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STANDING ADVISORY GROUP MEETING

FASB/IASB PROJECTS AND POTENTIAL CHALLENGES TO AUDITING

OCTOBER 13-14, 2010

Introduction

At the July 2010 Standing Advisory Group ("SAG") meeting, a panel discussed projects of the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") and their potential impact on auditors. The purpose of that discussion was to help inform the staff of the SAG's views on auditing challenges and the potential need for new or revised auditing standards or staff guidance in response to the potential upcoming changes to U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRS"). At that meeting, Lawrence Smith, a FASB board member provided an overview of the FASB / IASB projects. Mr. Smith noted, among other things, that the volume and nature of the proposed changes to the accounting standards may pose unique audit challenges.[1/] More specifically, Mr. Smith suggested that possible audit challenges may arise from 1) a fundamental change in the accounting framework from

[1/] See July 2010 SAG discussion paper and related FASB presentation slides at http://pcaobus.org/News/Events/Pages/07152010_SAGMeeting.aspx.

rules-based to principles-based accounting standards,[2] and 2) the need for significantly more issuer judgment in preparing the financial statements.[3]

Some SAG members indicated that it would be beneficial to discuss potential audit issues contemporaneously with the FASB comment letter review process. In light of this feedback, the SAG will discuss at its October meeting certain recently proposed FASB accounting standards updates ("ASU")[4] and potential audit issues identified by the staff of the Office of the Chief Auditor based on a review of those ASUs. This briefing paper and the planned SAG discussion are not meant to debate the proposed accounting standards themselves. Rather, the paper and discussion are intended to highlight potential auditability issues that may be encountered due to (i) changes in the overall accounting framework and (ii) the nature and scope of changes proposed in many of the FASB's ASUs.

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[2] E.g., the proposed changes in revenue recognition standards would eliminate more than 200 pieces of specific guidance and include "disclosure objectives" intended to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows from customers.

[3] E.g., the projects discussed included financial instruments, fair value, revenue recognition, leases, consolidation, insurance, and financial statement presentation.

[4] The FASB currently has several proposed ASUs available for public comment. However, the discussion will focus on certain of these proposed ASUs that FASB has begun receiving comment letters on: FASB Proposed ASU, *Revenue from Contracts with Customers* (comment period ends October 22, 2010); FASB Proposed ASU, *Amendments for Common Fair Value Measurement and Disclosure and Disclosure Requirements in U.S. GAAP and IFRS* (comment period ended September 7, 2010); FASB Proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (comment period ends September 30, 2010) and; FASB Proposed ASU, *Disclosure of Certain Loss Contingencies* (comment period ended September 20, 2010).

The discussion will also include FASB ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and Allowance for Credit Losses* (Topic 310), which was issued in July 2010 and is effective for public companies. The proposed and final ASUs are available from the FASB's Web site at: www.fasb.org.

The proposed FASB ASUs discussed in this paper are significantly more principles-based than FASB's existing standards, which include more detailed guidance. FASB has indicated an effect of moving towards a principles-based accounting model is that "preparers and auditors would need to apply professional judgment in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgments, including some divergence in practice."[5/] In addition to being more principles-based, in many of the proposed ASUs, the FASB is moving away from a historical cost measurement attribute towards a fair value measurement attribute, necessitating management to identify and apply more fair value measurements to its financial statement items. This trend in standards results in greater use of estimates by management.

This briefing paper provides brief summaries of selected FASB proposed ASUs and a finalized ASU, and highlights certain potential audit related challenges including:

- Increased use of fair values, estimates and judgments,
- Increased emphasis on disclosure objectives and related disclosure principles, and
- Changes in accounting disclosure requirements for contingencies.

I. Summaries of Selected FASB Accounting Standards Updates and Proposed Accounting Standards Updates

In order to facilitate the discussion among SAG members regarding the effects on auditing of a changing accounting framework, below are brief summaries of certain FASB ASU and proposed ASUs.[6/]

5/ FASB, *"Proposal for a Principles-Based Approach to U.S. Standard Setting"* (October 2002).

6/ These summaries are based on summaries from FASB's final or proposed ASUs. Readers should refer to each respective FASB final or proposed ASU for a complete discussion and additional commentary.

A. Revenue from Contracts with Customers

The FASB's Proposed ASU, *Revenue from Contracts with Customers* (the "Revenue ASU") would replace a significant part of the existing accounting guidance for revenue transactions, including certain industry-specific guidance, with a new model. The objective of the Revenue ASU is to improve financial reporting by clarifying the principles for recognizing revenue and creating a single joint revenue recognition standard for U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRS"), which entities would apply across various industries and capital markets.[7/] Under this model an entity would be required to identify the contract with a customer, separate performance obligations under the contract, determine the transaction price, allocate the transaction price to the performance obligations, and recognize revenue when the entity satisfies each performance obligation. The Revenue ASU would apply to all contracts to provide goods or services to customers, with certain exceptions.[8/]

B. Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

The FASB's Proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Financial Instruments ASU"), would affect "all entities that have financial instruments",[9/] including long-term receivables. The Financial Instruments ASU states that the "main objective in developing this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments."[10/]

7/ To clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and IFRS, the FASB and the IASB initiated a joint project on the subject of revenue recognition. According to the FASB website, the corresponding IASB Exposure Draft is the same except for minor differences in spelling, style, and format. See http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011146.

8/ Revenue ASU, paragraph 6, which indicates exceptions may include leases, insurance contracts, and financial instruments.

9/ Financial Instruments ASU, at 1.

10/ Ibid. See also paragraph 2 of Financial Instruments ASU at 23.

C. Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

The FASB's ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (the "Credit Quality ASU"),[11/] "affects all entities with financing receivables, excluding short-term trade accounts receivable or receivables measured at fair value or lower of cost or fair value."[12/] The ASU states that the update is "intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses."[13/]

D. Amendments for Common Fair Value Measurement

The FASB's Proposed ASU, *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS* (the "Fair Value ASU"), may change how some entities determine fair value and also may require additional disclosures about fair value measurements. The Fair Value ASU states that "[t]his proposed Update is a result of the continuing efforts of the FASB and the International Accounting Standards Board (IASB) to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS)."[14/] The amendments "would apply to all reporting entities that are required or permitted to measure or disclose the fair value of an asset, a liability, or an instrument classified in shareholders' equity in the financial statements.[15/]

E. Disclosure of Certain Loss Contingencies

The FASB's Proposed ASU, *Disclosure of Certain Loss Contingencies* (the "Contingencies ASU"), enhances existing disclosures with additional information to

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11/ The Credit Quality ASU is effective for interim and annual reporting periods ending on or after December 15, 2010.

12/ Credit Quality ASU, at 1.

13/ Ibid.

14/ Fair Value ASU, at 1.

15/ Ibid.

enable users of financial statements to understand the nature, potential magnitude, and potential timing (if known) of loss contingencies. The Contingencies ASU proposes that disclosure of asserted but remote loss contingencies may be necessary to inform users about the entity's vulnerability to a potential severe impact ("certain asserted remote loss contingencies"). It also requires that entities disclose tabular reconciliations by class of accrued loss contingencies including changes in amounts accrued and related descriptions of significant changes to those accruals.[16/]

II. Potential Audit-Related Challenges

A. Increased Use of Fair Value, Estimates, and Judgments

The proposed ASUs reflect an increased use of fair value, estimates, and judgments. Certain examples include –

Revenue from Contracts with Customers

- "In determining the transaction price (for example, estimating variable consideration) and allocating the transaction price on the basis of stand-alone selling prices, an entity would be required to use estimates more extensively than in applying existing standards."[17/] For example, "the proposed requirements specify that an entity should initially measure its rights and performance obligations at the transaction price – that is the amount of consideration that the entity receives, or expects to receive, from the customer."[18/] Thus, the Revenue ASU would generally change the existing practice of accounting for revenue at the amount billed to the customer when collectability is reasonably assured to recording revenue at the amount a company expects to receive from the customer.

Financial Instruments

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period (e.g., loans held-for-investment would be required to be measured at fair value, whereas they

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16/ Contingencies ASU, paragraph 450-20-50-1F.g.

17/ Revenue ASU, paragraph IN25.e.

18/ Revenue ASU, paragraph BC79.

are measured at amortized cost under current accounting standards).[19/] Additionally, core deposit liabilities would be measured using a current value method and also subject to re-measurement which would differ from the historical model of reflecting core deposits at the amount due depositors.[20/]

- Hedge accounting would be amended to require more qualitative assessments. Further, to qualify for hedge accounting, hedge relationships would need to be "reasonably effective" rather than "highly effective"; "reasonably effective" is not defined in the Financial Instrument ASU, whereas "highly effective" is a defined term in the existing standard.[21/]

Fair Value

- When a reporting entity manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk of each counterparty, and the offsetting market risks are "substantially the same,"[22/] the Fair Value ASU permits an exception to the current requirements in measuring the fair value of financial assets and financial liabilities. The term substantially the same is not defined in the Fair Value ASU.

Discussion Topics –

The staff is seeking the SAG's view on the potential auditing challenges resulting from the following and other accounting changes in these FASB proposed ASUs. In particular, the staff is interested in the SAG's views on –

- Potential challenges to auditing under the new accounting standards given the possibility for greater diversity by preparers in reporting transactions with similar facts and circumstances (e.g., preparers and auditors may

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19/ Financial Instruments ASU, at 3.

20/ Ibid, at 4.

21/ Ibid, at 4-5.

22/ Fair Value ASU, paragraph 45.

interpret the terms "substantially the same" or "reasonably effective" differently resulting in diversity in practice).

- The possible need for new or revised PCAOB auditing standards or additional audit guidance because of the significant increase in the use of fair values, estimates and judgments by preparers (e.g., some have suggested the need for separate auditing guidance in response to the proposed changes in accounting for revenue).

B. Increased Emphasis on Disclosure Objectives and Related Disclosure Principles

The following FASB ASU and proposed ASUs reflect an increased emphasis on disclosures that achieve specified objectives. Under these FASB ASU and proposed ASUs, preparers would be called on to use their judgment to determine the nature and extent of information that should be disclosed to meet the objectives stated in the standard. Certain examples include –

Revenue from Contracts with Customers

- The Revenue ASU provides for increased judgment in determining the appropriate level of disclosures by stating that an "entity shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements"[23/] "…If it has not met the disclosure objective then the entity shall disclose whatever additional information is necessary to meet that objective."[24/]

Financial Instruments

- The Financial Instruments ASU requires that the entity "determine, in light of facts and circumstances, how much detail it is required to provide to satisfy the disclosure requirements, and how it disaggregates information into classes for assets with different risk characteristics," and indicates that an entity "should strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial instruments and

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23/ Revenue ASU, paragraph 70.

24/ Revenue ASU, paragraph 71.

allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial instruments and associated risks."[25/]

Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

- The Credit Quality ASU requires an entity to strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail.[26/]

Amendments for Common Fair Value Measurement

- The Fair Value ASU requires a measurement uncertainty analysis for fair value measurements categorized within Level 3 of the fair value hierarchy.[27/] If changing one or more of the unobservable inputs used in a fair value measurement to a different amount that could have reasonably been used in the circumstances and would have resulted in a significantly higher or lower fair value measurement, it requires an entity to disclose the effect of using those different amounts and how it calculated that effect.[28/]

Discussion Topics –

The staff is seeking the SAG's view on what new challenges auditors may encounter as a result of these and other accounting changes in these FASB ASU and proposed ASUs. In particular, the staff is interested in the SAG's views on –

25/ Financial Instruments ASU, paragraph IG 171. Additional disclosure guidance is included in paragraphs IG 169 and IG 170.

26/ Credit Quality ASU, paragraph 23.

27/ Fair Value ASU, paragraph 68.

28/ Ibid.

- Potential auditing challenges an auditor would face in determining whether a company's disclosures meet the requirements of the proposed accounting standards and sufficiently describe the information essential for fair presentation of the financial statements (e.g., under the new disclosure framework, when does a disagreement over the extent of disclosure rise to a level of an audit difference?).

- Potential auditing challenges an auditor would face in evaluating information included in the measurement uncertainty analysis. Do other "amounts that could have been reasonably used in the circumstances" indicate a bias in estimates or an audit difference (e.g., what if a majority of amounts disclosed are less than those estimates used in preparing the financial statements)?

C. Changes in Accounting Disclosure Requirements for Contingencies

The Contingencies ASU would update Accounting Standards Codification Topic 450, *Contingencies* ("ASC Topic 450"), which provides accounting guidance for the recognition of liabilities arising from loss contingencies for financial statements prepared in accordance with GAAP.

- The Contingencies ASU provides disclosure objectives and principles that an entity considers when developing disclosures regarding loss contingencies. The disclosure principles would require disclosure in the early stages of a loss contingency's life cycle of information to enable users to understand the nature, potential magnitude, and (if known) potential timing of the loss contingency. The disclosure principles acknowledge that available information may be limited in the early stages of a loss contingency, and therefore disclosure may be less extensive. The disclosure principles require more extensive disclosure in subsequent periods as additional information about a potential unfavorable outcome becomes available, including public companies providing tabular reconciliations by class of accrued loss contingencies during the reporting period.[29/]

- The Contingencies ASU states, "[d]isclosure of asserted but remote loss contingencies may be necessary, due to their nature, potential magnitude,

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29/ Contingencies ASU, paragraph 8.

or potential timing (if known) to inform users about the entity's vulnerability to a potential severe impact."[30/] The Contingencies ASU also notes the need for the exercise of judgment in assessing the specific facts and circumstances (e.g., potential impact on operations, the cost to defend, the amount of effort and resources management may have to devote to resolve the contingency) to determine whether disclosure about a remote contingency is necessary.[31]

- The Contingencies ASU would require disclosure of the following for asserted remote contingencies: (a) publicly available quantitative information; (b) other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the loss; and (c) information about possible recoveries from insurance and other sources only if, and to the extent that, it has been provided to the plaintiff(s) in a litigation contingency or it is discoverable by either the plaintiff or a regulatory agency.[32/]

AU sec. 337 – *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* ("AU sec. 337") provides guidance on inquiries of a company's legal counsel to corroborate the information furnished by management concerning litigation, claims and assessments. The auditing standard notes that "an auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention."[33/] AU sec. 337 also states that a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims and assessments. It states that evidential matter obtained from the client's inside counsel or legal department may provide the auditor with the necessary corroboration of information furnished by management but it is not a substitute for information outside counsel refuses to furnish.[34/]

30/ Ibid.

31/ Ibid.

32/ Ibid.

33/ AU sec. 337.06.

34/ AU sec. 337.08.

Discussion Topic –

The staff is seeking the SAG's view on what new challenges auditors may encounter as a result of the proposed changes in the accounting for loss contingencies. In particular, the staff is interested in the SAG's views on –

- Potential challenges for auditors in obtaining the audit evidence necessary to evaluate the proposed disclosure (or the lack of disclosures) of certain asserted remote loss contingencies that potentially may have a severe impact on the company (e.g., guidance for an attorney's response to an auditor's inquiry is provided by the American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* ("ABA SOP").[35/] The ABA SOP was developed to work in tandem with existing Topic 450 and AU sec. 337. The ABA SOP does not address the disclosure of certain asserted remote loss contingencies. The PCAOB has no jurisdiction over attorneys' professional requirements. As such, are there other sources of evidence an auditor could obtain regarding remote loss contingencies?).

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[35/] AU sec. 337C.