



The Association of  
Accountants and  
Financial Professionals  
in Business

August 9, 2017

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

**Re: PCAOB Rulemaking Docket Matter No. 43/Release No. 2017-002, Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and PCAOB Rulemaking Docket Matter No. 44/Release No. 2017-003, Proposed Amendments to Auditing Standards for Auditor’s Use of *Specialists***

Dear Board and Staff Members:

This letter provides the comments of the Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) on the Public Company Accounting Oversight Board’s (PCAOB or Board) Proposed Auditing Standard, *Auditing Accounting Estimates, Including Fair Value Measurements* (Estimates Proposal) and the *Proposed Amendments to Auditing Standards for Auditor’s Use of Specialists* (Specialists Proposal). We have chosen to provide one combined letter for the two Proposals as we believe the development of accounting estimates for financial reporting and the possible use of specialists in that process are interdependent in a great number of situations, particularly for more complex estimates. The Proposals recognize this interdependence through numerous cross references between the two documents.

The IMA is a global association representing over 90,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world’s largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at [www.imanet.org](http://www.imanet.org) (About IMA, Advocacy Activity, Areas of Advocacy, Financial Reporting Committee).

We previously commented on the August 19, 2014 PCAOB Staff Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements* (FRC letter dated February 25, 2015) and the May 15, 2015 PCAOB Staff Consultation Paper on *The Auditor’s Use of the Work of Specialists* (FRC letter dated July 15, 2015). We are pleased that the Proposals address some of the matters raised by us and many others. However, the Proposals present no clear evidence which indicates that the audit deficiencies found by the PCAOB related to accounting estimates and the use of specialists result from deficiencies in the existing auditing standards. Accordingly, we are not convinced that new or revised standards are required. We are concerned that the Proposals may result in incremental work not necessitated by circumstances but by fear of inspections. We do support changes to revise the organization of the existing auditing standards to make them more logical and easier to apply.

Below we share our concerns and observations regarding the Proposals.



## **Management's Responsibility vs Tone of Proposals**

As noted in the Estimates Proposal, financial reporting requirements have called for more and more accounting estimates over the years, often having a significant impact on results of operations and financial position. And many of these recent requirements involve complex processes and methods.

Numerous examples of accounting estimates are included in the Proposals. For example, the Estimates Proposal lists certain valuations of financial and non-financial assets, impairments of long-lived assets, allowances for credit losses, contingent liabilities, revenues from contracts from customers, valuation of certain liabilities, fair value of financial instruments, valuations of assets and liabilities in a business combination, inventory valuation allowances, and equity-related transactions. And Figure 2 in the Specialists Proposal includes several of these as well as some others in a list of fourteen examples of activities that involve the work of specialists.

While not stated explicitly in the Proposals, accounting estimates could be arrayed on a continuum ranging from "simple" to "complex." For example, it is common for companies to accrue estimated payables such as a month's utility expense – based on monthly averages or perhaps some even more accurate internal record keeping. Companies thus record expenses in periods in which they are incurred even though invoices that include more precise measures are not received until after the closing process is complete. These would be examples of "simple" accounting estimates which can be prepared by most company accounting staff without the need of specialists.

The "complex" estimates include such matters as asset retirement obligations to decommission a nuclear power plant many years in the future and the determination of oil & gas reserves used in the amortization of exploration and development costs and used for impairment evaluations of oil & gas properties. While such estimates lend important credibility to financial reporting, these "complex" estimates obviously involve a great deal of judgment and their ultimate accuracy is not knowable until many years into the future. And most importantly, the skills involved in making knowledgeable estimates go well beyond accounting and require individuals with special skills.

The inclusion of only certain accounting estimates in Figure 2 of the Specialists Proposal implies that the PCAOB believes there is a bright dividing point on the above continuum of "simple" to "complex" accounting estimates. For certain estimates, it is an important management judgment as to whether expertise beyond that in the company accounting/finance function is needed. For example, consider allowances for credit losses. For companies with a relatively stable customer base and many years of experience therewith, accounting personnel may feel quite comfortable estimating credit losses. However, for a large bank, such process is likely to involve company personnel specialized in at least credit and legal matters. Similarly, inventory valuation allowances might well be reliably estimated by company accounting personnel in certain cases but require manufacturing, sales, and legal specialists to assist in other cases.

Our point is not just to take issue with the listing in Figure 2 of the Specialists Proposal. Rather, it is to note that in all cases along the continuum described above financial management must judge whether it has sufficient expertise within its own function to make reliable accounting estimates. If not, financial management will have to determine whether to "make or buy" such expertise. In other words, management will determine if such expertise exists within the company and can be used, and if not whether it is cost



beneficial to hire such expertise, or use outside specialists. Management takes this responsibility quite seriously.

The Securities and Exchange Commission (SEC) requires companies to include disclosure about critical accounting policies and estimates in Management's Discussion and Analysis. The estimates that have the greatest impact on the financial statements, and/or involve the greatest amount of management judgment are so disclosed by companies. The SEC expects companies to provide sensitivity analysis information to provide investors and other users with an understanding of the subjectivity involved. Financial management takes seriously its responsibility to provide accounting estimates and related disclosures according to generally accepted accounting standards and SEC requirements.

We are concerned that the tone of the Proposals asserts a strong predisposition by management to present its financial statements in a biased manner. In fact, the word "bias" or a form thereof is used 124 times in the Estimates Proposal and five times in the Specialists Proposal. Further, "moral hazard" is a prominent justification given for the positions taken in the Specialists Proposal and is also mentioned in the Estimates Proposal. Together, these words and notions suggest a strong prejudice that management will not act in the best interests of investors and other users of their financial statements. We can certainly understand emphasizing the need for auditor skepticism, but our reading of these proposals leads us to believe that the PCAOB believes auditors must become cynical about management's motives. Is it the PCAOB's intention to establish a new threshold beyond healthy skepticism? Further, we fear that the cynical tone when reflected in the inspection process will result in incremental audit work not necessitated by facts and circumstances but driven by fear of second guessing in the inspection process.

While asserting that auditors need to be more skeptical in auditing accounting estimates, the Estimates Proposal presumes this will be accomplished largely by wording changes to existing standards. As noted on page 41, "The use of terms such as 'evaluate' and 'compare' instead of 'corroborate' and greater emphasis on auditors identifying the significant assumptions in accounting estimates could promote a more deliberative approach to auditing estimates, rather than a mechanical process of looking for evidence to support management's assertions." In our opinion, such subtle shadings of meaning are unlikely to have any impact in behavior. A more likely outcome of such wording changes would be for them to be used by PCAOB inspectors to challenge auditors to perform much more work. At a minimum, such wording changes add to our concern that firms will "audit up" in fear of more critical inspections.

We believe that standards setters should be objective and that standards reflect objectivity. Rather than the unnecessary negative emphasis, we urge the PCAOB to provide a more balanced discussion in any final standards. While it may be perfectly appropriate to warn auditors of the possibility of management bias in certain situations, a more objective discussion should also mention the many factors that require or at least motivate management to act responsibly. For example, consider the following guardrails.

- CEO and CFO attestations as supported by disclosure committees.
- Required company reporting on internal control over financial reporting supplemented by external auditor attestation for larger companies.
- Internal auditing.
- Audit committee oversight of significant accounting policies and estimates as well as the overall financial reporting process.
- Codes of ethics for accounting/finance and other company personnel.



- SEC reviews of periodic filings.
- Possibility of civil litigation for any accounting misstatements.

In addition, we note the guardrails in the recently issued *Mandatory Performance Framework for the Certified in Entity and Intangible Valuations Credential* that require professional skepticism as well as a consideration of management bias when valuation professionals perform valuation services for financial reporting. We expect similar requirements for valuation professionals to be included in guidance for the valuation of financial instruments.

### **More Auditing ≠ Better Estimates**

Uncertainty is inherent in estimates. By definition, estimates lack precision/accuracy. The Proposals indicate that more auditing of accounting estimates and more attention to the use of specialists in the audit process will automatically result in more reliable or accurate accounting estimates. For example, page 40 of the Estimates Proposal includes, "These improvements should enhance audit quality and, in conjunction with the clarification of the procedures the auditor should perform, give investors and audit committees greater confidence in the accuracy of financial statements (footnote omitted)." And page 41 in that Proposal notes, "In turn, assuming that firms comply with the new requirements, this should increase and make more uniform the quality of the information presented in the financial statements." Page 40 in the Specialists Proposal states "In turn as auditors are better able to identify and detect potential risks of material misstatements, this may also spur companies and their specialists over time to improve the quality of financial reporting and their work".

Contrary to these statements, more audit work will not necessarily produce high quality accounting estimates. Management has the responsibility for high quality accounting estimates. If a company has done a truly slip shod job, such as in a couple of the egregious enforcement cases cited, reasonable auditing could catch the situation. But more auditing will not help determine whether, for example, there will be slightly better technology available 25 years from now to help decommission a power plant or whether future oil & gas prices will be sufficient to cover estimated drilling and completion costs to warrant extraction of estimated oil & gas reserves. While auditing may identify certain material omissions or errors, all the auditing in the world will not automatically help make an estimate of something that will or may occur many years in the future more accurate.

As noted in the FRC letter dated July 15, 2015 on page 3, auditors can add confirmation value to the financial reporting process but they should not be expected to overcome basic deficiencies in the information to be assessed. The Specialists Proposal seems to confuse auditing and accounting as indicated by the statement on page 32 "Because investors' perceptions of the credibility of financial statements are influenced by their perception of audit quality, the auditor's appropriate use of the work of specialists may increase the credibility of the accounting estimates in the financial statements."

### **Incremental Audit Work**

It is very difficult to determine whether or how audit procedures would actually change from the wording in the Specialist Proposal. For example, on page 41 of that Proposal in describing the potential costs of the new standard, the Proposal says, "The most significant impact of the proposal on costs for auditors is expected to result from the proposed requirements to test and evaluate the work of a company's specialist. Compared with the existing requirements, the auditor will be required in all cases to evaluate the significant assumptions used



by the specialist, as currently required by other auditing standards only in certain circumstances, as well as the methods used by the specialist (footnotes omitted)." But page 42 of that Proposal notes that, "The proposal's impact would also likely vary, however, depending on whether any of the proposed requirements have already been incorporated in audit firms' audit methodologies or applied in practice by individual engagement teams." In several places in the Specialists Proposal it mentions that some, if not all, of the major firms have already implemented most of the procedures suggested in the Specialists Proposal.

Specifically, auditors in testing and evaluating the work of a company's specialist will now have to (i) test and evaluate data used by the specialist and evaluate whether the data was appropriately used by the specialist, (ii) evaluate the appropriateness of methods and reasonableness of significant assumptions used by the specialists, and (iii) evaluate the relevance and reliability of the specialist's work and its relationship to the relevant assertion. It is uncertain whether these specific procedures in the Specialists Proposal would cause firms to "fine tune" or otherwise to increase current procedures and how the PCAOB inspection process might affect how firms apply such new guidance. In addition, we are uncertain how these specific procedures will improve audit quality.

We understand that the larger audit firms indicate that they generally follow procedures similar to the Proposals but note that any new standards will cause the firms to carefully evaluate their procedures. Preparer FRC members believe that their auditors will do more work as a result of both Proposals based on concern that PCAOB inspectors may expect more work around estimates and the use of specialists. We are reminded of the original internal control auditing work that apparently went well beyond what was "intended." We urge the PCAOB to get specific feedback from audit firms of all sizes to determine the potential costs to shareholders of the Proposals.

**Readability of Proposals**

We find the Proposals difficult to digest. Consider the following.

|                                  | <u>Estimates Proposal</u> | <u>Specialists Proposal</u> |
|----------------------------------|---------------------------|-----------------------------|
| Pages of text                    | 57 <sup>a</sup>           | 61 <sup>b</sup>             |
| Pages of appendixes              | 92                        | 78                          |
| Number of footnotes <sup>c</sup> | 173                       | 141                         |
| Questions for commenters         | 43                        | 43                          |

<sup>a</sup> includes 29 pages of economic analysis

<sup>b</sup> includes 31 pages of economic analysis

<sup>c</sup> largely referring to academic studies and auditing standards

After wading through the dense documents, we do not find the economic considerations convincing and object to the tone as discussed above. The academic studies seem to be fairly selective in quoting those who agree with the direction the PCAOB proposes and include no studies that would be in conflict.

To obtain broad feedback, we suggest the PCAOB take a more reader friendly approach to its proposals. The PCOAB could have simply said something like the following.



- Audit deficiencies are still being found with respect to auditing estimates and the use of specialists, primarily with smaller firms and foreign firms.
- Amendments in the Estimates Proposal will improve the existing standards by placing audit guidance in a single standard and updating the standards for certain developments.
- Amendments in the Specialists Proposal segregating and clarifying requirements for evaluation of company's employed or engaged specialists from supervision requirements for auditor employed or engaged specialists will clarify existing standards.
- Proposals largely reflect current practices at larger firms and practices followed to remediate audit deficiencies.
- Let us know what you think.

We believe that a clear, more direct style will elicit more feedback.

### **In Conclusion**

We disagree with the assertion on page 2 of the Estimates Proposal that further integration with risk assessment standards could prompt greater audit attention to estimates with a greater risk of material misstatement. We believe that management and auditors pay a great deal of attention to significant estimates and we are concerned that the Estimates Proposal will result in incremental audit work across the board. Our concern would be mitigated in a final standard without a negative tone and the implication that more audit work equals better numbers and that clearly indicates that the objective is to improve the existing standards by placing audit guidance for estimates in a single standard and updating standards for certain developments.

We agree with the reorganization aspects of the Specialists Proposal but are concerned about any expansion of auditing procedures given the extensive discussions of moral hazard and management bias. The amendments are fairly reasonable as they are mainly revising the auditing literature so that specialists employed by or engaged by companies and specialists employed by or engaged by accounting firms are treated appropriately. We agree that the current auditing standards can be clarified.

The SEC and PCAOB enforcement cases cited seem to demonstrate that a few auditors will not follow auditing standards no matter how detailed they are or how clearly they are written. We are concerned that the net result of the two Proposals would be to require more work by all auditors at more cost to companies as a way of trying to address the failures of a few.

We appreciate the opportunity to express our views on the Proposals. Please let me know if you would like us to further explain these views or provide added information.

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder".

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