

# SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-86269; File No. PCAOB-2019-02)

July 1, 2019

## Public Company Accounting Oversight Board; Order Granting Approval of Auditing Standard 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, and Related Amendments to PCAOB Auditing Standards

### I. Introduction

On March 20, 2019, the Public Company Accounting Oversight Board (the “Board” or the “PCAOB”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 107(b)<sup>1</sup> of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and Section 19(b)<sup>2</sup> of the Securities Exchange Act of 1934 (the “Exchange Act”), a proposal to adopt Auditing Standard 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* and related amendments to PCAOB auditing standards (collectively, the “Proposed Rules”).<sup>3</sup> The Proposed Rules were published for comment in the Federal Register on April 4, 2019.<sup>4</sup> At the time the notice was issued, the Commission extended to July 3, 2019 the date by which the Commission

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<sup>1</sup> 15 U.S.C. 7217(b).

<sup>2</sup> 15 U.S.C. 78s(b).

<sup>3</sup> The PCAOB staff originally issued a staff consultation paper on this matter in 2014. *See Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014), available at [https://pcaobus.org/Standards/Documents/SCP\\_Auditing\\_Accounting\\_Estimates\\_Fair\\_Value\\_Measurements.pdf](https://pcaobus.org/Standards/Documents/SCP_Auditing_Accounting_Estimates_Fair_Value_Measurements.pdf). In 2017, the Board issued a proposed rule. *See Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017) (“PCAOB Proposal”), available at <https://pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf>.

<sup>4</sup> *See* Release No. 34-85434 *Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards* (Mar. 28, 2019), 84 FR 13396 (Apr. 4, 2019) available at <https://www.sec.gov/rules/pcaob/2019/34-85434.pdf>.

should take action on the Proposed Rules.<sup>5</sup> We received four comment letters in response to the notice.<sup>6</sup> This order approves the Proposed Rules, which we find to be consistent with the requirements of the Sarbanes-Oxley Act and the securities laws and necessary or appropriate in the public interest or for the protection of investors.

## **II. Description of the Proposed Rules**

On December 20, 2018, the Board adopted AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* and related amendments to PCAOB auditing standards.<sup>7</sup> The Proposed Rules are intended to strengthen and enhance the requirements for auditing accounting estimates, including fair value measurements, by replacing the existing three standards<sup>8</sup> with a single standard that sets forth a uniform, risk-based approach. The requirements contained within the Proposed Rules are discussed further below.

### **A. Changes to PCAOB Standards**

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<sup>5</sup> See *id.*

<sup>6</sup> We received comment letters from Deloitte & Touche LLP, April 10, 2019 (“Deloitte Letter”); the Council of Institutional Investors, April 18, 2019 (“CII Letter”); PricewaterhouseCoopers LLP, April 25, 2019 (“PwC Letter”); and the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, April 25, 2019 (“CCMC Letter”). Copies of the comment letters received on the Commission order noticing the Proposed Rules are available on the Commission’s website at <https://www.sec.gov/comments/pcaob-2019-02/pcaob201902.htm>.

<sup>7</sup> See *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2018-005 (Dec. 20, 2018) (“PCAOB Adopting Release”), available at <https://pcaobus.org/Rulemaking/Docket043/2018-005-estimates-final-rule.pdf>.

<sup>8</sup> See Auditing Standard (“AS”) 2501, *Auditing Accounting Estimates* (originally issued in April 1988), which applies to auditing accounting estimates in general (“accounting estimates standard”); AS 2502, *Auditing Fair Value Measurements and Disclosures* (originally issued January 2003), which applies to auditing the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements (“fair value standard”); and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (originally issued in September 2000), which applies to auditing financial statement assertions for derivative instruments, hedging activities, and investments in securities (“derivatives standard”).

The Proposed Rules include a single standard that replaces the accounting estimates standard, the fair value standard, and the derivatives standard.<sup>9</sup> The Proposed Rules also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments. In addition, the Proposed Rules include amendments to several other PCAOB auditing standards to align them with the new standard on auditing accounting estimates. The Proposed Rules will make the following changes to existing requirements:

- Provide direction to prompt auditors to devote greater attention to addressing potential management bias in accounting estimates, as part of applying professional skepticism.

In this regard, the Proposed Rules:

- Amend AS 2110, *Identifying and Assessing Risks of Material Misstatement* to 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;
- Emphasize certain key requirements to focus auditors on their obligations, when evaluating audit results, to exercise professional skepticism, including evaluating whether management bias exists;
- Remind auditors that audit evidence includes both information that supports and corroborates the company's assertions regarding the financial statements and information that contradicts such assertions;

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<sup>9</sup> See *id.*

- Require the auditor to identify significant assumptions used by the company and describe matters the auditor should take into account when identifying those assumptions;
- Provide examples of significant assumptions (important to the recognition or measurement of the accounting estimate), such as assumptions that are susceptible to manipulation or bias;
- Emphasize requirements for the auditor to evaluate whether the company has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions;
- Explicitly require the auditor, when developing an independent expectation of an accounting estimate, to have a reasonable basis for the assumptions and method he or she uses;
- Require that the auditor obtain an understanding of management's analysis of critical accounting estimates and take that understanding into account when evaluating the reasonableness of significant assumptions and potential management bias;
- Recast certain existing requirements using terminology that encourages maintaining a skeptical mindset, such as "evaluate" and "compare" instead of "corroborate;"
- Strengthen requirements for evaluating whether data was appropriately used by a company that build on requirements in the fair value standard, and include a new requirement for evaluating whether a company's change in the source of data is appropriate;

- Clarify the auditor’s responsibilities for evaluating data that build on the existing requirements in AS 1105, *Audit Evidence*; and
- Amend AS 2401, *Consideration of Fraud in a Financial Statement Audit*, to clarify the auditor’s responsibilities when performing a retrospective review of accounting estimates and align them with the requirements in the new standard.
- Extend certain key requirements in the fair value standard to other accounting estimates in significant accounts and disclosures to reflect a more uniform approach to substantive testing. For estimates not currently subject to the fair value standard, this will:
  - Refine the three substantive approaches common to the accounting estimates standard to include more specificity, similar to the fair value standard;
  - Describe the auditor’s responsibilities for testing the individual elements of the company’s process used to develop the estimate (i.e., methods, data, and significant assumptions);
  - Set forth express requirements for the auditor to evaluate the company’s methods for developing the estimate, including whether the methods are:
    - In conformity with the requirements of the applicable financial reporting framework; and
    - Appropriate for the nature of the related account or disclosure, taking into account the auditor’s understanding of the company and its environment; and

- Require the auditor to take into account certain factors in determining whether significant assumptions that are based on the company’s intent and ability to carry out a particular course of action are reasonable.
- Further integrate requirements with the Board’s risk assessment standards<sup>10</sup> to focus auditors on estimates with greater risk of material misstatement. The Proposed Rules incorporate specific requirements relating to accounting estimates in AS 2110 and AS 2301 to inform the necessary procedures for auditing accounting estimates.

Specifically, the Proposed Rules will:

- Amend AS 2110 to include risk factors specific to identifying significant accounts and disclosures involving accounting estimates;
- Align the scope of the Proposed Rules with AS 2110 to apply to accounting estimates in significant accounts and disclosures;
- Amend AS 2110 to set forth requirements for obtaining an understanding of the company’s process for determining accounting estimates;
- Require auditors to respond to significantly differing risks of material misstatement in the components of accounting estimates, consistent with AS 2110;
- Remind auditors of their responsibility to evaluate conformity with the applicable financial reporting framework, reasonableness, and potential management bias and its effect on the financial statements when responding

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<sup>10</sup> The Board’s “risk assessment standards” include AS 1101, *Audit Risk*; AS 1105; AS 1201, *Supervision of the Audit Engagement*; AS 2101, *Audit Planning*; AS 2105, *Consideration of Materiality in Planning and Performing an Audit*; AS 2110; AS 2301, *The Auditor’s Responses to the Risks of Material Misstatement*; and AS 2810, *Evaluating Audit Results*.

to the risks of material misstatement in accounting estimates in significant accounts and disclosures;

- Require the auditor, when identifying significant assumptions, to take into account the nature of the accounting estimate, including related risk factors, the applicable financial reporting framework, and the auditor's understanding of the company's process for developing the estimate;
  - Include matters relevant to identifying and assessing risks of material misstatement related to the fair value of financial instruments;
  - Add a note in AS 2301 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; and
  - Add a note to AS 2301 providing that for certain 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.
- Make other updates to the requirements for auditing accounting estimates, including:
    - Update the description of what constitutes an accounting estimate to encompass the general characteristics of the variety of accounting estimates, including fair value measurements, in financial statements;
    - Set forth specific requirements for evaluating data and pricing information used by the company or the auditor that build on the existing requirements in AS 1105;

- Establish more specific requirements for developing an independent expectation that vary depending on the source of data, assumptions or methods used by the auditor and build on AS 2810 to provide a requirement when developing an independent expectation as a range; and
- Relocate requirements in the derivatives standard for obtaining audit evidence when the valuation of investments is based on investee results as an appendix to AS 1105.
- Provide specific requirements and direction to address auditing the fair value of financial instruments, including:
  - Establish requirements to determine whether pricing information obtained from third parties, such as pricing services and brokers or dealers, provides sufficient appropriate audit evidence, including:
    - Focus auditors on the relevance and reliability of pricing information from third-party sources,<sup>11</sup> regardless of whether the pricing information was obtained by the company or the auditor;
    - Establish factors that affect relevance and reliability of pricing information obtained from a pricing service;
    - Require the auditor to perform additional audit procedures to evaluate the process used by the pricing service when fair values are based on transactions of similar financial instruments;

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<sup>11</sup> The requirements in this area focus primarily on pricing information from pricing services and brokers or dealers, but also cover pricing information obtained from other third-party pricing sources, such as exchanges and publishers of exchange prices.



- Require the auditor to perform additional procedures on pricing information obtained from a pricing service when no recent transactions have occurred for either the financial instrument being valued or similar financial instruments;
  - Establish conditions under which less information is needed about particular methods and inputs of individual pricing services in circumstances where prices are obtained from multiple pricing services; and
  - Establish factors that affect the relevance and reliability of quotes from brokers or dealers.
- Require the auditor to understand, if applicable, how unobservable inputs were determined and evaluate the reasonableness of unobservable inputs.

## **B. Applicability and Effective Date**

The Proposed Rules would be effective for audits of financial statements for fiscal years ending on or after December 15, 2020. The PCAOB has proposed application of the Proposed Rules to include audits of emerging growth companies (“EGCs”),<sup>12</sup> as discussed in Section IV below, and audits of brokers and dealers under Exchange Act Rule 17a-5.

## **III. Comment Letters**

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<sup>12</sup> The term “emerging growth company” is defined in Section 3(a)(80) of the Exchange Act (15 U.S.C. 78c(a)(80)). See also Release No. 33-10332 *Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act* (Mar. 31, 2017), 82 FR 17545 (Apr. 12, 2017).

The comment period on the Proposed Rules ended on April 25, 2019. We received four comment letters from accounting firms, an investor association, and an issuer organization.<sup>13</sup> Commenters generally supported the Proposed Rules.<sup>14</sup> Most commenters encouraged us to support the PCAOB's plans to monitor implementation, conduct post-implementation review, or monitor advancements in technology that may affect application of the Proposed Rules.<sup>15</sup> One commenter raised concerns regarding the effective date due to other financial reporting activities that need to be implemented and the potential impact on smaller audit firms.<sup>16</sup>

The Sarbanes-Oxley Act requires us to determine whether the Proposed Rules are consistent with the requirements of the Sarbanes-Oxley Act and the securities laws or are necessary or appropriate in the public interest or for the protection of investors.<sup>17</sup> In making this determination, we have considered the comments we received, as well as the feedback received and modifications made by the PCAOB throughout its rulemaking process. The discussion below addresses the significant points raised in the comment letters we received.

### **A. General Support for the Proposed Rules**

Commenters generally supported the Proposed Rules, including strengthening the audit requirements by applying a more uniform, risk-based approach to the audit of accounting estimates,

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<sup>13</sup> See Deloitte Letter, PwC Letter, CII Letter, and CCMC Letter.

<sup>14</sup> See Deloitte Letter, PwC Letter, CII Letter, and CCMC Letter.

<sup>15</sup> See e.g., Deloitte Letter; PwC Letter, and CCMC Letter.

<sup>16</sup> See CCMC Letter.

<sup>17</sup> See Section 107(b)(3) of the Sarbanes-Oxley Act. The Sarbanes-Oxley Act also specifies that the provisions of Section 19(b) of the Exchange Act shall govern the proposed rules of the Board. See Section 107(b)(4) of the Sarbanes-Oxley Act. Section 19 of the Exchange Act covers the registration, responsibilities, and oversight of self-regulatory organizations. Under the procedures prescribed by the Sarbanes-Oxley Act and Section 19(b)(2) of the Exchange Act, the Commission must either approve or disapprove, or institute proceedings to determine whether the proposed rules of the Board should be disapproved; and these procedures do not expressly permit the Commission to amend or supplement the proposed rules of the Board.

including fair value measurements.<sup>18</sup> One commenter agreed with the Board’s view that the evolution of financial reporting frameworks has resulted in the expanded use of estimates and expressed support for a single, more uniform principles-based standard to address the auditing of accounting estimates, including fair value measurements, that is aligned with the Board’s risk assessment standards.<sup>19</sup> Another commenter stressed the need for the Proposed Rules because accounting estimates, and particularly fair value measurements and related disclosures, provide investors with “more useful information than amounts that would be reported under amortized cost or other existing alternative accounting approaches” and because the PCAOB has observed numerous deficiencies in auditing accounting estimates.<sup>20</sup> The commenter also indicated that the Proposed Rules will strengthen auditor responsibilities, improve audit quality, and further investor protection.<sup>21</sup>

## **B. Implementation Efforts**

Most commenters noted their desire for ongoing monitoring by the PCAOB if the Proposed Rules are approved.<sup>22</sup> Two commenters specifically supported the PCAOB’s plan<sup>23</sup> to monitor implementation, including advances in technology and any related effects on the application of the proposed amendments.<sup>24</sup> Another commenter recommended that the Commission, as part of its oversight of the PCAOB, should request that the PCAOB periodically update the Commission on

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<sup>18</sup> See Deloitte Letter, CII Letter, PwC Letter, and CCMC Letter.

<sup>19</sup> See PwC Letter.

<sup>20</sup> See CII Letter.

<sup>21</sup> See id.

<sup>22</sup> See e.g., Deloitte Letter, PwC Letter, and CCMC Letter.

<sup>23</sup> See PCAOB Adopting Release at 3, 21, and 46.

<sup>24</sup> See Deloitte Letter and CCMC Letter.

the PCAOB’s activities for monitoring the implementation of the Proposed Rules along with the PCAOB’s findings and responses to these activities, including the PCAOB’s plans for a post-implementation review.<sup>25</sup>

In the PCAOB Adopting Release, the Board stated it would monitor implementation to determine whether additional interpretive guidance is necessary, including monitoring the advancement of technology.<sup>26</sup> In addition, the PCAOB has an established program to conduct post-implementation reviews of its rules and standards to evaluate the overall effect of significant rulemakings.<sup>27</sup>

We acknowledge the importance of monitoring the implementation of the Proposed Rules. The Commission staff works closely with the PCAOB as part of our general oversight mandate.<sup>28</sup> As part of that oversight, Commission staff will keep itself apprised of the PCAOB’s activities for monitoring the implementation of the Proposed Rules and update the Commission, as necessary.

### **C. The Effective Date of the Proposed Rules**

As noted above, the Proposed Rules would be effective for audits of financial statements for fiscal years ending on or after December 15, 2020. One commenter expressed concerns related to the effective date as a result of other financial reporting activities, including upcoming effective dates of certain Financial Accounting Standards Board (“FASB”) projects, other PCAOB

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<sup>25</sup> See CCMC Letter.

<sup>26</sup> See PCAOB Adopting Release at 3, 21, and 46.

<sup>27</sup> See PCAOB website at <https://pcaobus.org/EconomicAndRiskAnalysis/pir/Pages/default.aspx>.

<sup>28</sup> See Section 107 of the Sarbanes-Oxley Act.

standards, and a view that smaller audit firms may be disproportionately impacted.<sup>29</sup> The commenter suggested a phased implementation of the Proposed Rules. Specifically, the commenter recommended, as an example, that the Commission allow triennially inspected audit firms<sup>30</sup> to elect an effective date of audits for fiscal years ending on or after December 15, 2021, while also permitting earlier implementation since smaller audit firms may be disproportionately impacted.<sup>31</sup> The commenter further expressed the belief that a phased implementation may facilitate post-implementation reviews of the Proposed Rules.<sup>32</sup>

In the PCAOB Adopting Release, the Board recognized the effort required for other implementation efforts, but stated the effective date determined by the Board was designed to provide auditors with a reasonable period of time to implement the Proposed Rules, without unduly delaying the intended benefits of the Proposed Rules.<sup>33</sup>

We believe the Board has appropriately balanced the amount of time needed by audit firms to implement the Proposed Rules with the objectives of, and benefits obtained from, the Proposed Rules. In this regard, we note that, aside from the commenter who suggested that the Commission consider a phased implementation approach, we received no other comments from audit firms, including triennially inspected audit firms, requesting a phased implementation.

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<sup>29</sup> See CCMC Letter.

<sup>30</sup> “Triennially inspected audit firms” are audit firms that, in accordance with PCAOB Rule 4003(b), are required to be inspected at least once in every three calendar years if, during that time, the audit firm issued an audit report for at least one issuer but no more than 100 issuers. An audit firm is required to be inspected on an annual basis if, during the prior calendar year, it issued audit reports for more than 100 issuers (“annually inspected audit firms”). See PCAOB Rule 4003, *Frequency of Inspections*, available at [https://pcaobus.org/Rules/Pages/Section\\_4.aspx](https://pcaobus.org/Rules/Pages/Section_4.aspx).

<sup>31</sup> See CCMC Letter.

<sup>32</sup> See id.

<sup>33</sup> See PCAOB Adopting Release at 58.

In addition, there could be practical implications of allowing for a phased implementation approach related to an auditor performance standard.<sup>34</sup> For example, audits of multi-national companies often involve the work of more than one auditor conducted in accordance with AS 1205, *Part of the Audit Performed by Other Independent Auditors* (“AS 1205”), wherein a principal auditor may provide instructions to the other auditors. Under a phased implementation approach, an annually inspected audit firm serving as the principal auditor may instruct a triennially inspected audit firm to follow the Proposed Rules before the triennially inspected audit firm has implemented the Proposed Rules. This approach could create challenges for the triennially inspected audit firm as it would be instructed to implement the Proposed Rules on individual engagements even though it may not have updated its methodologies or trained its professionals on the Proposed Rules, which could have a negative effect on audit quality.

Further, within the Global Networks of accounting firms,<sup>35</sup> many of the affiliated accounting firms outside the United States are triennially inspected audit firms. Many of these affiliated firms participate in the multi-national audits discussed above. Our understanding is that these arrangements make it more practical for the Global Network Firms to adopt the Proposed Rules simultaneously across their respective networks. As a result, the Global Network Firms may not delay implementation for the triennially inspected audit firms within their network.

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<sup>34</sup> The CCMC Letter references differences in considering a phased implementation approach for an auditor performance standard as compared to an auditor reporting standard, which is why it did not suggest a phased implementation approach based on issuer size similar to the auditor communicating critical audit matters in accordance with AS 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

<sup>35</sup> See PCAOB website for a listing of “Global Networks” and further discussion, [available at https://pcaobus.org/Registration/Firms/Pages/GlobalNetworkFirms.aspx](https://pcaobus.org/Registration/Firms/Pages/GlobalNetworkFirms.aspx).

Based on these considerations, we do not believe a phased implementation approach for the Proposed Rules, including providing triennially inspected audit firms with the option to delay implementation, is necessary or appropriate in the public interest or for the protection of investors.

#### **IV. Effect on Emerging Growth Companies**

In the PCAOB Adopting Release, the Board recommended that the Commission determine that the Proposed Rules apply to audits of EGCs.<sup>36</sup> Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as amended by Section 104 of the Jumpstart Our Business Startups Act of 2012, requires that any rules of the Board “requiring mandatory audit firm rotation or a supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis)” shall not apply to an audit of an EGC. The provisions of the Proposed Rules do not fall into these categories.

Section 103(a)(3)(C) further provides that “[a]ny additional rules” adopted by the PCAOB after April 5, 2012, do not apply to audits of EGCs “unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.” The Proposed Rules fall within this category. Having considered those statutory factors, we find that applying the Proposed Rules to the audits of EGCs is necessary or appropriate in the public interest.

The PCAOB provided information identified by the Board’s staff from public sources,

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<sup>36</sup> See PCAOB Adopting Release at 56.

including data and analysis of EGCs that sets forth its views as to why it believes the Proposed Rules should apply to audits of EGCs. To inform consideration of the application of auditing standards to audits of EGCs, the PCAOB staff has also published a white paper that provides general information about characteristics of EGCs (“EGC White Paper”).<sup>37</sup> In addition, the Board sought public input on the application of the Proposed Rules to the audits of EGCs.<sup>38</sup> Commenters who addressed this question supported applying the proposed requirements to audits of EGCs, citing benefits to the users of EGC financial statements and the risk of confusion and inconsistency if different methodologies were required for EGC and non-EGC audits.<sup>39</sup>

In the PCAOB Adopting Release, the Board expressed its belief that accounting estimates are common in the financial statements of many EGCs.<sup>40</sup> The Board also noted that data from 2012-2016 reported inspection findings for audits of EGCs indicated a relatively high number of deficiencies (i.e., 45%-60% of Part I findings on audits of EGCs) related to the accounting estimates standard and the fair value standard.<sup>41</sup> The PCAOB further observed that “[s]ince EGCs tend to be smaller public companies, their accounting estimates may be less

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<sup>37</sup> See *Characteristics of Emerging Growth Companies as of November 15, 2017* (Oct. 11, 2018), available at <https://pcaobus.org/EconomicAndRiskAnalysis/Documents/White-Paper-Characteristics-Emerging-Growth-Companies-November-2017.pdf>.

<sup>38</sup> See PCAOB Proposal; see also, comment letters provided to the PCAOB related to this matter, available at <https://pcaobus.org/Rulemaking/Pages/docket-043-comments-auditing-accounting-estimates-fair-value-measurements.aspx>.

<sup>39</sup> See PCAOB Adopting Release at 53.

<sup>40</sup> See *id.* at 53. The five Standard Industrial Classification (SIC) codes with the highest total assets as a percentage of the total assets for the EGC population are: (i) real estate investment trusts; (ii) state commercial banks; (iii) national commercial banks; (iv) crude petroleum and natural gas; and (v) pharmaceutical preparations. See EGC White Paper at 14-15. In the PCAOB Adopting Release, the Board noted that financial statements of companies operating in these industries would likely have accounting estimates that include, for example, asset impairments and allowances for loan losses.

<sup>41</sup> See PCAOB Adopting Release at 55-56.



likely to involve complex processes, although those estimates may constitute some of the largest accounts in EGCs' financial statements."<sup>42</sup> The Board noted that the Proposed Rules are "risk-based and scalable for firms of all sizes," and expressed the view that "any related cost increases are justified by expected improvements in audit quality."<sup>43</sup>

Additionally, the PCAOB Adopting Release noted that "any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs would require auditors to address the differing requirements within their methodologies, which would create the potential for confusion."<sup>44</sup> In the EGC White Paper, the PCAOB staff stated that "[a]pproximately 99% of EGC filers were audited by accounting firms that also audit issuers that are not EGC filers."<sup>45</sup>

The PCAOB Adopting Release also noted EGCs generally tend to have shorter financial reporting histories and as a result, there is less information available to investors regarding such companies relative to the broader population of public companies.<sup>46</sup> As such, the Proposed Rules, which are intended to enhance audit quality, could increase the credibility of financial statement disclosures by EGCs.<sup>47</sup>

We agree with the Board's analysis. We believe the Proposed Rules will benefit EGCs at least as much as non-EGCs, in part, because of the prevalence of accounting estimates in financial statements of many EGCs. Specifically, we agree with the Board applying the

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<sup>42</sup> See id at 54.

<sup>43</sup> See id at 45.

<sup>44</sup> See id at 53.

<sup>45</sup> See EGC White Paper at 20.

<sup>46</sup> See PCAOB Adopting Release at 54.

<sup>47</sup> See id at 54.

Proposed Rules to EGCs would be consistent with the objective of the Proposed Rules to provide a more uniform, risk-based approach to auditing accounting estimates but also provide a scalable approach for firms of all sizes. Additionally, we also agree with the Board that Proposed Rules could increase the credibility of the financial statement disclosures by EGCs.

As such, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, we believe there is a sufficient basis to determine that applying the Proposed Rules to the audits of EGCs is necessary or appropriate in the public interest.

## **V. Conclusion**

The Commission has carefully reviewed and considered the Proposed Rules, the information submitted therewith by the PCAOB, and the comment letters received. In connection with the PCAOB's filing and the Commission's review,

A. The Commission finds that the Proposed Rules are consistent with the requirements of the Sarbanes-Oxley Act and the securities laws and are necessary or appropriate in the public interest or for the protection of investors; and

B. Separately, the Commission finds that the application of the Proposed Rules to the audits of EGCs is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.

IT IS THEREFORE ORDERED, pursuant to Section 107 of the Sarbanes-Oxley Act and Section 19(b)(2) of the Exchange Act, that the Proposed Rules (File No. PCAOB-2018-005) be and hereby are approved.

By the Commission.

Eduardo A. Aleman  
Deputy Secretary