A CAQ COVID-19 RESOURCE

# Auditing Accounting Estimates in the COVID-19 Environment

Published April 2020

CAQ

THECAQ.ORG

**WE WELCOME YOUR FEEDBACK**

Please send comments or questions to info@thecaq.org

The COVID-19 pandemic and the related market conditions create many new uncertainties for public companies, auditors, investors and audit committees. As SEC Chair Jay Clayton recently recognized, the continuing operation of the US capital markets is an essential component of our national response to, and recovery from, COVID-19. The complexities of auditing accounting estimates already are well documented, and in an era of COVID-19 driven uncertainty, auditor focus in these areas becomes even more important. This publication is intended to assist auditors in navigating through this uncertainty by providing a high-level overview of auditor's responsibilities related to the auditing of estimates and to highlight COVID-19 related considerations.

This resource is intended as general information and should not be relied upon as being definitive or all-inclusive, or a substitute for PCAOB and SEC rules, standards, guidance, or other resources.

## TECHNICAL REQUIREMENTS

### New Requirements for Audits of Fiscal Years Ending On or After December 15, 2020

Auditors need to be aware that there are new requirements for auditing accounting estimates that take effect for audits of fiscal years ending on or after December 15, 2020. The requirements in the PCAOB's Auditing Standard 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (AS 2501) will apply to estimates in significant accounts and disclosures. AS 2501 will be replacing three existing standards, AS 2501, *Auditing Accounting Estimates* (Extant AS 2501), AS 2502, *Auditing Fair Value Measurements and Disclosures* (Extant AS

2502), and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (Extant AS 2503). It is important to note that most non-calendar year end audits for 2020 will need to adhere to Extant AS 2501, AS 2502, and AS 2503.

While this document is estimates focused, many higher risk estimates involve the use of specialists both by management in developing estimates and by auditors auditing estimates. The PCAOB also amended two existing auditing standards, AS 1105, *Audit Evidence* (AS 1105), and AS 1201, *Supervision of the Audit Engagement* (AS 1201), and replaced AS 1210, *Using the Work of a Specialist*, with a new AS 1210, *Using the Work of an Auditor-Engaged Specialist* (AS 1210). The amendments in AS 1105 and AS 1201 and new AS 1210 will also be effective for audits of fiscal years ending on or after December 15, 2020.

***This resource has been prepared based upon the amended and new requirements for auditing estimates and using specialists; however, it may still be useful in considering the impact COVID-19 may have on auditing accounting estimates and using specialists in accordance with the extant requirements.***

### Internal Control Considerations

The auditor's responsibilities for evaluating the internal controls around estimates have not changed. If management typically has a review control that is designed to review data and assumptions used in determining an estimate, the auditor will want to understand how that control operated, taking into consideration the uncertainties in the environment and its impact on the data and assumptions. If management is designing and implementing new controls, auditors will need to evaluate the design and test implementation of those controls.

### Identifying and Assessing Risks of Material Misstatement

AS 2110, *Identifying and Assessing Risks of Material Misstatement (As Amended for FYE 12/15/2020 and After)* (AS 2110) establishes the requirements regarding the process of identifying and assessing the risks of material misstatement.[1] As part of the auditor's risk assessment procedures, auditors need to understand the process used to develop estimates. When obtaining an understanding of a company's information system, auditors are now explicitly required to understand whether the related accounts involve accounting estimates, and if so the processes used by management to develop the estimates including:

+ The methods used, which may include models;
+ The data and assumptions used, including the source from which they are derived; and
+ The extent to which the company uses third parties (other than specialists), including the nature of the service provided and the extent to which the third parties use company data and assumptions.[2]

After identifying the accounts which contain accounting estimates, the auditor will need to consider if these represent significant accounts. The PCAOB has provided specific risk factors to aid in identifying significant accounts and disclosures involving estimates. AS 2110 notes the following factors to be considered for all accounts involving accounting estimates:

+ The degree of uncertainty associated with the future occurrence or outcome of events and conditions underlying the significant assumptions;
+ The complexity of the process for developing the accounting estimate;
+ The number and complexity of significant assumptions associated with the process;
+ The degree of subjectivity associated with significant assumptions (for example, because of significant changes in the related events and conditions or a lack of available observable inputs); and
+ If forecasts are important to the estimate, the length of the forecast period and degree of uncertainty regarding trends affecting the forecast.[3]

1 See 2110.01.
2 PCAOB Staff Guidance: *Auditing Accounting Estimates.*
3 See 2110.60A

Once the significant accounts are identified, the auditor is required to determine the risks of material misstatements associated with each significant account and if any of these risks represent a fraud risk and/or a significant risk.

### Responding to the Risks of Material Misstatement

In performing substantive procedures to respond to the identified and assessed risks of material misstatement, auditors should test accounting estimates using one or a combination of the following approaches as outlined by AS 2501:

+ Test the company's process used to develop the accounting estimate;
+ Develop an independent expectation for comparison to the company's estimate; and
+ Evaluate audit evidence from events or transactions occurring after the measurement date related to the accounting estimate for comparison to the company's estimate.

As part of executing the approach or approaches laid out above, auditors are required to do the following:

+ Determine that the estimate is in conformity with the applicable financial reporting framework, including whether the data is appropriately used and that significant assumptions are appropriately applied within that reporting framework;
+ Evaluate whether the estimate is appropriate for the nature of the related account or disclosure based on the auditor's understanding of the company and the environment; and
+ Evaluate the reasonableness of significant assumptions used by the company when evaluating the company's methods used to develop the estimate. In practice, auditors sometimes develop their own expectation of a significant assumption as a means of evaluating the reasonableness of the company's assumption. In these circumstances, the auditor should have a reasonable basis for that expectation.[4]

## COVID-19 CONSIDERATIONS

Many companies will see a material financial statement impact from COVID-19. Changes in estimates may be a key driver behind those financial statement effects. Uncertainties around the duration of the strategies to mitigate the COVID-19 pandemic could make it more difficult for management to determine the assumptions and inputs into accounting estimates, such as future cash flows. COVID-19 also could result in asset impairments or triggering events. Auditors may have to perform additional or more robust procedures around estimates given current economic conditions as a result of COVID-19.

### Potential Impact on Risk Assessment

The auditor's assessment of risk for certain estimates may change from prior years or even throughout the audit period. For example, in prior years an audit team may have determined that the accounts receivable allowance for doubtful accounts was not a significant account for a company with a limited number of customers where a history of consistent timely payment was considered a reliable predictor to inform future expectations. However, economic uncertainty may result in incremental risks, including credit risk. The audit team may determine that due to heightened risk of customer default, this balance now represents a significant account in accordance with AS 2110[5] and a greater likelihood of material misstatement.

Similarly, auditors should determine if any previously identified risks are now indicative of a significant risk. In making this judgment, auditors should consider the factors included in AS 2110. These factors instruct the auditor to assess whether the risk is related to recent significant economic, accounting, or other developments[6] and the degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.[7] The presence of these factors alone does not necessarily indicate a significant risk, but they should be evaluated and considered when determining the nature, timing and extent of planned audit procedures. For example,

4 PCAOB Staff Guidance: *Auditing Accounting Estimates.*
5 See AS 2110.60
6 AS 2110.71c
7 AS 2110.71f

there may be new significant risks or higher risks of material misstatement associated with certain estimates, such as impairment of goodwill or intangible assets, restructuring activity, or the fair value of the company's investments or financial instruments, or more broadly due to material financial reporting implications, such as liquidity, debt covenant compliance, and going concern issues.

### Potential Impact on Fraud Risk Assessment

COVID-19 may give rise to a heightened risk of fraud for reasons that may include increased economic uncertainty, potential impact of a virtual workforce on company internal controls, as well as other factors. Auditors should assess if the effects of COVID-19 have added new or elevated fraud risks related to estimates, and adjust the nature, timing and extent of their testing accordingly.

### Internal Control Considerations

Management may have changes in their accounting estimate processes as a result of the uncertain economy. These process changes may result in changes to previously designed controls or the identification of new controls. For example, when using a discounted cash flow model to arrive at the fair value of a reporting unit, management may address economic uncertainty by employing the modeling of multiple scenarios and weighing these scenarios based on probability of occurrence. This could result in the need for new or enhanced controls over the reasonableness and completeness of the multiple scenarios as well as over the reasonableness of how the probabilities were determined and assigned. As usual, auditors will need to have a skeptical mindset when assessing how management is evidencing the operation of controls and adjusting the design, if necessary, to take into account the impact of the changing environment. Management may continue to adapt and refine their responses to COVID-19 throughout the audit period, resulting in multiple changes to the design or manner of operation of their internal controls. As such, it may be necessary to reperform inquiries and other procedures related to internal controls at intervals during the audit.

### Importance of Professional Skepticism

Auditing estimates remotely and in an uncertain economy will pose new challenges for auditors. While navigating through this, it is important for auditors to keep a questioning mindset and to consider contradictory evidence. Management might have previously relied on historical data, and other sources, in developing accounting estimates that may no longer be appropriate or relevant as a result of COVID-19. Further, management may struggle to identify the evidence needed to support their accounting estimates in a timely manner. It is critical for auditors to remember the importance of obtaining sufficient appropriate audit evidence. Management may be under increased pressure to only consider certain evidence in analyzing accounting estimates in order to mitigate the negative impact of the pandemic on the company's financial statements. In determining if there is a material misstatement in management's accounting estimates, whether due to fraud or error, auditors should consider any contradictory evidence in evaluating management's calculation.

### Specialist Involvement

Auditors may have been able to evaluate estimates in prior years without the use of a specialist. However, those estimates now may require additional auditor considerations and expertise. For example, in a stable economy an auditor may have been able to evaluate certain assumptions within a valuation model, such as future cash flows or discount rates, without the use of a valuation specialist by comparing management's inputs to industry averages or historical results. In these uncertain times, industry averages or historical results may not be sufficient on their own to support the reasonableness of these assumptions and therefore the auditor may require the assistance of a valuation specialist to complete these audit procedures. Valuation specialists can help auditors evaluate whether management's estimates have appropriately considered the current economic risk factors and conditions. Additionally, other specialists such as actuaries or pricing specialists can help with other estimates, such as pension benefit obligation and derivative valuation. If auditors choose to involve a specialist, AS 1210 outlines the requirements for auditors when using a specialist, including the requirement for auditors to clearly communicate expectations to the specialist and appropriately monitoring his or her work.