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# EXPOSURE DRAFT

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## 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 22, 2019**

**Comments are requested by November 22, 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](mailto:sherry.hazel@aicpa-cima.com).

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# 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).<sup>1</sup>

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

### 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 from new

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

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, a need was also identified 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 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 generally accepted auditing standards (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. ISA 540 (Revised) 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 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 2501, *Auditing Accounting Estimates*, and retitles the standard. The standard also rescinds PCAOB AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

AS 2501 (Revised) is effective for audits of fiscal years ending on or after December 15, 2020; the standard was approved by the SEC on July 1, 2019.<sup>2</sup>

### **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<sup>3</sup> in the development of the proposed SAS and related amendments. Although the ASB made certain changes to the proposed SAS and proposed related 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

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<sup>2</sup> See SEC Release No. 34-86269, *Public Company Accounting Oversight Board; Order Granting Approval of Auditing Standard 2501, Auditing Accounting Estimates, Including Fair Value Measurements, and Related Amendments to PCAOB Auditing Standards*.

<sup>3</sup> PCAOB Release No. 2018-005 *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards* replaces PCAOB AS 2501, *Auditing Accounting Estimates*, and retitles the standard as *Auditing Accounting Estimates, Including Fair Value Measurements*; rescinds PCAOB AS 2502, *Auditing Fair Value Measurements and Disclosures* and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*; and revises other PCAOB auditing standards.

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, use of automated tools and techniques, 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 on the Audit Evidence ED are due 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 is integral to the accompanying proposed 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 explain the nature of accounting estimates by discussing the concept of estimation uncertainty and also provide 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 to separately assess inherent and control risk and introduce the concept of a *spectrum of inherent risk*. Respondents are encouraged to read paragraphs 2–9 of the proposed SAS to aid in their 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?

- **Scalability.** The proposed SAS contains guidance on how the requirements of the proposed SAS can be scaled. The proposed SAS is intended to be scalable for all types of accounting estimates, from those that are relatively “simple” to those that are complex.

As explained in paragraph 3 of the proposed SAS, although the proposed SAS applies to all accounting estimates, 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, 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.

Examples of paragraphs in the proposed SAS that include guidance on how the requirements of this proposed SAS can be scaled include paragraphs A21–A23, A64, A68, and A84. These paragraphs demonstrate how the proposed SAS is scalable depending on the risk assessment and the responses to the assessed risk of material misstatement.

- **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,<sup>4</sup> 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 risks of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect 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 that 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
  - these controls are relevant to the audit; if so, the auditor is required to evaluate their design and determine whether they have been implemented.
  - to test the operating effectiveness of relevant controls.

Certain requirements in other AU-C sections are repeated in the proposed SAS to emphasize the importance of those requirements in the context of auditing estimates. The supplementary materials to this exposure draft include a flowchart that identifies these requirements.

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<sup>4</sup> 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*.

- ***Exercise of professional skepticism.*** The exercise of professional skepticism when auditing 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 reasonable<sup>5</sup> 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 development 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
  - 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.

- ***Appendixes to the proposed SAS.*** Appendixes form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related AU-C section or within the title and introduction of the appendix itself.<sup>6</sup> The proposed SAS contains the following appendixes:
  - Appendix A, “Inherent Risk Factors,” provides further explanation about the nature of the inherent risk factors of estimation uncertainty, subjectivity, and complexity, and their interrelationships, in the context of making accounting estimates and selecting management’s point estimate and related disclosures for inclusion in the financial statements.
  - Appendix B, “Communication With Those Charged With Governance,” includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

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<sup>5</sup> See also paragraph .15c of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*.

<sup>6</sup> Paragraph .A65 of AU-C section 200.

- Appendix C, “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*,” addresses the amendments to certain AU-C sections.

## Effective Date

If issued as final, the proposed SAS would be effective for audits of financial statements for periods ending on or after 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 amendments to eliminate any inconsistencies (see appendix C 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 instruments and securities measured or disclosed at fair value were mainly related to performing audit procedures and not related to evaluating audit evidence (and AU-C section 501 is designed to address considerations related to evaluating 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. Guidance from paragraphs .A11–.A19 of AU-C section 501 has been included in the proposed SAS. The supplementary materials to this exposure draft include a document that maps paragraphs .A11–.A19 of AU-C section 501 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 after 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 22, 2019, until a final standard is issued. Please send responses to Sherry Hazel at [Sherry.Hazel@aicpa-cima.com](mailto:Sherry.Hazel@aicpa-cima.com) by November 22, 2019.

### **Supplements to the Exposure Draft**

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

- 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 the requirements from AU-C section 540
- Mapping of AU-C section 501 to the proposed SAS
- Flowchart of the linkages between the proposed SAS and other AU-C sections

### **Comment Period**

The comment period for this exposure draft ends on November 22, 2019.

## **Auditing Standards Board**

**(2019–2020)**

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**PROPOSED STATEMENT ON AUDITING STANDARDS**  
**AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES**

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# ***Proposed SAS Auditing Accounting Estimates and Related Disclosures***

## **Introduction**

### **Scope of This Proposed Statement on Auditing Standards**

1. This proposed Statement on Auditing Standards (SAS) addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it includes requirements and guidance that refer to or expand on how AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*;<sup>1</sup> AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; AU-C section 450, *Evaluation of Misstatements Identified During the Audit*; and AU-C section 500, *Audit Evidence*, and other relevant AU-C sections are to be applied with regard to accounting estimates and related disclosures. It also includes requirements and guidance related to the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

### **Nature of Accounting Estimates**

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity, or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: par. A1–A6 and app. A)

3. Although this proposed SAS applies to all accounting estimates, 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, 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)

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

## Key Concepts of This Proposed SAS

4. For purposes of assessing the risk of material misstatement at the relevant assertion level for accounting estimates, this proposed SAS requires inherent risk and control risk to be assessed separately. 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, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*,<sup>2</sup> 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 this 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 relevant assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion. (Ref: par. A8–A10, A66–A67, and app. A)

5. This proposed SAS refers to relevant requirements in AU-C section 315 and AU-C section 330 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.

6. This 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 relevant assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.

7. 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. (Ref: par. A11)

8. 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 reasonable<sup>3</sup> in the context of the applicable financial reporting framework or are

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<sup>2</sup> 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*.

<sup>3</sup> See also paragraph .15c of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*.

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: (Ref: par. A12–A13 and A140–A145)

- The development 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
- 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

### **Effective Date**

9. This proposed SAS is effective for audits of financial statements for periods ending on or after December 15, 2022.

### **Objective**

10. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable, in the context of the applicable financial reporting framework.

### **Definitions**

11. For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

**Accounting estimate.** A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. (Ref: par. A14)

**Auditor’s point estimate or auditor’s range.** An amount, or range of amounts, respectively, developed by the auditor in evaluating management’s point estimate. (Ref: par. A15)

**Estimation uncertainty.** Susceptibility to an inherent lack of precision in measurement. (Ref: par. A16 and app. A)

**Management bias.** A lack of neutrality by management in the preparation of information. (Ref: par. A17)

**Management’s point estimate.** The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

**Outcome of an accounting estimate.** The actual monetary amount that results from the resolution of the transactions, events, or conditions addressed by an accounting estimate. (Ref: par. A18)

## Requirements

### Risk Assessment Procedures and Related Activities

**12.** When obtaining an understanding of the entity and its environment, including the entity's internal control, as required by AU-C section 315, the auditor should obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding should be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels.<sup>4</sup> (Ref: par. A19–A23)

#### *The Entity and Its Environment*

- a. The entity's transactions and other events and conditions that may give rise to the need for or changes in accounting estimates to be recognized or disclosed in the financial statements (Ref: par. A24)
- 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: par. A25–A27)
- c. Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks (Ref: par. A28)
- d. The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in paragraph 13a–c (Ref: par. A29)

#### *The Entity's Internal Control*

- e. The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates (Ref: par. A30–A32)
- f. How management identifies the need for and applies specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's specialist (Ref: par. A33)
- g. How the entity's risk assessment process identifies and addresses risks relating to accounting estimates (Ref: par. A34–A35)
- h. The entity's information system as it relates to accounting estimates, including the following:

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<sup>4</sup> Paragraphs .05–.06 and .12–.13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

- 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 (Ref: par. A20 and A36)
- ii. For such accounting estimates and related disclosures, how management
  - (1) 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: par. A37–A38)
    - (a) selects or designs, and applies, the methods used, including the use of models (Ref: par. A39–A40)
    - (b) selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions (Ref: par. A41–A44)
    - (c) selects the data to be used (Ref: par. A45)
  - (2) understands the degree of estimation uncertainty, including by considering the range of possible measurement outcomes (Ref: par. A46)
  - (3) addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements (Ref: par. A47–A50)
- i. Control activities relevant to the audit over management’s process for making accounting estimates as described in paragraph 13h(ii) (Ref: par. A51–A55)
- j. How management reviews the outcomes of previous accounting estimates and responds to the results of that review

**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)

**14.** With respect to accounting estimates, the auditor should determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: par. A62–A64)

**Identifying and Assessing the Risks of Material Misstatement**

**15.** In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the relevant assertion level, as required by AU-C section 315,<sup>5</sup>

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<sup>5</sup> Paragraphs .26–.27 of AU-C section 315.

the auditor should separately assess inherent risk and control risk. The auditor should take the following into account in identifying the risks of material misstatement and assessing inherent risk: (Ref: par. A65–A72)

- a. The degree to which the accounting estimate is subject to estimation uncertainty (Ref: par. A73–A76)
- b. The degree to which one or both of the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: par. A77–A80)
  - i. The selection and application of the method, assumptions, and data in making the accounting estimate
  - ii. The selection of management’s point estimate and related disclosures for inclusion in the financial statements

**16.** The auditor should determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 15 are, in the auditor’s judgment, a significant risk.<sup>6</sup> If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity’s controls, including control activities, relevant to that risk, and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.<sup>7</sup> (Ref: par. A81)

### **Responses to the Assessed Risks of Material Misstatement**

**17.** As required by AU-C section 330,<sup>8</sup> the auditor’s further audit procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level,<sup>9</sup> considering the reasons for the assessment given to those risks. The auditor’s further audit procedures should include one or more of the following approaches:

- a. Obtaining audit evidence from events occurring up to the date of the auditor’s report (see paragraph 20)
- b. Testing how management made the accounting estimate (see paragraphs 21–26)
- c. Developing an auditor’s point estimate or range (see paragraphs 27–28)

The auditor’s further audit procedures should take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.<sup>10</sup> The auditor should design and perform further audit procedures in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory.

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<sup>6</sup> Paragraph .28 of AU-C section 315.

<sup>7</sup> Paragraph .30 of AU-C section 315.

<sup>8</sup> Paragraphs .06–.15 and .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

<sup>9</sup> Paragraphs .06–.07 and .22 of AU-C section 330.

<sup>10</sup> Paragraph .07b of AU-C section 330.

(Ref: par. A82–A85)

**18.** As required by AU-C section 330,<sup>11</sup> the auditor should design and perform tests to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls, if

- a. the auditor’s assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively, or
- b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

In relation to accounting estimates, the auditor’s tests of such controls should be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.<sup>12</sup> (Ref: par. A86–A90)

**19.** For a significant risk relating to an accounting estimate, the auditor’s further audit procedures should include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.<sup>13</sup> (Ref: par. A91)

#### ***Obtaining Audit Evidence From Events Occurring Up to the Date of the Auditor’s Report***

**20.** When the auditor’s further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor’s report, the auditor should evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence in the context of the applicable financial reporting framework. (Ref: par. A92–A94)

#### ***Testing How Management Made the Accounting Estimate***

**21.** When testing how management made the accounting estimate, the auditor’s further audit procedures should include procedures, designed and performed in accordance with paragraphs 22–25, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to the following: (Ref: par. A95)

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

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<sup>11</sup> Paragraph .08 of AU-C section 330.

<sup>12</sup> Paragraph .09 of AU-C section 330.

<sup>13</sup> Paragraphs .15 and .22 of AU-C section 330.

## *Methods*

**22.** In applying the requirements of paragraph 21, with respect to methods, the auditor's further audit procedures should address the following:

- 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: par. A96 and A98)
- b.* Whether judgments made in selecting the method give rise to indicators of possible management bias (Ref: par. A97)
- 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 modeling, whether judgments have been applied consistently, and whether, when applicable (Ref: par. A99–A101)
  - 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.
  - 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.
- e.* Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: par. A102)

## *Significant Assumptions*

**23.** In applying the requirements of paragraph 21, with respect to significant assumptions, the auditor's further audit procedures should 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: par. A96 and A103–A104)
- b.* Whether judgments made in selecting the significant assumptions give rise to indicators of possible management bias (Ref: par. A97)
- 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 (Ref: par. A105)
- d.* When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so (Ref: par. A106)

## *Data*

**24.** In applying the requirements of paragraph 21, with respect to data, the auditor's further audit procedures should address the following:

- 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: par. A96 and A107)
- b. Whether judgments made in selecting the data give rise to indicators of possible management bias (Ref: par. A97)
- c. Whether the data is relevant and reliable in the circumstances (Ref: par. A108)
- d. Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms (Ref: par. A109)

## *Management's Selection of a Point Estimate and Related Disclosures About Estimation Uncertainty*

**25.** In applying the requirements of paragraph 21, the auditor's further audit procedures should address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to do the following:

- a. Understand estimation uncertainty (Ref: par. A110)
- b. Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty (Ref: par. A111–A115)

**26.** When, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor should (Ref: par. A116–A118)

- a. request management to perform additional procedures to understand estimation uncertainty or address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's responses in accordance with paragraph 25.
- b. if the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 27–28.
- c. evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

## *Developing an Auditor's Point Estimate or Range*

**27.** When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, including when required by

paragraph 26*b*, the auditor's further audit procedures should include procedures to evaluate whether the methods, assumptions, or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions, or data, these further audit procedures should be designed and performed to address the matters in paragraphs 22–24. (Ref: par. A119–A124)

- 28.** If the auditor develops an auditor's range, the auditor should
- a.* determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework. (Ref: par. A125–A126)
  - b.* design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial statements that describe the estimation uncertainty.

### ***Other Considerations Relating to Audit Evidence***

**29.** 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 comply with the relevant requirements in AU-C section 500.

**30.** When using the work of a management's specialist, the requirements in paragraphs 20–28 of this proposed SAS may assist the auditor in evaluating the appropriateness of the specialist's work as audit evidence for a relevant assertion in accordance with AU-C section 500.<sup>14</sup> In evaluating the work of the management's specialist, the nature, timing, and extent of the further audit procedures are affected by the auditor's evaluation of the specialist's competence, capabilities, and objectivity, the auditor's understanding of the nature of the work performed by the specialist, and the auditor's familiarity with the specialist's field of expertise. (Ref: par. A127–A133)

### **Disclosures Related to Accounting Estimates**

**31.** The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the relevant assertion level for disclosures related to an accounting estimate, other than those related to estimation uncertainty addressed in paragraphs 25*b* and 28*b*.

### **Indicators of Possible Management Bias**

**32.** The auditor should evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management

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<sup>14</sup> Paragraph .08*c* of AU-C section 500, *Audit Evidence*.

bias are identified, the auditor should evaluate the implications for the audit. When there is intention to mislead, management bias is fraudulent in nature. (Ref: par. A134–A137)

### **Overall Evaluation Based on Audit Procedures Performed**

**33.** In applying AU-C section 330 to accounting estimates,<sup>15</sup> the auditor should evaluate, based on the audit procedures performed and audit evidence obtained, whether (Ref: par. A138–A139)

- a. the assessments of the risks of material misstatement at the relevant 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.

**34.** In making the evaluation required by paragraph 33c of this proposed SAS, the auditor should take into account all relevant audit evidence obtained, whether corroborative or contradictory.<sup>16</sup> If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should evaluate the implications for the audit or the auditor’s opinion on the financial statements in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report*.

### ***Determining Whether the Accounting Estimates Are Reasonable or Misstated***

**35.** The auditor should determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated. AU-C section 450<sup>17</sup> provides guidance on how the auditor may distinguish misstatements (whether factual, judgmental, or projected) for the auditor’s evaluation of the effect of uncorrected misstatements on the financial statements. (Ref: par. A12–A13 and A140–A146)

**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>18</sup>

### **Communication With Those Charged With Governance, Management, or Other Relevant Parties**

**37.** In applying AU-C section 260, *The Auditor’s Communication With Those Charged With Governance*,<sup>19</sup> and AU-C section 265,<sup>20</sup> the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of

<sup>15</sup> Paragraphs .27–.28 of AU-C section 330.

<sup>16</sup> Paragraph .10 of AU-C section 500.

<sup>17</sup> Paragraph .A3 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit*.

<sup>18</sup> See also paragraphs .16 and .A16 of AU-C section 700.

<sup>19</sup> Paragraph .12a of AU-C section 260, *The Auditor’s Communication With Those Charged With Governance*.

<sup>20</sup> Paragraph .11 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

the entity's significant accounting practices and significant deficiencies and material weaknesses in internal control identified during the audit, respectively. In doing so, the auditor should consider the matters, if any, to communicate regarding accounting estimates and take into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity, or other inherent risk factors in making accounting estimates and related disclosures. In addition, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators. (Ref: par. A147–A148)

## **Documentation**

**38.** The auditor should include the following in the audit documentation:<sup>21</sup> (Ref: par. A149–A152)

- a. Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates
- b. The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the relevant assertion level,<sup>22</sup> taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks
- c. The auditor's responses when management has not taken appropriate steps to understand and address estimation uncertainty
- d. Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph 32
- e. Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated

## **Application and Other Explanatory Material**

### **Nature of Accounting Estimates**

#### *Examples of Accounting Estimates*

**A1.** Examples of accounting estimates related to classes of transactions, account balances, and disclosures include the following:

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of infrastructure assets
- Valuation of financial instruments

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<sup>21</sup> Paragraphs .08–.12 and .A8 of AU-C section 230, *Audit Documentation*.

<sup>22</sup> Paragraph .30b of AU-C section 330.

- Outcome of pending litigation
- Provision for expected credit losses
- Valuation of insurance contract liabilities
- Warranty obligations
- Employee retirement benefits liabilities
- Share-based payments
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Nonmonetary exchanges of assets or liabilities between independent parties
- Revenue recognized for long-term contracts

### ***Methods***

**A2.** A *method* is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognized method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black-Scholes option-pricing formula. A method is applied using a computational tool or process, sometimes referred to as a *model*, and involves applying assumptions and data and taking into account a set of relationships between them.

### ***Assumptions and Data***

**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.

**A4.** For purposes of this proposed SAS, *data* is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as *derived data* when such techniques have a well-established theoretical basis and, therefore, less need for management judgment. Otherwise, such information is an assumption.

**A5.** Examples of data include one or more of the following:

- Prices generated by market transactions
- Operating times or quantities of output from a production machine
- Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement

- Forward-looking information, such as economic or earnings forecasts obtained from an external information source
- A future interest rate determined using interpolation techniques from forward interest rates (derived data)

**A6.** Data can come from a wide range of sources. For example, data can be

- generated within the organization or externally,
- obtained from a system that is either within or outside the general or subsidiary ledgers,
- observable in contracts, or
- observable in legislative or regulatory pronouncements.

***Scalability (Ref: par. 3)***

**A7.** Examples of paragraphs that include guidance on how the requirements of this proposed SAS can be scaled include paragraphs A20–A22, A63, A67, and A84.

**Key Concepts of This Proposed SAS**

***Inherent Risk Factors (Ref: par. 4)***

**A8.** Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. Appendix A, “Inherent Risk Factors,” further explains the nature of these inherent risk factors, and their interrelationships, in the context of making accounting estimates and their presentation in the financial statements.

**A9.** In addition to the inherent risk factors of estimation uncertainty, complexity, or subjectivity, other inherent risk factors that the auditor may consider in identifying and assessing the risks of material misstatement may include the extent to which the accounting estimate is subject to or affected by

- a change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework, which may give rise to the need for changes in the method, assumptions, or data used to make the accounting estimate.
- susceptibility to misstatement due to management bias or fraud in making the accounting estimate.

***Control Risk***

**A10.** An important consideration for the auditor in assessing control risk at the relevant assertion level is the effectiveness of the design of the controls that the auditor intends to rely on and the extent to which the controls address the assessed inherent risks at the relevant assertion level. The auditor’s evaluation that controls are effectively designed and have been implemented supports an

expectation about the operating effectiveness of the controls in determining whether to test them.

***Professional Skepticism (Ref: par. 7)***

**A11.** Paragraphs A60, A95, A96, A137, and A139 are examples of paragraphs that describe ways in which the auditor can exercise professional skepticism. Paragraph A152 provides guidance on ways in which the auditor’s exercise of professional skepticism may be documented and includes examples of specific paragraphs in this proposed SAS for which documentation may provide evidence of the exercise of professional skepticism.

***Concept of “Reasonable” (Ref: par. 8 and 35)***

**A12.** Other considerations that may be relevant to the auditor’s consideration of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework include whether

- the data and assumptions used in making the accounting estimate are consistent with each other and with those used in other accounting estimates or areas of the entity’s business activities, and
- the accounting estimate takes into account appropriate information as required by the applicable financial reporting framework.

**A13.** The term *applied appropriately* as used in paragraph 8 means in a manner that not only complies with the requirements of the applicable financial reporting framework but, in doing so, reflects judgments that are consistent with the objective of the measurement basis in that framework.

**Definitions**

***Accounting Estimate (Ref. par. 11)***

**A14.** Accounting estimates are monetary amounts that may be related to classes of transactions or account balances recognized or disclosed in the financial statements. Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition or disclosure relating to a class of transactions or account balances. For purposes of generally accepted auditing standards (GAAS), a fair value measurement is a form of accounting estimate.

***Auditor’s Point Estimate or Auditor’s Range (Ref: par. 11)***

**A15.** An auditor’s point estimate or range may be used to evaluate an accounting estimate directly (for example an impairment provision or the fair value of different types of financial instruments) or indirectly (for example an amount to be used as a significant assumption for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating a nonmonetary item of data or an assumption (for example, an estimated useful life of an asset).

***Estimation Uncertainty (Ref: par. 11)***

**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. Estimation uncertainty may exist even when the valuation method and data are well-defined. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may affect estimation uncertainty.

### ***Management Bias (Ref. par. 11)***

**A17.** Financial reporting frameworks often call for neutrality, that is, freedom from bias. Estimation uncertainty gives rise to subjectivity in making an accounting estimate. The presence of subjectivity gives rise to the need for judgment by management and the susceptibility to unintentional or intentional management bias. The susceptibility of an accounting estimate to management bias increases with the extent to which there is subjectivity in making the accounting estimate.

### ***Outcome of an Accounting Estimate (Ref: par. 11)***

**A18.** Some accounting estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this proposed SAS. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or a liability is transferred may differ from the related accounting estimate made at the reporting date because, with the passage of time, the market participants' perceptions of value have changed.

## **Risk Assessment Procedures and Related Activities**

### ***Obtaining an Understanding of the Entity and Its Environment (Ref: par. 12)***

**A19.** AU-C section 315<sup>23</sup> requires the auditor to obtain an understanding of certain matters about the entity and its environment, including the entity's internal control. The requirements in paragraph 12 of this proposed SAS relate more specifically to accounting estimates and build on the broader requirements in AU-C section 315.

**A20.** The classes of transactions, events, and conditions within the scope of paragraph 12*h* of this proposed SAS are the same as the classes of transactions, events, and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 19*a* and *d* of AU-C section 315. In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider

- whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from nonrecurring or unusual transactions.
- how the information system addresses the completeness of accounting estimates and related disclosures, in particular, for accounting estimates related to liabilities.

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<sup>23</sup> Paragraphs .12–.25 of AU-C section 315.

## *Scalability*

**A21.** The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the entity's internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matters apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates; the applicable financial reporting requirements may be simple to apply; and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree, and there may be fewer controls relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be performed primarily through inquiries of management with appropriate responsibilities for the financial statements and observation of management's process for making the accounting estimate.

**A22.** By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity, or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or more extensive, than in the circumstances in paragraph A20.

**A23.** The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities: (Ref: par. A73 and A150)

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

## *The Entity and Its Environment*

The Entity's Transactions and Other Events and Conditions (Ref: par. 12a)

**A24.** Changes in circumstances that may give rise to the need for or changes in accounting estimates may include, for example, whether

- the entity has engaged in new types of transactions,

- terms of transactions have changed, or
- new events or conditions have occurred.

The Requirements of the Applicable Financial Reporting Framework (Ref: par. 12*b*)

**A25.** Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor’s determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework to not be the most appropriate in the circumstances of the entity.<sup>24</sup>

**A26.** 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,
  - 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.

**A27.** 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:

- 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.

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<sup>24</sup> Paragraph .12*a* of AU-C section 260.

- 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.
- 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.

Regulatory Factors (Ref: par. 12c)

**A28.** Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks and in determining whether such regulatory frameworks

- address conditions for the recognition, or methods for the measurement, of accounting estimates or provides related guidance thereon,
- specify or provide guidance about disclosures in addition to the requirements of the applicable financial reporting framework,
- provide an indication of areas for which there may be a potential for management bias to meet regulatory requirements, or
- contain 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.

The Nature of the Accounting Estimates and Related Disclosures That the Auditor Expects to Be Included in the Financial Statements (Ref: par. 12d)

**A29.** Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

*The Entity’s Internal Control Relevant to the Audit*

The Nature and Extent of Oversight and Governance (Ref: par. 12e)

**A30.** In applying AU-C section 315,<sup>25</sup> the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation as it relates to whether

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and
- the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.

**A31.** 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 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.

**A32.** Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that

- require significant judgment by management to address subjectivity,
- have high estimation uncertainty,
- are complex to make, for example, because of the extensive use of IT, large volumes of data or the use of multiple data sources or assumptions with complex interrelationships,
- had or ought to have had a change in the method, assumptions, or data compared to previous periods, or
- involve significant assumptions.

Management's Application of Specialized Skills or Knowledge, Including the Use of

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<sup>25</sup> Paragraph .15 of AU-C section 315.

Management's Specialists (Ref: par. 12f)

**A33.** The auditor may consider whether the following circumstances increase the likelihood that management needs to engage a specialist:

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values<sup>26</sup>
- The unusual or infrequent nature of the condition, transaction, or event requiring an accounting estimate

The Entity's Risk Assessment Process (Ref: par. 12g)

**A34.** Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in the following:

- The requirements of the applicable financial reporting framework related to the accounting estimates
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used
- The entity's information system or IT environment
- Key personnel

**A35.** Matters that the auditor may consider in obtaining an understanding of how management identifies and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so, how, management does the following:

- Pays particular attention to selecting or applying the methods, assumptions, and data used in making accounting estimates
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors
- Identifies financial or other incentives that may be a motivation for bias
- Monitors the need for changes in the methods, significant assumptions, or the data used in making accounting estimates

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<sup>26</sup> See, for example, FASB *Accounting Standards Codification* 820, *Fair Value Measurement*.

- Establishes appropriate oversight and review of models used in making accounting estimates
- Requires documentation of the rationale for or an independent review of significant judgments made in making accounting estimates

The Entity's Information System Relating to Accounting Estimates (Ref: par. 12h(i))

**A36.** During the audit, the auditor may identify classes of transactions, events, and conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. AU-C section 315 addresses circumstances in which the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency or material weakness in internal control with regard to the entity's risk assessment process.<sup>27</sup>

Management's Identification of the Relevant Methods, Assumptions, and Sources of Data (Ref: par. 12h(ii)(1))

**A37.** If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate; is itself a response to changes in the environment or circumstances affecting the entity or to changes in the requirements of the applicable financial reporting framework or regulatory environment; or whether management has another valid reason.

**A38.** If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions, and data is appropriate in view of the current environment or circumstances.

Methods (Ref: par. 12h(ii)(1)(a))

**A39.** 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.

Models

**A40.** Management may design and implement specific controls around models used for making accounting estimates, whether it's 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 control activities relevant to the audit include the following:

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<sup>27</sup> Paragraph .18 of AU-C section 315.

- 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.
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, and 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.

Assumptions (Ref: par. 12h(ii)(1)(b))

**A41.** Matters that the auditor may consider in obtaining an understanding of how management selected the assumptions used in making the accounting estimates include, for example, the following:

- The basis for management’s selection and the documentation supporting the selection of the assumption. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.
- How management assesses whether the assumptions are relevant and complete.
- When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity’s business activities, or with other matters that are
  - within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset’s useful life) and whether they are consistent with the entity’s business plans and the external environment, and

- outside the control of management (for example, assumptions about interest rates, mortality rates, or potential judicial or regulatory actions).
- The requirements of the applicable financial reporting framework related to the disclosure of assumptions.

**A42.** With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgments to support them, as follows:

- a. Those that reflect what market participants would use in pricing an asset or liability, developed based on market data obtained from sources independent of the reporting entity
- b. Those that reflect the entity's own judgments about what assumptions market participants would use in pricing the asset or liability, developed based on the best data available in the circumstances

In practice, however, the distinction between (a) and (b) may not always be apparent, and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different market participants.

**A43.** Assumptions used in making an accounting estimate are referred to as *significant assumptions* in this proposed SAS if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate. A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.

#### Inactive or Illiquid markets

**A44.** When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding the following:

- Whether management has implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances.
- Whether management has resources with the necessary skills or knowledge to adapt or develop a model, if necessary, on an urgent basis, including selecting the valuation technique that is appropriate in such circumstances.
- Whether management has the resources to determine the range of outcomes, given the uncertainties involved, for example, by performing a sensitivity analysis.
- Whether management has the means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment, and relevant business risks and the implications for the entity's accounting estimates, in such circumstances.

- Whether management has an appropriate understanding of how the price data, and the relevance thereof, from particular external information sources may vary in such circumstances.

Data (Ref: par. 12*h*(ii)(1)(c))

**A45.** Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include the following:

- The nature and source of the data, including information obtained from an external information source
- How management evaluates whether the data is appropriate
- The accuracy and completeness of the data
- The consistency of the data used with data used in previous periods
- The complexity of the IT systems used to obtain and process the data, including when this involves handling large volumes of data
- How the data is obtained, transmitted, and processed and how its integrity is maintained

How Management Understands and Addresses Estimation Uncertainty (Ref: par. 12*h*(2)–(3))

**A46.** Matters that may be appropriate for the auditor to consider relating to whether and how management understands the degree of estimation uncertainty include, for example, the following:

- Whether, and if so, how, management identified alternative methods, significant assumptions, or sources of data that are appropriate in the context of the applicable financial reporting framework
- Whether, and if so, how, management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate

**A47.** The requirements of the applicable financial reporting framework may specify the approach to selecting management’s point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognize that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.

**A48.** For example, with respect to fair value estimates, FASB *Accounting Standards Codification* (ASC) 820<sup>28</sup> indicates that if multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. In other cases,

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<sup>28</sup> Paragraph 24B of FASB ASC 820-10-35.

such as estimates for loss contingencies, FASB ASC 450<sup>29</sup> indicates that when recognition criteria are met and the reasonably estimable loss is a range, if no amount in the range is a better estimate than any other amount, the minimum amount in the range is required to be accrued.

**A49.** The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. These disclosures or disclosure objectives may address, for example, the following:

- The method of estimation used, including any applicable model and the basis for its selection
- Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as
  - assumptions developed internally, or
  - data, such as interest rates, that are affected by factors outside the control of the entity
- The effect of any changes to the method of estimation from the prior period
- The sources of estimation uncertainty
- Fair value information
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions

**A50.** In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty. Examples follow:

- The disclosure of information about the assumptions made about the future and other major sources of estimation uncertainty that give rise to a higher likelihood or magnitude of material adjustment to the carrying amounts of assets and liabilities after the period end. Such requirements may be described using terms such as *key sources of estimation uncertainty* or *critical accounting estimates*. They may relate to accounting estimates that require management's most difficult, subjective, or complex judgments. Such judgments may be more subjective and complex, and accordingly, the potential for a consequential material adjustment to the carrying amounts of assets and liabilities may increase, with the number of items of data and assumptions affecting the possible future resolution of the estimation uncertainty. Information that may be disclosed includes the following:
  - The nature of the assumption or other source of estimation uncertainty

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<sup>29</sup> Paragraph 1 of FASB ASC 450-20-30.

- The sensitivity of carrying amounts to the methods and assumptions used, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes in respect of the carrying amounts of the assets and liabilities affected
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved
- The disclosure of the range of possible outcomes and the assumptions used in determining the range.
- The disclosure of specific information, such as
  - information regarding the significance of fair value accounting estimates to the entity’s financial position and performance, and
  - disclosures regarding market inactivity or illiquidity.
- Qualitative disclosures, such as the exposures to risk, and how they arise; the entity’s objectives, policies, and procedures for managing the risk and the methods used to measure the risk; and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures, such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk, liquidity risk, and market risk.

Control Activities Relevant to the Audit Over Management’s Process for Making Accounting Estimates (Ref: par. 12i)

**A51.** The auditor’s judgment in identifying controls relevant to the audit and, therefore, the need to evaluate the design of those controls and determine whether they have been implemented, relates to management’s process described in paragraph 12h(ii). The auditor may not identify relevant control activities in relation to all the elements of paragraph 12h(ii), depending on the complexity associated with the accounting estimate.

**A52.** As part of obtaining an understanding of the control activities relevant to the audit, the auditor may consider the following:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether

the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.

- The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored, or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for and the nature of the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

**A53.** When management makes extensive use of IT in making an accounting estimate, controls relevant to the audit are likely to include general IT controls and application controls. Such controls may address risks related to the following:

- Whether the IT system has the capability and is appropriately configured to process large volumes of data.
- Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular, when the systems do not have automated interfaces or may be subject to manual intervention.
- Whether the design and calibration of models is periodically evaluated.
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources.
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, and the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data.
- Whether management has controls around access, change, and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models.
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

**A54.** In some entities the term *governance* may be used to describe activities within the control

environment, monitoring of controls, and other components of internal control, as described in AU-C section 315.<sup>30</sup>

**A55.** For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of the following:

- The nature and extent of management’s use of accounting estimates
- The design and implementation of control activities that address the risks related to the data, assumptions, and models used to make the accounting estimates
- The aspects of the entity’s information system that generate the data on which the accounting estimates are based
- How new risks relating to accounting estimates are identified, assessed, and managed

*Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: par. 13)*

**A56.** A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain the following:

- Information regarding the effectiveness of management’s previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management’s current process.
- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
- Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.
- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing, and extent of further audit procedures.

**A57.** A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period’s financial statements or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

**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*

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<sup>30</sup> Paragraph .A78 of AU-C section 315.

*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.

**A59.** Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

**A60.** The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may, therefore, focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in market participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projection) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

**A61.** 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 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.

*Specialized Skills or Knowledge* (Ref: par. 14)

**A62.** Matters that may affect the auditor's determination of whether the engagement team

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

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

requires specialized skills or knowledge, include, for example, the following:<sup>33</sup>

- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, and insurance contract liabilities)
- The degree of estimation uncertainty
- The complexity of the method or model used
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made
- The procedures that the auditor intends to undertake in responding to assessed risks of material misstatement
- The need for judgment about matters not specified by the applicable financial reporting framework
- The degree of judgment needed to select data and assumptions
- The complexity and extent of the entity's use of IT in making accounting estimates

The nature, timing, and extent of the involvement of individuals with specialized skills and knowledge may vary throughout the audit.

**A63.** The auditor may not possess the specialized skills or knowledge necessary when the matter involved is in a field other than accounting or auditing (for example, valuation skills) and may need to use an auditor's specialist.<sup>34</sup>

**A64.** Many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

### **Identifying and Assessing the Risks of Material Misstatement (Ref: par. 4 and 15)**

**A65.** Identifying and assessing risks of material misstatement at the relevant assertion level relating to accounting estimates includes not only accounting estimates that are recognized in the financial statements but also those that are included in the notes to the financial statements.

**A66.** AU-C section 200<sup>35</sup> states that GAAS does not ordinarily refer to inherent risk and control risk separately. However, this proposed SAS requires a separate assessment of inherent risk and

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<sup>33</sup> Paragraph .16 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and paragraph .08e of AU-C section 300, *Planning an Audit*.

<sup>34</sup> See AU-C section 620, *Using the Work of an Auditor's Specialist*.

<sup>35</sup> Paragraph.A44 of AU-C section 200.

control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement, including significant risks, at the relevant assertion level for accounting estimates in accordance with AU-C section 330.<sup>36</sup> See paragraphs A149–A150 of this proposed SAS for discussion about documentation of inherent risk factors.

**A67.** As discussed in paragraph 4 of this proposed SAS, AU-C section 200<sup>37</sup> explains that inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining the following:

- Where inherent risk is assessed on the spectrum of inherent risk
- The reasons for the assessment given to the risks of material misstatement at the relevant assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 of this proposed SAS are responsive to those reasons

The interrelationships between the inherent risk factors are further explained in appendix A.

**A68.** The reasons for the auditor's assessment of inherent risk at the relevant assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity, or other inherent risk factors. Examples follow:

- Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity-specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes but may involve little subjectivity, and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

**A69.** The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect

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<sup>36</sup> Paragraph .07b of AU-C section 330.

<sup>37</sup> Paragraph .A42 of AU-C section 200.

simple accounting estimates to a lesser degree, and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.

**A70.** Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately, the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates, the auditor's application of professional skepticism may be particularly important.

**A71.** Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the relevant assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the relevant assertion level,<sup>38</sup> regardless of the degree to which the accounting estimate was subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate and, therefore, may assess inherent risk at the relevant assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period-end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the relevant assertion level.

**A72.** The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, or minimum) or in terms of the auditor's expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

***Estimation Uncertainty (Ref: par. 15a)***

**A73.** In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider the following:

- Whether the applicable financial reporting framework requires

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<sup>38</sup> Paragraph .32 of AU-C section 315.

- the use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
- the use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that are unobservable and, therefore, difficult for management to develop, or the use of various assumptions that are interrelated.
- disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may, therefore, be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management
  - to make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement), or
  - to obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

**A74.** The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

**A75.** In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A113–A114 and A144–A145).

**A76.** In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity’s ability to continue as a going concern. AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes requirements and provides guidance in such circumstances.

***Complexity or Subjectivity (Ref: par. 15b)***

*The Degree to Which Complexity Affects the Selection and Application of the Method*

**A77.** In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider the following:

- The need for specialized skills or knowledge by management, which may indicate that the method used to make an accounting estimate is inherently complex and, therefore, the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward-looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

*The Degree to Which Complexity Affects the Selection and Application of the Data*

**A78.** In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider the following:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.
- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

*The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions, or Data*

**A79.** In taking into account the degree to which the selection and application of method,

assumptions, or data are affected by subjectivity, the auditor may consider the following:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques, and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing is a source of inherent estimation uncertainty and gives rise to the need for management judgment in selecting a point estimate, which, in turn, creates an opportunity for management bias. For example, an accounting estimate that incorporates forward-looking assumptions may have a high degree of subjectivity, which may be susceptible to management bias.

***Other Inherent Risk Factors (Ref: par. 15b)***

**A80.** The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud, and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is, therefore, misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

***Significant Risks (Ref: par. 16)***

**A81.** The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

**Responses to the Assessed Risks of Material Misstatement**

***The Auditor's Further Audit Procedures (Ref: par. 17)***

**A82.** In designing and performing further audit procedures, the auditor may use any of the three testing approaches (individually or in combination) listed in paragraph 17. For example, when several assumptions are used to make an accounting estimate, the auditor may decide to use a different testing approach for each assumption tested.

***Obtaining Relevant Audit Evidence, Whether Corroborative or Contradictory***

**A83.** Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions.<sup>39</sup> Obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible

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<sup>39</sup> Paragraph .A1 of AU-C section 500.

sources of audit evidence.

**A84.** AU-C section 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.<sup>40</sup> Therefore, the consideration of the nature or quantity of the audit evidence may be more important when inherent risks relating to an accounting estimate is assessed at the higher end of the spectrum of inherent risk.

#### Scalability

**A85.** The nature, timing, and extent of the auditor's further audit procedures are affected by, for example, the following:

- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period-end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
- The reasons for the assessed risks of material misstatement.

#### ***When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls (Ref: par. 18)***

**A86.** Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity and, therefore, requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

**A87.** In determining the nature, timing, and extent of testing of the operating effectiveness of controls relating to accounting estimates, the auditor may consider factors such as the following:

- The nature, frequency, and volume of transactions
- The effectiveness of the design of the controls, including whether controls are appropriately designed to respond to the assessed inherent risk, and the strength of governance

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<sup>40</sup> Paragraph .07b and .A20 of AU-C section 330.

- The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information system to support transactions
- The monitoring of controls and identified deficiencies in internal control
- The nature of the risks the controls are intended to address, for example, controls related to the exercise of judgment compared with controls over supporting data
- The competency of those involved in the control activities
- The frequency of performance of the control activities
- The evidence of performance of control activities

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements. However, AU-C section 940 includes guidance and examples of factors that affect the risk associated with a control that may be useful information when determining the nature, timing, and extent of testing of the operating effectiveness of controls relating to accounting estimates.<sup>41</sup>

***Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence***

**A88.** When management makes extensive use of IT to conduct business, it may be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

**A89.** Circumstances when risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level may exist include

- when controls are necessary to mitigate risks relating to the initiation, recording, processing, or reporting of information obtained from outside of the general and subsidiary ledgers.
- information supporting one or more assertions is electronically initiated, recorded, processed, or reported. This is likely to be the case when there is a high volume of transactions or data, or a complex model is used, requiring the extensive use of IT to ensure the accuracy and completeness of the information. A complex expected credit loss provision may be required for a financial institution or utility entity. For example, in the case of a utility entity, the data used in developing the expected credit loss provision may comprise many small balances resulting from a high volume of transactions. In these circumstances, the auditor may conclude that sufficient

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<sup>41</sup> Paragraph .A66 of AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*.

appropriate audit evidence cannot be obtained without testing controls around the model used to develop the expected credit loss provision.

In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information.

**A90.** As part of the audit of the financial statements for certain entities, the auditor also may be required by law or regulation to undertake additional procedures in relation to, or to provide an assurance conclusion on, internal control. In these and other similar circumstances, the auditor may be able to use information obtained in performing such procedures as audit evidence, subject to determining whether subsequent changes have occurred that may affect its relevance to the audit.

***Significant Risks (Ref: par. 19)***

**A91.** When the auditor's further audit procedures in response to a significant risk consist only of substantive procedures, AU-C section 330<sup>42</sup> requires that those procedures include tests of details. Such tests of details may be designed and performed under each of the approaches described in paragraph 17 of this proposed SAS based on the auditor's professional judgment in the circumstances. Examples of tests of details for significant risks related to accounting estimates include the following:

- Examination, for example, examining contracts to corroborate terms or assumptions
- Recalculation, for example, verifying the mathematical accuracy of a model
- Agreeing assumptions used to supporting documentation, such as third-party published information

***Obtaining Audit Evidence From Events Occurring Up to the Date of the Auditor's Report (Ref: par. 20)***

**A92.** In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For example, sale of the complete inventory of a discontinued product shortly after the period-end may provide sufficient appropriate audit evidence relating to the estimate of its net realizable value at the period-end. In other cases, it may be necessary to use this testing approach in connection with another approach in paragraph 17.

**A93.** For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and, therefore, may not be relevant to the measurement of the fair value accounting estimate.

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<sup>42</sup> Paragraph .22 of AU-C section 330.

**A94.** Even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*. AU-C section 560 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment of or disclosure in the financial statements have been identified<sup>43</sup> and appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.<sup>44</sup> Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions, or events, the auditor's work under AU-C section 560 is particularly relevant.

***Testing How Management Made the Accounting Estimate (Ref: par. 21)***

**A95.** Testing how management made the accounting estimate may be an appropriate approach when, for example

- the auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is appropriate.
- the accounting estimate is based on a large population of items of a similar nature that individually are not significant.
- the applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
- the accounting estimate is derived from the routine processing of data.

Testing how management made the accounting estimate may also be an appropriate approach when neither of the other testing approaches is practical to perform or may be an appropriate approach in combination with one of the other testing approaches.

*Changes in Methods, Significant Assumptions, and the Data From Prior Periods* (Ref: par. 22a, 23a, and 24a)

**A96.** The auditor may need to have further discussions with management about the following circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used:

- When there is a change from prior periods in a method, or significant assumption
- When the data is not based on new circumstances or new information
- When significant assumptions are inconsistent 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

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<sup>43</sup> Paragraph .09 of AU-C section 560.

<sup>44</sup> Paragraph .11 of AU-C section 560.

*Indicators of Management Bias (Ref: par. 22b, 23b, and 24b)*

**A97.** When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained, indicating that the method, assumptions, and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case, the assumption used was from the end of the range that resulted in the most favorable measurement outcome.

*Methods*

*The Selection of the Method (Ref: par. 22a)*

**A98.** 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 the following:

- 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.
- 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 A134–A137)

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

*Complex Modeling (Ref: par. 22d)*

**A99.** A model, and the related method, is more likely to be complex when

- understanding and applying the method, including designing the model and selecting and using appropriate data and assumptions, requires specialized skills or knowledge;
- it is difficult to obtain data needed for use in the model because there are restrictions on the availability or observability of, or access to, data; or

- it is difficult to maintain the integrity (for example, accuracy, consistency, or completeness) of the data and assumptions in using the model due to multiple valuation attributes, multiple relationships between them, or multiple iterations of the calculation.

**A100.** Matters that the auditor may consider when management uses a complex model include, for example, the following:

- Whether the model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of
  - the model's theoretical soundness,
  - the model's mathematical integrity,
  - the accuracy and completeness of the model's data and assumptions, and
  - the model's output as compared to actual transactions.
- Whether appropriate change control policies and procedures exist.
- Whether management uses appropriate skills and knowledge in using the model.

**A101.** Management may make adjustments to the output of the model to meet the requirements of the applicable financial reporting framework. In some industries these adjustments are referred to as *overlays*. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions market participants would use in similar circumstances.

Maintenance of Integrity of Significant Assumptions and the Data Used in Applying the Method (Ref: par. 22e)

**A102.** Maintaining the integrity of significant assumptions and the data in applying the method refers to the maintenance of the accuracy and completeness of the data and assumptions through all stages of information processing. A failure to maintain such integrity may result in corruption of the data, and assumptions and may give rise to misstatements. In this regard, relevant considerations for the auditor may include whether the data and assumptions are subject to all changes intended by management, and not subject to any unintended changes, during activities such as input, storage, retrieval, transmission, or processing.

*Significant Assumptions* (Ref: par. 23)

**A103.** Relevant considerations for the auditor regarding the appropriateness of the significant assumptions in the context of the applicable financial reporting framework and, if applicable, the appropriateness of changes from the prior period may include the following:

- Management's rationale for the selection of the assumption.
- Whether the assumption is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry, and environment in which the entity operates.

- Whether a change from prior periods in selecting an assumption is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial statements or may be an indicator of possible management bias (see paragraphs A134–A137).

**A104.** Management may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there may be variation because different market participants will use different assumptions. A sensitivity analysis may lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, including “pessimistic” and “optimistic” scenarios.

**A105.** Through the knowledge obtained in performing the audit, the auditor may become aware of or may have obtained an understanding of assumptions used in other areas of the entity’s business. Such matters may include, for example, business prospects, assumptions in strategy documents, and future cash flows. Also, if the engagement partner has performed other engagements for the entity, AU-C section 315<sup>45</sup> requires the engagement partner to consider whether information obtained from those other engagements is relevant to identifying risks of material misstatement. This information may also be useful to consider in addressing whether significant assumptions are consistent with each other and with those used in other accounting estimates.

**A106.** The appropriateness of the significant assumptions in the context of the requirements of the applicable financial reporting framework may depend on management’s intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities, and the applicable financial reporting framework may require management to do so. The nature and extent of audit evidence to be obtained about management’s intent and ability is a matter of professional judgment. When applicable, the auditor’s procedures may include the following:

- Review of management’s history of carrying out its stated intentions
- Inspection of written plans and other documentation, including, when applicable, formally approved budgets, authorizations, or minutes
- Inquiry of management about its reasons for a particular course of action
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor’s report
- Evaluation of the entity’s ability to carry out a particular course of action given the entity’s economic circumstances, including the implications of its existing

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<sup>45</sup> Paragraph .08 of AU-C section 315.

commitments and legal, regulatory, or contractual restrictions that could affect the feasibility of management's actions

- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that significant assumptions reflect those used by market participants.

Data (Ref: par. 24a)

**A107.** Relevant considerations for the auditor regarding the appropriateness of the data selected for use in the context of the applicable financial reporting framework and, if applicable, the appropriateness of the changes from the prior period may include the following:

- Management's rationale for the selection of the data
- Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry, and environment in which the entity operates
- Whether the change from prior periods in the sources or items of data selected or data selected, is based on new circumstances or new information. When it is not, it is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate 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 paragraphs A133–A136)

Relevance and Reliability of the Data (Ref: par. 24c)

**A108.** When using information produced by the entity, AU-C section 500 requires the auditor to evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances, to obtain audit evidence about the accuracy and completeness of the information and evaluate whether the information is sufficiently precise and detailed for the auditor's purposes.<sup>46</sup>

Complex Legal or Contractual Terms (Ref: par. 24d)

**A109.** Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include the following:

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract

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<sup>46</sup> Paragraph .09 of AU-C section 500.

- Inquiring of the entity’s legal counsel regarding the legal or contractual terms
- Inspecting the underlying contracts to
  - evaluate the underlying business purpose for the transaction or agreement, and
  - consider whether the terms of the contracts are consistent with management’s explanations.

*Management’s Selection of a Point Estimate and Related Disclosures About Estimation Uncertainty*

Management’s Steps to Understand and Address Estimation Uncertainty (Ref: par. 25a)

**A110.** Estimation uncertainty is the susceptibility to an inherent lack of precision in measurement. This arises when the required monetary amount for a financial statement item cannot be measured with precision through direct observation of the cost or price. The susceptibility to a lack of precision in measurement is often referred to in accounting frameworks as *measurement uncertainty*. Relevant considerations regarding whether management has taken appropriate steps to understand and address estimation uncertainty may include whether management has

- a. understood the estimation uncertainty, by identifying the sources, and assessing the degree of inherent variability in the measurement outcomes and the resulting range of reasonably possible measurement outcomes;
- b. identified the degree to which, in the measurement process, complexity or subjectivity affect the risk of material misstatement, and addressed the resulting potential for misstatement by applying
  - i. appropriate skills and knowledge in making accounting estimates, and
  - ii. professional judgment, including identifying and addressing susceptibility to management bias; and
- c. addressed estimation uncertainty through appropriately selecting management’s point estimate and related disclosures that describe the estimation uncertainty.

The Selection of Management’s Point Estimate and Related Disclosures of Estimation Uncertainty (Ref: par. 25b)

**A111.** Matters that may be relevant regarding the selection of management’s point estimate and the development of related disclosures about estimation uncertainty include whether

- the methods and data used were selected appropriately, including when alternative methods for making the accounting estimate and alternative sources of data were available.
- valuation attributes used were appropriate and complete.

- the assumptions used were selected from a range of reasonably possible amounts and were supported by appropriate data that is relevant and reliable.
- the data used was appropriate, relevant, and reliable, and the integrity of that data was maintained.
- the calculations were applied in accordance with the method and were mathematically accurate.
- management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
- the related disclosures appropriately describe the amount as an estimate and explain the nature and limitations of the estimation process, including the variability of the reasonably possible measurement outcomes.

**A112.** Relevant considerations for the auditor regarding the appropriateness of management's point estimate may include the following:

- When the requirements of the applicable financial reporting framework prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribes a specific measurement method, whether management has followed the requirements of the applicable financial reporting framework
- When the applicable financial reporting framework has not specified how to select an amount from reasonably possible measurement outcomes, whether management has exercised judgment, taking into account the requirements of the applicable financial reporting framework

**A113.** Relevant considerations for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures

- that describe the amount as an estimate and explain the nature and limitations of the process for making it, including the variability in reasonably possible measurement outcomes. The framework also may require additional disclosures to meet a disclosure objective.<sup>47</sup>
- about significant accounting policies related to accounting estimates. Depending on the circumstances, relevant accounting policies may include matters such as the specific principles, bases, conventions, rules, and practices applied in preparing and presenting accounting estimates in the financial statements.
- about significant or critical judgments (for example, those that had the most significant effect on the amounts recognized in the financial statements) as well as significant forward-looking assumptions or other sources of estimation uncertainty.

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<sup>47</sup> Paragraph 1A of FASB ASC 820-10-50.

In certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation, or in the case of a compliance framework, for the financial statements not to be misleading.

**A114.** The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and, therefore, the more persuasive the audit evidence needs to be to determine, in accordance with paragraph 35, whether management’s point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

**A115.** If the auditor’s consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter.<sup>48</sup>

*When Management Has Not Taken Appropriate Steps to Understand and Address Estimation Uncertainty (Ref: par. 26)*

**A116.** When the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty, additional procedures that the auditor may request management to perform to understand estimation uncertainty may include, for example, consideration of alternative assumptions or the performance of a sensitivity analysis.

**A117.** In considering whether it is practicable to develop a point estimate or range, matters that the auditor may need to take into account include whether the auditor could do so without impairing independence.<sup>49</sup> This may include relevant ethical requirements that address prohibitions on assuming management responsibilities.

**A118.** If, after considering management’s response, the auditor determines that it is not practicable to develop an auditor’s point estimate or range, the auditor is required to evaluate the implications for the audit or the auditor’s opinion on the financial statements in accordance with paragraph 34.

***Developing an Auditor’s Point Estimate or Using an Auditor’s Range (Ref: par. 27–28)***

**A119.** Developing an auditor’s point estimate or range to evaluate management’s point estimate and related disclosures about estimation uncertainty may be an appropriate approach when, for example

- the auditor’s review of similar accounting estimates made in the prior period financial statements suggests that management’s current period process is not expected to be effective.

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<sup>48</sup> See AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*.

<sup>49</sup> See management responsibilities under the “Nonattest Services” interpretation (ET sec. 1.295) under the “Independence Rule” (ET sec. 1.200) of the AICPA Code of Professional Conduct.

- the entity's controls within and over management's process for making accounting estimates are not well-designed or properly implemented.
- events or transactions between the period-end and the date of the auditor's report have not been properly taken into account, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
- there are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range.
- management has not taken appropriate steps to understand or address the estimation uncertainty (see paragraph 26).

**A120.** The decision to develop a point estimate or range also may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value or the most likely outcome).

**A121.** The auditor's decision about whether to develop a point estimate, rather than a range, may depend on the nature of the estimate and the auditor's judgment in the circumstances. For example, the nature of the estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.

**A122.** The auditor may develop a point estimate or a range in a number of ways, for example, by

- using a different model than the one used by management, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- using management's model but developing alternative assumptions or data sources to those used by management.
- using the auditor's own method but developing alternative assumptions to those used by management.
- employing or engaging a person with specialized expertise to develop or execute a model, or to provide relevant assumptions.
- considering other comparable conditions, transactions, or events, or, where relevant, markets for comparable assets or liabilities.

**A123.** The auditor also may develop a point estimate or range for only part of the accounting estimate (for example, for a particular assumption or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

**A124.** When using the auditor's own methods, assumptions, or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions, or data. For example, if the auditor uses the auditor's own assumptions in developing

a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgments in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

**A125.** The requirement in paragraph 28a for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.

**A126.** The size of the auditor's range may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income), and this measure is relatively small in relation to assets or other balance sheet measures. This situation is more likely to arise in circumstances in which the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, in which a high degree of estimation uncertainty is more typical, and there may be specific requirements in the applicable financial reporting framework in that regard. Based on the procedures performed and audit evidence obtained in accordance with the requirements of this proposed SAS, the auditor may conclude that a range that is multiples of materiality is, in the auditor's judgment, appropriate in the circumstances. When this is the case, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes. Paragraphs A140–A145 include additional considerations that may be relevant in these circumstances.

### ***Other Considerations Relating to Audit Evidence (Ref: par. 30)***

**A127.** Information to be used as audit evidence, regarding risks of material misstatement relating to accounting estimates, may have been produced by the entity, prepared using the work of a management's specialist, or provided by an external information source.

#### *External Information Sources*

**A128.** As explained in AU-C section 500,<sup>50</sup> 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. Examples follow:

- 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.

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<sup>50</sup> Paragraph .A32 of AU-C section 500.

- 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 26b 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 models (for example, for a derivative instrument or security, a pricing model or cash flow projection model). Proposed SAS *Audit Evidence*<sup>51</sup> provides relevant guidance.
- When, for derivative instruments or securities
  - 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
  - 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.

**A129.** For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include the following:

- 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

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<sup>51</sup> Paragraphs 9 and A43 of proposed SAS *Audit Evidence*.

developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable

- 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
  - 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 (OTC) 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 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.

**A130.** When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions, and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's consideration of the nature, timing, and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class, rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker-indicative quotes for individual securities. Proposed SAS *Audit Evidence*<sup>52</sup> provides guidance with respect to restrictions placed by the external information source on the provision of supporting information.

#### *Management's Specialist*

**A131.** Assumptions relating to accounting estimates that are made or identified by a management's specialist become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor applies the relevant requirements in this proposed SAS to those assumptions.

**A132.** If the work of a management's specialist involves the use of methods or sources of data

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<sup>52</sup> Paragraphs 9 and A43 of proposed SAS *Audit Evidence*.

relating to accounting estimates, or developing or providing findings or conclusions relating to a point estimate or related disclosures for inclusion in the financial statements, the requirements in paragraphs 21–29 of this proposed SAS may assist the auditor in applying AU-C section 500.<sup>53</sup>

### *Service Organizations*

**A133.** AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*, deals with the auditor’s understanding of the services provided by a service organization, including internal control, as well as the auditor’s responses to assessed risks of material misstatement. When the entity uses the services of a service organization in making accounting estimates, the requirements and guidance in AU-C section 402 may assist the auditor in applying the requirements of this proposed SAS.

### **Indicators of Possible Management Bias (Ref: par. 32)**

**A134.** Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods. For example, if accounting estimates included in the financial statements are considered to be individually reasonable but management’s point estimates consistently trend toward one end of the auditor’s range of reasonable outcomes that provide a more favorable financial reporting outcome for management, such circumstances may indicate possible bias by management.

**A135.** Examples of indicators of possible management bias with respect to accounting estimates include the following:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances
- Selection or development of significant assumptions or the data that yield a point estimate favorable for management objectives
- Selection of a point estimate that may indicate a pattern of optimism or pessimism

When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions about the reasonableness of individual accounting estimates. However, in some cases, the audit evidence may point to a misstatement, rather than simply an indicator of management bias.

**A136.** Indicators of possible management bias may affect the auditor’s conclusion about whether the auditor’s risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management’s judgments in making accounting estimates. Further, indicators of possible management bias may affect the auditor’s conclusion about whether the financial statements as a whole are free from material misstatement, as discussed in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, or AU-C section 703, *Forming*

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<sup>53</sup> Paragraph .08c of AU-C section 500.

*an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA.*<sup>54</sup>

**A137.** In addition, in applying AU-C section 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud.<sup>55</sup> Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor, may cause the auditor to reassess whether the auditor's risk assessments, in particular, the assessment of fraud risks, and related responses remain appropriate.

### **Overall Evaluation Based on Audit Procedures Performed (Ref: par. 33)**

**A138.** As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures.<sup>56</sup> In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence that differs significantly from the information on which the risk assessment was based. For example, the auditor may have identified that the only reason for an assessed risk of material misstatement is the subjectivity involved in making the accounting estimate. However, while performing procedures to respond to the assessed risks of material misstatement, the auditor may discover that the accounting estimate is more complex than originally contemplated, which may call into question the assessment of the risk of material misstatement (for example, the inherent risk may need to be re-assessed on the higher end of the spectrum of inherent risk due to the effect of complexity) and, therefore, the auditor may need to perform additional further audit procedures to obtain sufficient appropriate audit evidence.<sup>57</sup>

**A139.** With respect to accounting estimates that have not been recognized, a particular focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have, in fact, been met. When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

### ***Determining Whether the Accounting Estimates Are Reasonable or Misstated* (Ref: par. 35)**

**A140.** In determining whether, based on the audit procedures performed and evidence obtained, management's point estimate and related disclosures are reasonable or are misstated

- when the audit evidence supports a range, the size of the range may be wide and, in some circumstances, may be multiples of materiality for the financial statements as a whole (see also paragraph A125). Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate

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<sup>54</sup> Paragraph .14 of AU-C section 700 or paragraph .39 of AU-C section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*.

<sup>55</sup> Paragraph .32b of AU-C section 240.

<sup>56</sup> Paragraph .A73 of AU-C section 330.

<sup>57</sup> See also paragraph .32 of AU-C section 315.

audit evidence has been obtained regarding the reasonableness of the amounts within the range.

- the audit evidence may support a point estimate that differs from management’s point estimate. In such circumstances, the difference between the auditor’s point estimate and management’s point estimate constitutes a misstatement.
- the audit evidence may support a range that does not include management’s point estimate. In such circumstances, the misstatement is the difference between management’s point estimate and the nearest point of the auditor’s range.

**A141.** Paragraphs A111–A115 provide guidance to assist the auditor in evaluating management’s selection of a point estimate and related disclosures to be included in the financial statements.

**A142.** When the auditor’s further audit procedures include testing how management made the accounting estimate or developing an auditor’s point estimate or range, the auditor is required to obtain sufficient appropriate audit evidence about disclosures that describe estimation uncertainty in accordance with paragraphs 25*b* and 28*b* and other disclosures in accordance with paragraph 31. The auditor then considers the audit evidence obtained about disclosures as part of the overall evaluation, in accordance with paragraph 35, of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated.

**A143.** AU-C section 450 also provides guidance regarding qualitative disclosures<sup>58</sup> and when misstatements in disclosures could be indicative of fraud.<sup>59</sup>

**A144.** The auditor’s evaluation about whether the financial statements achieve fair presentation<sup>60</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. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated.

**A145.** AU-C section 705<sup>61</sup> provides guidance on the implications for the auditor’s opinion when the auditor believes that management’s disclosures in the financial statements are inadequate or misleading, including, for example, with respect to estimation uncertainty.

### **Written Representations**

**A146.** Part of the auditor’s audit evidence includes obtaining representations from management about whether management believes the methods, significant assumptions, and the data used in

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<sup>58</sup> Paragraph .A23 of AU-C section 450.

<sup>59</sup> Paragraph .A24 of AU-C section 450.

<sup>60</sup> Paragraph .16 of AU-C section 700.

<sup>61</sup> Paragraphs .23–.24 of AU-C section 705.

making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement, or disclosure that is in accordance with the applicable financial reporting framework.<sup>62</sup>

### **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,
- 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.

### **Documentation (Ref: par. 38)**

**A149.** AU-C section 315<sup>65</sup> and AU-C section 330<sup>66</sup> provide requirements and guidance on documenting the auditor's understanding of the entity, risk assessments, and responses to assessed risks. This guidance is based on the requirements and guidance in AU-C section 230, *Audit Documentation*.<sup>67</sup> In the context of auditing accounting estimates, the auditor is required to prepare audit documentation about key elements of the auditor's understanding of the entity and its environment related to accounting estimates. In addition, the auditor's judgments about the assessed risks of material misstatement related to accounting estimates, and the auditor's responses, may likely be further supported by documentation of communications with those charged with governance and management.

**A150.** In documenting the linkage of the auditor's further audit procedures with the assessed risks

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<sup>62</sup> Paragraph .16 of AU-C section 580, *Written Representations*.

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

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

<sup>65</sup> Paragraphs .33 and .A152-.A155 of AU-C section 315.

<sup>66</sup> Paragraphs .30 and .A76 of AU-C section 330.

<sup>67</sup> Paragraph .09c of AU-C section 230.

of material misstatement at the relevant assertion level, in accordance with AU-C section 330, this proposed SAS requires that the auditor take into account the reasons given to the risks of material misstatement at the relevant assertion level. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.

**A151.** The auditor also may consider documenting the following:

- When management's application of the method involves complex modeling, whether management's judgments have been applied consistently and, when applicable, that the design of the model meets the measurement objective of the applicable financial reporting framework.
- When the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree, the auditor's judgments in determining whether specialized skills or knowledge are required to perform the risk assessment procedures, to design and perform procedures responsive to those risks, or to evaluate the audit evidence obtained. In these circumstances, the documentation also may include how the required skills or knowledge were applied.

**A152.** AU-C section 230<sup>68</sup> notes that although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may, nevertheless, provide evidence of the auditor's exercise of professional skepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion about the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this proposed SAS for which documentation may provide evidence of the exercise of professional skepticism by the auditor include the following:

- Paragraph 12*d*, regarding how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial statements and how that expectation compares with the entity's financial statements prepared by management
- Paragraph 17, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory
- Paragraphs 22*b*, 23*b*, 24*b*, and 32, which address indicators of possible management bias

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<sup>68</sup> Paragraph .A9 of AU-C section 230.

- Paragraph 34, which addresses the auditor's consideration of all relevant audit evidence, whether corroborative or contradictory

**A153.**

## **Appendix A — Inherent Risk Factors**

### **Introduction**

1. In identifying, assessing, and responding to the risks of material misstatement at the relevant assertion level for an accounting estimate and related disclosures, this proposed SAS requires the auditor to take into account the degree to which the accounting estimate is subject to estimation uncertainty; the degree to which the selection and application of the methods, assumptions, and data used in making the accounting estimate; and the selection of management's point estimate and related disclosures for inclusion in the financial statements are affected by complexity, subjectivity, or other inherent risk factors.

2. Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which give rise to challenges in appropriately making the accounting estimate. This appendix provides further explanation about the nature of the inherent risk factors of estimation uncertainty, subjectivity, and complexity and their interrelationships in the context of making accounting estimates and selecting management's point estimate and related disclosures for inclusion in the financial statements.

### **Measurement Basis**

3. The measurement basis and the nature, condition, and circumstances of the financial statement item give rise to relevant valuation attributes. When the cost or price of the item cannot be directly observed, an accounting estimate is required to be made by applying an appropriate method and using appropriate data and assumptions. The method may be specified by the applicable financial reporting framework, or is selected by management, to reflect the available knowledge about how the relevant valuation attributes would be expected to influence the cost or price of the item on the measurement basis.

### **Estimation Uncertainty**

4. Susceptibility to a lack of precision in measurement may be referred to in accounting frameworks as *measurement uncertainty*. Estimation uncertainty is defined in this proposed SAS as susceptibility to an inherent lack of precision in measurement. It arises when the required monetary amount for a financial statement item that is recognized or disclosed in the financial statements cannot be measured with precision through direct observation of the cost or price. When direct observation is not possible, the next most precise alternative measurement strategy is to apply a method that reflects the available knowledge about cost or price for the item on the relevant measurement basis, using observable data about relevant valuation attributes.

5. However, constraints on the availability of such knowledge or data may limit the verifiability of such inputs to the measurement process and, therefore, limit the precision of

measurement outcomes. Furthermore, most accounting frameworks acknowledge that there are practical constraints on the information that should be taken into account, such as when the cost of obtaining it would exceed the benefits. The lack of precision in measurement arising from these constraints is inherent because it cannot be eliminated from the measurement process. Accordingly, such constraints are sources of estimation uncertainty. Other sources of measurement uncertainty that may occur in the measurement process are, at least in principle, capable of elimination if the method is applied appropriately and, therefore, are sources of potential misstatement, rather than estimation uncertainty.

6. When estimation uncertainty relates to uncertain future inflows or outflows of economic benefits that will ultimately result from the underlying asset or liability, the outcome of these flows will only be observable after the date of the financial statements. Depending on the nature of the applicable measurement basis and on the nature, condition, and circumstances of the financial statement item, this outcome may be directly observable before the financial statements are finalized or may only be directly observable at a later date. For some accounting estimates, there may be no directly observable outcome at all.

7. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.

### **Complexity**

8. Complexity (that is, the complexity inherent in the process of making an accounting estimate, before consideration of controls) gives rise to inherent risk. Inherent complexity may arise when

- there are many valuation attributes with many or nonlinear relationships between them.
- determining appropriate values for one or more valuation attributes requires multiple data sets.
- more assumptions are required in making the accounting estimate, or when there are correlations between the required assumptions.
- the data used is inherently difficult to identify, capture, access, or understand.

9. Complexity may be related to the complexity of the method and the computational process or model used to apply it. For example, complexity in the model may reflect the need to apply

probability-based valuation concepts or techniques, option pricing formulae, or simulation techniques to predict uncertain future outcomes or hypothetical behaviors. Similarly, the computational process may require data from multiple sources or multiple data sets to support the making of an assumption or the application of sophisticated mathematical or statistical concepts.

10. The greater the complexity, the more likely it is that management will need to apply specialized skills or knowledge in making an accounting estimate or engage a management's expert, for example, in relation to

- valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques,
- the underlying valuation attributes that may be relevant given the nature of the measurement basis and the nature, condition, and circumstances of the financial statement items for which accounting estimates are being made, or
- identifying appropriate sources of data from internal sources (including from sources outside the general or subsidiary ledgers) or from external information sources, determining how to address potential difficulties in obtaining data from such sources or in maintaining its integrity in applying the method, or understanding the relevance and reliability of that data.

11. Complexity relating to data may arise, for example, in the following circumstances:

- a.* When data is difficult to obtain or when it relates to transactions that are not generally accessible. Even when such data is accessible, for example, through an external information source, it may be difficult to consider the relevance and reliability of the data, unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed
- b.* When data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, is difficult to understand without transparency about the rationale and information taken into account in developing those views
- c.* When certain types of data are inherently difficult to understand because they require an understanding of technically complex business or legal concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products

## **Subjectivity**

12. Subjectivity (that is, the subjectivity inherent in the process of making an accounting estimate, before consideration of controls) reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. When such limitations exist, the applicable financial reporting framework may reduce the degree of subjectivity by providing a required basis for making certain judgments. Such requirements may, for example, set explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgments through requirements for disclosures about those judgments.

13. Management judgment is generally needed in determining some or all of the following matters, which often involve subjectivity:

- To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques, and factors to use in the estimation method, having regard to available knowledge
- To the extent valuation attributes are observable when there are various potential sources of data, the appropriate sources of data to use
- To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to make, having regard to the best available data, including, for example, market views
- The range of reasonably possible outcomes from which to select management's point estimate, and the relative likelihood that certain points within that range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework
- The selection of management's point estimate, and the related disclosures to be made, in the financial statements

14. Making assumptions about future events or conditions involves the use of judgment, the difficulty of which varies with the degree to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the degree to which those events or conditions are determinable based on knowledge, including knowledge of past conditions, events, and related outcomes. The lack of precision also contributes to estimation uncertainty, as described previously.

15. With respect to future outcomes, assumptions will only need to be made for those features of the outcome that are uncertain. For example, in considering the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and the amount and timing of any such loss.

16. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain. In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment.

17. It may be necessary for management to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information that may highlight repeating historical patterns that can be extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends). These may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends. Difficult judgments may be needed about the predictive value of such information.

18. The extent and nature (including the degree of subjectivity involved) of the judgments taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the risk of and opportunity for management bias or fraud may also be increased.

### **Relationship of Estimation Uncertainty to Subjectivity and Complexity**

19. Estimation uncertainty gives rise to inherent variation in the possible methods, data sources, and assumptions that could be used to make an accounting estimate. This gives rise to subjectivity and, hence, the need for the use of judgment in making the accounting estimate. Such judgments are required in selecting the appropriate methods and data sources, in making the assumptions, and in selecting management's point estimate and related disclosures for inclusion in the financial statements. These judgments are made in the context of the recognition, measurement, presentation, and disclosure requirements of the applicable financial reporting framework. However, because there are constraints on the availability and accessibility of knowledge or information to support these judgments, they are subjective in nature.

20. Subjectivity in such judgments creates the opportunity for unintentional or intentional management bias in making them. Many accounting frameworks require that information prepared for inclusion in the financial statements should be neutral (that is, it should not be biased). Given that bias can, at least in principle, be eliminated from the estimation process, sources of potential bias in the judgments made to address subjectivity are sources of potential misstatement, rather than sources of estimation uncertainty.

21. The inherent variation in the possible methods, data sources, and assumptions that could be used to make an accounting estimate (see paragraph 19) also gives rise to variation in the possible measurement outcomes. The size of the range of reasonably possible measurement outcomes results from the degree of estimation uncertainty and is often referred to as the *sensitivity of the accounting*

*estimate*. In addition to determining measurement outcomes, an estimation process also involves analyzing the effect of inherent variations in the possible methods, data sources, and assumptions on the range of reasonably possible measurement outcomes (referred to as *sensitivity analysis*).

22. Developing a financial statement presentation for an accounting estimate, which, when required by the applicable financial reporting framework, achieves faithful representation (that is, complete, neutral, and free from error) includes making appropriate judgments in selecting a management point estimate that is appropriately chosen from within the range of reasonably possible measurement outcomes and related disclosures that appropriately describe the estimation uncertainty. These judgments may themselves involve subjectivity, depending on the nature of the requirements in the applicable financial reporting framework that address these matters. For example, the applicable financial reporting framework may require a specific basis (such as a probability-weighted average or a best estimate) for the selection of the management point estimate. Similarly, it may require specific disclosures or disclosures that meet specified disclosure objectives or additional disclosures that are required to achieve fair presentation in the circumstances.

23. Although an accounting estimate that is subject to a higher degree of estimation uncertainty may be less precisely measurable than one subject to a lower degree of estimation uncertainty, the accounting estimate may still have sufficient relevance for users of the financial statements to be recognized in the financial statements if, when required by the applicable financial reporting framework, a faithful representation of the item can be achieved. In some cases, estimation uncertainty may be so great that the recognition criteria in the applicable financial reporting framework are not met, and the accounting estimate cannot be recognized in the financial statements. Even in these circumstances, there may still be relevant disclosure requirements, for example, to disclose the point estimate or range of reasonably possible measurement outcomes and information describing the estimation uncertainty and constraints in recognizing the item. The requirements of the applicable financial reporting framework that apply in these circumstances may be specified to a greater or lesser degree. Accordingly, in these circumstances, there may be additional judgments that involve subjectivity to be made.

**A154.**

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

**(Ref: par. A147)**

1. Matters that the auditor may consider communicating with those charged with governance with respect to the auditor's views about significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures include the following:

- 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
- The relative materiality of the accounting estimates to the financial statements as a whole
- Management's understanding (or lack thereof) regarding the nature and extent of and the risks associated with accounting estimates
- Whether management has applied appropriate specialized skills or knowledge or engaged appropriate experts
- The auditor's views about differences between the auditor's point estimate or range and management's point estimate
- The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements
- Indicators of possible management bias
- Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates
- When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods
- Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate in the context of the measurement objectives, the nature, conditions and circumstances, and other requirements of the applicable financial reporting framework
- The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions

- Whether significant assumptions are consistent with each other and with those used in other accounting estimates or with assumptions used in other areas of the entity's business activities
- When relevant to the appropriateness of the significant assumptions or the appropriate application of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so
- How management has considered alternative assumptions or outcomes and why it has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate
- Whether the data and significant assumptions used by management in making the accounting estimates are appropriate in the context of the applicable financial reporting framework
- The relevance and reliability of information obtained from an external information source
- Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external information source or valuations performed by management or management's expert
- Significant differences in judgments between the auditor and management or management's expert regarding valuations
- The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates
- 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

**A155.**

**Appendix C – 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***

This appendix addresses the amendments to certain AU-C sections. This table is a reference tool for these amendments.

<b>SAS No. 122 AU-C Section</b>	<b>Title</b>	<b>Paragraphs Amended</b>
<a href="#">200</a>	<i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards</i>	.A44
<a href="#">230</a>	<i>Audit Documentation</i>	.A9, .A12, .A30
<a href="#">240</a>	<i>Consideration of Fraud in a Financial Statement Audit</i>	.A53
<a href="#">260</a> , as amended by SAS 134	<i>The Auditor’s Communication With Those Charged With Governance</i>	.12, .A27, .A28, .A56, .A57
<a href="#">501</a>	<i>Audit Evidence — Specific Considerations for Selected Items</i>	.01, .04, .06–.10, .A1, .A2, .A5–.A6, .A8, .A11–.A19
<a href="#">580</a>	<i>Written Representations</i>	.16, .A13–.A14
<b>SAS No. 134 AU-C Section</b>	<b>Title</b>	<b>Paragraphs Amended</b>
<a href="#">700</a>	<i>Forming an Opinion and Reporting on Financial Statements</i>	.15c
<a href="#">701</a>	<i>Communicating Key Audit Matters in the Independent Auditor’s Report</i>	.08b, title before .A21
<b>SAS No. 136 AU-C Section</b>	<b>Title</b>	<b>Paragraphs Amended</b>
<a href="#">703</a>	<i>Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA</i>	.40

## **Amendments to Various Sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as Amended**

(*Boldface italics* denote new language. Deleted text is in ~~strikethrough~~.)

1. The amendment to each AU-C section is effective for audits of financial statements for periods ending on or after December 15, 2022.

### ***AU-C Section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards***<sup>\*</sup>

[No amendment to paragraphs .01–.A43.]

#### *Risks of Material Misstatement*

...

**.A44** *The assessment of the risks of material misstatement may be expressed in quantitative terms, such as percentages or nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.* GAAS do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. However, *proposed SAS Auditing Accounting Estimates and Disclosures*<sup>15</sup> *requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, for accounting estimates at the relevant assertion level in accordance with section 330, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*<sup>16</sup> *In identifying and assessing risks of material misstatement for significant classes of transactions, account balances, or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. ~~The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.~~*

<sup>15</sup> Paragraph 16 of proposed SAS Auditing Accounting Estimates and Disclosures.

<sup>16</sup> Paragraph .07b of AU-C section 330.

[All subsequent footnotes are renumbered.]

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

[No further amendment to AU-C section 200.]

### **AU-C Section 230, Audit Documentation**

[No amendment to paragraphs .01–.A7. Paragraph .A8 included for contextual purposes only.]

#### *Documentation of Compliance With GAAS (Ref: par. .08a)*

**.A8** In principle, compliance with the requirements of this section will result in the audit documentation being sufficient and appropriate in the circumstances. Other AU-C sections contain specific documentation requirements that are intended to clarify the application of this section in the particular circumstances of those other AU-C sections. The specific documentation requirements of other AU-C sections do not limit the application of this section. Furthermore, the absence of a documentation requirement in any particular AU-C section is not intended to suggest that there is no documentation that will be prepared as a result of complying with that AU-C section.

**.A9** Audit documentation provides evidence that the audit complies with GAAS. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed to the terms of the audit engagement with management or, when appropriate, those charged with governance.
- An auditor’s report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances in accordance with GAAS.
- Regarding requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  - For example, there may be no single way in which the auditor’s professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor’s exercise of professional skepticism in accordance with GAAS, *for example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management’s assertions, documenting how the auditor evaluated that*

*evidence, including the professional judgments made in forming a conclusion about the sufficiency and appropriateness of the audit evidence obtained.* ~~Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.~~

- Similarly, that the engagement partner has taken responsibility for the direction, supervision, and performance of the audit in compliance with GAAS may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.<sup>6</sup>

<sup>in 6</sup> [Footnote omitted for purposes of this proposed SAS.]

*Documentation of Significant Findings or Issues and Related Significant Professional Judgments (Ref: par. .08c)*

[No amendment to paragraphs .A10–.A11.]

**.A12** Some examples of circumstances in which, in accordance with paragraph .08, it is appropriate to prepare audit documentation relating to the exercise of professional judgment include, when the findings, issues, and judgments are significant,

- the rationale for the auditor's conclusion when a requirement provides that the auditor *should consider* certain information or factors, and that consideration is significant in the context of the particular engagement.
- the basis for the auditor's conclusion on the reasonableness of areas of subjective judgments *made by management* ~~(for example, the reasonableness of significant accounting estimates).~~
- *The basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework or are misstated.*
- the basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of a specialist or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
- when section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, applies, the auditor's determination of the key audit matters or the determination that there are no key audit matters to be communicated, including in

the extremely rare circumstances in which the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

[No amendment to paragraphs .A13–.A29.]

### **Exhibit — Audit Documentation Requirements in Other AU-C Sections**

**.A30** The following lists the main paragraphs in other AU-C sections that contain specific documentation requirements. This list is not a substitute for knowledge of the AU-C sections:

- a. Paragraphs .10, .13, and .16 of section 210, *Terms of Engagement*
- b. Paragraphs .25–.26 of section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- c. Paragraphs .43–.46 of section 240, *Consideration of Fraud in a Financial Statement Audit*
- d. Paragraph .28 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- e. Paragraph .20 of section 260, *The Auditor's Communication With Those Charged With Governance*
- f. Paragraph .12 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- g. Paragraph .14 of section 300, *Planning an Audit*
- h. Paragraph .33 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- i. Paragraph .14 of section 320, *Materiality in Planning and Performing an Audit*
- j. Paragraphs .30–.33 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- k. Paragraph .12 of section 450, *Evaluation of Misstatements Identified During the Audit*
- l. Paragraph .20 of section 501, *Audit Evidence — Specific Considerations for Selected Items*

- m. Paragraph .08 of section 520, *Analytical Procedures*
- n. Paragraph 22 of **proposed SAS** ~~section 540~~, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- o. Paragraph .28 of section 550, *Related Parties*
- p. Paragraph .22 of section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- q. Paragraphs .49 and .64 of section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
- r. Paragraphs .33–.35 of section 610, *Using the Work of Internal Auditors*
- s. Paragraph .17 of section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
- ~~t.~~ Paragraph .13 of section 915, *Reports on Application of Requirements of an Applicable Financial Reporting Framework*
- ~~u.~~ Paragraphs .42–.43 of section 930, *Interim Financial Information*
- ~~v.~~ Paragraphs .39–.42 of section 935, *Compliance Audits*

[No further amendment to AU-C section 230.]

#### **AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit***

[No amendment to paragraphs .01–.A50. Paragraphs .A51–.A52 included for contextual purposes only.]

*Accounting Estimates (Ref: par. .32b)*

**.A51** The preparation and fair presentation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and monitor the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions about the entity's performance and profitability.

**.A52** The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether an indication exists of a possible bias on the part of management. This review is not intended to call into question the auditor’s professional judgments made in the prior year that were based on information available at the time.

**.A53** A retrospective review is also required by *proposed SAS section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.<sup>20</sup> That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management’s *previous accounting estimates* prior period estimation process, audit evidence about the outcome, or when applicable, the subsequent reestimation *to assist* of prior period accounting estimates that is pertinent to making *in identifying and assessing the risks of material misstatement in the* current period accounting estimates, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor’s review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this section may be carried out in conjunction with the review required by *proposed SAS Auditing Accounting Estimates and Related Disclosures* section 540.

<sup>20</sup> Paragraph ~~1409~~ of *proposed SAS section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

[No further amendment to AU-C section 240.]

## **AU-C Section 260, *The Auditor’s Communication With Those Charged With Governance***

[No amendment to paragraphs .01–.09. Paragraphs .10–.11 included for contextual purposes only.]

### **Matters to Be Communicated**

#### ***The Auditor’s Responsibilities With Regard to the Financial Statement Audit***

**.10** The auditor should communicate with those charged with governance the auditor’s responsibilities with regard to the financial statement audit, including that (Ref: par. .A13–~~A18~~A17)

- a. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are prepared, in all material respects, in accordance with the applicable financial reporting framework.
- b. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

#### ***Planned Scope and Timing of the Audit***

**.11** The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: par. .A19–.A24)

***Significant Findings or Issues From the Audit***

**.12** The auditor should communicate with those charged with governance (Ref: par. .A25–.A26)

- a. the auditor’s views about qualitative aspects of the entity’s significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor should (Ref: par. .A27–.A29)
  - i. explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity and
  - ii. determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor’s conclusions regarding the reasonableness of those estimates.
- b. significant difficulties, if any, encountered during the audit. (Ref: par. .A30)
- c. disagreements with management, if any. (Ref: par. .A31)
- d. circumstances that affect the form and content of the auditor’s report, if any. (Ref: par. .A32–.A33)
- ~~d~~e. other findings or issues, if any, arising during the audit that are, in the auditor’s professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process. (Ref: par. ~~.A27.A34–.A36~~)

[No amendment to paragraphs .13–.A26. Paragraph .A29 included for contextual purposes only.]

***Qualitative Aspects of the Entity’s Significant Accounting Practices (Ref: par. .12a)***

**.A27** Financial reporting frameworks ordinarily allow for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures, for example, the use of key assumptions in the development of accounting estimates ~~for which there is significant measurement uncertainty~~. In addition, law, regulation, or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to “critical accounting estimates” or “critical accounting policies and practices” to identify and provide additional information to users about the most difficult, subjective, or complex judgments made by management in preparing the financial statements.

**.A28** As a result, the auditor’s views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities

for oversight of the financial reporting process. For example, in relation to the matters described in paragraph .A27, those charged with governance may be interested in the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks and the quality of the disclosures *views on the degree to which complexity, subjectivity, or other inherent risk factors affect the selection or application of the methods, assumptions, and data used in making a significant accounting estimates, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework*. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may also include comment on the acceptability of significant accounting practices and the quality of the disclosures. *When applicable, this may include whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity, for example, when an alternative acceptable method for making an accounting estimate would, in the auditor's judgment, be more appropriate*. The appendix, "Qualitative Aspects of Accounting Practices," identifies matters that may be included in this communication.

~~.A29~~ ~~A25~~ Certain accounting estimates have higher estimation uncertainty because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. In communicating with those charged with governance about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates, the auditor may consider communicating

- the nature of significant assumptions,
- the degree of subjectivity involved in the development of the assumptions, and
- the relative materiality of the items being measured to the financial statements as a whole.

[No amendment to paragraphs .A30–.A55.]

## **Appendix — Qualitative Aspects of Accounting Practices**

**.A56** The communication required by paragraph .12a and discussed in paragraphs .A24–.A25 may include such matters as the following:

### **Accounting Policies**

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering the need to balance the cost of providing information with

the likely benefit to users of the entity's financial statements (when acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities)

- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements (the communication may include the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity, and the timing of a change in accounting policies with regard to expected new accounting pronouncements)
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative material or consensus)
- The effect of the timing of transactions in relation to the period in which they are recorded

### **Accounting Estimates and Related Disclosures**

- ~~For items for which estimates are significant, issues discussed in section *Appendix 2 of proposed SAS 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, includes matters that the auditor may consider communicating with respect to significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures. including the following examples:~~
  - ~~○ Management's identification of accounting estimates~~
  - ~~○ Management's process for making accounting estimates~~
  - ~~○ Risks of material misstatement~~
  - ~~○ Indicators of possible management bias~~
  - ~~○ Disclosure of estimation uncertainty in the financial statements~~

### **Financial Statement Disclosures**

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, going concern, subsequent events, and contingency issues)

- The overall neutrality, consistency, and clarity of the disclosures in the financial statements

### **Related Matters**

- The potential effect on the financial statements of significant risks and exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements
- The extent to which the financial statements are affected by unusual transactions, including nonrecurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets (the communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements)
- The selective correction of misstatements (for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings)

### **Exhibit — Requirements to Communicate With Those Charged With Governance in Other AU-C Sections**

**A57** Requirements for the auditor to communicate with those charged with governance are included in other AU-C sections. This section does not change the requirements in

- a. paragraph .17 of section 210, *Terms of Engagement*
- b. paragraphs .21, .38ci, and .39–.41 of section 240, *Consideration of Fraud in a Financial Statement Audit*
- c. paragraphs .14, .18, and .21–.23 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- d. paragraph .11 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- e. paragraph .27 of section 550, *Related Parties*

*f.* paragraphs .10b–c, .12a, .15a, .17a, and .18 of section 560, *Subsequent Events and Subsequently Discovered Facts*

***g.* paragraph 37 of proposed SAS Auditing Accounting Estimates and Related Disclosures**

*gh.* paragraph .28 of section 570, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*

*hi.* paragraphs .45–.48 of section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*

*ji.* paragraph .28 of section 610, *Using the Work of Internal Auditors*

*kj.* paragraph .16 of section 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

~~*lk.*~~ paragraphs .12, .14, ~~.20.24~~, and ~~.29.31~~ of section 705, *Modifications to the Opinion in the Independent Auditor’s Report*

~~*ml.*~~ paragraph ~~.09.12~~ of section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report*

~~*nm.*~~ paragraphs .08, .12, .15, and .18 of section 720, *Other Information in Documents Containing Audited Financial Statements*

~~*on.*~~ paragraph .06 of section 730, *Required Supplementary Information*

~~*po.*~~ paragraphs .23–.28 of section 930, *Interim Financial Information*

~~*qp.*~~ paragraphs .36–.37 of section 935, *Compliance Audits*

[No further amendment to AU-C section 260.]

## **AU-C Section 501, *Audit Evidence — Specific Considerations for Selected Items***

### **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.

[No amendment to paragraphs .02–.03.]

***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 **regarding** ~~in support of~~ the investee’s financial results, **including as applicable in the circumstances, performing the** ~~as follows~~ **following procedures**: (Ref: par. .A4–.A8)

- 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.
- 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 **regarding** ~~in support of~~ such amounts.
- 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)

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*.

[No amendment to paragraph .05.]

***Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value***

~~.06~~—With respect to investments in derivative instruments and securities measured or disclosed at fair value, the auditor should

- ~~a.~~—determine whether the applicable financial reporting framework specifies the method to be used to determine the fair value of the entity's derivative instruments and investments in securities and
- ~~b.~~—evaluate whether the determination of fair value is consistent with the specified valuation method. (Ref: par. ~~.A11–.A13~~)

~~.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.<sup>†</sup> (Ref: par. ~~.A14–.A15~~)

~~†~~Paragraph ~~.08~~ of section 500, *Audit Evidence*, addresses management's specialists.

~~.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~~)

### ***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~~)

### ***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~~)

[No amendment to paragraphs ~~.11–.25~~, which are renumbered as paragraphs ~~.06–.20~~. Subsequent footnotes also renumbered.]

## **Application and Other Explanatory Material**

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

**.A1** *The proposed SAS Auditing 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. This section addresses 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.*

**.A2.** Evaluating audit evidence for assertions about investments in securities and derivative instruments *often involves* ~~may involve~~ 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.

~~.A2~~ This section addresses only certain specific aspects relating to auditing valuation of investments in securities and derivative instruments. 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.

[No amendment to paragraph .A3. Paragraph .A4 and .A7 are provided for contextual purposes.]

***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.

**.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.

**.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 SAS Auditing Accounting Estimates and Related Disclosures addresses* ~~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.~~

[No amendment to paragraphs .A9-.A10.]

***Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value (Ref: par. .06-.08)***

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

~~.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<sup>4</sup> and the auditor’s determination of whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate.<sup>5</sup> 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.

————<sup>4</sup> Paragraphs .08a, .08c, .A12 .A14, and .A23 .A25 of section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

————<sup>5</sup> Paragraphs .12a and .A53 .A57 of section 540.

~~.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.

~~.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.

~~.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 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.<sup>6</sup>

<sup>6</sup> Paragraphs .A68 .A89 of section 540.

~~.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.~~

***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:~~

- ~~● 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.~~
- ~~● 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.~~

***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.

[No amendment to paragraphs .A20–.A72, which are renumbered as paragraphs .A11–.A64. Subsequent footnotes also renumbered.]

[No further amendment to AU-C section 501.]

**AU-C Section 580, *Written Representations***

[No amendment to paragraphs .01–.15.]

***Estimates***

**.16** The auditor should request *written representations from management and, when appropriate, those charged with governance* to provide written representations about whether *the methods, significant assumptions, and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement, or disclosure that is in accordance with the applicable financial reporting framework. The auditor should also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used.* it believes significant assumptions used by it in making accounting estimates are reasonable.

[No amendment to paragraphs .17–.A12.]

***Estimates (Ref: par. .16)***

~~.A13~~ Depending on the nature, materiality, and extent of estimation uncertainty, *Written* written representations about *specific* accounting estimates recognized or disclosed in the financial statements may include representations

- about the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework and the consistency in the application of the processes.
- *that the significant judgments made in making the accounting estimates have taken into account all relevant information of which management is aware.*
- *about the consistency and appropriateness in the selection or application of the methods, assumptions, and data used by management in making the accounting estimates.*

- that the assumptions appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity when relevant to the accounting estimates and disclosures.
- that disclosures related to accounting estimates, *including disclosures describing estimation uncertainty*, are complete and *reasonable in the context of the appropriate* ~~under the~~ applicable financial reporting framework.
- *that appropriate specialized skills or expertise has been applied in making the accounting estimates.*
- that no subsequent event ~~has occurred that would~~ requires adjustment to the accounting estimates and *related* disclosures included in the financial statements.
- *when accounting estimates are not recognized or disclosed in the financial statements, about the appropriateness of management’s decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.*

~~.A14 For those accounting estimates not recognized or disclosed in the financial statements, written representations also may include representations about the following:~~

- ~~• The appropriateness of the basis used by management for determining that the criteria of the applicable financial reporting framework for recognition or disclosure have not been met <sup>fn 4</sup>~~
- ~~• The appropriateness of the basis used by management to overcome a presumption relating to the use of fair value set forth under the entity’s applicable financial reporting framework for those accounting estimates not measured or disclosed at fair value~~

[No amendment to paragraphs .A15–.A34, which are renumbered as paragraphs .A14–.A33. Subsequent footnotes also renumbered.]

## Exhibit A — Illustrative Representation Letter

~~.A35~~ .A34 The following illustrative letter includes written representations that are required by this and other AU-C sections in effect for audits of financial statements for periods ending on or after December 15, 2012. It is assumed in this illustration that the applicable financial reporting framework is accounting principles generally accepted in the United States, that the requirement in section 570, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*, to obtain a written representation is not relevant, and that no exceptions exist to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, for the purpose of expressing an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Except where otherwise stated below, immaterial matters less than \$[insert amount] collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

We confirm that [, *to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's report),*]:

#### *Financial Statements*

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation and fair presentation of the financial statements in accordance with U.S. GAAP. (par. .10a)
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. (par. .10b)
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud. (par. .12a)
- ***The methods, data, and significant*** ~~Significant~~ assumptions used by us in making accounting estimates, ~~including those measured at fair value,~~ ***and their related disclosures are appropriate to achieve recognition, measurement, or disclosure that is reasonable in the context of the applicable financial reporting framework.*** (par. .16)

- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP. (par. .17b)
- All events subsequent to the date of the financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed. (par. .18)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (par. .14)
- The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with U.S. GAAP. (par. .15)

*[Any other matters that the auditor may consider appropriate (see paragraph .A21).]*

*Information Provided*

- We have provided you with:
  - Access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation and other matters; (par. .11a)
  - Additional information that you have requested from us for the purpose of the audit; (par. .11a) and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence. (par. .11a)
- All transactions have been recorded in the accounting records and are reflected in the financial statements. (par. .11b)
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (par. .12b)
- We have *[no knowledge of any]* *[disclosed to you all information that we are aware of regarding]* fraud or suspected fraud that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or

— Others when the fraud could have a material effect on the financial statements (par. .12c)

- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (par. .12d)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (par. .13)
- We [*have disclosed to you all known actual or possible*] [*are not aware of any pending or threatened*] litigation, claims, and assessments whose effects should be considered when preparing the financial statements [*and we have not consulted legal counsel concerning litigation, claims, or assessments*]. (par. .15)
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (par. .17a)

[*Any other matters that the auditor may consider necessary (see paragraph .A21).*]

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[*Name of Chief Executive Officer and Title*]

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[*Name of Chief Financial Officer and Title*]

[No amendment to paragraphs .A36–.A38, which are renumbered as paragraphs .A35–.A37. Subsequent footnotes also renumbered.]

[No further amendment to AU-C section 580.]

***Amendments to Various Sections in SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as Amended***

(***Boldface italics*** denotes new language. Deleted text is in ~~strikethrough~~.)

2. The amendment to each AU-C section is effective for audits of financial statements for periods ending on or after December 15, 2022.

### **AU-C Section 700, *Forming an Opinion and Reporting on Financial Statements***

[No amendment to paragraphs .01–.14.]

#### **Requirements**

#### **Forming an Opinion on the Financial Statements**

....

**.15** In particular, in view of the requirements of the applicable financial reporting framework, the auditor should evaluate whether

- a.* the financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor should consider the relevance of the accounting policies to the entity and whether they have been presented in an understandable manner. (Ref: par. .A10)
- b.* the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate.
- c.* the accounting estimates *and related disclosures* made by management are reasonable.
- d.* the information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor should consider whether all required information has been included, and whether such information is appropriately classified, aggregated or disaggregated, and presented. (Ref: par. .A11)
- e.* the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements. (Ref: par. .A12)
- f.* the terminology used in the financial statements, including the title of each financial statement, is appropriate.

[No further amendment to AU-C section 700.]

### **AU-C Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report***

[No amendment to paragraphs .01–.07.]

## Requirements

### Determining Key Audit Matters

**.08** The auditor should determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor should take into account the following: (Ref: par. .A7–.A16)

- a. Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Ref: par. .A17–.A20)
- b. Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that *are subject to a high degree of* ~~have been identified as having high~~ estimation uncertainty (Ref: par. .A21–.A22)
- c. The effect on the audit of significant events or transactions that occurred during the period (Ref: par. .A23–.A24)

[No amendment to paragraphs .09–.A20. Paragraph .A21–.A22 provided for contextual purposes.]

*Significant Auditor Judgments Relating to Areas in the Financial Statements That Involved Significant Management Judgment, Including Accounting Estimates That ~~Have Been Identified as Are Subject to a High Degree of~~ Having High Estimation Uncertainty (Ref: par. 08b)*

**.A21** AU-C section 260 requires the auditor to communicate with those charged with governance the auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates, and financial statement disclosures.<sup>16</sup> In particular, this may include accounting policies that have a significant effect on the financial statements (and significant changes to those policies), especially in circumstances in which an entity’s accounting policies are not consistent with others in its industry.

**.A22** In many cases, the auditor’s communication with those charged with governance relates to accounting estimates and related disclosures. Among other things, estimates may be highly dependent on management judgment and are often the most complex areas of the financial statements, and the estimates may require the involvement of both a management’s expert and an auditor’s expert. Such estimates are often areas of significant auditor attention, and they may be identified as significant risks.

<sup>fn 16</sup> [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 701.]

## ***Amendments to SAS No. 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA***

*(Boldface italics denotes new language. Deleted text is in ~~strikethrough~~.)*

3. The amendment to AU-C section 703 is effective for audits of financial statements for periods ending on or after December 15, 2022.

### ***AU-C Section 703, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA***

[No amendment to paragraphs .01–.39.]

#### **Forming an Opinion on the ERISA Plan Financial Statements**

....

**.40** In particular, in view of the requirements of the applicable financial reporting framework, the auditor should evaluate whether

- a.* the ERISA plan financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor should consider the relevance of the accounting policies to the plan and whether they have been presented in an understandable manner. (Ref: par. .A65)
- b.* the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate.
- c.* the accounting estimates ***and related disclosures*** made by management are reasonable.
- d.* the information presented in the ERISA plan financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor should consider whether all required information has been included, and whether such information is appropriately classified, aggregated or disaggregated, and presented. (Ref: par. .A66)
- e.* the ERISA plan financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the ERISA plan financial statements. (Ref: par. .A67)
- f.* the terminology used in the ERISA plan financial statements, including the title of each financial statement, is appropriate.

[No further amendment to AU-C section 703.]