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United States Government Accountability Office
Washington, DC 20548

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Audit and Attest Standards
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Subject: AICPA Auditing Standards Board (ASB) September 2009 Exposure Draft for a proposed Statement on Auditing Standards (SAS), entitled “*Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures (Redrafted)*.”

This letter provides the U.S. Government Accountability Office’s (GAO) comments on the ASB’s proposed SAS on auditing accounting estimates.

Our comments on changes resulting from applying the clarity drafting conventions and from converging with the International Standard on Auditing (ISA) are detailed below. Proposed editorial changes are detailed in the attachment to this letter.

Comments on Changes Resulting from Applying the Clarity Drafting Conventions and Convergence with ISA 540

(1) We believe that the objectives to be achieved by the auditor as stated in the proposed SAS are appropriate.

(2) While we agree with the revisions made to the existing standard to converge with ISA 540, the proposed SAS could be improved by modifying these revisions, as follows:

- **Evaluating the Adequacy and Fair Presentation of Disclosure Related to Accounting Estimates**

The proposed standard does not adequately address the importance of auditors evaluating the adequacy and fair presentation of disclosures of estimates that give rise to significant risks. Paragraph 19 only addresses the auditor’s responsibility to evaluate financial statement disclosures for conformity with the requirements of the applicable financial reporting framework, and paragraph 20 only requires the auditor to evaluate the adequacy of disclosure of estimation uncertainty. It is particularly important for auditors to evaluate the adequacy and fair presentation

of disclosure of estimates that give rise to significant risks so that readers understand the nature and variability of these estimates and are not misled.

To address this omission, we recommend revising paragraph 20 as follows:

19. The auditor should obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: par. A128–A129)

20. For accounting estimates that give rise to significant risks, the auditor also should evaluate the adequacy and fair presentation of the related disclosures. Such evaluation includes the adequacy of the disclosure of their estimation uncertainty ~~in the financial statements~~ in the context of the applicable financial reporting framework. (Ref: par. A130–A132)

Similarly we recommend revising the objective in paragraph 6 to address the adequacy and fair presentation of disclosures related to accounting estimates as follows:

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether
- a. accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and
 - b. related disclosures in the financial statements are adequate and fairly presented in the context of the applicable financial reporting framework.

In addition, a new paragraph that would follow paragraph 1 should be added to the scope section of this proposed SAS to summarize the auditor’s responsibility to evaluate whether disclosures related to accounting estimates achieve fair presentation. We suggest adding a paragraph similar to paragraph 2 from the Proposed SAS *Related Parties*. The following is suggested wording:

[new paragraph to follow paragraph 1] This SAS, which applies to all financial statement audits, requires auditors to evaluate the adequacy of significant estimates and related disclosures in the audited entity’s financial statements. Other SASs also require the auditor to evaluate if the financial statements—including accounting estimates and related disclosures—achieve fair presentation. For example, the proposed SAS *Forming an Opinion and Reporting on Financial Statements* requires the auditor to evaluate whether the financial statements achieve fair presentation. The proposed SAS *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* states that “when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditor should evaluate whether the financial statements include informative disclosures

similar to those required by GAAP.” It also requires the auditor to evaluate whether additional disclosures beyond those specifically required by the framework, related to matters that are not specifically identified on the face of the financial statements or other disclosures may be necessary for the financial statements to achieve fair presentation.

(3) We agree with the differences between the proposed SAS and ISA 540. We also believe that the proposed SAS would be more helpful to auditors if more complete guidance were provided on the types of written representations that the auditor may request related to accounting estimates in financial statements. Paragraph A126 of the proposed SAS advises readers to see paragraph 17 of the proposed SAS *Written Representations* (Redrafted). We recommend also summarizing in paragraph A126 the representations related to accounting estimates in the proposed *Written Representations* SAS. This would assist auditors in identifying representations that are relevant to their audit. Accordingly, we recommend revising paragraph A126 as follows:

A126. Part of the auditor’s audit evidence includes obtaining representations from management about whether (1) management’s process is appropriate for determining accounting estimates; (2) the assumptions reflect management’s ability and intent; (3) related disclosures are complete and in accordance with the applicable financial reporting framework; (4) any subsequent events require adjustment to the estimates or related disclosures and (5) management believes significant assumptions used in making accounting estimates are reasonable. See paragraph 17 of the proposed SAS *Written Representations* (Redrafted).

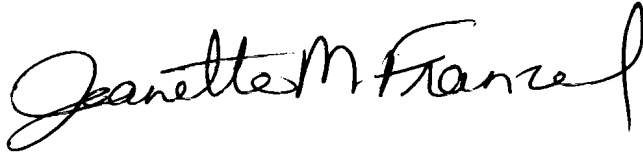
(4) We agree that the governmental considerations have been dealt with appropriately and we are not aware of any that should be included in the proposed standard. But we have concerns with the guidance given for audits of smaller, less complex entities. In particular, paragraph A68 states the following specific to audits of smaller, less complex entities:

A68. When a longer period between the balance sheet date and the date of the auditor’s report exists, the auditor’s review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may be the case particularly in some smaller owner-managed entities, especially when management does not have formalized control procedures over accounting estimates.

We recommend deleting this paragraph because the example does not pertain only to audits of smaller, less complex entities. This concept is applicable to all entities and it is described in paragraph A64, which states that events occurring up to the date of the auditor’s report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. We believe the concepts in paragraph A64 apply for audits of all entity types and make paragraph A68 unnecessary.

We thank you for considering our comments on these important issues.

Sincerely yours,

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive style with a large, looping initial "J".

Jeanette Franzel
Managing Director
Financial Management and Assurance

Attachment

GAO Suggested Editorial and Other Changes to Proposed SAS
 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates and
 Related Disclosures (Redrafted)”

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements; rather, it could be an outcome of estimation uncertainty (see previous paragraph 2). In the case of fair value accounting estimates Also, an observed outcome may be affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.</p>	<p>The second sentence in Paragraph 4 is true for all accounting estimates, not just for accounting estimates involving fair value.</p>
<p>Risk Assessment Procedures and Related Activities 8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, as required by paragraphs 5–6 and 11–12 of p Proposed SAS <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Redrafted)</i> <u>requires auditors to obtain an understanding of the entity and its environment, including the entity’s internal control.</u> The auditor should obtain an understanding of the following—in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: [....]</p>	<p>Dividing the one long sentence in paragraph 8 into two shorter sentences will make the standard easier to read and understand.</p>
<p>Nature of Accounting Estimates (Ref: par. 2) A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability, or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, whereas other financial reporting frameworks are less specific.</p>	<p>We believe that the application guidance in paragraph A125 is of such importance that it belongs in the beginning of the application materials.</p>

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>A125. <u>Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.</u></p>	
<p>A8. Estimation involves judgments based on information available <u>up to the report release date when the financial statements are prepared.</u> For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions, or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management, <u>if the auditor had known the outcome of those future conditions, transactions, or events prior to the report release date.</u></p>	<p>We suggest this wording to correctly state the time period of the auditors responsibility for information disclosed in the financial statements and to reword the sentence to improve its clarity.</p>
<p>Management Bias A9 Financial reporting frameworks often call for neutrality, that is, freedom from bias. However, accounting estimates are imprecise and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits Indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.</p>	<p>This statement is true for all audits, not just continuing audits; therefore we suggest deleting the phrase for continuing audits.</p>
<p>A10. Management bias can be difficult to detect at an account level. <u>In some situations,</u> it may</p>	<p>Prefacing the second sentence is appropriate since it does not apply in all situations.</p>

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>only be identified <u>only</u> when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods.</p> <p>Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of financial statements. However, where intention to mislead exists, management bias is fraudulent in nature.</p>	
<p>A36. <i>Changes in Methods for Making Accounting Estimates</i> (Ref: par. 8(c)(v)) In obtaining an understanding of how management makes the accounting estimates, the auditor is required to obtain an understanding about whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate or is, itself, a response to such changes. For example, if management changes the basis of making an accounting estimate by deciding to use different inputs to its model, the auditor challenging the reasonableness of <u>challenges whether</u> the change and the new inputs are reasonable in light of economic circumstances <u>will assist the auditor in evaluating the appropriateness of the change.</u></p>	<p>Rewording the last sentence of paragraph A36 will avoid an implied present tense requirement.</p>
<p>A56. Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, it is important may be necessary for the auditor—in determining whether management has appropriately applied the requirements of the applicable financial</p>	<p>Revising the second sentence of paragraph A56 will apply the clarity drafting conventions and convey that obtaining sufficient appropriate audit evidence related to collateral is important in auditing debt instruments.</p>

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<p>reporting framework—to obtain sufficient appropriate audit evidence regarding the existence, value, rights, and access to or transferability of such collateral (including consideration of whether all appropriate liens have been filed and to consider whether appropriate disclosures about the collateral have been made.</p>	
<p>A61. For Two <u>examples of appropriate responses to the assessed risk of material misstatement, as discussed in paragraph 13, are:</u></p> <ul style="list-style-type: none"> • when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. For example, • when the estimation uncertainty associated with an accounting estimate is high, and an accounting estimate based on a proprietary model for which unobservable inputs exist, it may be that a combination of the responses to assessed risks in paragraph 13 <u>may be is</u> necessary in order to obtain sufficient appropriate audit evidence. 	<p>These changes will provide a more appropriate lead-in and make the paragraph easier to read and understand.</p>
<p>Considerations Specific to Smaller, Less Complex Entities</p> <p>A71. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. <u>However, the provisions of this standard still require the auditor, when auditing smaller, less complex entities, to obtain sufficient appropriate audit evidence about accounting estimates used in preparing the entity’s financial statements.</u> Smaller entities with active management involvement may not have <u>limited extensive</u> descriptions of accounting procedures, <u>unsophisticated</u> accounting records, or <u>few</u> written policies. Even if the entity has no formal established process, management <u>may still be</u> able to provide a basis upon which the auditor can test the accounting estimate.</p>	<p>The added sentence will alert the auditor that the requirements of this standard apply even if a smaller less complex entity has less structured processes. Also, we suggest rewording the third and fourth sentences to provide a better description of estimation processes often found at small, less complex entities.</p>
<p>A124. Paragraph A3 of proposed SAS <i>Evaluation of Misstatements Identified in an Audit</i> (Redrafted), provides guidance on</p>	<p>Making the fourth bullet point into a separate sentence and adding additional guidance will assist auditors in identifying and addressing</p>

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<p>distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of</p> <ul style="list-style-type: none"> • misstatements about which no doubt exists (factual misstatements). • differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements). • the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements). <p>• in some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.</p> <p><u>In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult and unnecessary. In such situations, it may be appropriate to classify the entire misstatement in one category.</u></p>	<p>misstatements resulting from a combination of such circumstances.</p>
<p>A125 Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.</p>	<p>We believe that the application guidance in paragraph A125 is of such importance that we suggest moving it to the beginning of the application materials. Refer to our comment on paragraph A1 in this attachment.</p>

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<p>Conforming Amendment to AU Section 380, <i>The Auditor's Communication With Those Charged With Governance</i> (Redrafted) (page 51)</p> <p>A24a. Certain accounting estimates are particularly sensitive 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 and about the basis for the auditor's conclusions regarding the reasonableness of those estimates, the auditor <u>may determine that it is appropriate to communicate</u> consider communicating the nature of significant assumptions used in fair value measurements <u>and other significant estimates</u>, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of <u>significant estimates</u> to the financial statements as a whole.</p>	<p>Revising the second sentence will make it easier to understand and apply. We also suggest expanding the communication to include significant estimates, since these estimates are important for understanding the entity's financial statements and relevant to the responsibility of those charged with governance to oversee the financial reporting process.</p>