BDO

Tel: 312-856-9100
Fax: 312-856-1379
www.bdo.com

330 North Wabash, Suite 3200
Chicago, IL 60611

August 30, 2017

Via E-mail: comments@pcaobus.org

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

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 Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting Oversight Board's (the PCAOB or the Board) *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements, and Proposed Amendments to PCAOB Auditing Standards* (the Proposal or Proposed Standard). Consistent with the views expressed in our comment letter dated November 3, 2014 on the PCAOB Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements*, we support the development of a single standard that is aligned with the PCAOB's risk assessment standards and the addition of incremental guidance relating to third-party pricing services.

While we recognize that the PCAOB engaged in outreach to explore the views of market participants and others, and considered the International Auditing and Assurance Standards Board's International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* and the corresponding AICPA auditing standard, AU-C Section 540, we note that much of the application guidance from these standards, that is instrumental to ensuring consistent application, is missing from the Proposed Standard. We believe the inclusion of such application guidance is necessary for a proper understanding to apply the requirements and would, accordingly, enhance audit quality. In particular, we believe useful guidance from AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AS 2503), may have been lost in the process of merging the three separate standards on auditing accounting estimates and fair value measurements into a single standard. Discussion of the more significant areas where we believe additional guidance would be appropriate to include within the Proposed Standard is provided in the discussion of our comments below.

Our comments are focused on the following areas of significance within the Proposal:

1. Objective of the Proposed Standard
2. AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
3. Responding to Risks of Material Misstatement
4. Third-Party Pricing Information

5. Valuation of Investments Based on Investee Financial Condition or Operating Results
6. Estimation Uncertainty
7. Other Matters

1. Objective of the Proposed Standard

The objective paragraph of the Proposed Standard explains that 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 a material misstatement.' We believe the current structure of the objective is misleading. The inclusion of the phrase 'and are free from bias' within the objective may inappropriately give the impression that while the auditor is obtaining sufficient appropriate evidence to determine whether accounting estimates are reasonable they are also determining that the estimate is free from bias. To avoid this implication we suggest deleting the phrase 'and free from bias' from the objective and including a more fulsome discussion of the auditor's consideration of whether indicators of possible management bias exist within the section of the standard that discusses the auditor's evaluation of the results of audit procedures.

2. AS 2503, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities

While we support replacing the three existing standards that address auditing accounting estimates and fair value measurements into one single, updated standard that strengthens auditing practices and applies a more uniform risk based approach – we believe that in the process some useful guidance has been lost, which we believe is helpful to practitioners in auditing estimates with higher estimation uncertainty. For example, we note that the discussion in AS 2503 relating to the inherent risk assessment is missing. We believe this discussion, while not a requirement to perform any particular procedures, would provide useful information for practitioners in the application of the requirements of the proposed standard. For this reason, we believe the addition of the guidance in AS 2503, paragraph 8, that provides examples of considerations that might affect the auditor's assessment of inherent risk for assertions about a derivative or security would promote a more effective audit and provide for consistent application of the requirements. Those examples include; management's objectives; complexity of the features of the derivative or security; whether the transaction that gave rise to the derivative or security involved the exchange of cash; the entity's experience with the derivative or security; whether the derivative is a freestanding or embedded feature of an agreement; and whether external factors affect the assertion.

Moreover, we note that paragraphs 10 and 11 of AS 2503, which provide guidance relating to obtaining an understanding of internal control to plan the audit, have not been carried forward to the new standard. Paragraph 10 explains that controls for an entity with extensive derivatives transactions may include:

- Monitoring by a control staff that is fully independent of derivative activities

- Obtaining approval, prior to exceeding limits, from members of senior management, who are independent of derivative activities
- Senior management address limit excesses and divergences from approved strategies
- Transmittal of derivatives positions to risk measurement systems are accurate
- Reconciliations are performed to ensure data integrity
- Constraints on derivative activities are defined and identified excesses justified
- Performance of reviews of identified controls are performed regularly
- Review of limits in the context of changes in strategy, risk tolerance and market conditions

Paragraph 11 further explains that the extent of understanding of internal control over derivatives and securities depends on how much information the auditor needs to identify types of potential misstatements, consider factors that affect the risk of material misstatement, design tests of controls, when applicable, and design substantive tests. Additionally, this paragraph states that the understanding obtained may include controls over derivative and security transactions from initiation to inclusion in the financial statements.

We believe the inclusion of such guidance would enhance the clarity of the purpose of the required procedures.

We also note that guidance relating to the use of a service organization whose services are part of the entity's information system, as it relates to the entity's information system for derivatives and securities is missing. We believe such guidance should be retained.

3. Responding to Risks of Material Misstatement

Substantive Procedures Performed Relating to Significant Accounts and Disclosures

Paragraphs .05 - .07 of the Proposed Standard explain that the auditor is required to perform substantive procedures to accounting estimates in significant accounts and disclosures, and that as the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. However, we believe it is important to recognize that the 'amount' of evidence may not necessarily increase, but the persuasiveness and sufficiency of the evidence should increase. Additionally, we believe the proposed standard is unclear how the nature, timing, and extent of procedures might vary based on the significance of risk, and therefore request clarification within the Proposed Standard.

Identification of Significant Assumptions

Paragraph 15 of the Proposed Standard provides a list of factors that are relevant to identifying significant assumptions. Items a. through d. address specific characteristics about the assumption. However, item e. is broader and encompasses assumptions that 'otherwise are related to an identified and assessed risk of material misstatement of the estimate.' One interpretation of this overarching factor might result in all assumptions underlying an estimate being considered significant. We do not believe this is the intention of the requirement and, as such, suggest including explanatory guidance regarding the interaction of the factors in identifying significant assumptions within the standard. Furthermore, we do not believe the auditor should be required to identify an assumption as significant as a result of management's identification of the assumption as significant in the recognition or measurement of the accounting estimate. We believe such identification should be based on the auditor's professional judgment, considering the factors provided in paragraph 15, independent of management's assessment.

4. Third-Party Pricing Information

Appendix A to the Proposed Standard sets out guidance for the auditor when using pricing information from third parties as audit evidence and requires the auditor to evaluate the relevance and reliability of the pricing information. Paragraph .A4 explains that the 'reliability of audit evidence depends on the nature and source of the evidence and the circumstances under which it is obtained.' Generally, third-party pricing services provide independent pricing information that is free from influence of users of the service and, as such, provides audit evidence that results in higher reliability. For this reason we believe, when a financial instrument has lower estimation uncertainty, the auditor should be permitted to test management's price by obtaining a price from a different pricing service than management.

Additionally, we note that paragraph .A5 explains that when fair values are based on transactions of similar financial instruments, the auditor should understand how those transactions are identified and considered comparable to the financial instrument being valued as part of the procedures performed to determine whether the pricing information provides sufficient appropriate evidence. However, this information may not always be available from the third-party pricing service due to the proprietary nature of the valuation, and for this reason we suggest revising the requirement to allow the auditor to look to the asset class and other relevant characteristics of the financial instrument.

5. Valuation of Investments Based on Investee Financial Condition or Operating Results

We support providing additional guidance describing the auditor's responsibilities for obtaining sufficient appropriate audit evidence when the valuation of an investment selected for testing is based on the investee's financial condition, as we believe this will enhance the consistent application of audit procedures. However, we note that within Appendix A to AS 1105, there is no discussion regarding the auditor's responsibility to obtain an understanding of management's processes and controls over the recording of amounts related to such an investment. While we recognize that AS 2110, *Identifying and Assessing Risks of Material Misstatement*, addresses the auditor's assessment of risk overall, we believe it would be helpful to specifically make reference to understanding management's procedures and controls in this circumstance to emphasize the importance of understanding management's valuation process as part of the auditor's assessment of the risk of material misstatement.

Paragraph .A3b of the Proposed Appendix to AS 1105 addresses subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the company's auditor's report. It requires the auditor to 'read available interim financial statements of the investee and other available information and make inquiries of the investee to identify subsequent events and transactions that could be material to the company's financial statements.' We do not believe that this requirement is necessary given that subsequent event procedures are already set out in AS 2801, *Subsequent Events.* Additionally, we suggest replacing the proposed requirement to inquire of the investee with application guidance that explains that such inquiry may be appropriate in certain circumstances in response to the auditor's assessment of the risk of material misstatement.

We also note that the Proposed Appendix to AS 1105, paragraph .A4b, would require the auditor to 'obtain information about the procedures the investee's auditor performed and the results thereof or review the audit documentation of the investee's auditor.' Based on our experience, company management may not always have direct access to investee management to be able to arrange for the company auditor to perform the proposed procedures and in some cases, the company may not have the authority to obtain such information. Accordingly, we recommend revising paragraph .A4b to recognize such practical challenges.

6. Estimation Uncertainty

When developing an independent expectation as a range, the Proposed Standard (AS 2501, paragraph 25) requires the auditor to determine that the range is appropriate for identifying a misstatement of the accounting estimate and is supported by sufficient appropriate audit evidence. However, we suggest recognizing within the Proposed Standard that the degree of estimation uncertainty associated with an accounting estimate, particularly in certain industries, may inherently result in a wider range of reasonable estimates and that the auditor may conclude, after performing sufficient appropriate procedures, that management's accounting estimate is reasonable. Such an approach would be consistent with the International Auditing and Assurance Standards Board, Proposed International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph A134, which includes the following guidance:

> In certain circumstances, the auditor's range for an accounting estimate may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures. In these circumstances, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important.

7. Other Matters

Applicability

We support application of the Proposed Standard and amendments to emerging growth companies (EGCs) and brokers and dealers, since we believe the proposed guidance would be beneficial to users of financial information of these entities.

Effective Date

To ensure audit firms have the necessary time to update firm methodologies, develop and implement training, and ensure effective quality control process to support implementation, similar to our suggestion in our comment letter on Rulemaking Docket Matter No. 044, we suggest providing for an effective date for audits of fiscal years beginning two years after the Securities and Exchange Commission approves the final standard.

* * * *

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Christopher Tower, National Managing Partner – Audit Quality and Professional Practice at 714-668-7320 (ctower@bdo.com), Phillip Austin, National Managing Partner - Auditing at 317-730-1273 (paustin@bdo.com), or Patricia Bottomly, Partner – National Assurance at 310-557-8538 (pbottomly@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP