

Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards

Amendments to PCAOB Auditing Standards: Comparison to Existing Standards (PCAOB Release No. 2018-005, Appendix 2)

On December 20, 2018, the Public Company Accounting Oversight Board adopted amendments to its standards, as reflected in “Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards,” PCAOB Release No. 2018-005. The amendments are not yet effective, pending approval by the Securities and Exchange Commission.

This comparison document was prepared by staff of the Office of the Chief Auditor as a reference tool for the amendments presented in Appendix 2 of the PCAOB release. It shows changes from the existing standards, with added text underscored and deleted text ~~stricken through~~.

APPENDIX 2

Amendments to PCAOB Auditing Standards

- I. AS 1015 is amended by revising paragraph .11 to read as follows:

.11 The independent auditor's objective is to obtain sufficient appropriate evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, many accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates in significant accounts and disclosures based on information that could reasonably be expected to be available ~~prior to~~through the ~~completion~~date of ~~field work~~the auditor's report.⁵ As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.

⁵ See AS 2501, Auditing Accounting Estimates, Including Fair Value Measurements, which discusses the auditor's responsibility to obtain sufficient appropriate evidence to determine whether accounting estimates in significant accounts and disclosures are properly accounted for and disclosed in the financial statements.

- II. AS 1105 is amended by adding a note at the end of paragraph .08:

Note: If a third party provides evidence to an auditor subject to restrictions, limitations, or disclaimers, the auditor should evaluate the effect of the restrictions, limitations, or disclaimers on the reliability of that evidence.

- III. AS 1105 is amended by adding a new Appendix B:

Appendix B—Audit Evidence Regarding Valuation of Investments Based on Investee Financial Results

.B1 For valuations based on an investee's financial results, the auditor should obtain sufficient appropriate evidence in support of the investee's financial results. The auditor should read available financial statements of the investee and the accompanying audit report, if any. Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose,¹ to the investor's auditor may constitute sufficient appropriate evidence.

¹ In determining whether the report of another auditor is satisfactory for this purpose, the auditor may consider performing procedures such as making inquiries as to the professional reputation and standing of the other auditor, visiting the other auditor and discussing the audit procedures followed and the results thereof, and reviewing the audit program and/or working papers of the other auditor.

.B2 If in the auditor's judgment additional evidence is needed, the auditor should perform procedures to gather such evidence. For example, the auditor may conclude that additional evidence is needed because of significant differences in fiscal year-ends, significant differences in accounting principles, changes in ownership, changes in conditions affecting the use of the equity method, or the materiality of the investment to the investor's financial position or results of operations. Examples of procedures the auditor may perform are reviewing information in the investor's files that relates to the investee such as investee minutes and budgets and cash flows information about the investee and making inquiries of investor management about the investee's financial results.

.B3 If the investee's financial statements are not audited, or if the investee auditor's report is not satisfactory to the investor's auditor for this purpose, the investor's auditor should apply, or should request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.

.B4 If the carrying amount of the security reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, the auditor should obtain sufficient appropriate evidence in support of these amounts.

Note: The auditor should look to the requirements of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, and the applicable financial reporting framework with respect to auditing fair value measurements and evaluating asset impairment.

.B5 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph, including an appropriate title, should be added to the auditor's report because of the change in reporting period.²

² See AS 2820, *Evaluating Consistency of Financial Statements*.

.B6 The auditor should evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its carrying amount that is other than temporary. In addition, with respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the investor auditor's report, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor to identify subsequent events and transactions that are material to the investor's financial statements. Such events or transactions of the type contemplated in paragraphs .05–.06 of AS 2801, *Subsequent Events*, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the investee's results of operations, recognition should be given to events or transactions of the type contemplated in AS 2801.03.

.B7 Evidence relating to material transactions between the entity and the investee should be obtained to evaluate (a) the propriety of the elimination of unrealized profits and losses on transactions between the entity and the investee that is required when the equity method of accounting is used to account for an investment under the applicable financial reporting framework and (b) the adequacy of disclosures about material related party transactions.

- IV. AS 1205 is amended by adding footnote 6 to paragraph .14, such that AS 1205.14 reads as follows:

Long-Term Investments

.14 With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the work and report of the other auditor in his report on the financial statements of the investor. (See paragraphs .06–.11.) When the work and reports of other auditors constitute a major element of evidence with respect to investments accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.⁶

⁶ For situations in which the valuation of an investment selected for testing is based on the investee's financial results and neither AS 1201 nor AS 1205 applies, the auditor should look to the requirements of Appendix B of AS 1105, *Audit Evidence*.

- V. AS 1301 is amended by revising footnote 17 to paragraph .12 to read as follows:

¹⁷ See AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, which discusses the auditor's ~~responsibilities~~responsibility to obtain ~~and evaluate~~ sufficient appropriate ~~audit~~ evidence to ~~support significant~~ determine whether accounting estimates in ~~an audit of~~significant accounts and disclosures are properly accounted for and disclosed in the financial statements.

- VI. AS 1301 is amended by revising footnote 23 to paragraph .13 to read as follows:

²³ See AS 2501, which discusses the auditor's ~~responsibilities~~responsibility to obtain ~~and evaluate~~ sufficient appropriate ~~audit~~ evidence to ~~support significant~~ determine whether accounting estimates in ~~an audit of~~significant accounts and disclosures are properly accounted for and disclosed in the financial statements.

- VII. AS 1301 is amended by deleting the thirteenth bullet of Appendix B, referring to AS 2502, *Auditing Fair Value Measurements and Disclosures*.

- VIII. AS 2110 is amended by revising subparagraphs (d) and (e) of paragraph .28 and adding a second and third note, such that AS 2110.28 reads as follows:

.28 Information System Relevant to Financial Reporting. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

- a. The classes of transactions in the company's operations that are significant to the financial statements;
- b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;
- c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;
- d. How the information system captures events and conditions, other than transactions,¹⁶ that are significant to the financial statements; ~~and~~
- e. Whether the related accounts involve accounting estimates and if so, the processes used to develop accounting estimates, including:
 - (1) The methods used, which may include models;
 - (2) The data and assumptions used, including the source from which they are derived; and
 - (3) 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; and
- f. The period-end financial reporting process.

Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

Note: The requirements in AS 2601, *Consideration of an Entity's Use of a Service Organization*, with respect to the auditor's responsibilities for obtaining an understanding of controls at the service organization apply when the company uses a service organization that is part of the company's information system over financial reporting.

Note: For critical accounting estimates,^{16A} paragraph .18 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*,

provides that the auditor should 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 on its financial condition or operating performance,^{16B} and take that understanding into account when evaluating the reasonableness of significant assumptions and potential management bias.

¹⁶ Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

^{16A} See paragraph .A3 of AS 1301, *Communications with Audit Committees*.

^{16B} See U.S. Securities and Exchange Commission, *Financial Reporting Release No. 72, Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (Dec. 19, 2003), 68 FR 75056 (Dec. 29, 2003), at Section V ("Critical Accounting Estimates") for management's responsibilities related to critical accounting estimates.

IX. AS 2110 is amended by revising the first bullet of paragraph .52 to read as follows:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and, (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures; ~~—~~, and (c) how the financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures;

X. AS 2110 is amended by adding a new paragraph .60A after paragraph .60:

.60A Additional risk factors relevant to the identification of significant accounts and disclosures involving accounting estimates include the following:

- a. The degree of uncertainty associated with the future occurrence or outcome of events and conditions underlying the significant assumptions;
- b. The complexity of the process for developing the accounting estimate;

- c. The number and complexity of significant assumptions associated with the process;
- d. 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
- e. If forecasts are important to the estimate, the length of the forecast period and degree of uncertainty regarding trends affecting the forecast.

XI. AS 2301 is amended by adding a second note at the end of paragraph .17:

Note: For certain accounting estimates involving complex models or processes, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions.

XII. AS 2301 is amended by adding a note at the end of paragraph .36:

Note: 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.

XIII. AS 2301 is amended by deleting footnote 19 to paragraph .38.

XIV. AS 2301 is amended by adding a footnote to paragraph .40, such that AS 2301.40 reads as follows:

.40 Taking into account the types of potential misstatements in the relevant assertions that could result from identified risks, as required by paragraph .09b., can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.¹⁹

¹⁹ See, e.g., AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, which discusses the auditor's responsibility to obtain sufficient appropriate evidence to determine whether accounting estimates in significant accounts and disclosures are properly accounted for and disclosed in the financial statements.

XV. AS 2401 is amended by revising the first paragraph of the third bullet of paragraph .54 to read as follows:

- *Management estimates.* The auditor may identify a fraud risk involving the development of management estimates. This risk may affect a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other postretirement benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. ~~As indicated in AS 2501, Auditing Accounting Estimates, estimates are based on subjective as well as objective factors and there is a potential for bias in the subjective factors, even when management's estimation process involves competent personnel using relevant and reliable data.~~

XVI. AS 2401 is amended by revising the first sentence of the second paragraph of the third bullet of paragraph .54 to read as follows:

In addressing an identified fraud risk involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see AS 2501.09 through .14), Auditing Accounting Estimates, Including Fair Value Measurements.

XVII. AS 2401 is amended by revising paragraphs .63 through .64 to read as follows:

.63 **Reviewing accounting estimates for biases that could result in material misstatement due to fraud.** In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates²⁴ and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. AS 2810.24 through .27 discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

²⁴ ~~See AS 2501.02 and .16 for a definition of accounting estimates and a listing of examples.~~

.64 The auditor ~~also~~ should perform a retrospective review of accounting estimates in significant accounting accounts and disclosures²⁴ by comparing the prior year's estimates reflected in the financial statements of the prior year to actual results, if any, to

determine whether ~~management~~management's judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The ~~significant~~ accounting estimates selected for testing should ~~include~~be those ~~that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management~~for which there is an assessed fraud risk. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates. This review, however, is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

²⁴ See AS 2110.60–.64, which describes requirements related to the identification of significant accounts and disclosures.

XVIII. AS 2502 and AS 2503 are rescinded.

XIX. AS 2805 is amended by adding a new subparagraph to paragraph .06, after subparagraph s:

s-1. 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.

XX. AS 3101 is amended by revising footnote 34 to paragraph .18 to read as follows:

³⁴ See paragraph .32 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and* .B5 of Appendix B, *Audit Evidence Regarding Valuation of Investments in Securities* Based on Investee Financial Results, of AS 1105, *Audit Evidence*.

XXI. AS 4105 is amended by deleting footnote 36 to paragraph .B1.

XXII. AI 16 is rescinded.