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August 30, 2017

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

PCAOB Rulemaking Docket Matter No. 043: PCAOB Release No. 2017-002, *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards* (June 1, 2017)

Dear Ms. Brown:

This letter provides the GAO's comments on the Public Company Accounting Oversight Board's (PCAOB) referenced proposed auditing standard and amendments. GAO promulgates generally accepted government auditing standards, which provide professional standards for auditors of government entities in the United States.

We support the PCAOB's efforts to update the standards for auditing accounting estimates. However, we believe that the proposed standard could benefit from aligning certain requirements with proposed requirements in the International Auditing and Assurance Standards Board's Proposed International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*. We believe that harmonization will reduce inconsistencies between two similar standards. Specifically, we suggest consolidating the set of requirements for identifying and assessing the risks of material misstatement specific to accounting estimates in one standard rather than amending other standards with risk assessment requirements for estimates. Given the deficiencies in auditing accounting estimates identified by PCAOB inspections staff, we believe that grouping the risk assessment requirements specific to auditing estimates in one standard will enhance auditors' ability to identify and assess the risks of material misstatement related to accounting estimates and to tailor the auditor response to the identified risks. We support the proposed organization of requirements in the standard by methods, data, and assumptions. We have found this approach to be useful in our audits of complex estimates in the federal government.

The PCAOB is seeking comment on a number of questions related to the proposed standard. Our responses, as applicable, to the PCAOB's questions follow in an enclosure to this letter. We believe that our suggestions will enhance the consistency of the standard with those promulgated by other standard setters.

Thank you for the opportunity to comment on these important issues. If you have questions about this letter or would like to discuss any of the matters it addresses, please contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,

A handwritten signature in black ink, appearing to read "James R. Dalkin". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Enclosure

Response to Questions

Discussion of the Proposed Rules

- 1. Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns related to auditing accounting estimates that the Board should address? Are there additional concerns that the Board should seek to address?**

We believe that the discussion of the reasons to improve auditing standards sufficiently describes the nature of concerns related to auditing accounting estimates that the Public Company Accounting Oversight Board (PCAOB) should address. We have not identified any additional concerns that the board should seek to address.

- 2. Does the information presented above reflect current audit practice? Are there additional aspects of current practice of both larger and smaller audit firms that are relevant to the need for standard setting in this area?**

We believe that the information presented above reflects current audit practice. We have not identified any additional aspects of current practice that are relevant to the need for standard setting in this area.

- 3. Are there additional changes needed to improve the quality of audit work related to accounting estimates that the Board should include in its proposal?**

See our responses to questions 17, 18, 19, 20, 22, 29, 41, 42, and 43.

- 4. Are there any other areas relating to auditing accounting estimates that the Board should address in the proposed standard (e.g., are there related areas of practice for which additional or different requirements are needed, such as the use of data analytics)?**

We have not identified any other areas relating to auditing accounting estimates that the Board should address in the proposed standard.

- 5. Are there considerations affecting accounting estimates relative to the financial reporting frameworks, such as recent changes to revenue recognition or impairment of financial instruments, that the proposed standard does not adequately address?**

See our response to question 17.

Economic Considerations

- 6. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to further assess current practice.**

We are not providing comments in response to this question.

- 7. The Board requests comment generally on the analysis of the need for the proposal. The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.**

We are not providing comments in response to this question.

- 8. The Board requests comment generally on the potential benefits to investors and the public. Are there additional benefits the Board should consider?**

We are not providing comments in response to this question.

- 9. The Board requests comment generally on the potential costs to auditors and companies they audit. Are there additional costs the Board should consider?**

We are not providing comments in response to this question.

- 10. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.**

We are not providing comments in response to this question.

- 11. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release adequate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?**

We are not providing comments in response to this question.

Special Considerations for Audits of Emerging Growth Companies

- 12. The Board requests comment generally on the analysis of the impacts of the proposal on Emerging Growth Companies (EGCs). Are there reasons why the proposal should not apply to audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?**

We are not providing comments in response to this question.

- 13. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?**

We are not providing comments in response to this question.

Applicability of the Proposed Requirements to Audits of Brokers and Dealers

- 14. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?**

We are not providing comments in response to this question.

Effective Date

15. How much time following SEC approval would accounting firms need to implement the proposed requirements?

We are not providing comments in response to this question.

16. Would the effective date as described above provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

We are not providing comments in response to this question.

Proposed Standard

17. Are the scope and objective of the proposed standard clear?

We believe that the scope of the proposed standard is clear. However, we suggest that the objective of the standard be broadened to state that auditors should determine whether accounting estimates and disclosures are reasonable in the context of the applicable financial reporting framework. We believe that the proposed objective to determine whether accounting estimates have been disclosed in conformity with the applicable financial reporting framework does not properly address situations in which management may need to provide disclosures beyond those specifically required by the framework that are necessary to achieve the fair presentation of the financial statements as a whole. We also believe that the proposed objective to determine whether accounting estimates are free from bias that results in material misstatement is too narrow. While we acknowledge the importance of assessing bias in accounting estimates, the proposed objective does not address the other possible causes of material misstatement. In our view, broadening the objective will increase the clarity of the standard; will make it easier for auditors to effectively apply; and will harmonize the objective with the International Auditing and Assurance Standards Board's (IAASB) International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* (ED-540).

18. Are there challenges in tailoring the scalability of the auditor's response to identified risks of material misstatement as described in the proposal? If so, what are they and how can they be addressed?

We agree that the proposed standard will be scalable if auditors respond to risk of material misstatement and focus on the standard's objective to obtain sufficient appropriate evidence. However, in our view, the proposed requirements for identifying, assessing, and responding to risks of material misstatement could be consolidated and clarified.

Specifically, we suggest that the proposed standard could benefit from the following revisions:

- Consolidating the set of requirements for identifying and assessing the risks of material misstatement specific to accounting estimates in one standard, similar to paragraphs 10 through 13 of the IAASB's ED-540, rather than amending other standards with risk assessment requirements for estimates. For example, we believe that it would be appropriate to require gaining an understanding of internal control specific to accounting estimates in the proposed standard. We also suggest that the proposed standard require auditors to perform a retrospective review of accounting estimates (currently in AS

2401.64), and that the PCAOB revise the requirement for retrospective review to note that it will assist in identifying and assessing the risk of material misstatement, similar to paragraph 11 of the IAASB's ED-540.

- Defining “components” in paragraph .04 of the proposed standard.
- Clarifying how auditors demonstrate that the responses to the assessed risks of material misstatement involve the application of professional skepticism in gathering and evaluating audit evidence, as required by the third note in paragraph .05. We suggest that the PCAOB could instead require auditors to evaluate both corroborative and contradictory audit evidence similar to the requirement in the IAASB's ED-540, paragraph 23. We believe that this approach could be more straightforward for auditors to implement when evaluating audit evidence related to estimates.

Given the deficiencies in auditing accounting estimates identified by PCAOB inspections staff, we believe that revising the proposed requirements for identifying, assessing, and responding to risks of material misstatement will enhance auditors' ability to identify and assess the risks of material misstatement related to accounting estimates and to tailor the auditor response to the identified risks.

19. Should the proposed standard limit the auditor's selection of an approach and, if so, under what circumstances?

We support the proposed standard that allows the auditor to use judgment in determining the appropriate approach or approaches for testing the accounting estimate. However, we encourage the PCAOB to consider whether auditors should always evaluate audit evidence from events or transactions occurring after the measurement date related to the accounting estimate. In our view, there would be limited circumstances in which this approach would not provide appropriate audit evidence to determine whether accounting estimates are reasonable.

20. Are the proposed requirements for evaluating the company's method used to develop accounting estimates clear? Are there other matters that are important to evaluating a method that should be included in the proposed requirements?

We believe that the proposed requirements for evaluating the company's method for developing accounting estimates are clear. We suggest that the proposed standard could benefit from additional requirements for evaluating the company's method, such as those included in the IAASB's ED-540, including evaluating whether

- the design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;
- adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances;
- the integrity of significant data and significant assumptions has been maintained in applying the method; and
- calculations are mathematically accurate and appropriately applied.

21. Are there any further requirements regarding testing internal data or evaluating the relevance and reliability of external data that the Board should consider?

We believe that the proposed requirements regarding testing internal data and evaluating the relevance and reliability of external data are sufficient.

22. Are the proposed requirements to evaluate whether data was appropriately used by the company clear? Are there other criteria the auditor should assess to make this evaluation? If so, what are they?

We believe that the proposed requirements for whether the company appropriately used the data are clear. The auditor should also assess whether management has appropriately understood or interpreted significant data, including with respect to contractual terms in evaluating whether the company appropriately used the data, similar to requirements in the IAASB's ED-540.

23. Are the proposed requirements for the auditor to identify significant assumptions and to evaluate whether the company has a reasonable basis for significant assumptions used clear? Do those requirements pose any practical difficulties and, if so, how could the proposed standard be revised to address those difficulties?

We believe that the proposed requirements for the auditor to identify significant assumptions and to evaluate whether the company has a reasonable basis for significant assumptions used are clear. We do not foresee those requirements posing any practical difficulties.

24. Are the proposed requirements described above for developing an independent expectation clear? Are there other matters relevant to the proposed requirements that the Board should consider?

We believe that the proposed requirements for developing an independent expectation are clear and sufficient.

25. Is the proposed requirement that the auditor have a reasonable basis for the assumptions and method used when the auditor independently derives assumptions, or uses his or her own method in developing an independent expectation, clear? Are there other matters relevant to the proposed requirement that the Board should consider?

We believe that the proposed requirement that the auditor have a reasonable basis for the assumptions and method used when independently deriving assumptions or using his or her own method in developing an independent expectation is clear and sufficient.

26. Are there instances today when auditors generate or accumulate data directly and use that data to develop an independent estimate, rather than obtain data from a third party or the company under audit? If so, please describe those instances and how the proposed requirements should address them.

We have not encountered any instances in GAO audits when auditors generate or accumulate data directly and use those data to develop an independent estimate, rather than obtain data from a third party or the entity under audit.

27. Are there instances when auditors obtain methods from third parties in developing an independent expectation of an accounting estimate? If so, please describe those instances and whether and how the proposed requirements should address them.

We have not encountered any instances in GAO audits when auditors obtain methods from third parties in developing an independent expectation of an accounting estimate.

28. Are the proposed requirements for developing an independent expectation when using the company's data, assumptions, or methods clear?

We believe that the proposed requirements for developing an independent expectation when using the company's data, assumptions, or methods are clear.

29. Is the proposed requirement for an auditor's range clear? Are there other matters relevant to the auditor developing a range that the Board should consider?

We believe that the proposed requirement for an auditor's range is clear. However, we suggest that the PCAOB consider whether the proposed standard could benefit from additional guidance regarding how to assess material misstatement when there is a large degree of measurement uncertainty, similar to guidance in paragraph A144 in the IAASB's ED-540. Also, the PCAOB could consider whether to provide guidance to auditors on when it may be appropriate to discuss significant measurement uncertainty in the auditor's report. While this additional discussion in the auditor's report could be considered a critical audit matter, we believe that auditors may find guidance on significant measurement uncertainty helpful.

30. Are there additional factors that the auditor should take into account when evaluating the relevance of the audit evidence obtained from events or transactions occurring after the measurement date?

We believe that the factors in the proposed standard are sufficient.

31. Are there other matters relevant to financial instruments that should be considered or included in Appendix A of the proposed standard?

We did not identify any other matters relevant to financial instruments that should be considered or included in appendix A of the proposed standard.

32. Are there other matters that the auditor should take into account when obtaining an understanding of the nature of the financial instruments being valued? If so, what are they?

We are not aware of any other matters that the auditor should take into account when obtaining an understanding of the nature of the financial instruments being valued.

33. Are there other sources of pricing information for financial instruments that should be addressed in the proposed standard?

We are not aware of any other sources of pricing information for financial instruments that should be addressed in the proposed standard.

34. Are the requirements for using information from a pricing service clear? Are there other requirements that should be considered? For example, are there other methods used by pricing services to generate pricing information that are not currently addressed in the proposed standard?

We believe that requirements for using information from a pricing service are clear, and we are not aware of any other requirements that should be considered.

35. Do the requirements included in the proposed standard pose operational challenges for audit firms that use centralized groups? If so, what are they and how could they be addressed in the proposed standard?

We are not providing comments in response to this question.

36. Is the auditor's responsibility when evaluating relevance and reliability of pricing information from multiple pricing services clear?

We believe that the auditor's responsibility when evaluating relevance and reliability of pricing information from multiple pricing services is clear.

37. Are there other characteristics affecting the relevance and reliability of evidence provided by a broker quote that the proposed standard should include?

We have not identified other characteristics affecting the relevance and reliability of evidence provided by a broker quote that the proposed standard should include.

38. Are there additional factors that the auditor should take into account when evaluating the reasonableness of unobservable inputs?

We have not identified additional factors that the auditor should take into account when evaluating the reasonableness of unobservable inputs.

Proposed Amendments to PCAOB Standards

39. Are the proposed requirements for evaluating audit evidence regarding the valuation of investments based on investee financial condition or operating results clear?

We believe that the proposed requirements for evaluating audit evidence regarding the valuation of investments based on investee financial condition or operating results are clear.

40. Does the proposed alternative approach for audits of certain investment companies represent a significant change in practice for those audits? If so, how? Is that alternative approach applied in other circumstances? If so, what are those circumstances?

We are not providing comments in response to this question.

41. Are there other matters relevant to understanding the process used to develop accounting estimates that could be included in the risk assessment standard?

We believe that the standard could benefit from adding a requirement and considerations related to the auditor obtaining an understanding of how management identifies and addresses the risk of management bias. We believe that including this matter in the standard will prompt auditors to devote greater attention to addressing potential management bias in accounting estimates and assist auditors in appropriately assessing the risk of material misstatement. As noted above in our response to question 18, we also suggest including a consolidated set of requirements for identifying and assessing the risks of material misstatement specific to accounting estimates in the proposed standard rather than amending other standards with risk assessment requirements for estimates. We believe that grouping the risk assessment requirements specific to auditing estimates in one standard will enhance auditors' ability to identify and assess the risks of material misstatement related to accounting estimates and tailor the response to the identified risks.

42. Is it appropriate to include how financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures, as part of the discussion among key engagement team members of the potential for material misstatement due to fraud? If not, describe why it is not appropriate.

We believe that it is appropriate to require key engagement team members to discuss how financial statements could be manipulated through management bias in accounting estimates in significant accounts and disclosures. We agree that such a requirement would focus the auditor's attention on a risk that is particularly relevant to accounting estimates and further underscores the importance of applying professional skepticism in this area. However, we suggest that the requirement be included in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, in paragraphs .49 through .51. We believe that the discussion relates more directly to the overall discussion of the susceptibility of a company's financial statements to material misstatement.

43. Are the additional risk factors to identify significant accounts and disclosures involving accounting estimates clear?

We suggest that discussion of additional risk factors to identify significant accounts and disclosures should be revised as follows:

AS 2110.60A Additional risk factors relevant to the identification of significant accounts and disclosures involving accounting estimates include the following:

- a. The degree of uncertainty associated with the future occurrence or outcome of events and conditions underlying the significant assumptions;
- b. The complexity of the process for developing the accounting estimate, including the extent to which the process involves specialized skills or knowledge;
- c. The number and complexity of significant assumptions associated with the process;
- d. The complexity of the data used for developing the accounting estimate, including the difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of those data;

- e. The degree of subjectivity associated with significant assumptions (for example, because of significant changes in the related events and conditions or a lack of available observable inputs) and potential for management bias; and
- f. If forecasts are important to the estimate, the length of the forecast period and degree of uncertainty regarding trends affecting the forecast.

We believe that the additional risk factors noted above will assist auditors in effectively identifying significant accounts and disclosures and will align with the IAASB's ED-540.