Audit & Assurance Update
June 12, 2017

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PCAOB Issues Proposals to Enhance and Strengthen Requirements for Auditing Accounting Estimates, Including Fair Value, and to Address the Auditor's Use of the Work of Specialists

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Background

On June 1, 2017, the PCAOB proposed changes to its performance standards related to auditing accounting estimates, including fair value measurements, and the auditor's use of the work of specialists.[1] In developing both of its proposals,[2] the PCAOB gathered views from various market and industry constituents through the issuance of, and comments on, two

1 AS 1210.1 and related footnote 1 state that a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. AS 1210 further states that because income taxes and information technology are specialized areas of accounting and auditing, this specialist proposal does not apply to situations in which an income tax specialist or information technology specialist participates in the audit.

2 The proposals also include an economic analysis that (1) describes the baseline for evaluating the economic impacts of the proposal, (2) analyzes the need for the proposal, and (3) discusses potential economic impacts of the proposed requirements, including the potential benefits, costs, and unintended consequences.

Staff Consultation Papers that addressed each topic. In addition, the PCAOB has considered observations from its oversight activities; work of, and standards issued by, other standard setters (including the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB)); and the views expressed by members of the PCAOB's Standing Advisory Group (SAG) and Pricing Sources Task Force.

The PCAOB proposal on auditing accounting estimates, including fair value measurements (the "estimates proposal") strengthens and enhances the requirements for auditing accounting estimates by establishing a single standard. The new proposed standard sets forth a uniform, risk-based approach and emphasizes the need for the auditor to apply professional skepticism and devote greater attention to potential management bias when auditing accounting estimates. The estimates proposal also amends and rescinds certain auditing standards and interpretations related to auditing accounting estimates.

> "Accounting estimates are integral to financial statements, but often subjective and susceptible to management bias," said James R. Doty, PCAOB Chairman. "Enhancing the standards for auditing estimates will benefit investors by directing greater attention to this important area of the audit."

The PCAOB proposal on the auditor's use of the work of specialists (the "specialist proposal") amends two of its existing auditing standards to:

- Strengthen requirements for the auditor to evaluate the work of a company's specialist, including establishing a uniform, risk-based approach when using the work of a company's specialist as audit evidence.
- Apply a risk-based approach to supervising and evaluating the work of both auditor-employed and auditor-engaged specialists.

The specialist proposal also replaces and rescinds certain auditing standards and interpretations related to the auditor's use of the work of specialists.

> "This proposal establishes a logical, risk-based approach to using the work of company specialists and auditor specialists," said Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards. "It is an appropriate complement to our proposal to enhance the requirements for auditing accounting estimates, including fair value measurements."

The PCAOB has observed that, in many cases, specialists are used to either develop or assist in evaluating various accounting estimates. Stakeholders have urged the PCAOB to keep work on these two projects coordinated and also requested the PCAOB to present the proposed standards for comment at the same time. Certain provisions of the proposed auditing standards include references between the two proposals in order to illustrate how the proposed requirements in the two releases would work together.

Key Provisions of the Estimates Proposal

Currently, there are three PCAOB auditing standards (AS) that primarily address the auditing of accounting estimates, including fair value measurements.

- AS 2501, *Auditing Accounting Estimates* — Applies to auditing accounting estimates in general.
- AS 2502, *Auditing Fair Value Measurements and Disclosures* — Applies to auditing the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

- AS 2503, *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* — Applies to auditing financial statement assertions for derivative instruments, hedging activities, and investments in securities. Its scope includes, among other things, requirements for auditing the valuation of derivative instruments and securities, including those measured at fair value and those accounted for under the equity method.

These standards include approaches for substantively testing accounting estimates, including fair value measurements. However, the three standards vary in their level of detail in describing those approaches. The Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, and to amend the risk assessment standards to more specifically address certain aspects of auditing accounting estimates. The proposed standard also includes a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of information from pricing services.

The estimates proposal builds on the substantive testing approaches common to the three existing standards and is intended to strengthen PCAOB auditing standards in the following respects:

- Add or revise requirements and provide direction to prompt auditors to devote greater attention to addressing potential management bias in accounting estimates, while reinforcing the need for professional skepticism.
- Extend certain key requirements in existing AS 2502 to all accounting estimates in significant accounts and disclosures, to reflect a more uniform approach to substantive testing (e.g., certain requirements in existing AS 2502 will be applicable to estimates that are currently not subject to such standard).

> **Editor's Note:** The existing standard on auditing fair value measurements is the newest and most comprehensive of the existing standards on auditing accounting estimates and fair value measurements. In general, the existing fair value standard sets forth more detailed procedures for the common approaches related to auditing accounting estimates described below.

- Improve the integration with the risk assessment standards with additional considerations related to accounting estimates, to better inform the necessary procedures for auditing accounting estimates and to focus auditors' attention on estimates with greater risk of material misstatement.
- Make other updates to the requirements for auditing accounting estimates to provide additional clarity and specificity.
- Provide specific requirements and direction to address certain aspects unique to auditing fair values of financial instruments, including the use of information from pricing sources (e.g., pricing services and brokers or dealers).

The table below summarizes the estimates proposal's recommended changes to the auditing standards and interpretations:

Changes	Standard
Replace	AS 2501, *Auditing Accounting Estimates* *
Supersede	AS 2502, *Auditing Fair Value Measurements and Disclosures*
	AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

Changes	Standard
Amend	AS 1015, *Due Professional Care in the Performance of Work*
	AS 1105, *Audit Evidence*
	AS 2110, *Identifying and Assessing Risks of Material Misstatement*
	AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*
	AS 2401, *Consideration of Fraud in a Financial Statement Audit*
	AS 2805, *Management Representations*
Rescind	AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501*

* The estimates proposal includes retitling AS 2501 *Auditing Accounting Estimates, Including Fair Value Measurements.*

Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*

The proposed standard establishes requirements for performing substantive procedures when auditing accounting estimates in significant accounts and disclosures and updates the description of what constitutes an accounting estimate. The proposed standard focuses auditors on their obligations to exercise professional skepticism and to identify management bias.

The proposed standard states that applying substantive procedures to accounting estimates in significant accounts and disclosures is part of implementing an appropriate audit response and emphasizes that the auditor's response involves testing whether the significant accounts and disclosures are in conformity with the applicable financial reporting framework. It also emphasizes the need for auditors to respond to differing risks of material misstatement in the components of an accounting estimate.

The proposed standard retains the three basic approaches currently set forth in the existing standards related to auditing accounting estimates, as follows, while elaborating on the requirements for each approach:

- Testing the company's process used to develop the accounting estimate.
- Developing an independent expectation of the estimate for comparison to the company's estimate.
- Evaluating audit evidence from events or transactions occurring after the measurement date related to the accounting estimate for comparison to the company's estimate. Note that the proposed standard is generally consistent with the existing estimates standards as it relates to this testing approach.

Testing the Company's Process Used to Develop the Accounting Estimate

Similar to the existing standard, the proposed standard requires the auditor to evaluate whether the methods used by the company are (1) in conformity with the applicable financial reporting framework, and (2) appropriate for the nature of the related account or disclosure and the company's business, industry, and environment. In addition, the proposed standard:

- Clarifies that evaluating whether the methods are in conformity with the requirements of the applicable financial reporting framework includes evaluating whether the data and significant assumptions are appropriately applied.
- Addresses circumstances in which a company has changed its method for developing an accounting estimate by requiring the auditor to determine the reasons for the change.

Under the proposed standard, the auditor has a responsibility to evaluate the data used by the company (whether internal data or external data) and the manner in which the company used it, building on the requirements in AS 1105. It also requires the auditor to evaluate whether (1) the data is relevant to the measurement objective for the accounting estimate; (2) the data is internally consistent with its use by the company in other estimates tested; and (3) the source of the company's data has changed from the prior year and, if so, whether the change is appropriate.

The proposed standard sets forth criteria for the auditor to identify which of the assumptions used by the company are significant and provides that significant assumptions are those that are "important to the recognition or measurement of the estimate in the financial statements." It also describes factors that are relevant to identifying significant assumptions. The proposed requirement links the identification of significant assumptions used by management to the auditor's risk assessment, allowing the auditor to better determine which assumptions are significant to the estimate, while focusing on areas that could result in a material misstatement. The proposed standard also:

- Establishes that evaluating significant assumptions for reasonableness includes evaluating whether the company has a reasonable basis for those assumptions and whether they are consistent with factors such as the company's objectives; historical experience, taking into account changes in conditions affecting the company; and other significant assumptions in other estimates tested.
- Requires the auditor to take into account factors, to the extent applicable, that affect the company's intent and ability to carry out a particular course of action when such action is relevant to the significant assumption.

For critical accounting estimates,[3] the proposed standard requires the auditor to obtain an understanding of how management analyzed the sensitivity of its significant assumptions to change, based on other reasonably likely outcomes that would have a material effect.

Developing an Independent Expectation of the Estimate

The proposed standard more clearly sets forth the auditor's responsibilities when developing an independent expectation of an estimate for comparison to the company's estimate. Such responsibilities depend on the sources of the methods, data, and assumptions used by the auditor to perform the test, as set forth in the table below.

Auditor's Independent Expectation Developed Using:	Auditor Responsibility Under the Proposed Standard
Assumptions and methods of the auditor	Have a reasonable basis for the assumptions and methods
Data and assumptions obtained from a third party	Evaluate the relevance and reliability of the data and assumptions
Company data, assumptions, or methods	Test and evaluate in the same manner as when testing the company's process

If the company's data, assumptions, or methods are those of a company's specialist, the auditor would also be required to comply with the requirements in proposed Appendix B to AS 1105 when using the work of a company specialist as audit evidence.)

3 An accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material. [PCAOB AS 1301.A3]

The proposed standard also requires that if the auditor's independent expectation consists of a range rather than a point estimate, the auditor should determine that the range is appropriate for identifying a misstatement of the company's accounting estimate and is supported by sufficient appropriate audit evidence.

Information Obtained From a Third Party

The proposed standard also recognizes that the company's use of pricing information from third-party pricing sources affects the necessary procedures for testing and evaluating the company's process. Therefore, when third-party pricing information used by the company is significant to the valuation of financial instruments, the proposed standard requires the auditor to evaluate whether the company has used the information appropriately and whether it provides sufficient appropriate audit evidence.

In developing an independent expectation of an accounting estimate, auditors often obtain data or assumptions from a third party. The proposed standard directs the auditor to the existing requirements in AS 1105 under those circumstances to evaluate the relevance and reliability of such data or assumptions. Appendix A of the proposed standard would apply when the auditor develops an independent expectation of the fair value of financial instruments using pricing information from a third party.

Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements, Appendix A — Special Topics*

Appendix A of the proposed standard requires the auditor to perform specific procedures when auditing the fair value of financial instruments. The proposed appendix establishes requirements for how to determine whether pricing information obtained from third-party pricing sources provides sufficient appropriate audit evidence and requires the auditor to understand, if applicable, how unobservable inputs were determined and evaluate the reasonableness of unobservable inputs.

Amend AS 1105, *Audit Evidence*

The proposed amendment to AS 1105 adds an appendix to the standard to describe the auditor's responsibilities for obtaining sufficient appropriate audit evidence for certain situations in which the valuation of an investment selected for testing is based on the investee's financial condition or operating results. Examples provided of such situations are:

- Certain investments accounted for by the equity method.
- Investments accounted for by the cost method for which there is a risk of material misstatement regarding impairment.
- Investments measured at fair value for which the investee's financial condition or operating results are a significant input into the fair value determination.

The appendix emphasizes that the persuasiveness of the evidence needed by the auditor increases as the significance of the investee's financial condition and operating results to the valuation of the investment and the risk of material misstatement of the associated investment increase. The appendix provides guidance on the procedures the auditor should perform to obtain an understanding of the investee's financial condition, including requiring that when the audited financial statements are significant to the valuation of the investment, the auditor performs the following:

- Obtains and evaluates information about the professional reputation and standing of the investee auditor.

- Obtains information about the procedures the investee's auditor performed, and the results therefore, or reviews the audit documentation of the investee's auditor.

Amend AS 2110, *Identifying and Assessing Risks of Material Misstatement*

The proposed amendments to AS 2110:

- Require a discussion among the key engagement team members of how the financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures.
- Add new risk factors specific to identifying significant accounts and disclosures involving accounting estimates.
- Strengthen requirements for obtaining an understanding of the company's process for determining accounting estimates.

Amend AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*

The proposed amendment to AS 2301 includes the addition of a note, consistent with AS 2820, *Evaluating Consistency of Financial Statements*, to emphasize that performing substantive procedures for the relevant assertions of significant accounts and disclosures involves testing whether the significant accounts and disclosures are in conformity with the applicable financial reporting framework.

Amend AS 2401, *Consideration of Fraud in a Financial Statement Audit*

The proposed amendment to AS 2401 clarifies the auditor's responsibilities when performing a retrospective review of accounting estimates and aligns them with the requirements in the proposed standard. The proposed amendment specifically states that the retrospective review includes comparing the prior year's estimates to actual results, if any, for accounting estimates in significant accounts and disclosures.

Amend AS 2805, *Management Representations*

The proposed amendment to AS 2805 requires the auditor to obtain a written management representation related to the appropriateness of the methods, the consistency in application, the accuracy and completeness of data, and the reasonableness of significant assumptions used by the company in developing accounting estimates.

Key Provisions of the Specialist Proposal

Currently, the requirements for use of a company's specialist and an auditor-engaged specialist are combined in existing AS 1210, *Using the Work of a Specialist*. The requirements for use of an auditor-employed specialist are contained within existing AS 1201, *Supervision of the Audit Engagement*, as an auditor-employed specialist is considered a member of the engagement team under the existing standards. The PCAOB noted that the requirements for use of an auditor-engaged specialist differ from the requirements for an auditor-employed specialist, yet both serve a similar role in assisting auditors in obtaining and evaluating audit evidence. Further, the current standards apply the same requirements to an auditor-engaged specialist as a company's specialist, even though these specialists serve very different roles in the context of an audit. As indicated above, the auditor-engaged specialist assists in obtaining and evaluating audit evidence, whereas the company's specialists may be producing work that is used as audit evidence that the auditor-engaged or auditor-employed specialist assists in evaluating. As such, the specialist proposal separately addresses the auditor's use of the work of a company's specialist (a specialist employed or engaged by the company) and use of the work of an auditor's specialist (a specialist employed or engaged by the audit firm) to more closely align the proposed requirements to the roles of these various specialists in the context of an audit.

For use of the work of an auditor's specialist as audit evidence, the specialist proposal adds requirements for applying a risk-based approach to supervision of auditor-employed specialists and extends those requirements to auditor-engaged specialists. The specialist proposal also adds requirements for communication with the auditor's specialist regarding the scope of the work to be performed and the process for reviewing and evaluating the work of the specialist. Certain requirements for assessing the knowledge, skill, and ability of an auditor's specialist would be amended. The requirements for assessing the objectivity of an auditor-engaged specialist would also be amended to provide a description of objectivity.

The table below summarizes the specialist proposal's recommended changes to the auditing standards and interpretations:

Changes	Standard
Amend	AS 1105, *Audit Evidence*
	AS 1201, *Supervision of the Audit Engagement*
Replace	AS 1210, *Using the Work of a Specialist**
Rescind	AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*
	AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*

* The specialist proposal includes retitling AS 1210 *Using the Work of an Auditor-Engaged Specialist*.

Amend AS 1105, *Audit Evidence*

The proposed amendment to AS 1105 adds a new Appendix B to the standard that addresses additional auditor responsibilities with respect to the work of a company's specialist that is used as audit evidence. Appendix B includes requirements to understand the nature and purpose of the specialist's work, the source of data that the specialist's work is based upon, and the company's process for selecting and using the work of the specialist. With regard to the data the specialist's work is based upon, the added requirements address testing and evaluating the data and assessing whether the data was appropriately used by the specialist. For instances in which the company's specialist uses company-produced data, auditors would be required to test the accuracy and completeness of such data and to evaluate whether the data was appropriately used by the specialist.

The appendix also adds requirements related to obtaining an understanding of and assessing the knowledge, skill, and ability of the specialist, as well as the specialist's relationship to the company. In addition, the appendix adds requirements to perform procedures to test and evaluate the work of a company's specialist's, including an evaluation of the relevance and reliability of the specialist's work and whether the specialist's findings support or contradict the relevant assertion. Specifically, the specialist proposal expands current requirements for evaluating methods and significant assumptions used by a company's specialist for audit evidence in support of a non-fair value accounting estimate from "obtaining an understanding" of the methods and significant assumptions used to requiring evaluation of the appropriateness of the methods and reasonableness of the assumptions used under the proposed standard. These expanded requirements in the specialist proposal are consistent with existing requirements in the current standard when testing a fair value accounting estimate.

Editor's Note: In the release containing the specialist proposal, the PCAOB acknowledged that the proposed changes in requirements for the auditor to evaluate appropriateness of methods and reasonableness of assumptions used by a company's specialist when that company's specialist work is supporting a non-fair value accounting estimate could be a significant change in practice for some auditors and may cause an increase in costs to the auditors that may necessitate an increase in audit fees. The PCAOB indicated that these new requirements are intended to focus the auditor's attention on the work of the company's specialist, especially when that audit evidence is significant to support higher risk areas in order to increase the likelihood that the auditor would identify material misstatements that exist in those areas.

Amend AS 1201, *Supervision of the Audit Engagement*

The proposed amendment to AS 1201 adds a new Appendix C to the standard that addresses additional auditor responsibilities with respect to the work of an auditor-employed specialist. The appendix provides guidance regarding the necessary extent of supervision of an auditor-employed specialist, which would be based on the significance of the work performed; the risk of material misstatement being addressed; and the knowledge, skill, and ability of the auditor-employed specialist. It also requires that auditors inform an auditor-employed specialist about matters that could affect the specialist's work. The appendix also requires that auditor-employed specialists are assigned work based on their knowledge, skill, and ability, considering their compliance with independence and ethics requirements.

In addition, the appendix adds requirements to improve supervision of the auditor-employed specialist and improve coordination between the auditor and the auditor-employed specialist. Specifically, auditors would be required to inform the auditor-employed specialist of the objective, nature, and scope of the work to be performed (including responsibilities for testing data, evaluating methods used by the company or company's specialist, and evaluating significant assumptions). The appendix also adds requirements for evaluating the work of the auditor-employed specialist, including reviewing the findings and conclusions of the specialist for consistency with the underlying work performed and reviewing for contradictory information.

Amend AS 1210, *Using the Work of a Specialist*

The specialist proposal includes the proposed replacement and renaming of AS 1210. The specialist proposal renames the standard *Using the Work of an Auditor-Engaged Specialist* and adds requirements that address auditor responsibilities with respect to the work of an auditor-engaged specialist. Similar to the auditor-employed specialist changes described above, the proposed changes for an auditor-engaged specialist are intended to improve the supervision of and collaboration with the auditor-engaged specialist by the auditor as well as strengthening the evaluation of the auditor-engaged-specialist's work. As such, the requirements in this proposed standard would be relatively consistent with the requirements proposed to be added to AS 1201, *Supervision of the Audit Engagement*, except that this standard would also include requirements to assess objectivity of the auditor-engaged specialist, whereas that assessment would not be required under AS 1201, given that auditor-employed specialists are required to be independent under SEC and PCAOB rules. These requirements include evaluating whether the specialist or the entity that employs the specialist has a relationship to the company or any other conflicts of interest relevant to the work to be performed.

Applicability of the Proposals and Effective Dates

The proposed standards and amendments would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley, and to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes-Oxley. The PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies as defined in Section 3(a)(80) of the Securities and Exchange Act of 1934, and any factors specifically related to audits of brokers and dealers that may affect the application of the proposals to those audits.

Neither proposal includes an effective date, and the Board is seeking comment on the amount of time that auditors would need to respond to the proposed amendments contained in each proposal.

Comparison with IAASB and ASB Standards

The proposals include comparisons to several relevant standards of the IAASB and ASB. Although a comparison was made to those standards, the actual guidance from those standards was not included in the proposals. For estimates, the IAASB is currently proposing revisions to ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates*, to establish more robust requirements for auditing accounting estimates. The IAASB project is currently in the exposure draft phase. Information on the project and the exposure draft is available on the IAASB web site.

Feedback on the Proposals

We encourage stakeholders to study the proposals and submit comments to the PCAOB. In particular, the PCAOB is seeking feedback on the following:

- Appropriateness of the amendments proposed and any other areas of improvement in the existing standards.
- Practical challenges in applying the proposed requirements.
- Economic analysis considerations, including potential benefits to investors and the public, as well as potential costs to auditors and companies they audit.
- Potential unintended consequences of the proposals.
- Whether the proposals should apply to audits of emerging growth companies and brokers and dealers.

Submitting Comments

Written comments can be sent to:

Office of the Secretary, PCAOB
1666 K Street, NW
Washington, DC 20006-2803.

Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments on the estimates proposal and the specialist proposal should refer to PCAOB Rulemaking Docket Matters No. 043 and 044, respectively, in the subject or reference line and should be received by the Board by August 30, 2017.