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Office of the Secretary
Public Company Accounting Oversight Board
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Via Email to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 043, Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and Proposed Amendments to PCAOB Auditing Standards

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's proposed auditing standard, *Auditing Accounting Estimates, Including Fair Value Measurements* and Proposed Amendments to PCAOB Auditing Standards, and we respectfully submit our comments and recommendations thereon.

Overall, we see considerable value in enhancing the audit requirements relative to accounting estimates and fair value measurements. We commend the Board on its efforts thus far. We fully support a single standard to address estimate-related topics currently covered by three separate standards, as well as the retention of the three basic approaches to auditing accounting estimates. Nevertheless, we have concerns with certain aspects of the proposal, including the potential prescriptiveness of certain of the proposed requirements, as well as the general lack of acknowledgment and guidance for auditors in addressing estimates with significant estimation uncertainty. These concerns are discussed in greater detail below.

Scope and objective

The stated objective to the proposed standard is to "obtain sufficient appropriate audit evidence to determine whether accounting estimates are reasonable in the circumstances, have been accounted for and disclosed in conformity with the applicable financial reporting framework, and are free from bias that results in material misstatement."[1] While we appreciate the Board's desire to better focus the auditor on addressing management bias, we believe positioning this notion in the objective of the proposed standard could result in unintended consequences. First, we believe the use of the phrase "free from bias" could imply *absolute* assurance, which is inconsistent with the overall objective of the financial statement audit to obtain *reasonable* assurance. It also

[1] Paragraph .03 of Proposed Auditing Standard AS 2501.

contradicts the fact that all estimates, by their nature, contain some level of bias. Therefore, we recommend the notion be removed from the objective and the Board incorporate considerations specific to management bias in the "Identifying and Assessing Risks of Material Misstatement" section of the proposed standard.

Identifying and assessing the risks of material misstatement

Paragraph .04 of the proposed standard introduces the concept of "components of estimates," but its intended meaning is unclear. As currently presented, we believe it could either mean components such as inputs, assumptions, etc., used to develop the estimate, or components as in individual accounts aggregating into one financial statement line item (for example, individual investment balances or accounts that roll up into the company's total investments presented on the face of the financial statements). We believe this ambiguity could lead to misinterpretation by auditors and result in the misapplication of the requirements. As such, we request that the Board clarify its intentions in order to promote a better understanding by auditors in the appropriate application of the requirements to components of estimates.

We further believe the issue of "high measurement uncertainty" is not dealt with sufficiently in the proposed standard. As noted in our letter[2] in response to the 2014 Staff Consultation Paper on this topic, we believe the revised standard should better address the auditor's responsibilities and possible responses to high measurement uncertainty. It would be helpful if the proposal were to acknowledge that evidence may support a range of acceptable values that exceeds the level of materiality and that this level of uncertainty may exist regardless of the extent of audit procedures applied. For example, we note certain standard-setters emphasize the adequacy of company disclosures under a fair presentation framework as one element of addressing high measurement uncertainty. Along those lines, the PCAOB might consider circumstances where the transparency to the user could be compromised, without management disclosing what they view as the range of uncertainty and the support for the point estimate they chose. We believe the profession and PCAOB could effectively address these issues, and we believe enhancements to the proposed standard in this area would provide a significant benefit to users of the financial statements.

Responding to the risks of material misstatement

As noted in our introduction, we support the retention of the three basic approaches to auditing accounting estimates: testing the company's process, developing an independent estimate, and considering subsequent events. We believe these approaches, in general, are widely understood in the profession and, when applied properly, are effective means in obtaining sufficient appropriate audit evidence about an accounting estimate. However, we have some concerns, which are outlined below.

Testing the company's process used to develop the accounting estimate

There are certain areas of this approach, as set forth in the proposed standard, that are not consistent with a principles-based standards approach. For example, the requirement to evaluate

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[2] Refer to our letter dated November 3, 2014 submitted to the PCAOB in response to the Staff Consultation Paper, Auditing Accounting Estimates and Fair Value Measurements (August 19, 2014).

whether the methods used by the company are "appropriate for the nature of the related account or disclosure and the business, industry, and environment in which the company operates"[3] is predicated on the assumption that all companies within a particular industry use the same method in determining their accounting estimates. This would result in a required evaluation for all engagements and may be impractical or not meaningful. Rather, we believe that management's selection of an appropriate method is based on their specific facts and circumstances and that variety could exist among industry peers depending on the facts and circumstances of the company. Therefore, we believe that it would be more appropriate to require the auditor to evaluate whether the methods are appropriate "in the circumstances" and use the proposed factors more as considerations in assessing the adequacy of the method used. This enables the auditor to exercise judgment in considering what factors are most meaningful in evaluating the company's selected methods.

We believe the guidance provided by proposed paragraph .15 would be helpful to auditors in identifying significant assumptions. However, we are concerned that the criterion described in sub-bullet .15e, when considered in isolation, could lead auditors to conclude that all assumptions within an estimate are significant. We ask the Board to reconsider the presentation of this criterion and to also include a note to paragraph .15 that further describes the interplay of the sub-bullets to the paragraph so as to avoid situations where the auditor may determine all assumptions to be significant. Moreover, we disagree with the current note to proposed paragraph .15 because we do not believe the auditor should be required to identify a significant assumption merely because management identified it as such.

With regard to proposed paragraph .18, we are concerned with linking the requirement to the "critical accounting estimates" identified by management for which the auditor would obtain an understanding of management's sensitivity analyses of significant assumptions within these estimates. We believe putting this requirement in the context of critical accounting estimates may inappropriately link the financial statement audit to Management's Discussion & Analysis disclosures as required by the relevant Securities and Exchange Commission rules and regulations. In our view, the linkage to critical accounting estimates would imply that management has appropriately and sufficiently identified its critical accounting estimates as those with respect to the higher level of risk of material misstatement, which may not always be the case. It would be more appropriate for the auditor to execute this requirement in the context of significant risks or based on auditor judgment when sensitivity analysis would serve as an appropriate means of evaluating the reasonableness of significant assumptions.

Developing an independent expectation of the estimate

We are supportive of the change in terminology from "corroborate" to "evaluate" or "compare." We believe this change could further encourage the application of professional skepticism in executing those procedures.

[3] Paragraph .10b of Proposed Auditing Standard AS 2501.

Proposed paragraph .25 states, "If the auditor's independent expectation consists of a range … the auditor should determine that the range is appropriate for identifying a misstatement of the accounting estimate …" We are concerned by this requirement and believe it can lead to operational challenges for auditors. As currently written, it appears the auditor does not consider materiality in determining whether the range is appropriate, which is inconsistent with a risk-based approach to obtaining reasonable assurance. To remedy this, we recommend adding "material" to "misstatement" in the sentence above to better convey that the auditor should consider materiality in his/her determination.

Furthermore, the additional discussion to paragraph .25 in Appendix 3 to the proposal[4] acknowledges that outcomes of certain accounting estimates could vary widely, even beyond the auditor's established level of materiality, and that the range could provide a reasonable basis for identifying a material misstatement, so long it includes only supported outcomes. We believe this acknowledgement of high measurement uncertainty is not clear in the requirement itself but is an important concept to include in the standard, as we noted in our opening comments.

Appendix A – special topics

We appreciate the approach taken by the Board to include an appendix to the proposed standard to specifically address the unique audit implications of fair value measurements. However, it is unclear whether the requirements of the appendix should be applied to each individual financial instrument selected for testing or whether certain evaluations can be performed at a more aggregated level prior to audit procedures being applied. As currently written, it appears the auditor is required to perform his/her evaluation at the individual financial instrument level. We believe this could create considerable operational challenges in practice due to the precision implied in the proposed requirement as currently written.

Moreover, we encourage the Board to consider how the standard could acknowledge the use of (i) centralized pricing functions and (ii) firm-level due diligence procedures over pricing services, both of which are currently in place in various firms today. As currently written, the proposal implies that the engagement team must perform all the procedures relative to these functions for each estimate; however, this is not effective or efficient for engagement teams or the pricing services themselves. Instead, firms often perform due diligence procedures at the national level, which can then be leveraged by engagement teams in their specific engagement. We believe it would be particularly helpful to be clearer in the proposal with regard to how the results of national-level work interacts with the audit team's responsibility to arrive at sufficient, appropriate audit evidence.

With regard to paragraph .A4c, we are concerned about the potential operational challenges this requirement may introduce. It appears the auditor would be able to obtain this information only through inquiry, which may not be viewed as suitable evidence. Further, we believe this factor may only be relevant in instances where a controlled subsidiary of the company is a third-party pricing service. Therefore, in order to make it more operational, we believe it would be more

[4] Page A3-26 of the proposal.

appropriate to reference to the work performed by the auditor in accordance with AS 2410, *Related Parties*. We suggest, that the Board consider revising the requirement as follows: "whether the results of the procedures performed in accordance with AS 2410, *Related Parties,* indicate a relationship between the pricing service and the company by which company management has the ability to directly or indirectly control or significantly influence the pricing service."

Proposed amendments to other standards

AS 1105, *Audit Evidence*

With regard to paragraph .A2d proposed for AS 1105, it is unclear why the Board would limit the consideration of an audit of an investee to one performed under PCAOB standards. The extant requirement states, "Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose, to the investor's auditor may constitute sufficient evidential matter."[5] This requirement further has a footnote reference describing what the auditor may consider in determining whether a report is satisfactory. We believe audit reports issued under other sets of auditing standards, for example, auditing standards generally accepted in the United States of America or the International Standards on Auditing, could provide relevant audit evidence.

We recommend that the revised standard acknowledge that depending on the risks related to the investee, the company's auditor would evaluate whether a report issued under a different framework is sufficient and appropriate audit evidence. The company's auditor could then perform incremental procedures to "fill in the gaps" between the standards of the PCAOB and the other set of auditing standards used for the investee's audit. We recommend the Board consider building in the concepts from existing AS 2503.28 and the related footnote 14 to allow greater flexibility in these situations. This could then alleviate potential operational challenges that might occur by prescribing the use of the standards of the PCAOB as currently proposed in paragraph .A2d.

Proposed paragraph .A3b addresses procedures related to subsequent events of an investee that may impact the investor's financial statements. We note a seemingly small change in this requirement from the extant requirement in AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* that could have a significant impact on the ability of the auditor to meet the requirement. Currently, AS 2503.33 states, "… the auditor should read available interim financial statements of the investee and make appropriate inquiries of the **investor** to identify subsequent events…" [emphasis added]. Alternatively, the proposed requirement requires the auditor to make appropriate inquiries of the **investee** [emphasis added]. We strongly encourage the Board to retain the extant requirement. We believe it is more operational and sufficiently addresses the objectives of the requirement.

AS 2110, *Identifying and Assessing Risks of Material Misstatement*

We are supportive of specifically adding the notion of management bias in accounting estimates to the existing requirement of AS 2110. However, the amendment as currently proposed implies

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[5] Paragraph .28 of AS 2503.

the auditor should seek out bias in every single accounting estimate, which we do not believe results in the auditor focusing on the areas of risk during the fraud discussion. We believe more appropriate wording focuses on estimates that are "more susceptible" to material misstatement from management bias or where management bias is "more likely to" result in a material misstatement.

In our view, the additional risk factors provided in proposed paragraph .60A are generally helpful. Nevertheless, it is unclear whether sub-bullet a in that paragraph relates to high measurement uncertainty. As we note above, we believe this concept requires greater and more specific attention. Notwithstanding our concerns with this requirement, we believe auditors could significantly benefit from a clearer link between these factors and the resulting risk assessment, including identification of significant risks, and the development of the special audit response to those significant risks.

AS 2401, *Consideration of Fraud in a Financial Statement Audit*

We have considerable concerns that the proposed revisions to paragraph 64 of AS 2401 will have unintended consequences in practice. We believe such revisions change the meaning and manner of execution of a retrospective analysis. It is important that the determination to perform a retrospective review be risk-based as opposed to a requirement to conduct a retrospective review on any accounting estimates in significant accounts and disclosures. Further, we feel the revisions lend themselves to greater prescription, even though retrospective analysis is not always an effective evaluation of potential management bias for many estimates. Therefore, we believe this creates a significant amount of additional work without being effective in improving risk identification or overall audit quality. We strongly recommend the Board retain the extant requirement, which we believe is sufficiently operational in today's audits.

Other considerations

Interim reviews

Often, a company faces circumstances during an interim period that could lead to a significant revision in an estimate, such as an asset impairment or the bankruptcy filing of a large customer. In such cases, the auditor may need to perform procedures that go beyond the standard inquiry and analytical procedures performed during the typical interim review. Accordingly, stakeholders would further benefit if this proposal were to include additional guidance relative to estimates in the context of heightened procedures that may be necessary in performing a review of interim financial information.

Applicability and effective date

We believe all audits, including those of emerging growth companies and broker-dealers, would benefit from the enhancements and clarifications intrinsic within the final standard. While we do not expect a significant impact on our audit practice as a result of adoption, we generally expect that firms, including ours, would need sufficient time to update policies, methodologies, and related training in order to carry through the objectives of the overall proposal. Given the timing of when these updates are usually made during an audit cycle, we recommend the Board provide an effective date of two years after SEC approval.

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If you have any questions about our response, or wish to further discuss our comments, please contact Trent Gazzaway, National Managing Partner of Professional Standards, at (704) 632-6834 or Trent.Gazzaway@us.gt.com.

Sincerely,

Grant Thornton LLP