and related disclosures, and to enhance the auditor's focus on factors driving estimation uncertainty and potential management bias. Inspection findings globally have highlighted accounting estimates as a key area where enhancing standards was needed to improve audit performance. The AICPA's Enhancing Audit Quality Initiative has identified auditing accounting estimates as an area of focus in 2019. They note that nonconformity in this area is the most common audit issue detected by practice monitoring programs worldwide.

The AICPA's Auditing Standard's Board (ASB) has monitored developments related to the auditing of accounting estimates. In particular, the ASB followed the estimates projects of the International Auditing and Assurance Standards Board (IAASB) and Public Company Accounting Oversight Board (PCAOB) (see further discussion about these projects in the following sections). The ASB Estimates Task Force was formed to consider the implications of these projects when auditing accounting estimates for audits of nonissuers.

The IAASB performed outreach to identify issues regarding the auditing of accounting estimates for financial institutions and other entities in light of changing accounting standards relating to credit loss models for loan loss provisions. The outreach indicated that the issues identified with respect to the expected credit losses were equally relevant when auditing other complex accounting estimates. Further, there was also an identified need to foster an improved exercise of professional skepticism by the auditor. In October 2018, the IAASB issued International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, to address the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements.

At the same time, the PCAOB was also undergoing a project to strengthen and enhance the requirements for auditing accounting estimates. In December 2018, the PCAOB adopted Auditing Standard (AS) No. 2501 (Revised), *Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards* (PCAOB Release No. 2018-005).

The ASB has considered the revisions to auditing accounting estimates resulting from the IAASB and PCAOB projects in developing the changes to GAAS described in this exposure draft. The ASB believes the proposed changes will help auditors to perform appropriate audit procedures relating to auditing accounting estimates and related disclosures and will drive auditors to exercise professional skepticism, thereby improving audit quality.

IAASB Estimates Project

As mentioned previously, the IAASB issued ISA 540 (Revised) to address the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised), *Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment* (ISA 315 Revised), ISA 330, *The Auditor's Response to Assessed Risks* (ISA 330), ISA 450, *Evaluation of Misstatements Identified During the Audit* (ISA 450), ISA 500, *Audit Evidence* (ISA 500), and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias. The standard defines an accounting estimate as a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

ISA 540 (Revised) is effective for audits of financial statements for periods beginning on or after December 15, 2019.

PCAOB AS 2501

PCAOB AS No. 2501 (Revised) includes amendments to its standards for auditing accounting estimates and fair value measurements, under which three existing PCAOB standards will be replaced with a single, updated standard. The standard replaces PCAOB AS No. 2501, *Auditing Accounting Estimates*, and retitles the standard. The standard also rescinds PCAOB AS No. 2502, *Auditing Fair Value Measurements and Disclosures*, and AS No. 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

The new PCAOB estimates standard is effective for audits of fiscal years ending on or after December 15, 2020; the standard is pending SEC approval.

Convergence and the ASB Estimates Project

It is the ASB's strategy to converge its standards with those of the IAASB. In doing that, the ASB uses the corresponding ISA as the base in developing its standards. In making the proposed revisions to the accompanying proposed SAS, the ASB used ISA 540 (Revised) as the base.

The ASB has made certain changes to the language in ISA 540 (Revised) to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment. However, the ASB believes that such changes will not create substantive differences in application between ISA 540 (Revised) and the proposed SAS.

The ASB also considered the requirements in PCAOB Release No. 2018-005 in the development of the proposed SAS and related amendments and has also considered whether there are aspects of the PCAOB standard that if included in the requirements or application material of the proposed SAS would enhance audit quality for audits of financial statements of nonissuers in an effective and efficient manner. As a result, a few selected changes were made to the proposed SAS. Although certain changes were made to the proposed SAS and amendments in light of the PCAOB standard the ASB's primary focus was on convergence with ISA 540 (Revised).

Certain terminology used in the proposed SAS is directly derived from ISA 540 (Revised) and therefore may be different with common terminology used in accounting principles generally accepted in the United States of America (U.S. GAAP). The intent is for the proposed SAS to be financial reporting framework neutral and applicable to a variety of estimates, both those recorded at fair value and at cost. Accordingly, the ASB believes that the principles-based requirements and guidance within this proposed SAS are appropriately characterized, and that the terminology used in the standard is appropriate for the circumstances.

Request for Comment

1. Given the approach by the ASB to draft the proposed SAS using a framework neutral approach, are there any instances in which the use of certain examples or terminology in the proposed SAS would result in a lack of clarity when applying the financial reporting frameworks commonly used in the United States (for example, U.S. GAAP)?

Other Projects Related to Auditing Accounting Estimates

Audit Evidence

On June 20, 2019, the ASB issued an exposure draft of a proposed SAS *Audit Evidence* (Audit Evidence ED) to explain what constitutes audit evidence in an audit of financial statements and address how an auditor evaluates information to be used as audit evidence. The overall objective of the audit evidence project was to assess whether revisions of AU-C section 500, *Audit Evidence*, were necessary to address the evolving nature of business. This included the use of Emerging Technologies by both preparers and auditors, Audit Data Analytics, the application of Professional Skepticism, the expanding use of external information sources as audit evidence, and more broadly the accuracy, completeness, and reliability of such audit evidence. Comments are due on the Audit Evidence ED by September 18, 2019.

External Information Sources

The Audit Evidence ED notes that as part of ISA 540 (Revised), the IAASB issued a series of conforming amendments to other ISAs, including conforming amendments to ISA 500. In general, the conforming amendments to ISA 500 included a new definition of *external information sources*, and other related application material. The Audit Evidence ED includes the IAASB's conforming amendments to ISA 500 that were finalized in connection with ISA 540 (Revised).

The ASB made certain modifications to this content in order to achieve consistency with the attributes and factors of information put forth in the Audit Evidence ED. Paragraph 8 of the Audit Evidence ED defines *external information sources*. The application material and other information is presented primarily in appendix A, *Considerations Regarding the Use of External Information Sources*, of the Audit Evidence ED. The content relating to *external information sources* contained in the Audit Evidence ED in integral to the proposed estimates SAS.

Risk Assessment

The ASB's Risk Assessment task force has been monitoring the IAASB's project to revise ISA 315. The Risk Assessment Task Force's timetable to revise AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, will reflect the timing of the IAASB's ISA 315 project.

Fundamental Aspects of the Proposed SAS

The following summarizes what the ASB believes are the fundamental aspects of the proposed SAS.

- **Laying the Groundwork.** Paragraphs 2–3 of the proposed SAS explains the nature of accounting estimates by discussing the concept of estimation uncertainty, and also provides information on the scalability of the proposed SAS. Paragraphs 4–9 of the proposed SAS describe the key concepts contained in the proposed SAS, including the requirement for a separate assessment of inherent and control risk and introduces the concept of a spectrum of inherent risk. Respondents are encouraged to read paragraphs 2–9 of the proposed SAS to aid in your understanding of the concepts of the proposed SAS and the interplay between the proposed SAS and other AU-C sections.

Request for Comment

2. Are paragraphs 2–9 of the proposed SAS helpful in describing the key concepts of the proposed SAS, and do they adequately explain the interplay between the proposed SAS and other AU-C sections?

- **Separate Assessment of Inherent Risk and Control Risk.** The proposed SAS requires a separate assessment of inherent risk and control risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in AU-C section 200,² inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in the proposed SAS as the spectrum of inherent risk. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect

² Paragraph .A42 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*.

to the particular assertion. Paragraphs 16–17 of the proposed SAS address the identification and assessment of the risks of material misstatement.

- ***Enhanced Risk Assessment.*** The proposed SAS is intended to address the challenges auditors face when auditing accounting estimates by providing risk assessment requirements that are more specific to estimates, and that address the increasingly complex business environment and complexity in financial reporting frameworks. The proposed SAS focuses on how complexity, subjectivity and estimation uncertainty are taken into account when identifying and assessing risks of material misstatement. Paragraphs 13–15 of the proposed SAS address the risk assessment procedures and related activities.
- ***Responses to the Assessed Risks of Material Misstatement.*** The proposed SAS emphasizes that the auditor’s further audit procedures (including, when appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor’s assessment of control risk. Paragraphs 18–30 of the proposed SAS address the responses to the assessed risks of material misstatement and further audit procedures.
- ***Reference to Relevant Requirement in Other AU-C Sections.*** The proposed SAS refers to relevant requirements in AU-C section 315 and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, and provides related guidance, to emphasize the importance of the auditor’s decisions about controls relating to accounting estimates, including decisions about whether:
 - There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented.
 - To test the operating effectiveness of relevant controls.

There are certain places in the proposed SAS in which requirements in other AU-C sections are repeated in the proposed SAS as it relates to estimates to emphasize the importance of those requirement. The supplementary materials to this exposure draft include a flowchart that identifies this content.

- ***Exercise of Professional Skepticism.*** The exercise of professional skepticism in relation to accounting estimates is affected by the auditor’s consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or fraud. Paragraph 32 of the proposed SAS addresses indicators of possible management bias.
- ***Evaluation of the Estimates.*** This proposed SAS requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting

estimates and related disclosures are reasonable³ in the context of the applicable financial reporting framework, or are misstated. For purposes of this proposed SAS, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address the following:

- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;
- The selection of management's point estimate; and
- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

Paragraphs 33–36 of the proposed SAS address the overall evaluation based on audit procedures performed.

Effective Date

If issued as final, the proposed SAS would be effective for audits of financial statements for periods ending on or December 15, 2022.

Issues for Consideration

In drafting the proposed SAS, the ASB identified the following issues for which feedback is specifically requested:

Issue 1 – Interplay with AU-C section 501

AU-C section 501 addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with AU-C section 330, AU-C section 500 and other relevant AU-C sections regarding, among other things, investments in securities and derivative instruments. The ASB considered whether the content in paragraphs .01–.10 of AU-C section 501 and related application material in paragraphs .A1–.A19 aligned with the proposed SAS and has proposed conforming amendments to eliminate any inconsistencies (see appendix 3, *Proposed Amendments to Various Sections in SAS No. 122, Statements on Auditing Standards: Clarification and Recodification, as Amended, SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as Amended, and SAS No. 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA of the proposed SAS*).

Specifically, the ASB has proposed removing paragraphs .06–.10 from AU-C section 501 because the ASB recognized that the requirements in those paragraphs relating to investments in derivative

³ See also paragraph 15(c) of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* .

instruments and securities measured or disclosed a fair value were mainly related to the audit procedures that should be performed, and not related to evaluating audit evidence (and AU-C section 501 is designed to address considerations related to audit evidence). Furthermore, the ASB concluded that the requirements in those paragraphs are duplicative of the requirements in the proposed SAS and therefore should be removed from AU-C section 501 so that auditors are directed to the requirements in the proposed SAS to better assist with enhancing audit quality. Essential guidance in the application material in paragraphs .A11–.A19 have been included in the proposed SAS. The supplementary materials to this exposure draft include a document that maps paragraphs .A11–.A19 to the proposed SAS.

Request for Comment

3. Do you agree with the approach to the proposed changes to AU-C section 501? If not, please provide suggestions on a way forward?

Issue 2 — Effective Date

If issued as final, the proposed SAS would be effective for audits of financial statements for periods ending on or December 15, 2022.

Request for Comment

4. Does the proposed effective date provide sufficient time for preparers, auditors, and others to adopt the new standard and related conforming amendments.

Guide for Respondents

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. If you agree with proposals in the exposure draft, it will be helpful if you make the ASB aware of this view, as well.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available on the AICPA's website after November ____, 2019, until a final standard is issued. Please send responses to Sherry Hazel at Sherry.Hazel@aicpa-cima.com by November ____, 2019.

Supplements to the Exposure Draft

To assist respondents in identifying changes and in responding to this request to comment on the proposed SAS, the Audit and Attest Standards staff has prepared a series of documents that provide the following:

- ISA 540 (Revised) marked to reflect changes to the proposed SAS to highlight the differences between the proposed SAS and ISA 540 (Revised).
- Mapping of AU-C section 501
- Flowchart of the linkages between the proposed SAS and AU-C sections

Comment Period

The comment period for this exposure draft ends on November ____, 2019.

Auditing Standards Board

(2019–2020)

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