



## 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 and to vote to issue the standard as a final SAS.

#### 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 in 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. This proposed standard is also scheduled to be voted as a final standard at this ASB meeting (see agenda item 1).

### ***Risk Assessment***

In December 2019, the IAASB issued ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* as a final standard, including conforming amendments to other ISAs. The standard is effective for audits of financial statements for periods beginning on or after December 15, 2021. ISA 315 (Revised 2019) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements. ISA 315 (Revised 2019) requires a separate assessment of inherent and control risk for the identified risks of material misstatement at the assertion level and also included conforming amendments to ISA 540 (Revised). The Estimates task force has been coordinating with the Risk Assessment Task Force and recognizes that conforming amendments to the revised AU-C section 540 will be proposed as a result of the ASB's risk assessment project. At the January 2020 ASB meeting, the Risk Assessment Task Force discussed a draft document and will continue to discuss this proposed SAS with the ASB at this meeting. The Risk Assessment Task Force expects to seek ASB approval to issue the proposed SAS for exposure at the July 2020 ASB meeting. See Agenda item 4.

### **Agenda Items Presented**

- Item 2 — Estimates Cover Letter and Issue Paper
- Item 2A — Estimates SAS marked to reflect changes from the Estimates ED and March 11, 2020 ASB meeting
- Item 2B — Estimates SAS (clean)
- Item 2C — Comment letter analysis by paragraph (for informational purposes)
- Item 2D — Comment letter analysis by request for comment (Q1-Q4) (for informational purposes)

Ms. Burzenski will use agenda items 2 and 2A for discussion purposes.

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

At the January and March 2020 ASB meetings the ASB discussed various issues arising from the comment letter responses relating to the Estimates ED and provided the task force with guidance. The following is a summary of the ASB meetings and subsequent task force discussion. Subsequent to the March 2020 ASB meeting, the task force held two teleconference meetings.

### 1 - Fair Presentation (Paragraph 36)

At the January 2020 ASB meeting, 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 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.”

At the March 2020 ASB meeting, the task force proposed including this content as part of the requirement in paragraph 36. The ASB discussed the proposed change to paragraph 36 and directed the task force to consider moving the proposed new content to application material rather than including as part of the requirement to better align with AU-C 700, *Forming an Opinion and Reporting on Financial Statements*.

#### *Subsequent Task Force Discussion*

Accordingly, the task force is proposing to move the statement from paragraph 36 to paragraph A143 as follows:

36. In relation to accounting estimates, the auditor should evaluate whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole.<sup>1820</sup> 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.

A143. ~~A144.~~ The auditor’s evaluation about whether the financial statements achieve fair presentation<sup>6063</sup> includes the consideration of the overall presentation, structure, and content of the financial statements and whether the financial statements, including the related notes, represent the transactions and events in a manner that achieves fair presentation. 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. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are

<sup>1820</sup> See also paragraphs .16 and .A16 of AU-C section 700.

<sup>6063</sup> Paragraph .16 of AU-C section 700.

necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated.

***Action Requested of the ASB***

1. Does the ASB agree with the placement of this content in paragraph A143?

**2 - Fair Value Measurements**

At the January 2020 ASB meeting, 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.

At the March 2020 ASB meeting, the task force recommended that no change be made to the definition of accounting estimate and the example be retained in the application material in paragraph A14 because there were concerns with highlighting one type of estimate and believes it may cause confusion as to the scope of the definition. The ASB discussed the definition of an accounting estimate in paragraph 11 of the proposed estimates SAS and continued to support retaining as application material in paragraph A14 that “a fair value measurement is a form of accounting estimate.” The ASB discussed the term “fair value measurement” as used in generally accepted accounting principles as promulgated by the Financial Accounting Standards Board (GAAP) and asked the task force to consider ways to better link the accounting framework terminology.

***Subsequent Task Force Discussion***

The task force discussed ways to align the estimates SAS with the GAAP terminology of “fair value measurements.” The task force considered the recommendations from the comment letter responses relating to this topic. The task force noted that paragraphs 1 and A14 already specify fair value estimates and related disclosures are in the scope of this SAS and that a fair value measurement is a form of accounting estimate. The task force also noted that paragraph A48 provides a FASB GAAP example. To provide further clarification, the task force recommends that the following change be made to paragraph 3

3. Although this ~~proposed~~-SAS applies to all accounting estimates, [including fair value accounting estimates](#),<sup>1</sup> the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing, and extent of the risk assessment and further audit procedures required by this ~~proposed~~-SAS will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature,

<sup>1</sup> [For purposes of GAAS, a fair value measurement is a form of accounting estimate.](#)

and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this ~~proposed~~-SAS would not be expected to be extensive. When estimation uncertainty, complexity, or subjectivity are very high, such procedures would be expected to be much more extensive. This ~~proposed~~-SAS contains guidance on how the requirements of this ~~proposed~~-SAS can be scaled. (Ref: par. A7)

***Action Requested of the ASB***

2. Does the ASB agree with the proposed changes to paragraph 3 to further clarify that fair value measurements are a form of accounting estimate?

**3 - Communications With Those Charged With Governance (Appendix B (paragraph A154))**

At the March 2020 ASB meeting, the ASB discussed whether the content in Appendix B of the proposed SAS should be included in AU-C section 260. The ASB continued to support aligning the structure of the proposed SAS with ISA 540 (Revised) and supports retaining appendix B as proposed. The ASB asked the task force to consider ways to clearly show the interaction between AU-C 260 and appendix B of the proposed estimates SAS.

***Subsequent Task Force Discussion***

Subsequent to the March 11, 2020 ASB meeting, the task force discussed including a cross reference between appendix B of the estimates SAS and the *Appendix—Qualitative Aspects of Accounting Practices* in AU-C section 260. The task force noted that a cross reference to the content in the estimates SAS was already included as part of the proposed amendment to AU-C 260. The task force therefore is proposing that the following be included in appendix B of the proposed SAS.

**Appendix B – Communications With Those Charged With Governance**

(Ref: par. ~~A146A147~~)

1. [AU-C section 260, \*The Auditor’s Communication With Those Charged With Governance\*, requires the auditor to communicate with those charged with governance the auditor’s views about the qualitative aspects of the entity’s significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.<sup>1</sup> The \*Appendix — Qualitative Aspects of Accounting Practices\*<sup>2</sup> in AU-C section 260 identifies matters that may be communicated as part of this communication. The following is a list of additional matters](#) ~~Matters~~ that the auditor may consider communicating with those charged with governance with respect to the auditor’s views

<sup>1</sup> Paragraph .12 of AU-C section 260, *The Auditor’s Communication With Those Charged With Governance*.

<sup>2</sup> Paragraph .A56 of AU-C 260.

about significant qualitative aspects of the entity’s accounting practices related to accounting estimates and related disclosures. include the following:

***Action Requested of the ASB***

3. Does the ASB agree with the proposed changes to paragraph 1 of Appendix B to reference to the related content in AU-C section 260?

**4 - Use of the Term “Independent” (paragraph A30)**

At the March 11, 2020 ASB meeting, the task force proposed changes to paragraph A31 (renumbered as paragraph A30 in agenda item 2A) to address concerns raised by respondents that the third bullet of this paragraph refers to whether those charged with governance are independent from management when the requirements and application guidance of AU-C section 260 does not mention or correlate those charged with governance being independent of management. The task force recommended that the third bullet be changed to “are involved in managing the entity” to align closer with AU-C section 260. The ASB questioned whether the proposed changes to paragraph A31 would change the intent of the proposed SAS because a consideration of whether “those charged with governance are independent from management” may be different from whether “those charged with governance are involved in managing the entity”. The ASB asked the task force to reconsider the proposed edits to this paragraph and to consider whether the meaning of the paragraph has been changed.

***Subsequent Task Force Discussion***

Subsequent to the March 11, 2020 ASB meeting, the task force discussed whether the proposed edits changed the intent of the original bullet. The task force continues to have concerns with using the phrase “independent of management” when AU-C 260 does not include that concept. Further the task force believes that the intent of the paragraph is for the auditor to gain an understanding about whether those charged with governance have the information required to evaluate how management made the estimate. Therefore, the task force recommends that the first part of the third bullet be removed from the estimates SAS. See the following proposed change:

A30A31. The auditor may obtain an understanding of whether those charged with governance

- have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or IT used in making the accounting estimates,

- have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework,
- ~~are involved in managing the entity~~ ~~are independent from management~~, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate,
- oversee management's process for making the accounting estimates, including the use of models, or
- oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

***Action Requested of the ASB***

4. Does the ASB agree with the proposed changes to the third bullet of paragraph A30 to remove the reference to those charged with governance being independent from management?

**5 - Reassessment of Control Risk (paragraph A60)**

At the March 11, 2020 ASB meeting the ASB discussed whether, in the context of the retrospective review, the auditor would only reassess control risk and not consider inherent risk. The ASB noted that in some situations the auditor may not reassess control risk but rather may determine that more persuasive audit evidence needs to be obtained. The ASB asked the task force to reconsider the guidance in paragraph A61 (renumbered as paragraph A60 in agenda item 2A).

***Subsequent Task Force Discussion***

Subsequent to the March 2020 ASB meeting, the task force discussed the auditor's responsibilities and considered three options for revising this section. The following summarizes the three options.

***Option 1***

***The following proposed change reflects the task force's preference to provide a high-level example that can cover most situations.***

**A60A61**. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, an entity assumed a forecasted unemployment rate in the development of a loan loss estimate, and the actual losses and unemployment rate differed from that assumed. A difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized or that could

reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.<sup>32</sup> Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may [need to reconsider their risk assessment or reassess control risk and](#) may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

### **Option 2**

*The following proposed change provides a more detailed example that pulls in the assessment of control risk at maximum.*

**A60A61.** A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, an entity assumed a forecasted unemployment rate in the development of a loan loss estimate, and the actual losses and unemployment rate differed from that assumed. A difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.<sup>32</sup> Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may [need to reassess control risk if, for example, control risk has not been assessed as maximum or and](#) may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

### **Option 3**

*The following proposed change provides a more detailed example by including control deficiencies and the assessment of control risk at maximum.*

**A60A61.** A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, an entity assumed a forecasted unemployment rate in the development of a loan loss estimate, and the actual losses and unemployment rate differed from that assumed. A difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized or that could reasonably be expected to have been obtained and taken into account in the context of the

<sup>32</sup> Paragraph .15 of AU-C section 560, *Subsequent Events*.

<sup>32</sup> Paragraph .15 of AU-C section 560, *Subsequent Events*.

applicable financial reporting framework.<sup>32</sup> Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, a control deficiency may exist and therefore in addition to assessing whether there is a significant deficiency or material weakness of internal control, the auditor may need to reassess control risk if, for example, control risk has not been assessed as maximum ~~and~~or may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

***Action Requested of the ASB***

5. Does the ASB agree that paragraph A60 should be revised? If so, does the ASB have a preference for option 1, 2, or 3 above, or have a different recommendation?

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<sup>32</sup> Paragraph .15 of AU-C section 560, *Subsequent Events*.