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AUDIT QUALITY

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Understanding the Auditing Requirements for Accounting Estimates and the Use of Specialists: Considerations for Auditors and Management

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The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

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Purpose of This Resource

The Public Company Accounting Oversight Board (PCAOB) recently adopted new requirements for auditors related to:

- + auditing accounting estimates in significant accounts and disclosures, including fair value measurements,¹ and
- + the auditor's use of the work of specialists, including management's specialists and specialists employed or engaged by the auditor.²

The new and amended requirements are effective for audits of fiscal years ending on or after December 15, 2020 and the impact will vary based upon the facts and circumstances of each audit.

These requirements likely will have an indirect impact on other stakeholders such as chief financial officers and other members of

management and staff involved in and responsible for the preparation of the financial statements. Specialists employed or engaged by companies whose work is used in the preparation of the financial statements also may be directly or indirectly impacted by the new and amended auditing requirements. While these requirements apply to the auditor, management's responsibilities including maintaining internal accounting controls and accurate books and records, among others, remain unchanged.

The Center for Audit Quality (CAQ) and Financial Executives International (FEI) have teamed up to provide auditors and management an overview of these most recently adopted and amended requirements and considerations related to how they may impact their respective responsibilities for providing investors and our capital markets with high-quality, reliable financial information. •

¹ The new standard AS 2501: *Auditing Accounting Estimates, Including Fair Value Measurements* (AS 2501) replaced three existing standards: AS 2501: *Auditing Accounting Estimates*, AS 2502: *Auditing Fair Value Measurements and Disclosures* and AS 2503: *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Additionally, auditing interpretation, AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501*, has been rescinded. The PCAOB also amended AS 1105: *Audit Evidence* (AS 1105) to add a new Appendix B, *Audit Evidence Regarding Valuation of Investments Based on Investee Financial Results* and amended paragraphs .28, .52, and .60A of AS 2110: *Identifying and Assessing Risks of Material Misstatement* (AS 2110).

² The PCAOB amended AS 1105: *Audit Evidence* to add a new Appendix A, *Using the Work of a Company's Specialist as Audit Evidence* and added new paragraph .28A AS 2110. The PCAOB also amended AS 1201: *Supervision of the Audit Engagement* by adding a new Appendix C, *Supervision of the Work of Auditor-Employed Specialists* and replaced AS 1210: *Using the Work of a Specialist* with a new AS 1210: *Using the Work of an Auditor-Engaged Specialist*.

Auditing Accounting Estimates

The nature of accounting estimates varies from company to company and depends on a number of factors including the nature of the company's business, its industry, types of underlying transactions and the applicable accounting framework. Changes within financial reporting frameworks over the years have led to an increase in the use of accounting estimates, including fair value measurements, in the preparation of financial statements.

Preparers of financial statements use methods (including models), data, and assumptions to determine an accounting estimate. With the changes in the financial reporting frameworks, the complexity associated with certain accounting estimates has increased as has the subjectivity that can be associated with the underlying methods and assumptions management uses to develop accounting estimates. Auditors are required to understand the methods, assumptions, data, and relevant controls used by management to develop accounting estimates. This understanding informs the auditor's risk assessment and development of procedures to obtain sufficient appropriate evidence which serves as the basis for the auditor's conclusions.

Uncertainties and volatility in the economic environment may have a significant impact on the measurement uncertainty, complexity and subjectivity of accounting estimates, in particular those estimates that are dependent on management's intent and ability to carry out certain actions or are based on cash flow forecasts or other forward-looking projections. Such estimates will require significant judgment from management. The uncertainty and volatility in the economic environment may require changes in related processes and controls to support consistent exercise of sound judgments and use of relevant, quality information. As a result, accounting estimates will receive increased attention from auditors.



Use of Specialists

As the complexity of financial reporting has increased, including greater use of accounting estimates, specialists are increasingly being used by auditors and management in a multitude of ways that impact the preparation and auditing of the financial statements. The amendments are designed to be risk-based and scalable, so that the auditor's effort to evaluate the specialist's work is commensurate with the risk of material misstatement associated with the financial statement assertion to which the specialist's work relates and the significance of the specialist's work to that assertion. Auditors are required to determine whether a specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. Specialists are defined as those who possess a specialized skill or knowledge in a field other than accounting or auditing.³

Specialists can be employees of the audit firm or contracted by the audit firm and used by auditors to audit accounting estimates as well as in other areas associated with the audited financial statements and disclosures. For both auditor-employed and auditor-engaged specialists the new requirements highlight the supervisory responsibilities of the auditor.

Specialists also can be engaged or employed by management to assist with development of the accounting estimates. Auditors may use the work of specialists that are employed or engaged by company management when auditing accounting estimates. The PCAOB's amendments are intended to strengthen the requirements for evaluating the work of a company's specialist, whether employed or engaged by the company.

³ For example, see note to AS 1210.01 on the definition of a specialist.



Impact of Changes

The auditing of accounting estimates and the nature and extent of the auditor's use of the work of specialists will vary based on the facts and circumstances of each audit and estimate. In some cases, the new and amended requirements may already be reflected in current audit approaches as audit firms have made changes to their methodologies to address the evolving complexities and judgments in the auditing of accounting

estimates and using the work of specialists. The new and amended PCAOB requirements are designed to be scalable as the necessary audit evidence depends on the corresponding risk of material misstatement. The summary of key changes in auditing requirements provided below should be read in conjunction with the PCAOB auditing standards⁴ and should not be relied upon as a definitive or all-inclusive list of the changes and potential impacts.

ESTIMATES

Key Change - Increased emphasis on and additional prompts for auditors to devote greater attention to addressing potential management bias in accounting estimates, as part of applying professional skepticism.

Considerations for Auditors - Auditors are required to evaluate the potential for management bias in accounting estimates and its effect on the financial statements. How the financial statements could be manipulated through management bias in accounting estimates will be a required topic of the fraud

⁴ See the PCAOB's final rules and accompanying releases for [Estimates](#) and [Specialists](#), as well as the implementation pages for [Estimates](#) and [Specialists](#) that provide PCAOB specific guidance on implementation.

brainstorming discussion during audit planning. There also may be a more granular focus on the potential for management bias in management's selection of the methods, data, and significant assumptions in developing the estimate. The revised requirements remind auditors to consider (and evidence) the impact other relevant audit evidence, including contradictory evidence, obtained has on the estimate. The requirements further refine the retrospective review of the outcome of previous accounting estimates. For critical accounting estimates, 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.⁵

Considerations for Management - Auditors will gain an understanding of and evaluate whether management had a reasonable basis for the significant assumptions used in accounting estimates including looking to management's documentation,⁶ assessing the rationale, and analyzing critical accounting estimates⁷ when evaluating the reasonableness of the significant assumptions. Auditors also may ask questions about certain other aspects of the estimate when applying professional skepticism. Auditors will be understanding and evaluating internal controls, including requesting relevant internal control documentation⁸ with a contemporaneous record of and information about management's decision process when selecting from a range of assumptions, multiple data sources, and the various methods available when developing the estimate. Auditors also will want to understand the rationale and request documentation related to any changes made to methods, assumptions, and data sources.

Key Change - Amendments to various risk assessment standards⁹ to enhance the auditor's risk assessment process in relation to accounting estimates and provide more explicit integration of the amended risk assessment requirements with the new standard for auditing accounting estimates.

Considerations for Auditors - While the fundamental principles of risk assessment remain the same, auditors will need to consider new risk factors when identifying and evaluating the risks associated with estimates in significant accounts and disclosures. The new risk factors include: a) degree of uncertainty associated with underlying assumptions, b) complexity of the process for developing the estimate, c) number and complexity of significant assumptions, d) degree of subjectivity associated with significant assumptions, and e) length and degree of uncertainty in forecasts (if applicable).

Considerations for Management - Auditors may ask more detailed or additional questions about the process management follows in order to determine their accounting estimates, including the methods, assumptions and data used and whether (and how) management uses any third parties in their process. Auditors may ask for more information regarding the processes and controls that led to the selection of methods, data, and assumptions management used in the estimate. For example, auditors will need to understand how management assessed the extent of uncertainty associated with the estimation process and the relevant controls that have been implemented to address the related risks.

⁵ AS 2501.18

⁶ See Section 13(b)(2)(A) of the Securities Exchange Act of 1934

⁷ See SEC 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.

⁸ See Section 13(b)(2)(B) of the Securities Exchange Act of 1934

⁹ See AS 2110, AS 2301: *The Auditor's Responses to the Risks of Material Misstatement*, and AS 2810: *Evaluating Audit Results*.

Key Change - Impact of tailored risk assessment on the audit response.

Considerations for Auditors - Auditors are required to perform procedures that are responsive to the identified risks of material misstatement. To do this, auditors will obtain an understanding of how the methods, data, and assumptions are selected and applied by management to determine the accounting estimate. This more in-depth risk assessment process could result in the auditor performing audit procedures that are more targeted on the sources of potential misstatement within the accounting estimate. For example, some estimates have components that are subject to significantly differing risks of material misstatement and may require different audit approaches.

Considerations for Management - As a result of this enhanced understanding and risk assessment, the audit response and corresponding requests for audit evidence could be different from previous years. Audit requests could vary depending on the risk identified and the evidence needed to respond to such risks.

Key Change - A more uniform approach to substantive testing of estimates by extending certain key requirements for auditing fair value measurements to other types of accounting estimates in significant accounts and disclosures.

Considerations for Auditors - The extended requirements from the previous standard on auditing fair value measurements provide more specific requirements for testing or evaluating the methods, assumptions and data used to develop accounting estimates.

Considerations for Management - Management may receive more focused requests specific to the accounting estimates in significant accounts and disclosures. For example, management may receive more requests around the nature of their methods for developing the accounting estimate (such as whether other methods were considered or the basis for the decision to change the method used in the prior year) and significant assumptions that are dependent on the company's intent and ability to carry out specific courses of action.

Key Change - Certain aspects unique to auditing fair values of financial instruments, including the use of pricing information from third parties, such as pricing services and brokers or dealers, were addressed by the addition of a special topics appendix.¹⁰ This could impact how auditors will approach testing financial instruments whose pricing is based on information from third parties. In all cases, the auditor is required to obtain an understanding of management's process and relevant controls and in some cases, may need to test these controls.

Considerations for Auditors - Under the new requirements for obtaining an understanding of the nature of the financial instruments being valued, auditors may need to revisit their understanding of information from pricing services and broker quotes used as audit evidence. The enhanced understanding will drive the audit response and the procedures performed by the auditor with the focus on evaluating the relevance

¹⁰ See Appendix A of AS 2501.

and reliability of information provided by pricing services and brokers or dealers. The nature and extent of the evaluation related to information from pricing services and broker quotes also will depend on the complexity and risk of the underlying securities. Less information may be needed about an individual pricing service's processes, methods, and inputs when either management or the auditor uses information from multiple pricing services. However, the auditor will need to consider the requirements provided in AS 2501. A8 when using pricing information from multiple pricing services. For estimates with unobservable inputs, auditors will need to obtain an understanding of how unobservable inputs were determined and evaluate the reasonableness of the unobservable inputs.

Considerations for Management - Auditors may ask more questions about management's processes and controls for evaluating compliance with the applicable financial reporting framework when information from pricing services and brokers or dealers is used in the company's financial reporting process. The SEC staff previously reminded registrants about their responsibility to sufficiently understand the valuation techniques, assumptions and other inputs used by third-party pricing services to determine the fair value of financial instruments and to maintain effective internal controls in these areas.¹¹ Management may also experience auditors asking for information to understand how management determined unobservable inputs were reasonable including the information management considered when determining those inputs.

SPECIALISTS

Key Change - Amendments to risk assessment standards to expand requirements for the auditor's understanding of how management uses the work of company specialists.

Considerations for Auditors - As part of understanding the company's information system, auditors are required to obtain an understanding of the work and report(s), or equivalent communication, of company specialists, whether employed or engaged, and the related company processes, including the nature and purpose of the specialist's work, sources of data used by the specialist and the company's processes and relevant controls for using the work of specialists.

Considerations for Management - Auditors are likely to ask additional questions and look for evidence related to how management uses the work of specialists. This likely will include additional focus on management's controls over various aspects of the specialist's work, including management's initial assessment of the specialist's professional qualifications and relationship to the company and management when engaging a specialist from outside, information provided to the specialist, and the specialist's findings and conclusions that were used in the financial reporting process.

¹¹ See [Remarks to the Greater Cincinnati Mutual Fund Association, Alison Staloch, Chief Accountant, Division of Investment Management](#).

Key Change - Strengthening the requirements for assessment of the company specialist's professional qualifications and relationship to the company when the auditor intends to use the work of the specialist as audit evidence.

Considerations for Auditors - Auditors are required to assess a company specialist's knowledge, skill, ability, and the relationship between the company and the specialist, specifically whether it could give the company the ability to significantly affect the specialist's judgments. The new standard enhances some of the requirements in this area and clarifies that the auditor's assessment applies to both the specialist and the entity that employs the specialist, if other than the company. The auditor's assessment of the specialist's qualifications and relationship to the company and the assessed risk of material misstatement, among other things, are inputs into the auditor's determination of the nature and extent of testing needed to evaluate the specialist's work.

Considerations for Management - In instances where auditors utilize the work of a company specialist as audit evidence, management can expect additional inquiries from audit teams about the knowledge, skill, and ability of the company specialist, including reputation and standing of the entity that employs the specialist, if other than the company. Auditors may ask more questions about the relationship between the company (including management) and the specialist, including (if applicable) the entity that employs the specialist, and how it might affect the specialist's judgments.

Key Change - Setting forth factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company specialist.

Considerations for Auditors - Auditors will need to align their evaluation of the work of company specialists with the expanded requirements in AS 1105.A7. The nature, timing and extent of the evaluation will be driven by the auditor's assessment of the following four factors: (a) significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (b) the risk of material misstatement of the relevant assertion; (c) the level of knowledge, skill and ability of the company specialist; and (d) the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Considerations for Management - Management may expect additional auditor focus on areas that are seen as key drivers of risk related to the company specialist's work. Auditors also will look for more persuasive audit evidence in situations where the company has the ability to significantly affect the specialist's judgments or where there are doubts about the specialist's qualifications related to the work performed. Management also may expect requests for documentation around management's evaluation of the data, assumptions, and estimation methods used by the specialist (including understanding management's controls around the specialist's model(s), in particular when management does not have access to the model(s)).

Key Change - Expanded requirements for the auditor to evaluate the methods, significant assumptions, and data used by a company specialist.

Considerations for Auditors - Auditors will need to comply with expanded and more specific requirements for evaluating the methods, significant assumptions and data used by company specialists. They may need to obtain additional evidence regarding these inputs as significant assumptions or data are seen to be drivers of risks of material misstatement. The evaluation of the methods used may require specific auditor focus particularly if methods or models are proprietary.

Considerations for Management - Management and company specialists may receive additional inquiries and requests for information from auditors in relation to how management evaluates the methods, significant assumptions and data used by company specialists. These requests may cover management's related controls, and what support company specialists have for their methods, significant assumptions, or data. This includes their compliance with the applicable financial reporting framework, consistency of assumptions with those used in the specialist's field and other relevant information.

Key Change - Supplementing existing requirements with the objective of enhancing the coordination and evaluation of the auditor specialist's work.

Considerations for Auditors - The auditor is required to inform the auditor specialist—whether employed or engaged—about the work to be performed, which includes establishing and documenting an understanding with the specialist. In addition to a documented upfront understanding, the auditor will need to share relevant information with the specialist and design measures to coordinate the specialist's work.

Considerations for Auditors - This change impacts the requirements around the use of the auditor specialist (whether employed or engaged) so there would be minimal direct impact to management. Areas where management might see impact would include (a) more interaction with auditor specialists (e.g., participation in walkthroughs), (b) expanded inquiry and assessment related to the company's relationship to an auditor-engaged specialist and, (c) increased involvement of core audit team members in areas associated with the auditor specialist as a result of the increased supervision and review requirements.



Conclusion

Early and ongoing communication between auditors and management will be key for a successful implementation of the new and amended PCAOB requirements. Given the wide range of estimates of varying complexities to which the requirements apply, auditors should be clear about expectations and audit evidence requirements and have timely and ongoing conversations with management. Management

can look for opportunities to perform upfront planning and coordination with auditors to achieve clarity about expectations and timing, especially related to the expected documentation from both management and company specialists. Continuing dialogue between the auditors and company management will help enhance the effectiveness of the transition to these new and amended requirements and support quality audits. •

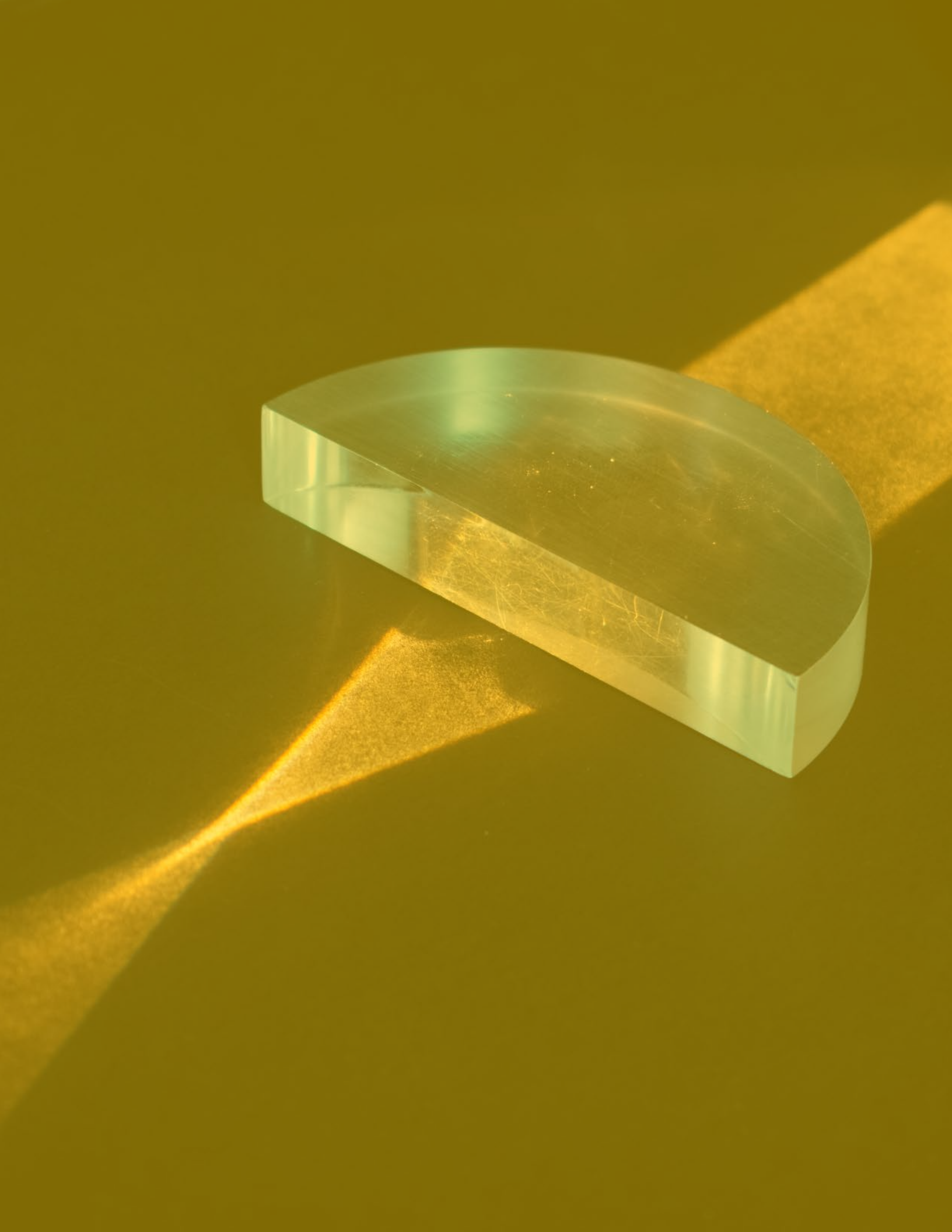


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