The Impact of Prior Estimate Accuracy and Evidence Strength on Auditors' Scrutiny and Evidence Reasonableness Judgments in Level 3 Investments

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SYNOPSIS: Audit standards require auditors to compare prior year accounting estimates to actual results to assess the potential for management bias and the effectiveness of management's processes to develop their estimates (AS 2401; AS 2810). We investigate how auditors' understanding of a client's prior estimate accuracy on a different estimate can impact various audit judgments surrounding estimates like Level 3 investments. An expert panel of audit partners first established that Level 3 investments are unique and need to be assessed independently from other Level 3 investments, as well as other estimates. In an experiment, we then find that client prior estimate accuracy appropriately impacts audit seniors' scrutiny judgments but inappropriately cascades to impact the interpretation of the reasonableness of client-provided benchmarks for current period estimates and their WACC assessments. Our research contributes to practice by demonstrating where a client's estimate history can improve judgments and where it can inappropriately influence them.

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I. SYNOPSIS AND INSIGHTS FOR PRACTICE

Complex estimates, although increasingly prevalent in financial statements (Griffith, Hammersley, and Kadous 2015; Ahn, Hoitash, and Hoitash 2020), are inherently difficult to audit because they involve subjective assumptions and measurement uncertainty. Current PCAOB inspection reports identify issues of auditors not sufficiently assessing evidence provided by management when auditing estimates (PCAOB 2025a; 2024a; 2023; 2022). Research suggests that evaluating the reasonableness of management's assumptions is one of the most challenging areas in auditing fair value measurements due to the lack of available market data (Cannon and Bedard 2017; Glover et al. 2019). PCAOB has continued to recognize this as a common deficiency area identified during inspections (PCAOB 2025a; 2025b; 2024a; 2024b; 2023; 2022) The valuation process for a Level 3 investment is unique since the inputs are unobservable, may be different every time the asset value is assessed, and are directly related to each specific instrument classified as Level 3. The lack of observable market data for Level 3 investments provides management the opportunity to strategically select evidence to support the assumptions in their estimates.

Auditing standards provide guidance to auditors to address this possibility of management bias specifically related to accounting estimates. AS 2110 and AS 2501 direct auditors to assess management bias related to significant estimates. In reference to evaluating audit results, AS 2810 describes the auditor's use of retrospective reviews of significant estimates in order to assess for potential bias. Standards describe retrospective reviews as comparing the prior year's estimates to actual results, and further state that auditors should perform retrospective reviews of significant estimates in order "to determine whether management's judgments and assumptions relating to the estimates indicate a possible bias on

the part of management" (AS 2401.64). The motivation for the standard is that 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 (AS 2401.64). However, as per auditing standards, the auditor should still evaluate the reasonableness of the significant assumptions and data used by the company to develop the estimate each year (AS 2501.16; AS 2501.A10; PCAOB 2019a; 2019b). This is of particular importance given that no Level 3 estimate is the same. In this study, we investigate how auditors' understanding of a client's estimate accuracy of different estimates made in prior years can impact various audit judgments surrounding estimates like Level 3 investments.

Examining this issue is important as regulators continue to express concern with auditors' abilities to audit estimates, and inspection findings consistently reveal significant deficiencies related to the audit of estimates and fair value measurements (PCAOB 2025a; PCAOB 2024a; PCAOB 2023; PCAOB 2022; IFIAR 2025, 2024; Church and Shefchik 2011). While auditors' understanding of a client's prior estimate accuracy, as prescribed by audit standards, can be effective to assess the risk of material misstatement for the current estimate, aid in identifying potential management bias, and the scope of audit work needed, the assessment of the current significant assumptions used by management and related audit evidence for a Level 3 should be based on the available current data. That is, the evidence to support the valuation of specific Level 3 investments is uncertain because nothing truly comparable exists in the market and so the assessment of the client-provided evidence to support the inputs is particularly ambiguous. Psychology research would suggest that implicit evaluations may be developed from an auditors' knowledge of the client's prior estimate accuracy, even of different estimates made in prior years, since auditors must evaluate this prior history based on audit standards (Mann, Kurdi and

Banaji 2020). In effect, auditors may automatically develop positive or negative implicit evaluations of the client based on this prior history. These impressions may not be updated for new information and can linger at an implicit level to impact later judgements. Importantly, this prior history is useful to determine the level of scrutiny needed to assess management provided inputs, as it will provide insight into the potential for management bias and the effectiveness of management's processes to develop their estimates. However, these implicit evaluations may lead to bias in auditors' evaluation of the client-provided evidence to support these assumptions in the direction of that evaluative impression. In the more concerning case of a positive implicit impression, auditors may let their guard down and unconsciously let these positive implicit evaluations impact their evaluation of the client-provided evidence to support an aggressive assumption. Inappropriate evaluation of the evidence may then lead to a biased discount rate assessment that is overly aggressive. Our study addresses when a client's estimate accuracy of different estimates made in prior years can help auditors' judgments and where it may lead to inappropriate judgments.

To address these questions, we first gathered data from an expert panel of ten audit partners. The partners reviewed a current Level 3 investment without information on a client's prior estimate accuracy and assessed the discount rate and the reasonableness of the client-provided benchmarks. This data provides an understanding of the partners' decisions before being introduced to any client history that would generate an implicit evaluation. Next the partners were provided the estimate accuracy information of different estimates made in the prior years and all audit partners indicated that the additional information would not change their assessment of the reasonableness of the benchmarks. In addition, qualitative responses by the expert panel indicate that Level 3 investments are unique and need to be assessed independently

from other Level 3 investments, as well as other estimates. We then conducted a 2 (accurate or inaccurate prior history) x 2 (moderate or weak evidence) between-participants experiment with audit seniors. Auditors in the Accurate Prior Estimates conditions were given information on a client's estimate accuracy where they were told that the client had several similar type Level 3 fair value investments in the past, unrelated to the current year investment, and no material adjustments were needed, while auditors in the Inaccurate Prior Estimates conditions were told that material adjustments were needed. We manipulated audit evidence strength with the composition of the benchmark set to determine if the impact of prior estimate accuracy is dependent on the strength of the evidence. In all conditions, the client identified two peer companies to justify the discount rate; one had superior similarity to the investment with a conservative discount rate and one had moderate similarity to the investment with a more aggressive discount rate. Auditors in the Moderately Weak Evidence conditions received a third peer company with the most aggressive discount rate of the set that had low similarity to the investment. Auditors in the Weak Evidence conditions received a third peer company that had very low similarity to the investment with that same aggressive discount rate. In our experiment, audit seniors assessed the level of scrutiny that they would use for the inputs provided by management, the reasonableness of the client-provided benchmarks that management provided to support the discount rate for a Level 3 investment and provided the discount rate for the Level 3 investment using this benchmarking analysis.

As would be expected based on audit standards, we find that auditors assess a higher level of scrutiny of the inputs provided by management when the client has inaccurate prior estimate history with Level 3 investments than accurate prior estimates. As expected, these results occur whether the client-provided benchmark information is of moderate or weak

strength. The results of the implicit impression from prior estimate accuracy do cascade to auditors' evidence reasonableness ratings. Auditors in the accurate prior history conditions rated the aggressive client-preferred benchmarks as more reasonable than auditors who received the same benchmarks in the inaccurate prior history conditions. These results occur whether the client-provided moderate or weak benchmarks to support their aggressive discount rate, providing further evidence that assessments of client-provided benchmarks differ depending on prior history. Furthermore, in the accurate prior history conditions, there is no difference in the reasonableness ratings between auditors who received a weak benchmark and auditors who received a moderately weak benchmark. The accurate prior history appears to have created such a strong positive implicit impression that auditors let their guard down and rate client-provided benchmarks of different levels of strength similarly. However, in the inaccurate prior history conditions, auditors scrutinized the client-provided information more and provided lower reasonableness ratings for the weak benchmark than the moderately weak benchmark. Similarly, an analysis of the listed discount rate (WACC rate) indicates that auditors assess a more aggressive discount rate consistent with the client preference when the client has an accurate rather than inaccurate prior history, and the impact of providing a moderately weak versus a weak benchmark is greater when the client has inaccurate rather than accurate prior history.

Our research has several implications for practice and research. Our findings should be of interest to regulators as they try to understand the implications of auditing standards on accounting estimates including fair value measurements. Audit standards require that auditors perform a retrospective review of past accounting estimates and compare them with actual results including accuracy of different estimates, indicating that the review may help auditors' assessment of risk of management bias in current period estimates (AS 2401). The findings of

this study indicate that client prior estimate accuracy can inappropriately cascade to impact the interpretation and evaluation of client-provided benchmarks and the discount rates for current period estimates due to these implicit evaluations. While retrospective reviews may indicate that the process used by management is reasonable and did not indicate a bias historically, by not appropriately evaluating the current supporting evidence the auditors may allow inappropriate evidence or garbage to be input into what may be a reasonable estimate process. Unfortunately, as the saying goes, garbage in, garbage out – even if the estimate process is appropriate, by letting their guard down and accepting inappropriate evidence the result may be a misstated estimate. Requiring retrospective reviews may have unintended consequences that allow for material misstatements to go undetected during a financial statement audit. Our results should also be of interest to firms as they continue to invest in training and methodologies to improve auditors' judgments for fair value measurements.

II. LITERATURE AND HYPOTHESIS DEVELOPMENT

Implicit processes play a fundamental role in decision making, influencing judgments across many domains. A consistent finding is that people evaluate stimuli implicitly as positive or negative (Ferguson and Mann 2014; Greenwald, Banaji and Nosek 2015; Mann et al., 2019). Even when an impression has been explicitly set aside, it can impact behavior at an implicit level (Rydell and McConnell 2006). If these implicit impressions are not updated, then they can erroneously impact later behavior. It turns out that implicit impressions are relatively challenging to undo, and persist even after individuals learn new information that should override them (Rule, Tskhay, Freeman and Ambady 2014).

Auditors' Level 3 judgments may be particularly susceptible to implicit evaluations. Consider that one assumption that auditors may have to evaluate in Level 3 valuations is a

client's chosen discount rate. A client can support a particular discount rate for a Level 3 valuation by comparing its discount rate to those of peer companies in the marketplace. Client management may strategically choose peer companies with more aggressive assumptions to justify their estimates or the assumptions underlying those estimates.

In this setting, implicit evaluations may be developed from an auditors' knowledge of the client's prior estimate accuracy since auditors must evaluate this prior history based on audit standards. While this prior history is useful to determine the level of scrutiny needed to assess management provided inputs of a specific estimate, these implicit evaluations may lead auditors to be biased in their evaluation of the client-provided benchmarks to support these assumptions in the direction of that evaluative impression. In effect, auditors may let their guard down and unconsciously let these implicit evaluations impact their evaluation of the client-provided benchmarks to support an aggressive assumption of a specific estimate. Inappropriate evaluation of the evidence may then lead to a biased discount rate assessment. The Level 3 environment is particularly challenging since the evidence to support management's inputs is ambiguous. Research on implicit evaluations has found that the mechanism by which these impressions influence the interpretation of evidence is by acting as a global anchor, which then has a significant positive relationship with later dimension ratings or attributes (Ingold, Dönni, and Lievens 2018). Auditors' susceptibility to this type of halo effect has been found to impact other types of audit tasks, such as the global knowledge of inherent risk factors resulting in halo effects (O'Donnell and Schultz 2005). However, recent research suggests that the impact of halo effects may be diminished if more analytic thinking is activated (Wen, Li, Georgiou, Huang, and Wang 2020). Given that each Level 3 is different since neither identical nor similar assets exist, auditors need to actively assess the client's estimates of key inputs and model assumptions. As

such, we believe it is important to examine the impact of the halo effect from a different estimate made in a previous year to the current year estimate in this Level 3 setting to see how implicit impressions appropriately (i.e., scrutiny judgments) or inappropriately (i.e. benchmark reasonableness ratings and discount rates) impact judgments. Based on prior research, the following hypotheses are proposed:

H1: Auditors will assess the level of scrutiny needed for the inputs provided by management higher when the client has inaccurate prior estimate history of a different Level 3 estimate than when the client has accurate prior estimate history.

H2a: Auditors will assess client-provided benchmarks to support an aggressive discount rate for a Level 3 investment as more reasonable when they have a client with accurate prior estimate history of a different Level 3 estimate than when they have a client with inaccurate prior estimate history.

H2b: Auditors will assess a more aggressive discount rate when they have a client with accurate prior estimate history of a different Level 3 estimate than when they have a client with inaccurate prior estimate history.

Recent psychology research has found that implicit evaluations are sometimes amenable to change (Bocian et. al., 2022; Mann et al., 2019). Impression formation can be a dynamic process where decision-makers change their impression based on new information, even if it is inconsistent with prior knowledge (Mende-Siedlecki, Cai, and Todorov 2013). However, when updating the impression, each piece of information may not carry the same weight. While prior research has found that implicit evaluations are particularly resistant to change, this recent research suggests that implicit evaluations can be highly responsive to single pieces of strong countervailing information (Cone and Ferguson 2015; Mann et al., 2019).

In our context, we propose that the influence of prior estimate accuracy on auditor judgment will be dependent on the strength of evidence that the client provides to support their position. In order to assess the valuation of a Level 3 investment, auditors will assess the

reasonableness of the client-provided evidence for the client's inputs for the valuation model. We propose that auditors' will be more susceptible to positive implicit evaluations from a client prior estimate accuracy when the client strategically selects stronger evidence to support their aggressive discount rate than weaker evidence. That is, auditors will be more likely to let their guard down when the client has a more accurate prior estimate history if the client provides more appropriate than less appropriate information to support their aggressive position. If a client has more accurate prior history, then the more appropriate information is likely to be more persuasive as it will not be countervailing information to the auditors' implicit evaluation of the client. This proposition is consistent with the recent psychology research that has found that strong countervailing information is needed to reduce the impact of implicit impressions.

Further, we propose that auditors' reasonableness ratings of the client-provided benchmarks will be impacted more by accurate prior estimate history than weak history. Auditors are likely to be more skeptical if the client has been inaccurate in the past with their estimates and more discerning of the reasonableness of the benchmarks. In effect, we propose that there are boundary conditions for the impact of implicit evaluations in the audit setting, such that auditors will be overall less susceptible to client estimate accuracy impacting their assessment of the benchmarks regardless of the strength of the evidence when their implicit impressions are negative. We propose that auditors will engage in more controlled processing (vs automatic) when presented with negative information from inaccurate prior history (Bocian et al., 2022). Alternatively, auditors will be more likely to let their guard down when they have a positive impression based on a prior history of accurate estimates. In this setting, auditors are expected to be more susceptible to client estimate accuracy such that they will assess the

moderately weak benchmarks similar to the weak benchmarks to support their client-preferred position. The following hypotheses are proposed:

H3a: The difference in auditors' assessments of the reasonableness of a moderately weak set of client-provided benchmarks and a weak set of benchmarks will be smaller when the client has accurate prior history of a different estimate than inaccurate prior history.

H3b: The difference in auditors' assessments of the discount rate when provided a moderately weak set of client-provided benchmarks and a weak set of benchmarks will be smaller when the client has accurate prior history of a different estimate than inaccurate prior history.

III. METHOD

Participants

Sixty-three senior auditors from Big-4 and other large public accounting firms participated in the experiment.[1] The auditors had an average of 44 months of experience, and 90% worked for a Big-4 accounting firm. Auditors had experience dealing with auditing investments (mean = 3.70) and with fair value instruments (mean = 4.88) [1 = Never; 7 = All the time]. There were no significant differences in months of audit experience, experience with auditing investments, and experience with fair value instruments across the experimental conditions (all p's > 0.10).

Task

Auditors took the role of an in-charge auditor for a hypothetical client to assess a Level 3 investment using benchmarking analysis of a new investment.[2] Management had elected to account for the investment under the fair value method as defined by ASC 820. Due to the lack

[1]The Institutional Review Board at the affiliated university approved the use of human participants for the experiments reported in this paper.

[2] The case is based on the materials in Bhattacharjee, Moreno, and Wright (2019).

of identifiable similar investments, management classified the investment as a Level 3 and utilized the discounted cash flows method to assess the fair value of the investment. Auditors were told that the audit team had completed some audit work on the discounted cash flows and that their task was to assess the weighted average cost of capital (WACC) assumption used by management. Management stated that they believed an 11% WACC was reasonable and provided support for that rate.

Independent Variables

Auditors were placed into one of four experimental conditions: Accurate Prior Estimates/Moderately Weak Evidence; Inaccurate Prior Estimates/Moderately Weak Evidence; Accurate Prior Estimates/Weak Evidence; and Inaccurate Prior Estimates /Weak Evidence. In the accurate prior estimates conditions, auditors were informed that, in prior years, management re-assessed the valuation of the other similar type investments when they were reclassified as Level 1, and it was determined that no adjustment from the previous value was required. This provided evidence that management was previously materially accurate when evaluating the value of different Level 3 investments. The inaccurate prior estimates conditions were told that, in prior years, management was required to materially adjust their valuations down when public market data was made available, providing evidence that management was previously not materially accurate when evaluating the value of different Level 3 investments.

The benchmarking analysis task involved comparing the investment to the peer companies with respect to industry, product lines, age, and asset size. All conditions received the same information on two peer companies to serve as benchmarks to support management's WAAC for the Healthcare Innovation valuation estimate. The first, Anacor, Inc., was designed to be the superior peer company since it was most similar to the investment company with respect

to industry, product lines, age, and asset size and utilized a 14.5% WACC. The second peer company, Bivanir Corp, was inferior to Anacor in terms of the similarity to the investment with respect to industry, product lines, age, and asset size and utilized a WACC rate of 10.5%. For the moderately weak evidence condition, auditors received information from the client on a third peer company, MedServices Corporation. This peer company was less similar to the investment than Bivanir Corp. with a WACC rate of 9%, which was close, albeit more aggressive than Bivanir Corp. In the weak evidence condition, auditors received information on a third peer company, OAI Industries, which was less similar to the investment than Bivanir Corp and also had a 9% WACC rate. Importantly, OAI Industries was the least similar to the investment than all other peer companies with respect to industry, product lines, age, and asset size. As such, while both the third peer companies were dissimilar to the investment, OAI Industries was less similar to the investment than MedServices Corporation. Hence, the presence of MedServices Corporation along with Anacor, Inc. and Bivanir Corp created the moderately weak evidence condition. The presence of OAI Industries in combination with Anacor, Inc. and Bivanir Corp created the weak evidence condition.

Dependent Variables and Post Experimental Questions

Auditors were asked to rate their level of scrutiny of the inputs provided by management as support of their WACC rate, provide assessments of the reasonableness of the benchmarks provided by management, and list the WACC rate that they believed should be used and provide a justification for that rate. Auditors then responded to several post experimental, manipulation check, and demographic questions.

IV. RESULTS

Expert Panel Data

We first gathered data from an expert panel of ten audit partners who had an average of 14.1 years of audit experience to further understand the impact of prior estimate accuracy on Level 3 judgments. The expert panel had significant experience with investments and fair value instruments rating their mean frequency with auditing investments and familiarity with fair value instruments as 8.2 and 7.9, respectively on a 9-point scale (endpoints for frequency and familiarity: 1 = never; not familiar and 9 = all the time; very familiar).

In the first part of the instrument, all audit partners (in both panels) reviewed the instrument with the more appropriate client-provided audit evidence. It did not include the client prior history manipulation. Audit partners provided their assessment of an appropriate WACC, with all partners providing a WACC at or above 14% (mean = 14.7). Partners also provided ratings of the reasonableness

of the peer companies (1 = Not reasonable at all; 9 = Very reasonable). All auditors rated the reasonableness of the superior peer company (Anacor) higher (mean = 7.60) than the peer company Bivanir (mean = 6.20), with MedServices receiving the lowest reasonableness ratings (mean = 1.60).

After providing their WACC assessments, auditors read the client estimate accuracy information and directly assessed if this information would be relevant or not relevant for assessing the discount rate for the current Level 3 investment of the client. Five audit partners received the accurate prior history information (mean = 13 years of experience) and five partners received the inaccurate prior history information (mean = 13.4 years of experience). All audit partners indicated that the prior history information would not change their assessment of the reasonableness of the client-provided peer companies. Nine of the ten audit partners indicated that the prior estimate information would not change their initial assessments of the WACC. One

audit partner who received the negative client manipulation changed the WACC assessment from 15% to 16%. Overall, this data suggests that the implicit impression from prior estimate history is not relevant for assessing the reasonableness of the WACC and that a normative WACC of 14% or greater is reasonable (see Appendix A for Table A1 with a summary of the expert data along with a discussion of the experts' qualitative responses).

Manipulation Check Results

To confirm the success of the prior estimate history manipulation, participants were asked to assess how accurate management's previous experience was in valuing two Level 3 investments (1 = Not materially accurate at all; 9 = Very accurate). Auditors in the Accurate Prior History conditions assessed the accuracy of management's previous experience higher (mean = 6.64; SD = 1.901) than auditors in the Inaccurate Prior History condition (mean = 2.90; SD = 1.845) conditions (t_{61} = 7.902; p = 0.001). Therefore, the manipulation of the prior estimate history was successful.

Test of Hypotheses

Assessed Level of Scrutiny

H1 posits that auditors will assess the level of scrutiny needed for the inputs provided by management as higher when the client has inaccurate as compared to accurate prior history. Figure 1 provides a visual description and Panel A of Table 1 presents the means (standard deviations) across the experimental conditions for auditors' assessed level of scrutiny of the inputs provided by management for the discount rate (1 = Less than typical amount; 5 = typical amount, 9 = More than typical amount). The ANOVA results shown in Panel B indicate a significant main effect for prior history (p= .003), but no significant main effect for evidence strength or the interaction between prior history and evidence strength (all p's > .05). As noted in

Panel C, auditors in the Inaccurate Prior History conditions felt they needed to scrutinize the inputs more (condition mean = 6.57) compared to auditors in the Accurate Prior History conditions (condition mean = 5.33; $t_{61} = 3.031$; p = 0.002), supporting H1. In fact, the mean level of scrutiny for the Accurate Prior History conditions is not significantly different from the midpoint of the scale (5 = typical amount of scrutiny) [p >10], while the mean rating of the Inaccurate History conditions is significantly higher than the midpoint (p < .05). Hence, auditors felt they needed to undertake more than a typical level of scrutiny of the client-provided inputs when the prior history was inaccurate, compared to when it was accurate.

Reasonableness Ratings of Third Peer Company

Figure 2 graphically shows the observed pattern of means of the reasonableness assessment of the third peer company by condition. Table 2 reports auditors' mean assessments of how reasonable it was for management to use the third peer company as a comparison company to assess the client's investment (1 = Not reasonable at all; 7 = Very reasonable), across experimental conditions. Panel B reports that auditors in the Accurate Prior History conditions assessed the reasonableness of the third peer company higher (condition mean = 3.45) as compared to auditors in the Inaccurate Prior History conditions (condition mean = 2.30; $t_{61} = -2.567$; p = 0.006). We also examine whether participants' reasonableness ratings were above or below the median assessed reasonableness of the third peer company (median split at 3). Results indicate that 67.5% of participants in the good history condition rated the reasonableness at or above the median, compared to 37.5% in the poor history condition ($\chi^2 = 2.67$; p = .051). Hence, consistent with H2a, auditors rate client-provided benchmarks to support an aggressive discount

rate for the investment as more reasonable when they have a client with accurate as opposed to inaccurate prior history.[3]

H3a argues that the difference in auditors' ratings of the reasonableness of a moderately weak set of client-provided benchmarks and a weak set of benchmarks will be smaller when the client has accurate instead of inaccurate prior history. Therefore, we test for the hypothesized pattern using a planned contrast, where the Accurate Prior History/Moderately Weak Evidence condition is assigned +2, the Accurate Prior History/Weak Evidence condition is assigned +2, the Inaccurate Prior History/Moderately Weak Evidence condition is assigned -1, and the Inaccurate Prior Estimate/Weak Evidence condition is assigned -3. The results of the planned contrast are presented in Panel C. The planned contrast is significant ($F_{1,62} = 9.17$, $p < 0.004$), and the residual between-cells variance is not significant ($F_{2,62} = 0.99$, $p = 0.376$). As noted by Guggenmos, Piercey, and Agoglia (2018), the pattern of findings suggests that the hypothesized contrast describes the data well, supporting H3a.

Assessed Discount Rate

H2b predicts that auditors will assess a more aggressive discount rate when they have a client with accurate as compared to inaccurate prior estimate history of a different Level 3 estimate. Figure 3 and Panel A of Table 3 reports the means (standard deviations) of auditors' assessed discount rate (WACC %) that they believe should be used across the experimental conditions. Panel B indicates that the mean discount rate assessed by the Accurate Prior History conditions (condition mean = 12.38%) is lower, or more aggressive, than the discount rate of the

[3] Recall that the first peer company (Anacor, Inc.) was designed to be the superior peer company and had a better similarity with the investment than the second client-preferred company, Bivanir Corp, and the third peer company, MedServices/ OAI Industries. All auditors recognized that Anacor, Inc was the superior peer company (overall mean = 6.35), while the rating for Bivanir was lower (overall mean = 4.46) [1 = Not reasonable at all; 7 = Very reasonable]. For both assessments, ANOVA results show no significant main effect for prior history or evidence strength, nor for the interaction between prior history and evidence strength (all p's > .05).

Inaccurate Prior History condition (condition mean = 14.03%; $t_{61} = 5.276$; $p = 0.001$), which supports H2b.[4]

H3b posits that the difference in auditors' assessments of the discount rate when provided a moderately weak set of client-provided benchmarks versus a weak set will be smaller when the client has accurate versus inaccurate prior history. As before, we test the hypothesized pattern using a planned contrast, where the Accurate Prior History/Moderately Weak Evidence condition is assigned -2, the Accurate Prior History/Weak Evidence condition is assigned -2, the Inaccurate Prior History/Moderately Weak Evidence condition is assigned +1, and the Inaccurate Prior History/Weak Evidence condition is assigned +3. As reported in Panel C, the planned contrast is significant ($F_{1,62} = 42.58$, $p < 0.001$), although the residual between-cells variance is marginally significant ($F_{2,62} = 2.96$, $p = 0.059$), supporting H3b.[5, 6]

As an additional analysis, we examine the next steps that auditors indicated they would take regarding the Level 3 assessment. Specifically, auditors were asked to specify the next audit step that they would take regarding the Level 3 investment valuation—a) conclude that the fair value is reasonable, b) continue to audit work under the assumption that the fair value is

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[4] Recall that once auditors have assessed the discount rate, they can mechanically calculate the gain or loss on the investment using a provided table. In our experiment, the assessed discount rates correspond to the following unrealized gains across four conditions: Accurate Prior History/Moderately Weak Evidence (mean = $7,892,851), Inaccurate Prior History/Moderately Weak Evidence (mean = $4,946,015), Accurate Prior History/Weak Evidence (mean = $5,500,318), and Inaccurate Prior History/Weak Evidence (mean = $2,373,402). Thus, we observe an 81.9% difference in the income statement gain amount between the Inaccurate Prior Estimates conditions ($3,659,708) and the Accurate Prior Estimates conditions ($6,660,334). Similar results are observed when participants calculated the assessed fair value of the investment: Accurate Prior History/Moderately Weak Evidence (mean = $14,392,851), Inaccurate Prior History/Moderately Weak Evidence (mean = $11,446,015), Accurate Prior History/Weak Evidence (mean = $12,000,304), and Inaccurate Prior History/Weak Evidence (mean = $8,873,402).

[5] In additional analysis, we examine whether participants' experience levels impacted the results of the dependent variables. We used months of audit experience, experience with auditing investments, and experience with fair value instruments as covariates and reanalyzed the results for each dependent variable. In each analysis, the results were the same as those reported in Table 1, Table 2, and Table 3, indicating that participants' experience did not influence the outcomes.

[6] Participants also assessed how appropriate is the 11% WACC rate being utilized by management to assess the fair value of the investment (1 = Not appropriate at all; 9 = Very appropriate). The average assessment was 4.48, but ANOVA results show no significant main effect for prior history or evidence strength, nor for the interaction between prior history and evidence strength (all p's > .05).

reasonable but delay forming a final conclusion, c) do not make a conclusion but call the manager immediately, or d) conclude that the fair value is materially overstated. Since audit seniors are unlikely to reach definitive conclusions about Level 3 investment valuation without input from their audit team, we observe that only three participants selected option a (conclude that the fair value is reasonable), and one participant chose option d (conclude that the fair value is materially overstated). Due to the low frequency in these two categories, we combined auditors' responses to the first two options (a and b), which indicate less concern with the valuation assessment and continue working, and compared them to the combined responses to the last two options (c and d), which suggest greater concern and contacting the manager.

Panel A of Table 4 reports the frequency (percentage) of participants' choices in both categories. Panel B suggests a significant difference in participants' choices between the accurate and inaccurate prior history conditions ($\chi^2 = 3.92$, $p = .024$). In untabulated analysis, we find that significantly more auditors in the inaccurate history conditions suggest next audit steps, indicating greater concern (75.9%) than less concern (24.1%; $\chi^2 = 7.759$, $p = .005$). However, there are no differences in the number of auditors in the accurate history conditions, indicating more (51.5%) versus less concern (48.15%; $\chi^2 = .030$, $p = .862$).

We conducted a second experiment, identical to the Main Experiment, except that the prior history manipulation used prior estimate history from a task outside the immediate task of fair value accounting (inventory obsolescence). The results from this second experiment are consistent with the Main Experiment and provide insight into the robustness of implicit impressions from prior estimate accuracy history (See Appendix for details on this supplementary experiment).

V. CONCLUSION

This study addresses whether auditors will let their guard down when a client has accurate prior estimate accuracy and whether this implicit evaluation will inappropriately influence their reasonableness ratings of client-provided benchmarks to support an aggressive WACC for a specific Level 3 investment. Auditors appropriately rated their level of scrutiny higher when the client had inaccurate prior estimate history than accurate prior history. However, auditors inappropriately rated the reasonableness of the same client-provided benchmarks inappropriately more reasonable when the client had accurate prior history rather than inaccurate prior history. These evidence assessments then impacted auditors' discount rate judgements. These findings have important implications for audit practice and auditing literature. Specifically, there may be unintended consequences related to the requirement of retrospective reviews of estimates in order to assess for potential management bias (AS 2401). The findings of this study indicate that client prior estimate accuracy can inappropriately cascade to impact the interpretation and evaluation of the reasonableness of client-provided benchmarks for current period estimates due to these implicit evaluations. As the evaluation of estimates should include both an assessment of management's process and the current inputs into the process, by inappropriately accepting evidence as reasonable auditors may miss a potential material misstatement related to the estimate. These findings also contribute to the growing auditing literature on auditors' fair value judgments. While audit research and practice continue to focus on ways to improve auditors' judgments regarding estimates including fair value, our results highlight another potential deficiency in auditor judgment in these challenging accounts. Client prior estimate accuracy can lead auditors to interpret the client-provided evidence to be consistent with their implicit evaluations.

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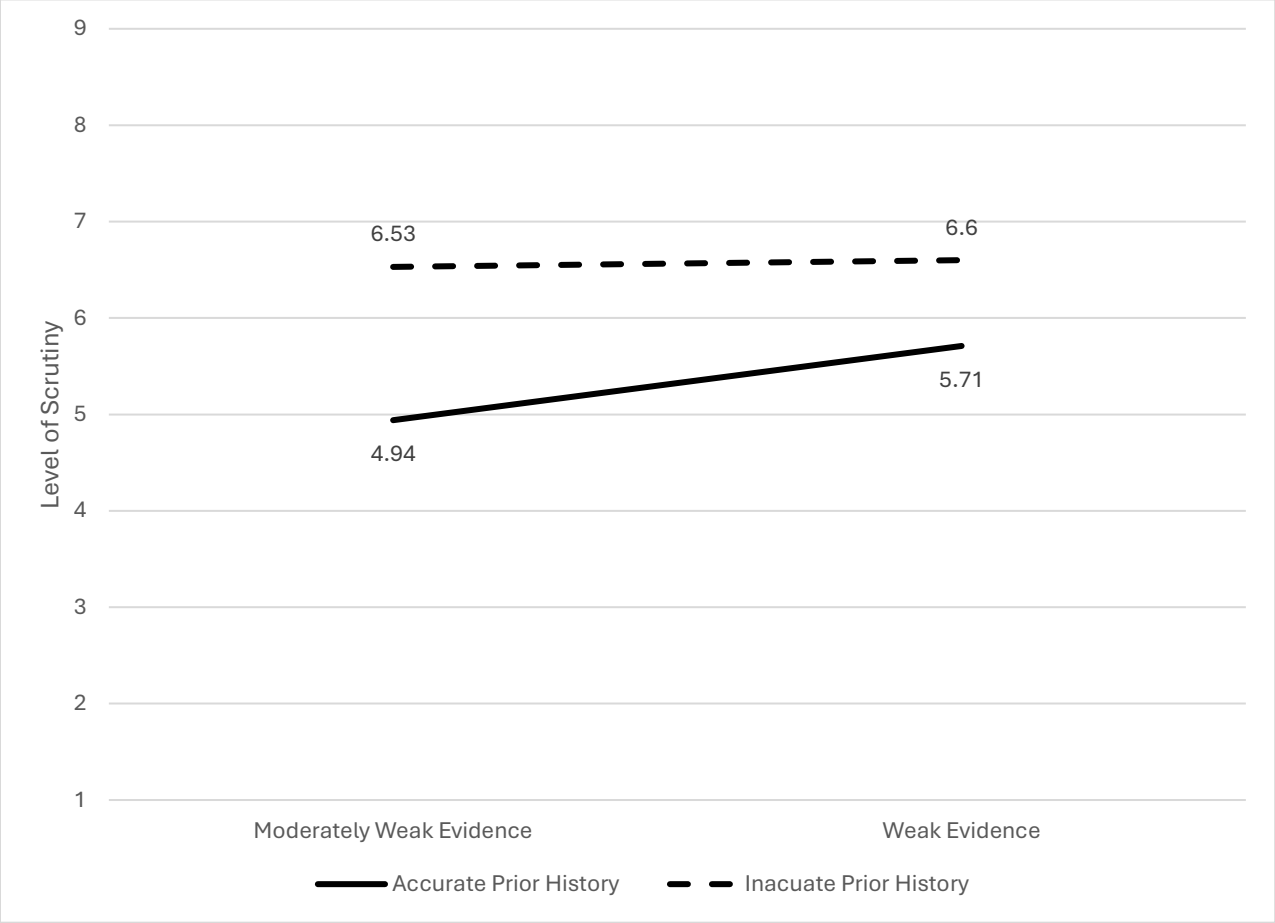
FIGURE 1

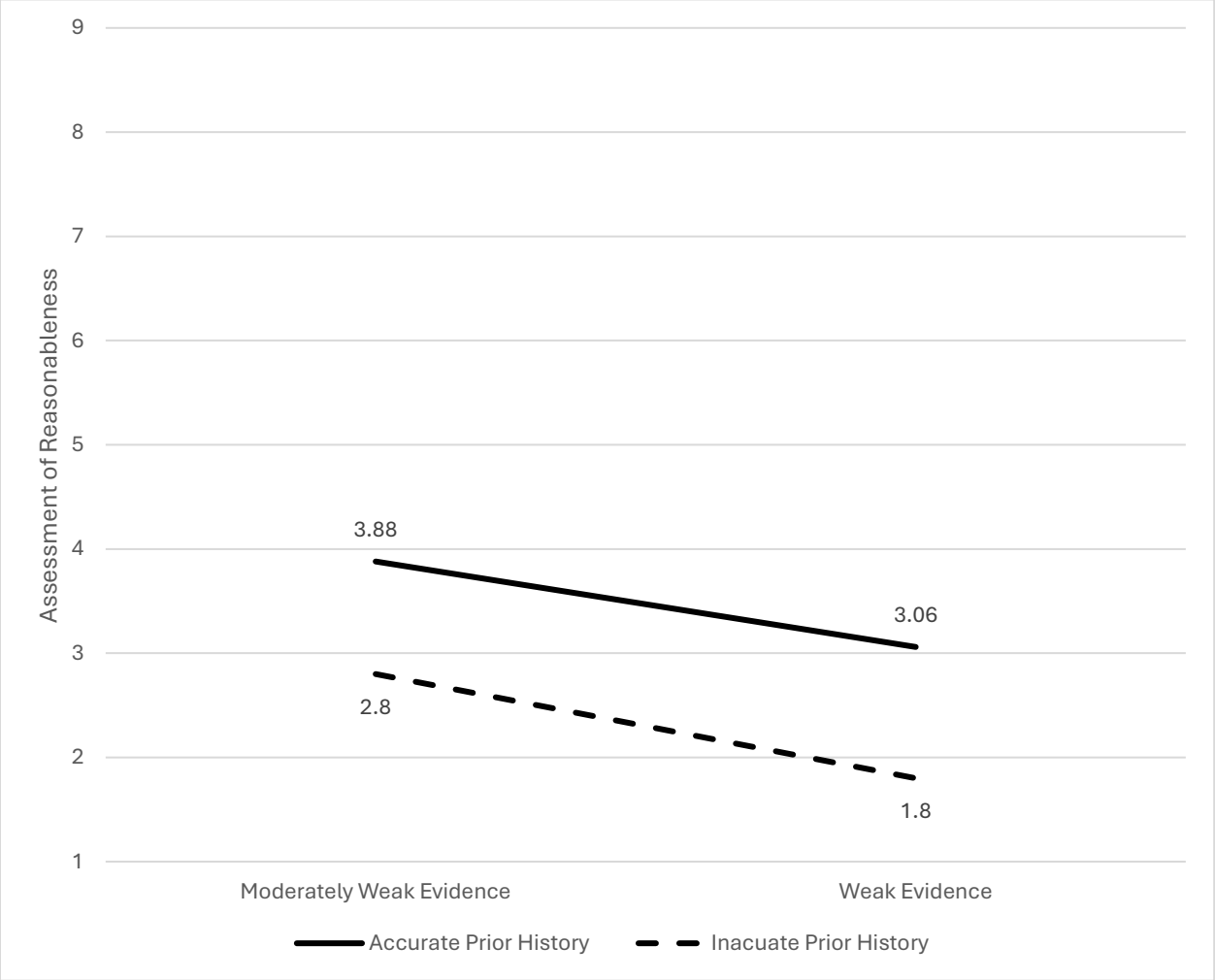
Observed Pattern of Means: Assessed Level of Scrutiny[a]



[a] Means of auditors' assessed level of scrutiny of the inputs provided by management for the discount rate (1 = Less than typical amount; 5 = typical amount, 9 = More than typical amount).

FIGURE 2

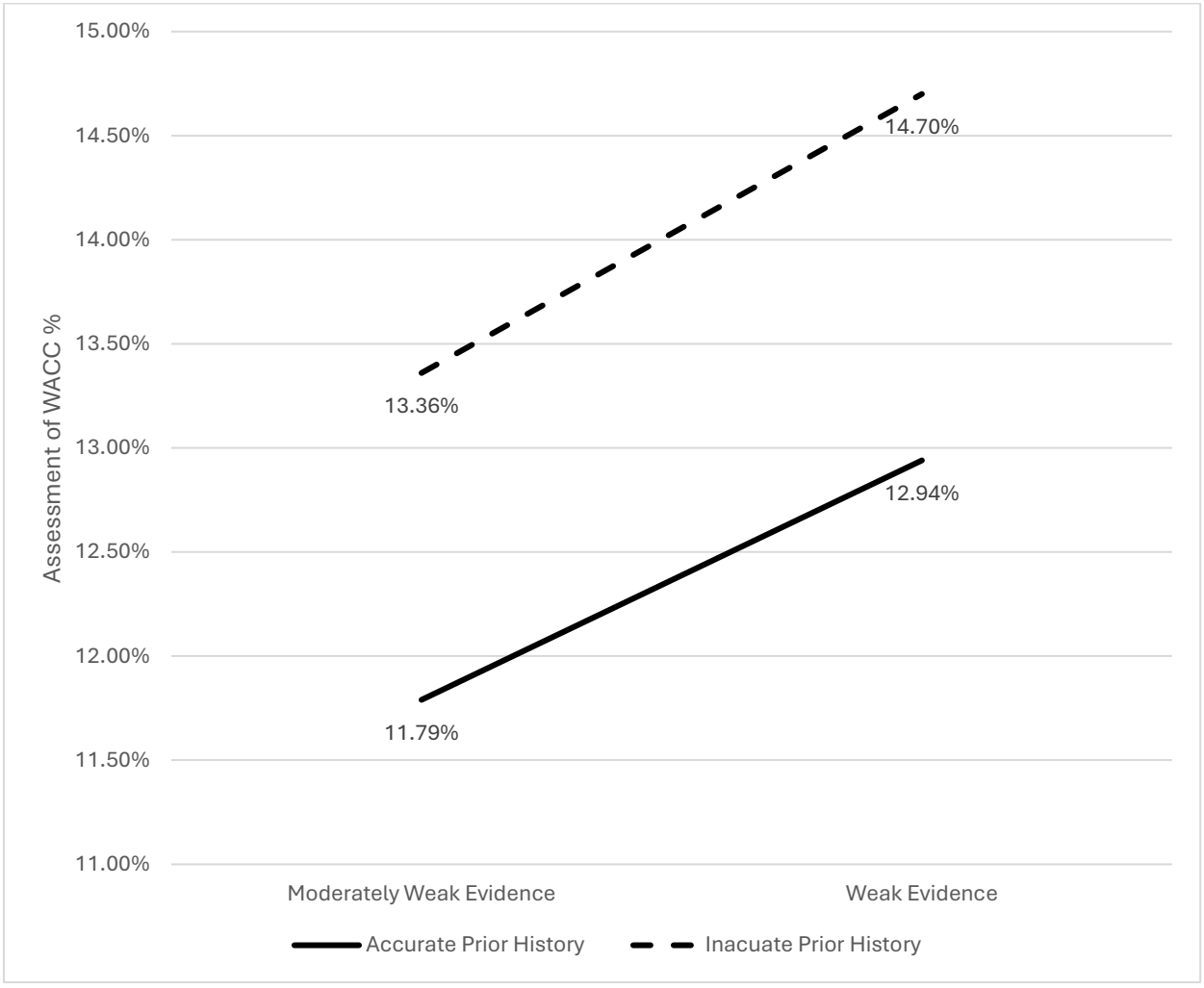
Observed Pattern of Means: Reasonableness Assessment of Third Peer Company[a]



[a] Means of auditors' assessment of the third peer companies (1 = Not reasonable at all; 9 = Very reasonable). Auditors received information from the client on a third peer company MedServices Corporation (moderately weak) or OAI Industries (weak).

FIGURE 3

Observed Pattern of Means: Assessed Discount Rate[a]



[a.] Means of auditors' assessed discount rate (WACC %) that they believe should be used across the experimental conditions.

TABLE 1
Impact of Prior Estimate Accuracy and Evidence Strength on Auditors' Assessed Level of Scrutiny of the Inputs Provided by Management

Panel A: Means (Standard Deviation)[a]

Variable	Moderately Weak Evidence		Weak Evidence	
	Accurate Prior History[b] **(n= 16)**	Inaccurate Prior History **(n= 15)**	Accurate Prior History[b] **(n= 17)**	Inaccurate Prior History **(n= 15)**
Level of Scrutiny of Management's Inputs	4.94 (1.69)	6.53 (1.64)	5.71 (1.40)	6.60 (1.72)

Panel B: Analysis of Variance[b]

Source of Variation	SS	df	F Ratio	*P*-Value
Prior History	24.346	1	9.339	0.003
Evidence Strength	2.738	1	1.050	0.310
Prior History X Evidence Strength	1.934	1	0.742	0.393
Error	153.800	59		

Panel C: T-Test Results--Accurate vs. Inaccurate Prior History (test of H1)[b]

Comparisons	t Statistic	df	P-Value
Accurate Prior History vs. Inaccurate Prior History	3.031	61	0.002

[a] Panel A reports the means (standard deviations) of auditors' assessed level of scrutiny of the inputs provided by management for the discount rate (1 = Less than typical amount; 5 = typical amount, 9 = More than typical amount).
[b] Panel B reports the ANOVA with prior history (accurate vs. inaccurate) and evidence strength (moderately weak or weak) as the independent variables.
[c] Panel C reports the relevant t-test comparisons between the groups. P-value is one-tailed due to directional prediction.

TABLE 2
Impact of Prior Estimate Accuracy and Evidence Strength on Auditors' Assessments of Third Peer Company

Panel A: Means (Standard Deviation)[a]

Variable	Moderately Weak Evidence		Weak Evidence	
	Accurate Prior History[b] **(n= 16)**	Inaccurate Prior History **(n= 15)**	Accurate Prior History[b] **(n= 17)**	Inaccurate Prior History **(n= 15)**
MedServices (third peer company)	3.88 (2.41)	2.80 (1.56)		
OAI Industries (third peer company)			3.06 (1.71)	1.80 (0.86)

Panel B: T-Test Results--Accurate vs. Inaccurate Prior History (test of H2a)[a]

Comparisons	t Statistic	df	P-Value
Accurate Prior History vs. Inaccurate Prior History	-2.567	61	0.006

Panel C: Contrast Test (test of H3a)[c]

Source	SS	df	F Ratio	*P*-Value
Contrast (+2, +2, -1, -3)	27.88	1	9.17	0.004
Residual between-cells variance	6.05	2	0.99	0.376

[a] Panel A reports the means (standard deviations) of auditors' assessment of the third peer companies (1 = Not reasonable at all; 9 = Very reasonable). Auditors received information from the client on a third peer company MedServices Corporation (moderately weak appropriate) or OAI Industries (less appropriate).
[b] Panel B reports relevant t-test comparisons. P-value is one-tailed due to directional prediction.
[c] Panel C reports the results of a contrast test. We use the following contrast weights to test H3a: +2 (Accurate Prior History/Moderately Weak Evidence), +2 (Accurate Prior History/Weak Evidence), -1 (Inaccurate Prior History/Moderately Weak Evidence), -3 (Inaccurate Prior Estimate/Weak Evidence).

TABLE 3
Impact of Prior Estimate History and Evidence Strength on Auditors' Assessed Discount Rate of Level 3 Judgments

Panel A: Means (Standard Deviation)[a]

Variable	Moderately Weak Evidence		Weak Evidence	
	Accurate Prior History **(n= 16)**	Inaccurate Prior History **(n= 15)**	Accurate Prior History **(n= 17)**	Inaccurate Prior History **(n= 15)**
Discount rate (WACC %)	11.79 (1.10)	13.36 (1.81)	12.94 (.99)	14.70 (.52)

Panel B: T-Test Results--Accurate vs. Inaccurate Prior History (test of H2b)[c]

Comparisons	t Statistic	df	P-Value
Accurate Prior History vs. Inaccurate Prior History	5.276	61	0.001

Panel C: Contrast Test (test of H3b)[c]

Source	SS	df	F Ratio	*P*-Value
Contrast (-2, -2, +1, +3)	7980.06	1	42.58	0.001
Residual between-cells variance	1111.47	2	2.96	0.059

[a.] Panel A reports the means (standard deviations) of auditors' assessed discount rate (WACC %) that they believe should be used across the experimental conditions.
[b.] Panel B reports the results of t-test comparisons between the relevant experimental groups. The p-value is one-tailed. The variable was rank-transformed to avoid estimation issues caused by skewness.
[c] Panel C reports the results of a contrast test. We use the following contrast weights to test H3b: -2 (Accurate Prior History/Moderately Weak Evidence), -2 (Accurate Prior History/Weak Evidence), +1 (Inaccurate Prior History/Moderately Weak Evidence), +3 (Inaccurate Prior Estimate/Weak Evidence).

TABLE 4
Impact of Prior Estimate Accuracy and Evidence Strength on Auditors' Next Steps Regarding the Investment Valuation

Panel A: Frequency (Percentage)[a]

Next Steps	Moderately Weak Evidence		Weak Evidence	
	Accurate Prior History[b] **(n= 16)**	Inaccurate Prior History **(n= 15)**	Accurate Prior History[b] **(n= 17)**	Inaccurate Prior History **(n= 15)**
Continue Working	8 (50.0%)	4 (28.6%)	8 (47.1%)	3 (20.0%)
Contact the Manager	8 (50.0%)	10 (71.4%)	9 (52.9%)	12 (80.0%)

Panel B: Chi-square Results--Accurate vs. Inaccurate Prior History[b]

Comparisons	χ^2 Value	df	P-Value
Accurate Prior History vs. Inaccurate Prior History	3.92	1	0.024

[a] Panel A reports the frequency (percentage) of auditors who selected the various next steps they would take regarding the Level 3 investment valuation. Auditors were asked to choose among the following next audit steps — a) conclude that the fair value is reasonable, b) continue audit work under the assumption that the fair value is reasonable but delay forming a final conclusion, c) not make a conclusion but call the manager immediately, or d) conclude that the fair value is materially overstated. We collapsed auditors' responses to the first two options (a and b), which indicate audit steps reflecting less concern and continuing with the audit work, and compared them with the collapsed responses to the last two options (c and d), which indicate audit steps reflecting greater concern and contacting the manager.

[b] Panel B reports the relevant Chi-square test comparisons between the groups. P-value is one-tailed due to directional prediction.

APPENDIX

Additional Discussion of Expert Panel Data

Panels A and B of Table A1 summarize the key results of the data gathering for the expert panel. We also reviewed the audit partners' qualitative responses to gain insight into why the prior history information would not be relevant to the benchmarking task for the Level 3 investment. The recurring theme appearing in the written responses listed in Table A1 is that Level 3 investments are unique and need to be assessed independently from other Level 3 investments.

We also gathered similar data from 10 audit seniors with 25 months of audit experience and mean assessed frequency with auditing investments and familiarity with fair value instruments of 6.7 and 6.0, respectively (endpoints for frequency and familiarity: 1 = never; not familiar and 9 = all the time; very familiar). The audit seniors responded to the same questionnaire as the expert panel of audit partners, with five seniors receiving information on the accurate estimate history and five seniors receiving information on inaccurate estimate history. The seniors rated the reasonableness of the superior peer company (Anacor) higher (mean = 7.70) than the peer company Bivanir (mean = 4.90), with MedServices receiving the lowest reasonableness ratings (mean = 1.70). Nine of the ten audit seniors indicated that the prior estimate accuracy information would not change their initial assessments of the WACC. One audit senior who received the inaccurate estimate history information indicated that the prior history can change their WACC, but kept the assessment unchanged at 15%. Similar to the audit partners, the seniors felt that management evaluating a different Level 3 investment accurately or inaccurately in the past should not influence their evaluation of the evidence provided for the current investment. The seniors noted that their current Level 3 investment assessments were

based on the inputs provided by management for the current decision. Given the similarity of the results with the audit partners, these findings indicate that the results of our main experiment were not due to expertise. Rather, the implicit evaluations from client prior estimate accuracy provided an unconscious evaluation because, once made consciously aware of the prior history in the additional data gathering, audit seniors are not susceptible to its impact.

Additional Details for Experimental Method

Auditors took the role of an in-charge auditor for a hypothetical client and assessed the level of scrutiny for the inputs provided by management, the reasonableness of the benchmarks, and the discount rate of an investment using benchmarking analysis. Participants read client background information, including information on the management team and select financial information. This information was followed by a discussion of the fair value issue. Participants received a memo prepared by management indicating an investment in a non-public company (Healthcare Innovations), which was still in its product development stage. They received background information and the previous two years of unaudited financial statements for Healthcare Innovations. Management had elected to account for the investment under the fair value method as defined by ASC 820. Due to the lack of identifiable similar investments, management classified the investment as a Level 3 and utilized the discounted cash flows method to assess the fair value of the investment. Auditors were told that the audit team had completed some audit work on the discounted cash flows and that their task was to assess the weighted average cost of capital (WACC) assumption used by management.

The memo then stated that management recognized an unrealized gain of $9.6 million for the appreciation of their ownership in the investment in the fourth quarter of the current year. Management provided a discounted cash flow worksheet that had been audited by the audit team,

which detailed the cash inflows and outflows. Finally, management provided support for the WACC assumption used to discount the cash flow projections. The memo summarized the risk profile of Healthcare Innovations using four key attributes of the company—the industry (biomedical technology industry), age (established in 2011), number of product lines (one product line, needleless injectors), and size ($8.4 million total assets). Management stated that they believed an 11% WACC was reasonable and provided support for that rate. This support was provided in the form of an industry WACC range (9 – 15%) and information on attributes and the WACC used by different peer companies. These peer companies were used to manipulate the benchmark set composition for evidence strength.

Supplementary Experiment

We explore the robustness of implicit evaluations from the client prior estimate accuracy by examining how the accuracy of unrelated prior estimates impacts current Level 3 investments. Since auditors will be auditing different types of estimates, it is possible that implicit evaluations may develop from other types of prior estimates and may, in turn, impact their current evaluations of Level 3 investments. The goal of the Supplementary Experiment is to examine the far-reaching impact of implicit evaluations from client prior estimate accuracy on audit judgment.

Sixty-two auditors with an average of 48 months of audit experience participated in Experiment 2. The majority (86%) of these auditors were senior associates. The auditors had experience dealing with auditing investments (mean = 5.98) and with fair value instruments (mean = 5.27) [1 = Never; 7 = All the time]. Auditors were randomly divided into the same four experimental conditions as described in the Main Experiment. There were no significant differences in months of audit experience, experience with auditing investments, and experience

with fair value instruments across the experimental conditions (all p's > 0.10). Experimental materials were the same as the Main Experiment, with the exception of the client's prior estimate accuracy manipulation. In the Supplementary Experiment, the client's prior history accuracy manipulation dealt with prior estimate history from a task outside of the immediate task of fair value accounting and instead focused on a more general area of estimates. This manipulation occurred earlier in the case materials during the discussion of the financial reporting summary. All experimental conditions were told that a few years ago, the client had to make an estimate for an inventory obsolescence reserve. In the accurate prior history condition, auditors were told that the audit team reviewed the estimate and did not require management to make a material adjustment to the obsolescence estimate. In the inaccurate prior history condition, auditors were told that the audit team reviewed the estimate and required management to make a material adjustment to the obsolescence estimate due to a consideration of new competitors for specific inventory lines. Management was in agreement with the adjustment. The dependent variables and post-experimental questions were the same as the Main Experiment.

Auditors in the Accurate Prior History conditions assessed the accuracy of management's previous experience higher (mean = 7.28; SD = 2.17; 1 = Not materially accurate at all; 9 = Very accurate) than in the Inaccurate Prior History (mean = 2.33; SD = 1. 74) conditions (t60 = 9.83; p = 0.001). The manipulation of the unrelated prior estimate is successful. Untabulated results show that auditors in the Inaccurate Prior History conditions felt they needed to scrutinize the inputs more (condition mean = 7.27) compared to auditors in the Accurate Prior History conditions (condition mean = 5.13; t60 = 8.773; p = 0.001). Thus, auditors felt they needed to undertake more than a typical level of scrutiny of the client-provided inputs when the prior history was inaccurate compared to when it was accurate.

Results also indicate that auditors in the Accurate Prior History conditions assessed the reasonableness of the third peer company marginally higher (condition mean = 3.56) as compared to auditors in the Inaccurate Prior History conditions (condition mean = 2.83; t_{60} = -1.394; p = 0.082). Additionally, the assessment of the Moderately Weak Evidence-Accurate Prior History condition (4.81) is higher than that of the Weak Evidence-Accurate Prior History condition (2.31; t_{30} = 3.598; p = 0.001). Similarly, the assessment of the Moderately Weak Evidence-Inaccurate Prior History condition (4.21) is higher than the assessments of the Weak Evidence-Inaccurate History condition (1.63; t_{28} = 6.065; p = 0.001). We also find that the mean discount rate assessed by the Accurate Prior History conditions (condition mean = 12.39%) is lower, or more aggressive, than the discount rate of the Inaccurate Prior History condition (condition mean = 13.53%; t_{60} = 4.253; p = 0.001). Additional results indicates that the mean discount rate assessed by the Moderately Weak-Accurate Prior History (11.78%) is significantly more aggressive than the Weak-Accurate Prior History condition (13.00 %; t_{30} = -3.535; p = 0.001), while the assessed rate in the Moderately Weak-Inaccurate Prior History condition (12.82%) is significantly more aggressive than the Weak-Inaccurate Prior History condition (14.15%; t_{28} = -2.399 ; p = 0.012).[7] Therefore, even when the prior estimate history is on an unrelated estimate, prior history impacts the client provided evidence.

[7]. In Experiment 2, the discount rate translates to the following unrealized gains across the four conditions: Moderately Weak-Accurate Prior History (mean =$8,252,966), Weak-Accurate Prior History (mean =$5,358,112), Moderately Weak-Inaccurate Prior History (mean = $4,699,750), and Weak -Inaccurate Prior History (mean = $3,363,930).

Table A1
Audit Partners' Assessments of Peer Companies and Information on Prior Estimates

Panel A: Audit partners provided accurate prior estimates

Partner # (years' audit exp)	No Prior Estimates				Prior Estimates (accurate)		
	Assessed[a] WACC (%)	Assess[b] Anacor	Assess[b] Bivanir	Assess[b] MedServices	Prior estimates change peer company assessments?	Prior estimates change assessed WACC?	Partner Comments
P1 (10 yrs.)	15	8	6	2	No	No	Prior estimates change peer companies? "Although it is information that would be useful in determining the risk level of the account, it is not needed when evaluating the evidence provided by management and verified by the audit team. It is clear that management is placing a significant of value on the MedServices benchmark company, but that company is the least comparable. The fact that management assessed previously held investments well should not outweigh the current evidence and how appropriate it is."
P2 (15 yrs.)	14	9	6	1	No	No	Prior estimates change peer companies? "Level 3 investments are very unique and just because the client gets it right on one, it doesn't mean they will get it right every time. In addition, these benchmarks relate to this investment and not the previously held investments. My assessment only relates to these specific benchmarks." Prior estimates change WACC? "As noted, Level 3 instruments are unique. The inputs and assumptions have to be assessed on a case by case basis."
P3 (12 yrs.)	14.5	7	6	2	No	No	Prior estimates change peer companies? "These benchmarks relate to this specific level 3 investment. I do not see why the information about previously held level 3 investments would change my assessment of benchmarks related to a different investment." Prior estimates change WACC? "Again, this WACC rate only relates to the assessment and valuation of the Healthcare Innovations investment."
P4 (11 yrs.)	15	8	7	3	No	No	Prior estimates change peer companies? "Previously held level 3 investments do not matter when arriving at a valuation for a different level 3 investment."
P5 (17 yrs.)	14.5	9	7	1	No	No	Prior estimates change peer companies? "The valuation of the Healthcare Innovations investment is based on these specific benchmarks. The other previous level 3 investments were based on their own evidence. Just because management got those right does not mean that we would I would look at the evidence for this investment differently."

							Prior estimates change WACC? "The WACC rate for this valuation pertains only to these level 3 investment. Although the previously held investments show that management used good judgment, we still need to support our assessment with the specific evidence and support as provided by management and verified by the audit team."

Panel B: Audit partners provided inaccurate prior estimates

Partner # (years' audit exp)	No Prior Estimates				Prior Estimates (inaccurate)		
	Assessed WACC (%)	Assess Anacor	Assess Bivanir	Assess MedServices	Prior estimates change peer company assessments?	Prior estimates change assessed WACC?	Partner Comments
P6 (12 yrs.)	14	8	6	2	No	No	Prior estimates change peer companies? "The benchmarks only relate to this specific investment. As not additional information was provided regarding the benchmarks my original assessment stands." Prior estimates change WACC? "Management does not have a good history for evaluating Level 3 investments, however, I think that poor judgment is continued for the current investment. As I already took into account the risks and related information into account for the investment, knowing they did not do a good job before does not change my assessment."
P7 (20 yrs.)	15	7	5	1	No	Yes (updated to 16%)	Prior estimates change peer companies? "The additional information on the previous investments does not help assess the evidence related to this specific investment." Prior estimates change WACC? "The management has had trouble with Level 3 evaluations before. I think this introduces more risk knowing this and should be taken into account when assessing the WACC rate. However, typically we suggest a range for a DCF rate with the range being adjusted for risk."
P8 (12 yrs.)	15	8	7	2	No	No	Prior estimates change peer companies? "The benchmarks relate to this investment. I assessed the reasonableness of the benchmarks based on the information for this specific investment. The additional information does not help me in assessing the reasonableness of these benchmarks." Prior estimates change WACC? "Although management has exhibited issues in the past, I feel that each "Level 3 investment needs to be assessed independently. There may be additional risk associated with management judgments if they have not done a good job in the past, but

							hopefully we have taken a reasonable amount of risk into consideration for each Level 3 investment. Level 3 investments are somewhat of a black box and the reason they are so hard is because there is nothing truly comparable in the market. If you look at this from the flip side, management could get 9 out of 10 Level 3 valuations right, but that 10th one, might be materially wrong. If we placed too much emphasis on management's judgment from other Level 3 investments, then we might not identify an issue with that 10th one. I believe we are better off focusing on the information we have at the time related to the specific investments in order to assess the valuations recorded by management."
Partner # (years' audit exp)	No Prior Estimates				Prior Estimates (inaccurate)		
	Assessed WACC (%)	Assess Anacor	Assess Bivanir	Assess MedServices	Prior estimates change peer company assessments?	Prior estimates change assessed WACC?	Partner Comments
P9 (13 yrs.)	15	7	6	2	No	No	Prior estimates change peer companies? "These benchmarks relate to this investment. The additional information does not provide information on if management used the wrong benchmarks for the prior investments. Even if that was an issue, we would still assess the direct evidence for this specific investment. Based on the information provided it appears we did our due diligence to make sure no missing relevant benchmarks were out there. Based on this, I would not change my assessment on the benchmarks as provided." Prior estimates change WACC? "Each Level 3 instrument is unique. I have personally seen clients get one Level 3 instrument wrong, requiring an adjustment when that instrument dropped to either a Level 2 or 1, but we did not adjust how we assessed the other Level 3 instruments. We must exercise our professional skepticism on every material account, which includes Level 3 instruments, regardless of management's prior ability to appropriately value it."
P10 (10 yrs.)	15	8	7	1	No	No	Prior estimates change peer companies? "These benchmarks were specific to this Level 3 investment. Prior estimates change WACC? "The additional information may raise the risk assessment of all Level 3 instruments, however, given that Level 3 fair value instruments implies there is little external information available to support valuations, it is not uncommon for management to make some missteps. As footnotes are clear that this is difficult and if

							material, would be cited in a CAM, I do not see why errors for other Level 3 instruments would impact out assessment of a specific Level 3 instrument.”

Note:
a. Audit partner’s assessment of the of the WACC rate that should be used for the discounted cash flows, without information on prior estimates.
b. Audit partner’s assessment of the peer companies (1 = Not reasonable at all; 9 = Very reasonable), without informational prior estimates