August 30, 2017

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

**RE: PCAOB Rulemaking Docket Matter No. 043**

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* (the "proposed standard") – and proposed amendments to PCAOB auditing standards included in PCAOB Release No. 2017-002 (the "release"). We commend the Board and its staff for its work to build on the feedback received on its August 2014 staff consultation paper and move forward with a standard-setting proposal.

**Overview**

The release outlines the PCAOB's three main reasons to improve standards for the auditing of accounting estimates, including fair value measurements. Our perspectives on each of these reasons, and related matters for the PCAOB to consider in finalizing the proposal, are summarized below.

***Eliminating differences among the three existing estimates standards***

We support the PCAOB's approach to developing a single more uniform principles-based standard to address the auditing of accounting estimates, including fair value measurements. We concur with the PCAOB's decision to retain the three approaches to testing estimates that are used today and allow the auditor to tailor the audit approach based on the most effective means of obtaining sufficient appropriate audit evidence depending on the specific underlying risks of material misstatement.

As is the case with many existing PCAOB standards, the proposed standard will call for firms to develop and maintain specialized guidance and tools to facilitate and promote a tailored application to particular estimates. Specifically, we envision a need for firms to continue to develop and maintain guidance to help auditors address the auditing of existing and new financial reporting requirements (e.g., the new standards addressing revenue from contracts with customers and allowances for credit losses) as well as continually evolving business transactions and arrangements in which accounting estimates are prevalent and significant. Guidance will also continue to be needed to address areas of significant auditor judgment, including how the auditor's approach to testing management's process might differ if a risk is assessed as a significant risk. The PCAOB may find it necessary over time to take additional steps to promote consistency in practice if concerns arise over the effectiveness of diverse approaches developed by individual firms.

***Updating requirements in auditing standards in light of prevalence of the use of third-party pricing sources and other developments***

Current PCAOB standards are largely focused on using information produced by the company. A number of steps taken by the PCAOB in the proposal appropriately acknowledge the growing use of information from third parties by companies and auditors. The proposed requirement in paragraph .20 of the proposed standard, together with Appendix A, appropriately recognizes the importance of information provided from third-party sources, such as pricing services and brokers or dealers, as inputs used by management in its estimation process or by the auditor for the purpose of developing an independent expectation.

***Specifically addressing the application of professional skepticism and responding to potential management bias***

Any new standard should support the performance of appropriate, scalable auditing procedures, including reinforcing professional skepticism and appropriate evaluation of the audit evidence. The PCAOB's approach to align the proposed standard with existing requirements in the risk assessment standards as well as AS 2810, *Evaluating Audit Results*, is a helpful way to reinforce the concept of professional skepticism and the need for auditors to consider potential management bias throughout the audit. We believe the enhanced focus on data and significant assumptions, including the requirement in paragraph .16a for the auditor to consider whether management has a reasonable basis for its judgments, are appropriate ways to prompt auditors to devote attention to addressing potential management bias in accounting estimates. However, we are concerned with how certain requirements have been articulated in the proposed standard, which is explained in more detail below.

In summary, we support the PCAOB's objective to strengthen the auditing of accounting estimates. With some changes, the proposal could help to accomplish this objective. In many areas, the proposal will better align standards with current practices, which may promote more consistency in practice and enhance audit quality. We believe much of the current proposal is generally consistent with how we as a firm approach the auditing of accounting estimates today, although initial implementation considerations and our limited outreach to engagement teams have identified areas in which further guidance in the proposed standard would be helpful to clarify the PCAOB's expectations.

In this letter, we have included certain suggestions related to some of the specific requirements described in, or implied by, the proposed standard to address what we see as potential practical challenges or areas where additional clarification would be helpful. We have organized our observations and recommendations into the following topical areas:

- Valuation of investments based on investee financial condition or operating results
- Third-party pricing sources
- Other concerns and potential areas for clarification
- Other matters

## I. Valuation of investments based on investee financial condition or operating results

Proposed Appendix A to Auditing Standard 1105, *Audit Evidence,* 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. This material builds upon paragraphs .28–.34 and .56–.57 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. The release states that the proposed amendments are intended to better align the required procedures to evaluate evidence obtained regarding the valuation of investments based on the investee's financial condition or operating results with the risk assessment standards.

These requirements would apply to a number of circumstances, including certain investments accounted for by the equity method and investments accounted for by the cost method for which there is a risk of material misstatement regarding impairment. The requirements would also apply to investments measured at fair value for which the investee's financial condition or operating results are a significant input into the fair value determination (for example, when the fair value of an investment is based on revenue or earnings multiple derived from the financial statements of a company). Significant assumptions used in the valuation of certain assets may not necessarily be (entirely) derived from financial statements. In some cases, key assumptions may be derived from information underlying the financial statements or may be based on other financial or non-financial information. Given the different circumstances, we believe it is important for auditing standards to direct auditors to consider the nature of the applicable accounting requirements and the evidence likely to be available to support the valuation. It is also necessary for auditors to obtain an understanding of management's process and controls over the recording of amounts in the financial statements related to its investment. These matters should then be taken into account in designing procedures that appropriately respond to the assessed risks of material misstatement. The auditor's focus in obtaining evidence should be on considering the relevance and reliability of information used as inputs to a valuation, including any controls relevant to this information. Audited financial statements can represent relevant and persuasive evidence when available, but are not the only source of potential evidence that auditors may obtain in relation to valuations.

In light of these views, we support the proposed language in paragraph .A1 of Appendix A that sets out a risk-based approach. However, we believe the requirements that follow are written in a manner that is overly prescriptive and would diminish the application of sound risk-based judgment. In our view, the requirements as drafted may be impracticable or impossible to implement.

***The expected procedures if the investee's audited financial statements are significant to the valuation of the company's investment (paragraph .A4 of Appendix A)***

We believe the PCAOB's intent in paragraph .A4 is to set out expectations in cases when the investee's audited financial statements – or information derived therefrom – are a significant input into the valuation (i.e., akin to data). The requirements appear to be premised on the assumptions that information used by management in the valuation is always derived directly from audited financial statements (without adjustment) and these audited financial statements will be available on a timely basis. If audited financial statements are available and are significant to the valuation of the company's investment, paragraph .A4 of the proposal would require the auditor to determine whether the audit of the investee provides sufficient appropriate audit evidence by performing certain procedures. Requiring the auditor to obtain information about the procedures the investee's auditor performed and the results thereof, or to review the audit documentation of the investee's auditor, may not be possible. In certain cases, the investee's auditor will not be under any obligation to provide information about the procedures the investee's auditor performed or provide access to audit documentation and may have little incentive to do so (e.g., given concerns over potentially creating liability for the investee or the auditor). We encourage the Board to consider replacing paragraph .A4b with an acknowledgment that, in some instances, obtaining this access may not be necessary or possible and, if this is the case, the auditor should focus efforts on the consideration of the processes and controls management has in place over the underlying information.

***The expected procedures if the investee's financial statements are not audited or the audited financial statements do not provide sufficient appropriate audit evidence (paragraph .A5 of Appendix A)***

If audited financial statements are not available or do not provide sufficient appropriate audit evidence, the expectation in the proposal is that the auditor will have access to investee management and be able to perform additional audit procedures or arrange for the investee's auditor to perform additional procedures. We have a significant concern that these requirements as drafted will create practical challenges in implementation.

For many noncontrolling investments, company management may not always have direct access to investee management to arrange for the company's auditor to perform the proposed procedures, and in many cases the company or the company's auditor may not be entitled to such information pursuant to the terms of the investment arrangement. We have a similar concern in relation to the proposed requirement in paragraph .A3b for the company's auditor to make inquiries of the investee regarding subsequent events, as often the company's auditor does not have direct access to investee management.

As noted in describing our concern with the proposed additional procedures when audited financial statements are available, it may not be possible for the company's auditor to compel an investee's auditor to perform additional procedures given the lack of a relationship between the two. As drafted, the requirements in paragraphs .A4 and .A5 would result in an approach similar to situations that involve the auditor's supervision of other auditors, which may not be appropriate in certain circumstances.

***Application of paragraph .A4***

The note to paragraph .A4 of Appendix A proposes an exception to the requirements of that paragraph for audits of investment companies in relation to obtaining information about the audit of the investee fund or reviewing audit documentation if the investee fund's audited financial statements are significant to the valuation of the investee fund presented by the investment company. We believe in such circumstances the auditor should understand and assess the processes and controls that management of the investor fund has in place, including their initial and ongoing due diligence. It is unclear whether the PCAOB intends additional audit effort through its requirement in the note to paragraph .A4 that requires the auditor to "test" the investment company's procedures. We also suggest the PCAOB consider whether additional exceptions should be permitted for other circumstances in which auditors cannot obtain access to the investee auditor or related audit documentation to overcome the practical limitation in applying paragraph .A4 in such circumstances. For example, we observe that the practical expedient set out in ASC 820, *Fair Value Measurement,* Paragraph 10-35-50, applies more broadly than to investment companies.

***The potential presumption that audits of investees must be conducted under PCAOB standards***

Paragraph .A2 of Appendix A would require the auditor to read available financial statements of the investee to obtain an understanding of whether the report of the investee's auditor indicates that the audit was performed under PCAOB standards and expressed an unqualified opinion. There are often situations when the financial statements of investees are audited under other auditing standards (for example, AICPA or IAASB standards). We do not believe the PCAOB intended to suggest that financial statements not audited in accordance with PCAOB standards would be unacceptable when valuation of an investment is based on the investee's financial condition or operating results. Use of different standards could be a factor to consider in evaluating the relevance and reliability of the audited financial statements, although we believe it would be helpful for the PCAOB to discuss the risk it is intending to address through this requirement.

## II. Third-party pricing sources

We support the inclusion of guidance addressing the use of pricing information from third parties as audit evidence. With respect to the overarching requirement in paragraph .A2 of the Appendix to proposed AS 2501, we question whether use of the word "tests" is appropriate in relation to pricing information provided by a third party used by management, as we believe it may be inconsistent with other requirements in the proposed standard. For example, the proposed requirements in paragraphs .A4–.A5 focus on relevance and reliability of pricing information in a manner similar to the proposed requirement in paragraph .13 that addresses the use of data from an external source and links to AS 1105. In addition, the release notes that the procedures in Appendix A apply to pricing information obtained from pricing sources used by management in their estimation process as well as from those obtained by the auditor for the purpose of developing an independent expectation.[1] The PCAOB should clarify whether the use of the word "tests" in paragraph .A2 is intended to set out a different work effort than what would be required by AS 1105 to evaluate information from external sources.

The release specifically notes that "like the existing estimates standards, the proposed standard does not require audit procedures to be applied to each individual financial instrument."[2] We believe this approach appropriately recognizes the manner in which information is typically received from pricing sources and how current practice takes this into account. We agree this approach focuses on assessing the relevance and reliability of the pricing information obtained and is better aligned with the auditor's assessment of risk. We suggest the following note to clarify paragraph .A4:

> Note: The procedures in paragraphs .A4–.A8 are not required to be applied to each individual financial instrument.

We support a risk-based approach to considering the nature and extent of procedures necessary to assess the relevance and reliability of evidence provided by third-party pricing sources. We find the factors in paragraph .A4 particularly useful in demonstrating the variability of third-party pricing sources and agree with the PCAOB's views in the release that the reliability of this information may differ, including the difference between pricing services and brokers or dealers. We agree it is useful for auditors to consider the factors outlined in paragraph .A5 of the proposed standard in considering the relevance of pricing information.

Paragraph .A4 of the proposed standard highlights that a consideration for the auditor in evaluating the reliability of pricing information is whether the pricing service has a relationship with management by which management has the ability to directly or indirectly control or significantly influence the pricing service. In practice, management may on a routine basis provide its specific trade activity back to the pricing service and may routinely challenge the pricing service's prices. We do not believe the PCAOB

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1 See page A3-34 of the release.

2 See page A3-34 of the release.

would view this as a means of significantly influencing the pricing service. We believe the practices we have observed are not indicative of management exerting control or significant influence over a pricing service. We believe the PCAOB should give further consideration to the specific risks that are intended to be addressed through this requirement and reconsider its necessity. In addition, while we believe the experience and expertise of the pricing service should be taken into account, the proposed requirement in paragraph .A4 should not imply that a pricing service that does not have lengthy experience pricing a particular instrument could not provide relevant and reliable information to be used as audit evidence. This is because a pricing source may have experience with pricing similar instruments and may have a robust process for doing so, which could make it a relevant and reliable source.

## III. Other concerns and potential areas for clarification

The following represent areas where we are unclear about the intent of certain requirements and have concerns about the potential implications of the proposal, as well as areas where we believe clarifications to the proposed standard would be helpful to support its effective implementation.

### *Retrospective reviews*

We note the PCAOB's proposal to amend AS 2401, *Consideration of Fraud in a Financial Statement Audit,* to clarify the auditor's responsibilities when performing a retrospective review of accounting estimates and align them with the requirements in the proposed standard. It would be helpful for the PCAOB to clarify whether its intent in proposing new paragraph .60A in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, was to provide explanation of the concept of "significant accounting estimates."

Previously, a retrospective review was required for "significant accounting estimates," which paragraph .64 of AS 2401 notes should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. We are of the view that changing the requirement to "the accounting estimates in significant accounts and disclosures" could then require a retrospective review to be performed for many more estimates when the estimation risk may be much more straightforward. We believe it is appropriate to continue to limit the requirement to perform retrospective reviews to a subset of accounting estimates, for example those that have high estimation uncertainty, and believe the proposal should include language that affirms this point.

### *Significant assumptions*

We appreciate the focus on significant assumptions, as well as the factors relevant to identifying significant assumptions in paragraph .15 of the proposed standard. These factors are generally consistent with how we evaluate significant assumptions today but could help to promote broader consistency in practice. However, paragraph .15e of the proposed standard on its own could inappropriately result in auditors determining that all assumptions underlying an estimate are significant. We recommend the Board include a note to paragraph .15 of the proposed standard that describes how the factors work together to aid the auditor in understanding the assumptions and determining which are significant to the estimate. We offer the following as a suggestion:

> Note: An accounting estimate may be based upon numerous individual and specific assumptions that will vary with the characteristics of the item being measured and the method used by the company in developing the accounting estimate. Not all assumptions

may be significant assumptions; rather, the auditor's consideration of these factors in identifying significant assumptions should take into account the assessed risks of material misstatement.

The note to paragraph .15 states that the auditor's identification of significant assumptions should include any assumptions the company has identified as significant assumptions used in an accounting estimate. Generally, management's processes and controls are designed to operate at a greater level of precision than the auditor's materiality and testing thresholds given their responsibilities for maintaining books and records and systems of internal accounting controls. Due to this difference, it is possible the auditor's conclusion as to which assumptions are significant could differ from management's. If the auditor is able to determine that an assumption is not significant (based on the factors provided in paragraph .15), the auditor should not be required to identify the assumption as significant solely because management did. As such, we recommend that the PCAOB remove this note from the proposed standard.

Finally, we note the requirement in paragraph .18 for auditors to obtain an understanding of how management has analyzed the sensitivity of its significant assumptions for critical accounting estimates. We agree this understanding could provide useful information about the efficacy of management's process, but the requirement may not always apply. For example, management may assert it is unable to analyze the sensitivity of some assumptions to change or may only do an analysis in the aggregate, which in our view does not provide meaningful information. As such, we are concerned that the proposed requirement may place undue emphasis on this particular management discussion and analysis (MD&A) disclosure, and believe the other requirements in paragraphs .16–.17 sufficiently address the auditor's considerations in relation to significant assumptions. If the PCAOB decides to retain the proposed requirement, clarification will be necessary to highlight that the intent is for the auditor to understand whether and, if so, how management analyzed the sensitivity of its significant assumptions to change. We believe the PCAOB should also explicitly acknowledge that considering information included in MD&A in accordance with the proposed standard does not change the auditor's responsibilities for this information in accordance with AS 2710, *Other Information in Documents Containing Audited Financial Statements,* (i.e., the new requirement is not intended to create new auditor responsibilities related to management's MD&A disclosures).

***Increased auditor focus on bias***

We agree that the consideration of potential management bias, and whether such bias results in a material misstatement, is an essential component of the auditor's evaluation of accounting estimates. We support many of the proposed requirements that focus auditors on their obligations to exercise professional skepticism and to identify management bias when evaluating audit results, including the proposed amendment to AS 2110 to require key engagement team members to discuss how the financial statements could be manipulated through management bias. We also support recasting certain existing requirements using more neutral terminology. However, the phase "free from bias that results in a material misstatement" in the objective in paragraph .03 and the requirement in paragraph .09 of the proposed standard could suggest a broader obligation than what is required. A more straightforward focus in the objective would more closely align with AS 2810. We suggest the following:

.03 The objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether accounting estimates are reasonable in the circumstances, <u>including whether accounting estimates:</u>
- <u>(a)</u> have been accounted for and disclosed in conformity with the applicable financial reporting framework,<u>;</u> and
- <u>(b)</u> are <u>not materially misstated as a result of bias</u> ~~free from bias that results in material misstatement~~.

We also recommend that the PCAOB consider similar changes to paragraph .09 of the proposed standard.

***Contradictory evidence***

The auditor applies the requirements of AS 1105 for purposes of designing and performing audit procedures to obtain sufficient appropriate audit evidence. Paragraph .02 of AS 1105 states audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions. In executing the audit, the auditor considers evidence obtained in other areas of the audit that may contradict evidence provided by the company to support an accounting estimate. This includes situations where the auditor has chosen to develop an independent expectation of an accounting estimate. Regardless of the nature of planned audit procedures, the auditor understands management's process for developing the accounting estimate and considers whether the auditor is aware of potentially contradictory audit evidence, either related to the estimate or from evidence obtained elsewhere in the audit. We recommend that the Board update the proposed standard to include the requirement in paragraph .02 of AS 1105. This would help clarify how an auditor should approach evaluating audit evidence obtained to determine if it corroborates or contradicts management's conclusions about the reasonableness of accounting estimates.

***Developing an independent expectation of the estimate***

We agree with the PCAOB's view that the auditor's understanding of the process the company used to develop the estimate, and the result of tests of relevant controls, should necessarily inform the auditor's decisions about the approach to take to auditing an estimate. The PCAOB should make clear, when developing an independent expectation of an estimate, the auditor's testing of management's process is limited to those areas on which the auditor intends to rely for purposes of developing the expectation. Said differently, if an auditor intends to use the same data or some of the significant assumptions used by management in its valuation, the auditor would need to test the data and certain assumptions. On the other hand, if the auditor is using a proprietary model to develop the independent expectation, the auditor would need to understand, but not necessarily evaluate, the company's method, since the auditor would be required to have a reasonable basis for the method used to develop the independent expectation in accordance with paragraph .22 of the proposed standard.

***Company's use of a specialist***

Paragraph .19 of the proposed standard incorporates elements of PCAOB Release No. 2017-003, in particular proposed Appendix B to AS 1105. Specifically, the requirement in paragraph .19 refers to "testing and evaluating the company specialist's work in conjunction with testing the company's process." We suggest that proposed AS 2502 be expanded to more closely mirror the underlying requirements in paragraphs .B6 and .B8 of proposed Appendix B to AS 1105, which differentiate between (1) testing the accuracy and completeness of company-produced data used by the specialists and (2) evaluating the relevance and reliability of data obtained from external sources, as well as evaluating other aspects of the specialist's work as described in paragraph .B8 of proposed Appendix B to AS 1105.

***Implications of the proposal on estimates other than fair value measurements***

While we are supportive of the PCAOB establishing a uniform principles-based standard to address the auditing of accounting estimates, our limited field testing has identified potential concerns with the applicability of certain of the requirements to less complex estimates. Notwithstanding the requirements are capable of being implemented across a variety of estimates, we question whether certain requirements in the proposed standard would be necessary when dealing with estimates other than fair value measurements. For example:

- Requiring an explicit evaluation (as contemplated by paragraph .10) of whether the method used by a manufacturing company to determine an inventory reserve is appropriate for the industry in which the company operates may be unnecessarily prescriptive.

- Requiring auditors to expressly consider – and document – all the factors in paragraph .16 for significant assumptions could increase costs without a corresponding benefit to audit quality. For certain estimates, it may be sufficient for the auditor to evaluate whether the company has a reasonable basis for the significant assumptions used.

- While we agree considering whether data and significant assumptions are internally consistent is appropriate, the extent of effort necessary to make an evaluation as contemplated by paragraph .14 may outweigh the benefits for certain estimates.

- Prescriptive requirements (such as paragraph .16b) for less complex estimates could unnecessarily lead to a "checklist-based approach" to documentation, rather than a more focused and straightforward consideration of the results of the auditor's procedures in determining whether the estimate was reasonable.

The identification of these matters through initial and limited field testing suggests the PCAOB may benefit from further analysis of the impact of its proposal across the audits of a wide range of estimates and valuations (e.g., varying by industry, size, complexity).

## IV. Other matters

***Applicability of the proposed standard***

We believe the PCAOB should develop its performance standards in a way that can be scaled and tailored to any audit. Having separate performance standards for audits of emerging growth companies or audits of brokers and dealers would be confusing and unhelpful to promoting consistency in audit quality. Accordingly, we support the PCAOB's position that the proposed standard and proposed amendments would apply to audits of emerging growth companies and to audits of brokers and dealers and have not identified any additional areas of concern unique to those audits.

***Effective date***

The PCAOB has suggested an effective date for audits for fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if that approval occurs in the fourth quarter). The reasonableness of this timeframe is dependent upon how the PCAOB considers and responds to the observations and suggestions from commenters and the extent to which the final standard is consistent with current practice.

***Coordination with the International Auditing and Assurance Standards Board (IAASB)***

We note the ongoing cooperation between the IAASB and PCAOB, primarily through outreach and PCAOB staff's participation in the IAASB's ISA 540 Task Force. It is clearly in the public interest to reach solutions that can bring about consistent, high-quality auditing standards when addressing the same or similar subject matters and auditing concepts. While there can be benefits to exposing different proposals by the boards concurrently, major differences in the underlying approach to auditing accounting estimates are not helpful. In our view, this risks confusion and will not help bring consistency in practice to how accounting estimates are addressed in the audit. We encourage both Boards to continue the dialogue as they move forward in finalizing their respective proposals.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Leonard Combs (973-236-5265) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

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