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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 043

Deloitte & Touche LLP ("D&T" or "we") is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Auditing Standard — Auditing Accounting Estimates, Including Fair Value Measurements* (the "Proposed Auditing Standard") and proposed amendments to PCAOB auditing standards (the "Proposed Amendments") (collectively, "the Proposal" or "the Release"), which addresses potential changes to various auditing standards (specifically, replacing PCAOB AS 2501, *Auditing Accounting Estimates* (PCAOB AS 2501), PCAOB AS 2502, *Auditing Fair Value Measurements and Disclosures* (PCAOB AS 2502), and PCAOB AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (PCAOB AS 2503) with a single standard) and potential amendments to the risk assessment standards to more specifically address certain aspects of auditing accounting estimates.

Our comments herein should be read concurrently with our comments provided in response to the request for comment from the PCAOB on the *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (the "Specialists Proposal"), as certain provisions of the proposed auditing standards include references between the two proposals in order to illustrate how the proposed requirements in the two releases would work together.

Overall Comments

We support the Board's efforts to enhance the standards of the PCAOB that address auditing accounting estimates, including fair value measurements, and to align the applicable requirements with the PCAOB's risk assessment standards. We commend the Board for developing a single standard on auditing accounting estimates and fair value measurements to replace the existing standards. We also agree with the PCAOB that the Proposed Auditing Standard achieves better integration and alignment with the PCAOB's risk assessment standards, and are pleased that the Proposed Auditing Standard retains the three approaches in the existing standards for testing accounting estimates.

We believe that the PCAOB's efforts in considering amendments to the standards addressing auditing accounting estimates, including fair value measurements along with the Specialists Proposal is thoughtful and appropriate. These concurrent proposals allow commenters to better evaluate and analyze the effect of such proposed amendments, both individually and collectively, and for the PCAOB to consider the feedback collectively as well. We continue to believe it will be important that any resulting amendments pertaining to these two proposals become effective at the same time. We recommend that the effective date should provide auditors with a period of at least two years from the time the standard is approved by the SEC, as we believe there could be significant efforts for accounting firms to undertake in order to properly prepare to implement these requirements. We also commend the PCAOB Staff and Board Members for devoting a significant portion of the June 1, 2017, *Open Board Meeting to Consider Adopting Standard on the Auditor's Report, and Proposing Updated Requirements for Auditing Accounting Estimates and an Auditor's Use of the Work of Specialists* ("Open Meeting") to discussing matters relevant to the Proposal.

We support the objectives of the Board's Proposal, and offer certain constructive suggestions to help clarify the final standards' requirements and auditors' responsibilities for auditing accounting estimates, including fair value measurements. We are ready to engage constructively with the Board and other stakeholders to provide our perspective and experiences in order to facilitate the development of improvements to the PCAOB's auditing standards that will enhance audit quality. In this letter, we present a summary of the primary matters for additional consideration that we have identified:

- Focus on Internal Control and Consideration of Risks of Material Misstatement Due to Fraud.
- Need for Practical Implementation Guidance and Possible Approach for Its Development.
- Consistency with International Standards.
- Using the Work of a Company Specialist.
- Developing an Independent Expectation as a Range.
- Audit Evidence Regarding Valuation of Investments Based on Investee Financial Condition or Operating Results.

We have also included more granular observations and suggestions in the attached appendix.

Focus on Internal Control and Consideration of Risks of Material Misstatement Due to Fraud

The Proposal lacks sufficient consideration of both (1) identification and testing of relevant controls and (2) identification of and response to risks of material misstatement due to fraud in relation to auditing accounting estimates. The Proposal should provide additional clarity and expanded guidance in these areas, building on the framework in the risk assessment standards, and PCAOB AS 2201, *An Audit of Internal Control over Financial Reporting that Is Integrated with an Audit of Financial Statements*.

Focus on Internal Control

Identifying and testing relevant controls that address risks of material misstatement relating to accounting estimates (for both integrated audits and audits of financial statements) can be particularly challenging given the nature of the controls that typically address accounting estimates (i.e., relevant controls are often complex, management review-type controls). Evaluating the design and implementation of these controls can be difficult for auditors in practice because of the complexity of the activities performed by the control owner and the judgment exercised in performing those activities. Further, we note that testing the operating effectiveness of controls, including controls over complex models or methods used, can be critical in auditing accounting estimates and, in some circumstances, may be required (i.e., in situations in which substantive procedures alone do not provide sufficient appropriate audit evidence[1]). In addition, it may be important to identify and test controls that address risks of material misstatement related to the following aspects:

- Complexity of a model.
- Large volumes of data, including the processing of data.
- Extraction or transfer of data from an IT system or between IT systems.

[1] See PCAOB AS 2301.17.

- Modifications to data.

- Selection and changes to assumptions.

We therefore suggest that the Proposal provide additional guidance to auditors in order to recognize circumstances, especially in today's environment, in which substantive procedures alone do not provide sufficient appropriate audit evidence. This may, for example, especially be the case for complex estimates that use large volumes of data when developing accounting estimates, which is becoming increasingly common because of changes in the applicable financial reporting frameworks (e.g., the issuance by the FASB of ASC 606, *Revenue from Contracts with Customers* (ASC 606), ASC 842, *Leases* (ASC 842), and ASC 326, *Financial Instruments-Credit Losses* (ASC 326)). In addition, we also believe the Proposal could be enhanced to encourage testing, in nonintegrated audits, of the operating effectiveness of controls in conjunction with substantive testing, as we believe this may often be the most effective audit strategy.

Consideration of Risks of Material Misstatement Due to Fraud

We agree with the Board that accounting estimates often are some of the areas of greatest risk in an audit, requiring additional audit attention and appropriate application of professional skepticism. It is important that the Proposal place appropriate emphasis on identifying and responding to the potentially heightened risks of material misstatement due to fraud related to accounting estimates that often arise because of the complexity and the subjectivity involved in their development. We believe this could be accomplished by enhancing connectivity between the Proposed Auditing Standard and the requirements of PCAOB AS 2401, *Consideration of Fraud in a Financial Statement Audit* (PCAOB AS 2401). For example, the Proposed Auditing Standard could provide reference to paragraphs 54 and 63-65 of PCAOB AS 2401 as it relates to responding to the risks of material misstatement in order to better connect the Proposed Auditing Standard to PCAOB AS 2401.

Need for Practical Implementation Guidance and Possible Approach for Its Development

Consistent with comments we made in response to the *Staff Consultation Paper — Auditing Accounting Estimates and Fair Value Measurements,* we believe the effectiveness of a single principles-based accounting estimates standard and the consistency of its application by auditors would be vastly improved if comprehensive implementation guidance were developed to support its application by auditors. Such implementation guidance might demonstrate how the auditing framework described in the Proposal could be applied to many different types of estimates with varying degrees of complexity and measurement uncertainty (including fair value estimates) and could focus, for example, on estimates that are the subject of common inspection findings (e.g., fair value measurement of goodwill, indefinite lived assets, investments, and securities[2]) and on new accounting estimates that may arise as a result of recent revisions to the accounting standards (e.g., ASC 606, ASC 842, ASC 326). In addition, implementation guidance might also address examples of situations in which management uses a specialist or information provided by a third party in developing the estimate, as well as when the auditor uses information provided by a third party when auditing an accounting estimate through developing an independent estimate for comparison to the entity's estimate. Such implementation guidance could also provide additional perspectives as to how to use the output of a centralized approach to address information developed by third-party information providers.

We believe it is important for such implementation guidance to be based on practical and current real-life examples to enhance the effectiveness of such guidance. To that end, auditors, preparers, specialists, and third-party information providers (including, but not necessarily limited to, pricing

[2] See International Forum of Independent Audit Regulators ("IFIAR"), Report on 2016 Survey of Inspection Findings (Mar. 3, 2017); IFIAR, Report on 2015 Survey of Inspection Findings (Mar. 3, 2016); (available at https://www.ifiar.org/IFIAR-Global-Survey-of-Inspection-Findings.aspx).

services) could work effectively and productively together to develop implementation guidance based on the framework for auditing accounting estimates described in the Proposal. We encourage the PCAOB to be involved in such an effort. Such implementation guidance could, in the context of specific accounting estimates, focus on considerations related to the identification and assessment of risks of material misstatement (including fraud risks, the consideration of management bias, and how the auditor might identify and consider contradictory evidence), as well as how to identify and test relevant controls.

Consistency with International Standards

Consistency of auditing standards used worldwide serves to enhance audit quality. To that end, we are aware of the Exposure Draft, proposed International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* ("ED-540") issued by the International Auditing and Assurance Standards Board ("IAASB") in April 2017. We note the differing approaches to auditing accounting estimates taken by the PCAOB and the IAASB in their proposed standards. We believe that such diversity in practice due to differing auditing standards is making it increasingly difficult for firms to develop international audit methodologies that are aligned with the requirements of both sets of standards. If it is determined that such consistency is not desirable for reasons specific to a particular jurisdiction, then standard setters should consider highlighting what they believe should differ and the reasons for such differences so it is clear what the incremental requirements are. In finalizing the Proposal, we recommend the PCAOB interact with the IAASB to understand the reasons underlying the differing approaches taken by the IAASB in their proposed standard and consider ED-540, as well as the responses to ED-540 and the Proposed Auditing Standard, in determining the necessary changes to the Proposed Auditing Standard and the Proposed Amendments.

Using the Work of a Company Specialist

The issues related to use of company specialists and information provided by third parties in developing accounting estimates or in independent estimates used by auditors in testing management's estimates are inextricably linked with the auditing challenges related to accounting estimates. We believe the requirements in the Proposed Auditing Standard, in conjunction with the Proposed Appendix B to PCAOB AS 1105, *Audit Evidence* (see the Specialists Proposal), will likely set expectations for auditors that will go well beyond the expectations for issuer management, resulting in practical challenges that will be difficult, if not impossible, for auditors to resolve. Specifically, paragraph 19 of the Proposed Auditing Standard requires the auditor to test and evaluate the company specialist's work in conjunction with testing the company's process. Paragraph 19, when considered in conjunction with proposed requirements related to testing the company's process, would require the auditor to test the methods, data, and significant assumptions used or developed by a company specialist in the same manner that the auditor would if the accounting estimate was developed without the assistance of a company specialist. In some cases, company specialists or third-party information providers view some or all aspects of their work product as proprietary (particularly when it comes to the fair value of securities) and difficulties exist in relation to issuer management obtaining information about how the accounting estimate was developed. In turn, this would result in the auditors' inability to obtain the necessary access to that information to address the requirements in the Proposed Auditing Standard. The requirements in the Proposed Auditing Standard would likely result in third-party information providers being overwhelmed with requests from auditors and result in an inability for the third-party information providers to individually address requests from auditors for the information needed to appropriately audit accounting estimates in accordance with the Proposed Auditing Standard. Further, in many cases, auditors will need to involve auditor's specialists to a far greater extent than what the extant standards require in order to apply these requirements appropriately. It is important that the Proposal, together with the Proposed Appendix B to PCAOB AS 1105, consider these practical challenges and provide clarity regarding how the auditor would be expected to overcome them. In addition, implementation guidance demonstrating how an auditor would test and evaluate the company specialist's work would help support the consistent application of the requirement in the Proposed Auditing Standard.

We request that you also consider our comments provided in response to the request for comment from the PCAOB on the Specialists Proposal on this matter given the reference in these requirements to the Proposed Appendix B to PCAOB AS 1105.

Developing an Independent Expectation as a Range

We note that paragraph 25 of the Proposed Auditing Standard requires that if the auditor's independent expectation consists of a range rather than a point estimate, the auditor should determine that the range is appropriate for identifying a misstatement of the accounting estimate and supported by sufficient appropriate audit evidence. The process involved in developing the estimate can be complex and involve significant levels of judgment and, thus, depending on the level of estimation uncertainty, the range of possible values for an accounting estimate could be wide (and in some cases exceed materiality). We suggest that the Proposed Auditing Standard explicitly acknowledge these situations. Further, the definition of the phrase "range is appropriate for identifying a misstatement" is unclear, and we therefore request the Board to clarify considerations for determining the "appropriateness" of a range. We suggest that, as estimation uncertainty and the range increases or as management's process becomes more complex, the auditor may be required to consider whether using either an alternative testing approach (i.e., testing the company's process used to develop the accounting estimate or evaluating audit evidence from events or transactions occurring after the measurement date) or a combination of testing approaches is appropriate to obtain sufficient appropriate audit evidence regarding the reasonableness of the accounting estimate. For example, the auditor may develop an independent expectation of the accounting estimate in which estimation uncertainty is high and the expectation consists of a range that is greater than materiality, thereby providing support for a conclusion about the sufficiency and appropriateness of the evidence. While this is consistent with the auditor's expectation based on historical experience and the nature, size, and composition of the account, the auditor may also determine that testing management's process, in addition to developing the independent expectation, is necessary to obtain an aggregation of sufficient appropriate audit evidence regarding the reasonableness of the accounting estimate.

Audit Evidence Regarding Valuation of Investments Based on Investee Financial Condition or Operating Results

Proposed Appendix A to PCAOB AS 1105 describes the auditor's responsibilities for obtaining sufficient appropriate audit evidence in certain situations in which the valuation of an investment selected for testing is based on the investee's financial condition or operating results.

PCAOB AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (PCAOB AS 2301), establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. As provided in AS 2301, the auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement.[3] As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures.[4] The requirements throughout Proposed Appendix A to PCAOB AS 1105 are unclear in the context of risk assessment and appear to contradict the PCAOB's risk assessment standards as they require the auditor to perform certain procedures based on other factors (e.g., significance of the investment), seemingly without regard for the identified and assessed risks of material misstatement. In the attached appendix, we have

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[3] See PCAOB AS 2301.08.

[4] See PCAOB AS 2301.37.

included specific areas in the Proposed Appendix A to PCAOB AS 1105 that we believe need further clarification to better align the requirements with the PCAOB's risk assessment standards.

Paragraph A4 of Proposed Appendix A to PCAOB AS 1105 also has certain requirements that involve the auditor (1) obtaining and evaluating information about the professional reputation and standing of the investee's auditor and (2) obtaining information about the procedures performed by the investee's auditor. These procedures seem to overlap with certain procedures in PCAOB AS 1205, *Part of the Audit Performed by Other Independent Auditors* (PCAOB AS 1205). For example, it is unclear if the requirements in paragraph A4a of the Proposed Auditing Standard are consistent with the requirements in paragraph 10 of PCAOB AS 1205, or if additional procedures would be necessary. In addition, the requirement in paragraph A4b could be interpreted to be similar to the requirement in PCAOB AS 1205, which states, in part:

> In addition, the principal auditor should consider performing one or more of the following procedures:
>
> - Visit the other auditor and discuss the audit procedures followed and results thereof.
>
> - Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of the audit work.
>
> - Review additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document.

As a result, it is unclear in situations in which paragraph A4 is applicable whether the requirements of PCAOB AS 1205 are also applicable (as well as whether paragraph A4 affects the reporting required by PCAOB Form AP). Therefore, we request that the Board provide further clarification on this matter. Furthermore, the requirements in paragraphs A4 and A5 of the Proposed Appendix A to PCAOB AS 1105 seem to overlap with the PCAOB's *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors* and the *Proposed Auditing Standard — Dividing Responsibility for the Audit with Another Accounting Firm* (collectively, the "Other Auditors Proposal") issued under PCAOB Rulemaking Docket Matter No. 042.

We do not believe that changes to standards related to investments valued based on the investee's financial condition or operating results should be done in isolation. Rather the PCAOB should address requirements related to communicating and being involved in an other auditor's work in conjunction with the Other Auditors Proposal as addressing each separately could result in unintended consequences. Further, addressing these requirements in tandem with the Other Auditors Proposal would put into context how the requirements in the Proposed Appendix A to PCAOB AS 1105 fit into the overall use of another auditor.

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D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential effects of the Proposal. We are ready to collaborate with the PCAOB on these important matters. If you have any questions or would like to discuss these issues further, please contact Dave Sullivan at 714-436-7788 or Megan Zietsman at 203-761-3142.

Very truly yours,

Deloitte & Touche LLP

Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
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Marc A. Panucci, SEC Deputy Chief Accountant
Sagar S. Teotia, SEC Deputy Chief Accountant
Russell G. Golden, FASB Chairman

APPENDIX

In this appendix, we have addressed certain issues raised in the Proposal in more detail. Our comments and observations are organized as follows:

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

II. Proposed Appendix A to PCAOB AS 1105, *Audit Evidence Regarding Valuation of Investments Based on Investee Financial Condition or Operating Results*

III. Proposed Amendments to the Risk Assessment Standards

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

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

Proposed AS 2501.09 requires the auditor to test the company's process, which involves performing procedures to test and evaluate the methods, data, and significant assumptions used in developing the estimate in order to form a conclusion about whether the estimate is reasonable in the circumstances, in conformity with the applicable financial reporting framework, and free from bias that results in material misstatement. However, it is unclear if the proposed requirement would include assumptions, models, and data used by company specialists and third-party information providers (regardless of whether management provided the information to the company specialists or the company specialist sourced or developed the information independently). If the proposed requirement does apply to assumptions, models, and data provided by company specialists or a third-party information provider, we believe there will be significant challenges by auditors in addressing this requirement, particularly when information provided or models used are considered proprietary by such company specialists or third-party information providers. Therefore, we recommend clarifying in paragraph 09 of the Proposed Auditing Standard how the requirement to test the company's process is affected if a company specialist or a third-party information provider assists the company in developing an accounting estimate.

Evaluating the Company's Methods

We support the requirement in paragraph 10 of the Proposed Auditing Standard related to the auditor evaluating whether the company's methods used to develop the accounting estimates are in conformity with the applicable financial reporting framework (which is consistent with existing standards). We also acknowledge that the existing standards require the auditor to consider whether the valuation method is appropriate in relation to the business, industry, and environment in which the entity operates when evaluating whether the entity's method of measurement is appropriate in circumstances in which there are no observable market prices and the entity estimates fair value using a valuation method.[5] However, we do not believe that the auditor should be required to evaluate whether the methods are "appropriate for the nature of the related account or disclosure and the business, industry, and environment in which the company operates[6]" for all accounting estimates, as we do not believe all methods accepted within the industry are objectively established for all accounting estimates in all circumstances, and in some cases, practices used by companies within the same industry may be justifiably different based on different underlying facts and circumstances. In addition, as management would not necessarily be compelled to consider the acceptability of a company's method against other methods used within the same industry, we do not believe it is appropriate to place the auditor in "management's shoes." We therefore believe it is sufficient and

[5] See paragraph 18 of extant AS 2502.

[6] See paragraph 10b of the Proposed Auditing Standard.

appropriate that the methods used to develop accounting estimates be evaluated by the auditor against the requirements of the applicable financial reporting framework, as this aligns with the requirements that management would have to comply with in preparing the financial statements. In determining if the methods used to develop accounting estimates are in conformity with the requirements of the applicable financial reporting framework, the auditor *may* include consideration of the business, industry, and environment in which the company operates. Even if it were possible to objectively or comprehensively determine accepted industry practices, it's not clear what the auditor would do when such practices might conflict with the requirements of the applicable financial reporting framework.

Paragraph 11 of the Proposed Auditing Standard requires the auditor to determine the reasons for a change in the method used by the company for determining the accounting estimate and evaluate the appropriateness of such change. We believe it would be more appropriate for management to determine the reasons for changing the method used to determine the accounting estimate and for the auditor to be required to evaluate whether management's reasons for making the change are appropriate. We also believe that clarification is needed regarding the requirement for the auditor to obtain an understanding of the reasons for the method selected by the company in circumstances in which the company has determined that different methods result in significantly different estimates and evaluate the appropriateness of the selection. It is unclear what the auditor's responsibility is in circumstances in which the company has not performed such an analysis (including whether a failure by management to perform this analysis is indicative of a control deficiency). Further, it's unclear what specifically constitutes a change in the method used by the company. For example, management may use multiple methods to develop a range and considers the output of each method to determine a best estimate. Management may select a point in the range that is not consistent with the point in the range in the prior reporting period (e.g., management has historically selected the mid-point in the range, but has selected a point at the high-end of the range in the current period), but may determine this represents the current best estimate for purposes of recording the accounting estimate. It is unclear whether this would be considered a change in method that would require evaluation in accordance with paragraph 11 of the Proposed Auditing Standard. Therefore, we recommend clarifying in paragraph 11 of the Proposed Auditing Standard what specifically constitutes a change in the method used by the company. We also recommend clarifying the auditor's responsibility when the company has not performed an analysis to determine whether different methods result in significantly different estimates.

Testing Data Used

We support the requirement in paragraph 13 of the Proposed Auditing Standard that requires the auditor to evaluate the relevance and reliability of data the company uses from an external source in accordance with PCAOB AS 1105. We believe the requirement in paragraph 13 should be expanded to clarify that company data supplied to a third party or company specialist is not data from an external source, but rather company data and should be evaluated in accordance with paragraph 12 of the Proposed Auditing Standard.

We support the requirement[7] added regarding the factors for the auditor to use to evaluate whether the data was appropriately used by the company in developing the accounting estimate. However, we believe additional clarification is necessary to provide a framework for evaluating if the source of the company's data has changed from the prior year and, if so, whether the change is appropriate.[8]

Identification of Significant Assumptions

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[7] See paragraph 14 of the Proposed Auditing Standard.

[8] See paragraph 14c of the Proposed Auditing Standard.

We believe further clarity as to the characteristics of significant assumptions as described in paragraph 15 of the Proposed Auditing Standard would be helpful to auditors, particularly for auditing fair value measurements; however, the characteristics should not be set forth as a list of factors that would need to always be explicitly evaluated for every assumption used by management to make an accounting estimate. Given the wide range of different types of estimates, certain factors may (1) not always be relevant, (2) vary in individual significance, or (3) be more important for consideration because of other relevant factors specific to particular assumptions. Therefore, we suggest that the lead-in sentence to the list of factors be revised to read as follows (additional text is shown using **bold underline**; recommended deletions to the text are shown using double ~~strikethrough~~:

> Factors**, as applicable,** that **the auditor may consider to be** ~~are~~ relevant in ~~to~~ identifying significant assumptions include whether the assumptions:

We are also concerned with the characteristic in paragraph 15e of the Proposed Auditing Standard that states a factor that is relevant to identifying significant assumptions includes whether the assumptions are "otherwise related to an identified and assessed risk of material misstatement to the estimate." We believe that this would require auditors to identify all assumptions for which a risk of material misstatement has been identified as significant, and therefore the determination of which assumptions are significant assumptions would be overly broad. All assumptions that give rise to a risk of material misstatement (even when determined not to be significant assumptions), would, in accordance with the PCAOB's existing risk assessment standards, have to be addressed through the performance of further audit procedures. As a result, not all assumptions would need to be designated as significant assumptions. Further, the persuasiveness of the audit evidence necessary to be obtained related to significant assumptions is likely greater than that necessary for assumptions that are not determined to be significant assumptions. We therefore suggest revising this last characteristic of significant assumptions to conform to the language presented in the *Staff Consultation Paper — Auditing Accounting Estimates and Fair Value Measurements* (Staff Consultation Paper), which would read as follows (additional text is shown using **bold underline**; recommended deletions to the text are shown using double ~~strikethrough~~:

> e. Otherwise are **important to the recognition or measurement of the accounting estimate**[9] ~~related to an identified and assessed risk of material misstatement to the estimate.~~

We also believe the requirement for the auditor to identify any assumptions as significant if the company has identified the assumption as significant would create challenges for the auditor in practice. Significant assumptions are not defined, nor is there a requirement for management to identify significant assumptions within U.S. GAAP. Therefore, there is no mutually agreed upon definition of a significant assumption used in an accounting estimate. Our concern is that, depending on how management defines a significant assumption, the auditor may have to identify assumptions as significant that the auditor otherwise would not have identified as significant. We believe the requirement should be clarified for the auditor to consider what management has identified as significant assumptions and have that information taken into account when auditors are identifying significant assumptions.

Evaluating the Reasonableness of Significant Assumptions

We support including requirements for understanding the significant assumptions underlying accounting estimates and testing those assumptions for reasonableness (which is consistent with existing standards). We believe the factors provided for evaluating the reasonableness of the significant assumptions are a good clarification; however, we would like the Board to provide clarity on how the factors for evaluation within paragraph 16 of the Proposed Auditing Standard address the

[9] See discussion on page 35 of the Staff Consultation Paper.

requirement to “test” in paragraph 09. Our interpretation is that the requirement to “test” from paragraph 09 is achieved through the actions identified in paragraph 16b that require the auditor to evaluate whether the significant assumptions are consistent with a number of factors. However, we would like the Board to clarify whether this interpretation is correct, or whether the Board has other expectations. In addition, we believe it would be appropriate to include a specific requirement to assess significant assumptions, as defined in accordance with the suggested revisions above, for management bias, individually and in the aggregate, as the assumptions may be reasonable but still be biased, especially when considered in the aggregate.

In addition, the Proposed Auditing Standard requires the auditor to evaluate whether the company has a “reasonable basis” for the significant assumptions used. The concept of reasonable basis appears in other PCAOB auditing standards, but primarily in relation to the rendering of an audit opinion. For example, AS 3101, *Reports on Audited Financial Statements*, provides that the auditor’s standard report includes “a statement that the auditor believes that his or her audit work provides a reasonable basis for his or her opinion.” Our concern is the existing uses of this terminology are quite different than how this new requirement is applied at the individual assessment of a significant assumption. In addition, “reasonable basis,” as used in the auditing standards, is aligned with the auditor obtaining reasonable assurance; however, “reasonable basis” as used in paragraph 16 of the Proposed Auditing Standard is in the context of management. As U.S. GAAP does not have any requirements that would provide insight into what “a reasonable basis” is, we believe this will result in management having differing interpretations when their auditors inquire as to the reasonable basis for their assumptions. Therefore, we request the Board to clarify the definition of “reasonable basis” as it relates to the evaluation of significant assumptions used by the company to develop an accounting estimate, or that the Board modify the wording to eliminate confusion with existing uses of this terminology.

While the factors included in paragraph 16b of the Proposed Auditing Standard for evaluating the consistency of significant assumptions may be generally helpful, we are concerned that a requirement for the auditor to evaluate the consistency of each significant assumption with all of the factors listed will be difficult to apply in practice. Also, as currently defined in the Proposed Auditing Standard, every assumption that gives rise to a risk of material misstatement would be considered a significant assumption, and therefore the requirements in paragraph 16b would be onerous for the auditor to execute and would be inconsistent with the risk assessment standards as it would eliminate the ability of the auditor to use judgment to appropriately scale the necessary audit procedures according to the perceived risk of certain assumptions. It is unclear what process the auditor would be expected to follow to define the factors and what level of detail would be expected (e.g., how much work would the auditor be expected to undertake to identify and assess “relevant industry, regulatory and other external factors” or “existing market information” beyond the overall understanding obtained as part of the auditor’s risk assessment activities performed to address the requirements of PCAOB AS 2110, *Identifying and Assessing Risks of Material Misstatement*). Any requirement for the auditor to evaluate significant assumptions should be grounded in the requirements of the applicable financial reporting framework as it is those requirements that management has to comply with (and that the company’s controls need to be designed to address).

Paragraph 17 of the Proposed Auditing Standard includes a list of factors the auditor should take into account when evaluating the reasonableness of a significant assumption based on the company’s intent and ability to carry out a particular course of action. We believe this list is generally helpful but are concerned with the auditor’s responsibility when such information does not exist. For example, the proposed requirement includes evaluating “the company’s written plans or other relevant documentation, such as budgets or minutes.” However, the company may not have formal written plans. In such scenarios, the auditor would be unable to meet the requirements of the Proposed Auditing Standard as currently written. We suggest that the lead-in sentence to the list of factors be revised to read as follows in order to consider such situations (additional text is shown using **<u>bold underline</u>**; recommended deletions to the text are shown using double ~~strikethrough~~:

> When a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should take into account the following factors**, as applicable,** in evaluating the reasonableness of the assumption:

Evaluating Audit Evidence from Events or Transactions Occurring after the Measurement Date

We support the Proposed Auditing Standard continuing to provide for the option of testing accounting estimates by considering audit evidence that may be provided by, or in relation to, events or transactions that occur after the measurement date. We believe the proposed requirement to address audit evidence that might be provided from subsequent events or transactions that are included in paragraph 28 of the Proposed Auditing Standard could be expanded to provide additional clarity regarding the assessment of whether the audit evidence is sufficient, reliable, and relevant to the company's accounting estimate.

Appendix A — Special Topics

We broadly support Appendix A, "Special Topics," of the Proposed Auditing Standard that provides requirements for the auditor to perform specific procedures when auditing fair value instruments. We commend the Board for recognizing the importance of information from third-party pricing services and brokers or dealers as sources of fair value measurements for financial instruments and addressing the topic in the Proposed Auditing Standard.

When using pricing information from pricing services or from a broker or dealer, the Proposed Auditing Standard includes factors that affect the relevance and reliability of such information, including the relationship that the pricing service or broker or dealer has with the company, by which company management has the ability to directly or indirectly control or significantly influence the pricing service.[10] We interpret the proposed requirements to imply that the auditor would be required to perform procedures to evaluate the objectivity and independence of the source of the pricing information. We request the Board to clarify the requirements of the auditor to evaluate the relationship of the source of the pricing information with the company, including factors the auditor would need to consider to evaluate.

We note that paragraph A6 of the Proposed Auditing Standard requires the auditor to perform additional audit procedures to evaluate the process used by the pricing service when the fair values are based on transactions of similar financial instruments. We request the Board to clarify what additional procedures the auditor should perform in order to evaluate such fair value estimates.

Paragraph A8 of the Proposed Auditing Standard suggests that when pricing information is obtained from multiple pricing services, less information is needed about the particular methods and inputs used by the individual pricing services when certain conditions are met. However, one of those conditions states that prices are "reasonably consistent," taking into account "the methods used," which seems to be contradictory. We interpret this to mean that the auditor would need to obtain information to understand the methods used in order to be able to obtain less information about the methods used by the individual pricing services. We believe further clarification on this condition is necessary in order to be properly applied in practice by auditors. In addition, this condition requires that prices be "reasonably consistent." We request the Board to clarify that the prices be "reasonably consistent between the pricing services from which pricing information is obtained," as we believe it could be interpreted in other ways (e.g., consistent over a period of time versus consistent at a point in time).

Timing of Substantive Procedures

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[10] See paragraphs A4c and A9a of the Proposed Auditing Standard.

Paragraph 05 of the Proposed Auditing Standard references AS 2301, which requires the auditor to design and implement appropriate responses that address risks of material misstatement. The Proposal includes the provision from AS 2301 that, as the assessed risk of material misstatement increases, the evidence that the auditor should obtain also increases. The evidence provided by substantive procedures depends on the mix of the nature, timing, and extent of those procedures.

Analyses have been performed into inspection findings (both generally, as well as specifically, related to auditing accounting estimates) supporting that time pressure during the year-end procedures is a relevant causal factor for audit deficiencies. We therefore believe that the Proposal should explicitly address whether and how substantive procedures to address accounting estimates can be performed as of an interim date. The appropriate approach for interim procedures might vary for different types of accounting estimates and would also be a function of the significance of the assessed risks of material misstatement; as such, flexibility in the wording used in the Proposed Auditing Standard would be necessary. This is also an area where implementation guidance could be developed to illustrate application of the requirements of the Proposal (see discussion in our overall comments for a possible approach to the development of such guidance). Generally, we believe that an appropriate approach would be for auditors to obtain a detailed understanding of accounting estimates as part of the risk assessment process and to perform procedures to evidence that understanding as of an interim date, including testing information used in developing accounting estimates and, if applicable, performing tests of the design and operating effectiveness of the related controls. In a well-controlled company, and particularly as it relates to less complex, less subjective accounting estimates, audit procedures performed at an interim date (including tests of relevant controls) should provide the basis for the auditor to perform less extensive procedures at year end (e.g., perform appropriate procedures to rollforward interim conclusions to the period end instead of performing all the work at the period end).

II. Proposed Appendix A to PCAOB AS 1105, *Audit Evidence Regarding Valuation of Investments Based on Investee Financial Condition or Operating Results*

As discussed in our overall comments, the requirements throughout Proposed Appendix A to PCAOB AS 1105 are confusing in the context of risk assessment and appear to contradict the PCAOB's risk assessment standards as they require the auditor to perform certain procedures based on other factors (e.g., significance of the investment), seemingly without regard for the identified and assessed risks of material misstatement. The following paragraphs illustrate specific areas in Proposed Appendix A to PCAOB AS 1105 that we believe need further clarification in order to better align the requirements with the PCAOB's risk assessment standards.

- Paragraph A1 of Proposed Appendix A to PCAOB AS 1105 states that the nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence in these situations depends on (a) the significance of the investee's financial condition and operating results to the valuation of the investment, (b) the risk of material misstatement of the associated investment, and (c) the availability of financial statements of the investee. This appears to be in conflict with the PCAOB's risk assessment standards (particularly PCAOB AS 2301), which states, "This standard establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement." We believe that the inclusion of items (a) and (c), to the exclusion of all other considerations, is inconsistent with PCAOB AS 2301.

- Paragraph A2 of Proposed Appendix A to PCAOB AS 1105 requires the auditor to read available financial statements of the investee to obtain an understanding of a variety of items. It is unclear if the auditor would be required to do this for every investment selected for testing if the valuation is based on the investee's financial condition or operating results regardless of the assessed risk of material misstatement. Paragraph A3 also includes a list of procedures the auditor is required to perform on all investments selected for testing when the valuation is based on the investee's financial condition or operating results without a qualifier as to the assessed risk of material misstatement. Additional clarity on these paragraphs is needed to more clearly align with the risk assessment standards and demonstrate how the auditor would exercise professional judgment in determining how to scale the procedures based on the level of risk.

- Paragraph A3 to Proposed Appendix A to PCAOB AS 1105 includes a requirement in paragraph A3d for the auditor to perform procedures with respect to factors if they are reported in the investee's financial statements and are reflected in the valuation of the company's investments. This requirement also seems to contradict the principles in the PCAOB's risk assessment standards as now, according to the Proposed Appendix A to PCAOB AS 1105, the auditor is to perform procedures on such factors <u>without regard to the risk of material misstatement associated with them or the potential impact they may have on the valuation of the company's investments</u>. We believe the auditor should exercise professional judgment in identifying and assessing the risks of material misstatement associated with the factors reflected in the valuation of the company's investment and perform procedures responsive to the assessed risks.

- Paragraph A4 requires the auditor to perform certain procedures if the investee's audited financial statements are significant to the valuation of the company's investments. It is unclear how this requirement interacts with the identification of risks of material misstatement as the risk assessment standards require that we identify and assess risks of material misstatement[11] and then design and perform audit procedures in a manner that addresses the assessed risks of material misstatement.[12] In accordance with the risk assessment standards, we would expect the required procedures in this paragraph to be applicable when a risk of material misstatement exists but clarity is needed.

We believe the examples provided in the Proposed Appendix A to PCAOB AS 1105 for situations in which the valuation of an investment is based on the investee's financial condition or operating results greatly expand the requirements on auditors relative to the extant standards,[13] particularly as the requirements that follow are applied to investments in these situations provided in the Proposed Appendix A to PCAOB AS 1105.

Proposed Appendix A to PCAOB AS 1105 requires the auditor to read available financial statements of the investee to obtain an understanding of whether the audit of the investee, if the investee's financial statements were audited, indicate that the audit was performed under PCAOB standards and expressed an unqualified opinion. In instances in which the financial statements are audited under other auditing standards (e.g., the auditing standards of the American Institute of Certified Public Accountants (AICPA) or the standards of the IAASB), it is unclear as to the impact. We believe additional clarification is needed on this matter because, as currently written, this may be interpreted as an implied requirement for all investees to have audits performed in accordance with PCAOB standards, when there is no requirement for such an audit.

The requirement for the auditor to read available interim financial statements of the investee and other available information and make inquiries of the investee to identify subsequent events and transactions that could be material to the company's financial statements may pose a challenge to auditors that will be difficult, if not impossible, to overcome. It is unclear whether the auditor would obtain such information directly from the investee or the investor can provide the information to the auditor as they will, and should, have controls and processes in place to monitor such information.

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[11] See PCAOB AS 2110.01.

[12] See PCAOB AS 2301.08.

[13] See PCAOB AS 2503.28-34.

Further, the definition of “available” is unclear in the requirement. Our concern is the term could be interpreted differently without further clarification. For example, available could be interpreted to mean public, generated by the company, or given to the investor; these different interpretations of “available” would result in inconsistent application of the requirements. We request the Board to provide further clarification on the definition of “available” for purposes of this requirement. As it relates to the information to be obtained by the auditor as a result of making inquiries of the investee, we are concerned with this requirement given there is no responsibility for the investee to provide complete and accurate information to the investor’s auditor on a timely basis. The note to paragraph A4b of the Proposed Appendix A to PCAOB AS 1105 provides for the auditor to perform alternative procedures to test the company’s procedures for understanding the characteristics of underlying investments and assessing the valuation process, rather than obtaining information about the audit or reviewing audit documentation when the audit is performed for an investment company. We believe this has broader applicability and should not be limited to audits of investment companies, but rather should be available to other situations in which we are performing procedures to address the risks of material misstatement related to the valuation of investments based on investee financial condition.

If the investee’s audited financial statements are significant to the valuation of the company’s investment, the auditor is required to determine whether the audit of the investee provides sufficient appropriate audit evidence by performing procedures outlined in Proposed Appendix A to PCAOB AS 1105. We request the Board to clarify the definition of “significant” in the context of this requirement as we believe it may be interpreted differently by auditors in practice. The procedures provided in Proposed Appendix A to PCAOB AS 1105 to determine whether the audit of the investee provides sufficient appropriate audit evidence require the auditor to obtain information about the procedures the investee’s auditor performed and the results thereof or review the audit documentation of the investee’s auditor. We interpret this requirement for the auditor to go beyond the report of the investee auditor on the investee’s audited financial statements and obtain additional information from the investee’s auditor regarding the procedures they performed. We believe that in some circumstances this requirement would be challenging for auditors to meet and even in situations in which the investor auditor is able to interact with the investee auditor, the nature and extent of information obtained is a matter of professional judgment and should be aligned with the significance of the assessed risks. We also believe it is unclear what “obtain information” means and whether it would be considered audit evidence.

PCAOB AS 2410, *Related Parties*, establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. Under this auditing standard, the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. As such, PCAOB AS 2410 currently provides for an approach for the auditor to evaluate relationships and transactions between the company and its related parties. It is unclear why, as part of Proposed Appendix A to PCAOB AS 1105, the auditor is required to perform procedures to identify significant transactions between the company and the investee and to evaluate the accounting for and disclosure of those transaction. We propose revising this requirement to link to PCAOB AS 2410 to avoid confusion concerning what procedures would be performed as part of this requirement that are not already included in AS 2410.

III. Proposed Amendments to the Risk Assessment Standards

PCAOB AS 1105

In the proposed amendments to PCAOB AS 1105, a note is added to paragraph 08 that requires the auditor to evaluate the effect of restrictions, limitations, or disclaimers on the reliability of evidence provided to an auditor by a third party if such evidence is subject to any of these matters. In applying the requirements in this proposed amendment, we believe it would be beneficial to provide additional clarification as to what a sufficient evaluation would include, including how the auditor would be expected to determine whether the evidence was ultimately sufficiently reliable.