



## Agenda Item 2

### Auditing Accounting Estimates

#### Objective of Agenda Item

To discuss revisions to the proposed Statement on Auditing Standards, *Auditing Accounting Estimates and Related Disclosures* (proposed SAS) after considering the comment letters received in connection with the exposure draft.

#### Task Force

The Estimates Task Force (Estimates TF) members are:

- Dora Burzenski (Chair)
- Doug Bennett
- Jeanne Dee
- Ilene Kassman
- Mike Lundberg
- Martin Hurden
- Laura Schuetze

#### Background

On August 22, 2019 the ASB issued an exposure draft *Proposed Statements on Auditing Standards—Auditing Accounting Estimates and Related Disclosures* (Estimates ED) with comments due by November 22, 2019. The proposed SAS addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. The Estimates TF received 30 comment letters. The comment letters can be viewed on the AICPA website by clicking [here](#).

#### Other Related ASB Projects

##### *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. Comments were due on the Audit

Evidence ED by September 18, 2019. 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 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*, and paragraphs A32 and A43 of the Audit Evidence ED. The Audit Evidence task force has proposed additional edits to this content to align with the changes to ISA 540 (Revised) as part of their comment letter process.

### ***Risk Assessment***

The Risk Assessment task force has been monitoring the IAASB's project to revise ISA 315, *Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment*. At its meeting in September 2019, the IAASB approved the proposed ISA 315 as a final standard, including conforming amendments to other ISAs. The standard will be effective for audits of financial statements for periods beginning on or after December 15, 2021. At the January 2020 ASB meeting, the Risk Assessment Task Force discussed a draft document. The ASB will continue to discuss this topic at the April 2020 ASB Meeting.

### **Agenda Items Presented**

- Item 2 — Estimates Cover Letter and Issue Paper
- Item 2A — Estimates – Discussion Draft marked from the ED
- Item 2B — Estimates – Comment Letter Analysis by paragraph
- Item 2C — Estimates – Comment Letter Analysis by Request for Comment (Q1-Q4)

Ms. Burzenski will use agenda items 2 and 2A for discussion purposes. Additionally, the ASB is asked to consider the disposition of the comment letter responses (as detailed in agenda items 2B and 2C) and provide the task force with any comments or concerns relating to the disposition of comments.

## **January 2020 ASB Meeting Outcomes and Subsequent Task Force Discussion**

At the January 2020 ASB meeting the ASB discussed eight issues contained in the issues paper (agenda item 8 from January 2020 ASB meeting) and provided direction to the task force. The following is summary of the direction received from the ASB at the January 2020 ASB meeting and subsequent task force discussion. Subsequent to the January 2020 ASB meeting, the task force held two teleconference meetings.

### **Issue 1 — Fair Presentation (Paragraph 36)**

The ASB directed the task force to consider adding application material to paragraph 36 of the proposed SAS that picks up language from paragraph .A16 of AU-C section 700 (and cross reference) that says “The auditor’s professional judgment concerning the fairness of the presentation of the financial statements is applied within the context of the financial reporting framework.”

#### ***Subsequent Task Force Discussion***

The task force agreed and proposed changes to paragraph 36 (see Agenda item 2A).

#### ***Action Requested of the ASB***

1. Does the ASB agree with the proposed changes to paragraph 36 in agenda item 2A?

### **Issue 2 — Impairment Considerations (Paragraph A27)**

The ASB agreed with the task force recommendation to remove paragraph A27 from the proposed SAS as it is not considered necessary.

#### ***Subsequent Task Force Discussion***

See deletion of paragraph A27 in Agenda item 2A.

#### ***Action Requested of the ASB***

No action requested of the ASB.

### **Issue 3 — Scope and Structure of the Proposed SAS**

The ASB continued to support the retention of the risk assessment guidance within the proposed SAS. The ASB asked the task force to retain the current structure of the proposed SAS and to (a) consider the amendments to ISA 540 (Revised) that resulted from the issuance of ISA 315 (Revised) and whether any of those amendments can be made through this project, or to coordinate possible changes with the risk assessment task force; and (b) to consider whether there are any broader concepts from the proposed SAS that should be included in AU-C section 315 that are not contemplated by the risk assessment task force.

***Subsequent Task Force Discussion***

The task force discussed whether the conforming and consequential amendments to ISA 540 (Revised) arising from the issuance of ISA 315 (Revised 2019) should be included in the final Estimates SAS. The task force agreed that many of the conforming and consequential amendments made to ISA 540 (Revised) arising from the issuance of ISA 315 (Revised 2019) relate to references to new content in ISA 315 (Revised 2019) that have not yet been reflected in GAAS (pending the AICPA's risk assessment project). There were a small amount of inconsequential changes that could be considered currently. Therefore, the task force expressed a strong preference to make all conforming amendments to the Estimates SAS at one time, as part of the risk assessment project. Concerns were expressed with the Estimates SAS moving ahead of the risk assessment project and causing more work and confusion when trying to realign once the risk assessment project is completed. Further, the estimates task force believes the proposed amendments to the estimates SAS should be exposed as part of the risk assessment exposure draft in keeping with due process.

Accordingly, the estimates task force recommends that the risk assessment project include proposed amendments to the final estimates SAS (once voted final at the April 2020 ASB meeting) to be exposed as part of the AU-C 315 exposure draft to keep the amendments aligned with the direction of that project. The Estimates task force will provide the risk assessment task force with the suggested amendments for the July 2020 ASB meeting.

***Action Requested of the ASB***

2. Does the ASB agree with the task force's approach to propose amendments to the final estimates SAS (once voted final at the April ASB meeting) and expose those proposed amendments as part of the risk assessment exposure draft?

**Issue 4 — Fair Value Measurements**

The ASB directed the task force to retain the title as proposed. The ASB asked the task force to consider whether the definition of accounting estimate should call out fair value measurements by bringing some of the content from paragraph A14 into the definition. The ASB agreed that the proposed SAS should be framework neutral and retain the references to "fair value accounting estimates" rather than "fair value measurement" because the latter term may imply a narrower view of what is intended to be included.

***Subsequent Task Force Discussion***

The task force considered whether to include the statement that "A fair value measurement is a form of an accounting estimate" in the definition of *Accounting Estimate* in paragraph 11 of the proposed SAS. The task force expressed a strong preference to retain this statement as part of the application material in paragraph A14. The task force had concerns

with highlighting one type of estimate and believes it may cause confusion as to the scope of the definition. Further, the task force believes that paragraph 1 of the proposed SAS clearly notes that fair value accounting estimates are included in the scope of this SAS. Accordingly, the task force recommends that no change be made to the definition of accounting estimate and the example be retained in the application material in paragraph .A14.

***Action Requested of the ASB***

3. Does the ASB agree that the definition of *accounting estimate* in paragraph 11 should be retained as exposed?

***Issue 5 — Professional Skepticism***

The ASB believes that much thought went into the crafting of the use of professional skepticism in ISA 540 (Revised) and directed to task force to retain the structure of the proposed SAS.

***Subsequent Task Force Discussion***

The task force agreed with the ASB's direction and has retained the structure of the proposed SAS as it relates to professional skepticism.

***Action Requested of the ASB***

No action requested of the ASB.

***Issue 6 — Use of the term reasonable***

The ASB supported retaining the term "reasonable" because it is a term that is used in the standards. To introduce a new term may have unintended consequences. No action requested of the ASB.

***Subsequent Task Force Discussion***

The task force agreed with the ASB's direction and has retained the term "reasonable" in the proposed SAS.

***Action Requested of the ASB***

No action requested of the ASB.

***Issue 7 — AU-C Section 501***

The ASB supported the placement in the proposed SAS of content from AU-C section 501 and agreed that any further changes needed to be considered relating to Appendix A, "Special Topics," of PCAOB Release 2018-005, or other sections of AU-C section 501 should be addressed by a separate project.

***Subsequent Task Force Discussion***

The task force agreed with the ASB’s direction.

***Action Requested of the ASB***

No action requested of the ASB.

***Issue 8 – Effective Date***

The ASB discussed the importance of aligning the effective date of this proposed SAS with the risk assessment project to converge AU-C section 315 with ISA 315 (Revised). The ASB also discussed whether the Audit Evidence project should also have the same effective date. The ASB asked the task force to give further consideration to options for an effective date, including whether to retain the effective date as proposed and then have the risk assessment project delay that effective date if the project runs too far behind, or to push out the effective date for the proposed SAS for another year (for periods ending on or after December 15, 2023 while recognizing that early implementation is permitted for those firms who wish to update their methodology for the ISAs and GAAS at the same time.) The board also discussed holding off voting the proposed SAS as final until comment letters are received on the risk assessment project.

***Subsequent Task Force Discussion***

The task force discussed the various effective dates for related standards and proposes changing to a “beginning of year” effective date for the estimates ED. However, the task force recognizes that there is a desire to align the effective dates of the various projects and believes it would be beneficial to align the effective date of the risk assessment SAS with the estimates SAS, if possible.

<b><i>Project</i></b>	<b><i>Proposed Effective Date</i></b>
<i>Audit Evidence</i>	Audits of financial statements for periods <u>beginning</u> on or after <del>December 15</del> <del>June 15</del> , 2021 [marked for change considered from ED]
<i>Auditing Accounting Estimates</i> [ISA 540 (revised) periods beginning on or after 12/15/19]	Audits of financial statements for periods <del>ending</del> <u>beginning</u> on or after December 15, 2022 [marked for change considered from ED]
<i>Risk Assessment (AU-C 315)</i> [ISA 315 (Revised 2019) periods beginning on or after 12/15/21]	Audits of financial statements for periods <u>ending</u> on or after December 15, 2023* * not yet proposed - assumes SAS is finalized in May or July of 2021, with 18-month implementation

***Action Requested of the ASB***

4. Does the ASB have a preference regarding how to align the effective dates of the various projects?

## **Matters for ASB Consideration**

The following matters are for ASB consideration and discussion.

### **Issue #1 — Retrospective Review**

Paragraph 13 of the proposed estimates SAS states the following:

13. The auditor should review the outcome of previous accounting estimates or, when applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor should take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: par. A56–A61)

One respondent (KPMG comment #48 in agenda item 2B) provided the following comment relating to paragraph 13:

***Retrospective review***

Paragraph 13 of Audit Evidence Exposure Draft requires a review of the outcome of previous accounting estimates or, when applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. While we acknowledge that the requirement includes consideration of the characteristics of the estimate in determining the nature and extent of the review, we believe that both the requirement and the related application material do not recognize that, for some estimates, a retrospective review may not be necessary, appropriate or, in fact, possible.

We agree that reviewing accounting estimates for consistent application of the relevant methods, assumptions and data, and to identify circumstances that may require changes in these elements of an estimate is an important aspect of the inherent risk assessment. However, a retrospective review may not be necessary to achieve these objectives in all circumstances. For example, fair value measurements based on level 1 and some level 2 inputs by their nature do not involve management judgment and hence a retrospective review of these estimates is unlikely to benefit the auditor's risk assessment. Furthermore, it is not clear what exactly a retrospective review for these estimates would entail. We find that the PCAOB's release text to the new AS 2501 adequately addresses the above-discussed concerns when providing rationale for a much narrower scope of the PCAOB's retrospective review requirement:

*“After consideration of comments, the amendment to AS 2401.64 was revised to further clarify that the accounting estimates selected for testing should be those for which there is*

*an assessed fraud risk. The scope of the retrospective review, as amended, is better aligned with the new standard and focuses the auditor on accounting estimates already identified through the risk assessment process as being susceptible to material misstatement due to fraud.*

*A separate requirement for performing a retrospective review is not necessary in the new standard as the requirement in AS 2401 would achieve the same objective. Further, for some estimates, the outcome of the estimate may not be known within a reporting period to facilitate such a review. Similarly, requiring a review over multi-year period would not be feasible for some estimates. Obtaining an understanding of the company's process for developing an estimate would necessarily provide information about the company's ability to make the estimate. In addition, the new standard requires the auditor to evaluate whether the company has a reasonable basis for significant assumptions used in accounting estimates.”*

The PCAOB acknowledged that the amended requirement in AS 2401, *Consideration of Fraud in a Financial Statement Audit* is not unlike what is included in ISA 540 (Revised) or AU-C 540, although the PCAOB’s requirement is more direct in its relation to fraud.

We believe that the concept of a retrospective review beyond consideration of fraud risk factors is not well understood. Without more guidance than what is provided in application paragraphs A56-A61 of the Proposed Standard, we don’t see the benefit to the requirement beyond what is already required by AU-C 240. And, as indicated above, performance of a retrospective review may be impractical or impossible for certain estimates.

The task force discussed ways to clarify this in the proposed SAS but was unable to propose changes that added clarity to the paragraph. The task force took the approach to minimize wording changes to maintain alignment with ISA 540 (Revised) and avoid any unintended consequences with further deviating from the wording in the ISA.

***Action Requested of the ASB***

5. Does the ASB believe there is a need for further clarification in paragraph 13 in response to the comment received? If so, specifically what additional guidance would the ASB like to be included?

Paragraph A58 of the proposed SAS states the following:

A58. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.<sup>31</sup> As a practical matter, the auditor’s review of previous accounting estimates as a risk assessment procedure in accordance with this proposed SAS may be carried out in conjunction with the review required by AU-C section 240.

One respondent (Eide Bailly comment #A38) provided the following comment:

Paragraph .A58, in relation to retrospective reviews, states that “As a practical matter, the auditor’s review of previous accounting estimates as a risk assessment procedure in accordance with this proposed SAS may be carried out in conjunction with the review

<sup>31</sup> Paragraph .32b(ii) of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

required by AU-C section 240.” We do not believe this is the Board’s intent; however, this sentence appears to allow the only retrospective review to be completed along with the substantive testing procedures rather than requiring a preliminary retrospective review as a risk assessment procedure as prescribed in paragraph .13. We believe paragraph .A58 should be revised to not conflict with paragraph .13. We believe that paragraph .A53 on page 88 provides a good example of how the concepts of retrospective review could be addressed in paragraphs .13 and .A56.

The task force discussed the timing of the retrospective review as required by AU-C section 240 and the proposed SAS. The task force recognizes that this is a complex area in practice and is not easily described. The task force believes that the wording in paragraph A58 is correct and does not conflict with the requirement in paragraph 13. Additionally, the task force does not believe that the wording in A58 is prescribing the order in which the retrospective review and the review required by AU-C 540 may be performed. Therefore, no changes have been proposed to paragraph A58.

***Action Requested of the ASB***

6. Does the ASB agree that paragraph A58 does not conflict with paragraph 13 as drafted?

**Issue #2 – Communications With Those Charged With Governance (paragraphs A147-A148 and Appendix B (paragraph A154))**

Paragraphs A147 – A148 state the following:

***Communication With Those Charged With Governance, Management, or Other Relevant Parties (Ref: par. 37)***

A147. In applying AU-C section 260, the auditor communicates with those charged with governance the auditor’s views about significant qualitative aspects of the entity’s accounting practices relating to accounting estimates and related disclosures.<sup>63</sup> Appendix B, “Communications With Those Charged With Governance,” includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

A148. AU-C section 265 requires the auditor to communicate in writing to those charged with governance significant deficiencies and material weaknesses in internal control identified during the audit.<sup>64</sup> Deficiencies in controls, which may also be significant deficiencies or material weaknesses, may include those related to controls over

- a. the selection and application of significant accounting policies and the selection and application of methods, assumptions, and data,
- b. risk management and related systems,

<sup>63</sup> Paragraph .12a of AU-C section 260.

<sup>64</sup> Paragraph .11 of AU-C section 265.

- c. data integrity, including when data is obtained from an external information source, and
- d. the use, development, and validation of models, including models obtained from an external provider, and any adjustments that may be required.

Five respondents (WA state, Virginia, NSAA, GT, and Eide Bailly) provided the following comments relating to communications with those charged with governance, specifically focusing on Appendix B of the ED.

**Comment #A89 in agenda item 2B (Office of WA State Auditor)**

Guidance in paragraph A154 includes a number of matters for auditors to consider communicating to those charged with governance regarding qualitative aspects of accounting estimates that appear to be very detailed explanations of the methodology. If an estimate and details about the methodology are so consequential, and management has not already communicated such matters to the governing body, then it may be more appropriate to communicate such matters as part of a control deficiency rather than as the auditor's views about significant qualitative aspects of accounting practices.

**Comment #A90 in agenda item 2B (Virginia)**

There are several items included in the guidance in paragraph A154 (Appendix B) discussing communications with those charged with governance that give the impression that the auditor should be explaining the methodology behind significant estimates in great depth, which should be management's responsibility. Auditors' communication with those charged with governance should be limited to explaining which estimates are significant, changes in methodology from the prior year, any disagreements with management regarding the estimates, and where management discloses them in the financial statements.

**Comment #A94 in agenda item 2B (Eide Bailly)**

Paragraph A154 discusses required communications with those charged with governance. There are required communications regarding estimates in general, and significant assumptions of estimates, but does not appear to have a specific requirement to communicate "significant estimates". We believe the guidance should more clearly distinguish the requirement to identify significant estimates.

**Action Requested of the ASB**

The task force continues to support aligning the structure of the proposed SAS with ISA 540 (Revised). The considerations and deliberations that the task force has had in relation to making changes suggested by the comment letters reflects the desire to maintain alignment. Therefore, no changes are proposed to the guidance in appendix B, specific to the communications under AU-C section 260.

7. Does the ASB support retaining appendix B as proposed?

**Comment #A93 in agenda item 2B (GT)**

**Appendix B**

We support the content included in Appendix B, “Communications with Those Charged with Governance”; however, we believe that this appendix would be more helpful if it were located in AU-C section 260, *The Auditor’s Communications with Those Charged with Governance*. When reading Appendix B, we noted some overlap in content with AU-C section 260; for example, we noted that the following bullets that appear in Appendix B are also addressed in the application guidance in AU-C section 260:

- How management identifies transactions, other events, and conditions that may give rise to the need for or changes in accounting estimates and related disclosures
- Risks of material misstatement
- Indicators of possible management bias
- The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions
- The reasonableness of disclosures about estimation uncertainty in the financial statements
- Whether management’s decisions relating to the recognition, measurement, presentation, and disclosure of the accounting estimates and related disclosures in the financial statements are in accordance with the applicable financial reporting framework

We further note that there is a section titled “Accounting Estimates” within the Appendix, “Qualitative Aspects of Accounting Practices,” in AU-C section 260 that could potentially be enhanced by combining the existing content of the appendix in AU-C section 260 with the incremental guidance proposed in Appendix B that has not already been addressed in the application guidance noted above. This move could reduce the duplication and, in our view, better position this guidance in AU-C section 260.

**Action Requested of the ASB**

The task force did not have a robust conversation about this comment and therefore does not have a view about whether this content should be moved to AU-C section 260. The task force has continued to support convergence with ISA 540 (Revised) and maintaining the alignment between the ISA and the AU-C, and supports retaining estimates related guidance in one place.

8. Does the ASB have a view about whether the content from appendix B should be moved to AU-C section 260?