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Office of the Secretary
PCAOB
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submitted via email to comments@pcaobus.org

PCAOB Release No. 2017-002, June 1, 2017, PCAOB Rulemaking Docket Matter No. 043: Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements And Proposed Amendments To PCAOB Auditing Standards

Dear Sirs,

The IDW appreciates the opportunity to comment on the above mentioned Release, hereinafter referred to as "the Release". We also commented on the Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements in a letter dated November 3, 2014. In commenting below on specific aspects of the current proposal we refer to that letter as "our previous letter".

In this letter, we express general support for the PCAOB's initiative, and then comment on those aspects of the Release with which we have concerns or upon which we hold firm views. We have chosen not to respond to individual questions posed throughout the Release.

General Support

As accounting standard setters continue to revise financial reporting requirements, both the prevalence and magnitude of estimates required to be accounted for and disclosed within financial statements are of increasing significance to investors and others who may seek to rely thereon.

As stated in our previous letter, we agree that the revision of the PCAOB's interim auditing standards is needed to address recent changes in both financial

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reporting, and developments in auditing practice, and also that issuing staff guidance cannot be the long-term solution, so that we support the issuance of a single standard mirroring ISA 540 to replace the existing PCAOB auditing standards in this area.

The reference to the 2008 financial crisis at the top of page 6 of the Release points to the various challenges, including market uncertainty associated with several of the types of complex accounting phenomena that accounting estimates are increasingly designed to portray.

Impact of Inherent Limitations Relating to Both Accounting Estimates and Management Bias on the Expectations Gap – Need for Balanced Clarification

In our previous letter, we cautioned that any project on accounting estimates would need to be sensitive to the risk of increasing public expectations concerning this aspect of the audit.

Whilst we support calls for the auditors' exercise of professional skepticism as a means to address management bias, we firmly believe that recognition of the inherent limitations pertaining to recognition and measurement of accounting estimates (i.e., primarily an accounting issue) as well as the identification and evaluation of management bias (i.e., primarily an auditing issue) is needed to counter unrealistic expectations in this area.

<u>Inherent Limitations – Recognition and Measurement of Accounting Estimates</u>

Accounting estimates are subjective in nature and inherent estimation uncertainty is a key feature that neither standard setters, preparers of financial statements, nor auditors - however diligent their work – can eliminate. We appreciate that AS 1015.11 already explains that there are inherent limitations of an audit in respect of accounting estimates (professional judgement is needed; audit evidence is persuasive rather than convincing). At various points, the Release points out a number of limitations on the auditor's ability to address the special challenges posed by accounting estimates. It is disappointing that the proposed standard does not include a comprehensive analysis distinguishing those that an auditor can address (e.g., analytical ability), can partly address (e.g., some features of management bias) from those that cannot be addressed (e.g., time constraints, limits on available information), as mentioned on pages 30 et seq. of the Release.

Inherent Limitations – Identification and Evaluation of Management Bias

The potential for management to be biased in making accounting estimates means that accounting estimates may be susceptible to "distortion" ranging from willful and fraudulent manipulation to a far less tangible, subconscious bias. Notwithstanding the special features of fraud, the former may generally be easier for an auditor to identify and evaluate than the latter.

Therefore it is essential that the public understand that there are also inherent limitations in regard to identification and evaluation of management bias that impact auditor's ability to determine whether accounting estimates are free from management bias, not least because financial reporting frameworks often permit a range of possible outcomes, and also because there is generally no "bright line" in financial reporting frameworks to distinguish between reasonable judgmental latitude, subconscious management bias and willful biased manipulation.

Neither AS 1015 nor proposed AS 2501 explain the limitations of an audit arising from the inherent limitations an auditor may face in regard to identifying and evaluating management bias in accounting estimates. We suggest the PCAOB address this, perhaps by adding text within AS 1015, such that the public's expectations of auditors can be well informed and reasonable.

Portrayal of the Auditor's Consideration of Management Bias as a Third and Distinct Part of the Objective

The Release proposes the following objective in AS 2501.03: "The objective of the auditor 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."

We are concerned that the presentation of freedom from bias as a third and distinct determination could be misleading in that it may imply an auditor override i.e., a determination going beyond the auditor's determination of whether accounting estimates are a) reasonable and b) accounted for and disclosed in conformity with the applicable financial reporting framework. It would not be appropriate for the PCAOB as an auditing standard setter to define the auditor's role so as to require the auditor introduce prudence or neutrality over and above the requirements of the applicable financial reporting framework. We do not believe that this is the PCAOB's intent as elsewhere in its suite of standards the PCAOB accords this phenomenon different treatment.

Furthermore, given the inherent limitations noted above, it is not possible for auditors to meet the objective of eliminating management bias.

Need for Clear and Consistent Treatment of the Potential for Management to be Biased in Making Accounting Estimates

As explained, we are of the view that the auditor's consideration of management bias does not constitute a third and distinct determination, but is an integral part of the auditor's overall determination of reasonableness – accounting estimates are considered individually but also in aggregate to determine whether they are reasonable in the context of the applicable financial reporting framework.

Paragraph .16 of the proposed auditing standard sets forth requirements for the evaluation of the reasonableness of significant assumptions, but does not explain what "reasonable" is intended to be in the context of accounting estimates in the context of the applicable financial reporting framework. We note that ED ISA 540.A2 includes text to explain reasonableness as a key concept and suggest the PCAOB might draw on this in finalizing the proposed standard.

As we explain below, the PCAOB's suite of standards needs to be consistent and clear as to the phenomenon of management bias – specifically whether it is only a fraud risk or also a further type of risk, and its consideration in the audit. Specifically:

- as we have noted, the proposed objective of AS 2501 appears to view it as a third determination, implying an auditor override;
- pages 28-29 of the Release imply it may be a different or non-fraud risk i.e., resulting from CEO/CFO-specific optimism or overconfidence;
- the risk assessment, risk response and fraud standards AS 2110, AS 2301 and AS 2401 treat management bias as just one of a number of fraud risks;
- AS 2401.63 et seq. requires a retrospective review of significant accounting estimates reflected in the financial statements of the prior year, treating it as a fraud risk.
- AS 2810.27 requires the auditor to perform a test for possible management bias when each accounting estimate included in the financial statements was individually reasonable, thus treating it as an integral part of the auditor's evaluation of audit results – however it is unclear whether this is intended as a risk response to fraud or to other factors such as those noted in the second bullet point above;

If indeed the Board intends management bias to extend beyond a fraud risk, it would be helpful to highlight the phenomenon of management bias as a specific risk factor in paragraph .04 of the proposed auditing standard. It would also be helpful to explain the role of professional skepticism in relation to management bias as well as to fraud in the third Note to paragraph .05 of the proposed auditing standard.

Desirability of Alignment with the International Standards on Auditing (ISA)

We refer to our previous letter in which we also referred to the desirability of aligning PCAOB standards with their corresponding ISA to the maximum extent possible, as well as our belief that it is not appropriate for the PCAOB to go further than the IAASB in requiring the auditor perform additional procedures that are based on guidance as opposed to requirements within the ISAs.

As the Board is aware, the exposure draft of Proposed ISA 540 (Revised): Auditing Accounting Estimates and Related Disclosures was issued earlier this year for comment.

We would like to reiterate our calls for maximum possible alignment and urge the two respective Boards to coordinate in this regard.

If you have any questions relating to our comments in this letter, we should be pleased to discuss matters further with you.

Yours truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Head of International Affairs