RENEWED FOCUS ON AUDITING ACCOUNTING ESTIMATES CALLS FOR COMPANIES TO REEXAMINE ACCOUNTING PROCEDURES

By Don Carpenter, MSAcc/CPA

Two recent developments have moved the use of estimates in financial accounting to the forefront. The AICPA Auditing Standards Board released a Statement of Auditing Standards exposure draft, *Auditing Accounting Estimates and Related Disclosures* and, concurrently, the Public Company Accounting Oversight Board (PCAOB) issued new guidance for auditing accounting estimates for accounting years ending on or after December 15, 2020.

The exposure draft spotlights how extensive the reliance on estimates is for material items in both the financial statements and related disclosures. It lists several areas that auditors should focus on because the reliance on estimates is critical:

- Useful lives and depreciation,
- Outcome of pending litigation,
- Insurance contract liabilities,
- Warranty obligations,
- Employee benefit obligations,
- Share-based payments,
- Impairment of long-lived assets,
- Long-term contracts, and
- Fair value accounting.

In evaluating the process and results that rely on the use of accounting estimates, auditors are directed to consider both the inherent risk factors and the control risk factors that are integral to financial statement integrity. Inherent risk factors include:

- Estimation uncertainty,
- Complexity and
- Subjectivity.

The weighting of these factors will differ in each area where estimation is applicable. For example, estimation uncertainty is not as critical where reliance can be placed on active, open-market transactions as compared to unique one-off value estimations. Likewise, complexity will increase when multiple input estimates are required or when a process requires a number of interrelated steps to complete.

The subjectivity of an estimate will increase as the range of possible results widens due to yet-to-be determined factors and possibilities. The auditor must consider whether inherent risk, complexity and subjectivity are being properly identified and managed, as well

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as adequately discussed in the disclosures accompanying the financial statements.

Distinct from inherent risk, the auditor must assess control risk. This evaluation includes an assessment of the degree to which it is possible to establish controls with regard to the specific estimation process and the extent to which the company is effectively relying on these controls. The assessment should include a consideration of management's evaluation of the appropriateness of the methodology employed to make the estimation. For example, should the process rely on a discounted cash flow model, option pricing or third party comparables?

Further, the auditor should consider the extent to which management is relying on third party or internal subject matter experts and the documentation that supports that reliance. The control assessment should also consider the appropriate segregation of duties, including review and the controls supporting data integrity and computer models.

Of course, all businesses do not have the same degree of reliance on estimates and every business will rely more heavily on estimates in some areas of their financial processes than in others. Organizations may be quite comfortable with the necessity of relying on estimates, but it is clear in these new releases that the auditor must rely on his/her professional judgement to independently assess the areas where reliance is most critical and where material

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misstatements are most likely to occur. This assessment must also include skeptical evaluation of the potential or actual presence of management bias. For example:

- Has management changed the method of developing an estimate or the source data upon which an estimate is determined?
- Does management have a pattern of selecting a point estimate that consistently indicates optimism or pessimism?

This emphasis on the review of accounting estimates supports PCAOB's AS 3101 that requires the auditor's report to include a discussion of critical audit matters, such as the use of estimates to measure financial statement results. (See "Auditor's Report is Scheduled for Remodeling" in the January/February 2019 issue of *Today's CPA*.)

Communication between the client's accounting team and the auditor become even more important. It's critical that there is a clear understanding of the areas where accounting estimates are relied on and the extent to which documentation will be required to help the auditor reach an independent decision regarding the appropriateness of the reliance.

In anticipation of this renewed emphasis on accounting estimates by auditors, companies would be well served to begin preparing now by taking several steps:

- Review all areas where estimates are critical to financial reporting and disclosures.
- Review accounting policies and procedures to determine the extent to which the process is documented and the potential for management bias is reduced.
- Review processes to confirm that they actually comply with the documentation.
- Determine if subjectivity can be reduced in critical areas by relying on the expertise of third parties.
- Review the status of SOC 1 Reports (System and Organization Controls Report) from third party advisors with the audit firm to evaluate whether additional reports will be required under the new guidance.
- Evaluate financial models and IT systems for data integrity and controls.
- Review current disclosures to determine if additional disclosure regarding the reliance on estimates and the estimation process should be made.

The renewed emphasis by both AICPA and PCAOB on the review of estimates in financial reporting serves as a reminder that professionalism in the field of accounting requires technical expertise and judgment, coupled with a freedom from bias to meet the needs of the market.