



Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and Proposed Amendments to PCAOB Auditing Standards

ICAEW welcomes the opportunity to comment on the Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and Proposed Amendments to PCAOB Auditing Standards published by PCAOB on 1 June 2017, a copy of which is available from this [link](#)

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MAJOR POINTS

1. We welcome these proposals on the audit of accounting estimates (estimates). The audit of estimates is a critical area in virtually all audits, not least because of the increasing use of fair values in accounting frameworks across the world.
2. The proposed standards are crisp and incorporate within them many of the elements of the IAASB's proposals. In particular, we support the move from a 'corroboration' mind-set, to one of 'evaluation'. This is an important shift with implications that go beyond the audit of estimates and to the heart of what it means to exercise professional scepticism in practice. We also welcome the increased emphasis on granularity in the approach to the components of estimates, as set out in paragraph .05.
3. We caution against raising expectations among investors about the impact of more robust auditing procedures on estimates themselves. Whatever auditors do, estimates remain estimates, subject to varying degrees of estimation uncertainty. Even so, these proposals provide an opportunity for the PCAOB to enhance the breadth and depth of investor understanding of estimates which continue to play an increasingly important role in financial reporting. The PCAOB itself notes that adoption of the auditor reporting standards provides investors with the information they have been asking for from auditors and we believe that there is scope for these proposals on estimates to do the same.
4. We are particularly encouraged by the good quality material on management bias included in the Discussion of the Proposed Rule and Appendix 3. The PCAOB's acknowledgement of the importance of bias in the context of audit is important. We urge the PCAOB to continue to develop its thinking on the implications of conscious and unconscious bias on auditor and management behaviour. Raising awareness of these behavioural issues, and articulating them in auditing standards will help mitigate their effects, help auditors manage their own behaviour, improve the quality of audit and in turn, help management improve the quality of financial reporting. Some firms are now starting to bring behavioural psychologists into the audit practice to help auditors understand their own patterns of behaviour more clearly, particularly as they relate to unconscious bias.

More is needed to achieve true scalability and auditors need to challenge management

5. The PCAOB's proposals focus on fair value estimates. While we are concerned that this represents an over-emphasis on a particular area that the PCAOB currently finds problematic and does little to future-proof the requirements, forward-looking information is now firmly embedded in many financial reporting frameworks. The challenges facing auditors dealing with revenue recognition, impairments and recoverability, accounting for intangibles and current expected credit losses (CECL) are the same as those faced by preparers. The focus on derivatives and complex financial instruments continues to sharpen in this period of significant change in financial reporting. The PCAOB needs to articulate clearly what it is that will be done better and differently by auditors, audit committees and management if confidence among investors is to be enhanced. This is at least as important as improving what auditors are doing in their working papers for inspection purposes.
6. The PCAOB's objectives are worthy, addressing the need for enhanced scepticism, the issue of third party pricing sources and a more uniform risk based approach to the audit of estimates. However, as we noted in our response to the Staff Consultation Paper that preceded this exposure, we believe there could be more emphasis on the need for *challenge* in the auditor's approach to management assertions. The current tone and emphasis is still on the rigour of process. This is critical, but not enough. We acknowledge and support the shift from a 'corroboration' mind-set, to one of 'evaluation' but the standard should require more focus on completeness and on what is not there.

7. The material on third party pricing sources raises expectations without providing adequate support to auditors in the most difficult situations. The requirements of auditors to extract information from third party pricing sources reflected in paragraphs A4b and A5c and A7 are simply unrealistic in some cases because some pricing services will not provide detail on methodology, data or assumptions to their clients, still less to the auditors of their clients. Requiring auditors to perform ‘additional’ procedures, in such cases, including evaluating the appropriateness of the valuation method and the reasonableness of inputs used by the pricing service, especially when there are no recent transactions either for the financial instrument being valued or for anything similar, without any suggestion as to what those procedures might be, is unhelpful to the smaller companies most likely to be unable to obtain an independent valuation and smaller audit firms without a pricing desk.
8. The PCAOB’s focus on process is not wrong in this context, it simply needs to go further. ICAEW’s thinking on the broader but closely related area of prospective financial information (PFI) is relevant in this context. Our Corporate Finance Faculty’s recent [Consultation paper on prospective financial information](#) updates our guidance for UK directors on the subject published in 2003. In that context we refer to three ‘preparation principles’, for PFI which we believe apply equally to many estimates, particularly those that are complex, including those based on proprietary models to which management and auditors may have no access.
9. The three basic preparation principles are the bases of sound *business analysis* which renders PFI reliable, *reasonable disclosure* of the relevant uncertainties and mitigating actions, and *subsequent validation* which renders the PFI comparable, and preparers accountable. Translated into auditing terms, this means that auditors need to challenge management to explain:
 - how they have obtained comfort that the estimate is actually based on a sound understanding of how the business actually works - to ensure that assumptions built into the model or background data actually reflect the business environment in which the entity operates;
 - how they have obtained comfort that the right business-specific disclosures have been made for the relevant uncertainties and mitigating factors;
 - how reliable previous estimates have turned out to be in practice, including why they were significantly different where relevant.
10. If management does not rise to this challenge, for whatever reason, auditors may consider whether the issue is a CAM but the important point is for all concerned to acknowledge that it is not enough for management to take a ‘take it or leave it’ approach when challenged by auditors, and it is not enough for auditors to perform their own rough independent calculations in the hope that the output is not too far away from the figures produced by or on behalf of management. Management and auditors need to engage more closely in these particularly difficult areas and auditors need a better sense of management’s ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.
11. The PCAOB discusses the impact of the limitations of auditors in terms of education and experience when attempting to deal with highly complex issues. These limitations, combined with time and other resource constraints, lead to the use of rules of thumb to evaluate the output of complex models. We urge the PCAOB to engage with the SEC and others involved in the capital markets to address these sensitive, structural issues. They have a significant impact on the quality of the audit of estimates and the PCAOB is well-placed to lead that discussion.
12. For the proposals to be implemented successfully, companies need to be encouraged by the SEC to ‘do the right thing’. The PCAOB should urge the SEC to raise levels of awareness of

the new requirements among registrants and to emphasise the importance of management providing:

- good quality support for the estimates they develop on a timely basis;
- clear and unambiguous disclosures.

The SEC should also be seen to be actively discouraging an attitude which challenges auditors to prove management's estimate wrong.

13. The PCAOB notes that some firm methodologies apply certain procedures for the audit of fair values to the audit of all estimates. A challenge to the development of standards that apply to the simplest of low risk inventory provisions as well as the most complex of high risk provisions is that there is a risk of over-engineering the approach to those at the lower end of the scale, and of failing to cover adequately those at the higher end. We have made this point robustly to IAASB and have strongly urged it to consider supplemental authoritative guidance at both ends of the scale.
14. There is increasing recognition of the need for audit regulators to provide examples of 'what good looks like', particularly in emerging and complex areas, and to signal their intentions publicly. While the PCAOB's constituency is significantly different to that of the IAASB, consistency in the approach to enforcement is important for all regulators. Audit inspectors need to know, and to be able to provide examples of, how the proposals can be applied well to both simple and highly complex estimates. We hear good reports of PCAOB inspectors signalling their intentions very clearly to firms. An area in which public signalling is particularly important is the audit of complex financial instruments where there is either no market for the instruments, or only unobservable inputs, no available details of the model, and/or the audit firm has no pricing desk with alternative tools at its disposal. Examples of what good looks can be critical in such situations.

Scepticism, shirking and opting to test management's process

15. The PCAOB states that the increased emphasis on scepticism and the requirement to consider all available evidence should discourage shirking (e.g., simply accepting management's assumptions, models, or estimates). These proposals would stand a better chance of discouraging shirking if they did not align the auditor's approach so closely with management's process.
16. On the one hand, the PCAOB notes that auditors invariably test management's process where that is an option, that they verify assertions on a piecemeal basis, and over rely on management's process rather than critically assessing the estimate, but it then effectively mandates work on management's process in paragraph .10 and the note to .07. When combined with work on management's process mandated in the context of reporting on internal controls over financial reporting, to take any other approach makes no sense. While we do not disagree with the required work on management's process, the combined effect of this and established practice will further entrench the use of the option to test management's process.
17. Understanding management's process is always important but testing it as an audit strategy is not always the best option. Developing an independent estimate, whether using rules of thumb or more sophisticated modelling techniques, has particular value where differences arise that create a basis for engagement with the company and where firms make genuine efforts to encourage this rather than avoiding engagement through the post-hoc rationalisation of differences. Larger firms increasingly use their own rigorously developed, tested and implemented models to provide high quality independent estimates in such cases and the PCAOB should acknowledge existence of such tools, the importance of their quality, the controls around them and the associated risks, their value to the audit of estimates, the extent of their use and their increasing importance within audit firm methodologies. Innovation in auditing is critical to the quality of audit.

18. The PCAOB should make it clear that auditors should not automatically choose this option simply because it is available, regardless of the quality of management's process, or because another route is less straightforward, especially if the alternative route might produce better quality audit evidence. Where appropriate, this would demonstrate the exercise of scepticism and reduce the emphasis on corroborative evidence. We have also made this point in our response to the IAASB.
19. Data analytics is increasingly used in the important area of impairment testing, among others, and there is no recognition at all in the standard of the implications of this development. Advances in technology have not been reflected in these proposals. Furthermore, there is no mention of how the proposals interact with the work on internal controls over financial reporting. Both are significant weaknesses in the proposals.

Respective proposals of the PCAOB and IAASB

20. The differences between the PCAOB's proposals and those of the IAASB are significant in terms of structure and content – markedly so. This cannot be efficient, or indeed right, especially for the audit of global financial institutions and in the light of the fact that global audit methodologies no longer distinguish between global and local requirements and instead seek to cover both IAASB and PCAOB requirements.
21. We emphasised in our response to the IAASB our belief that its proposals are in some respect over-engineered and that its three-factor approach works for the risk *assessment*, but not the response. We also noted that many commentators, when comparing the proposals side by side, find the structure of the PCAOB's proposals clearer, not least because they broadly reflect the existing approach. Nevertheless, we believe that the PCAOB can and should consider again the substance of the IAASB's proposals which are in most respects well-articulated, nuanced, granular and sophisticated, and consider whether the PCAOB can leverage more of this work than it is currently proposing to do.

RESPONSES TO SPECIFIC QUESTIONS

Q1: 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?

22. The discussion of the reasons to improve auditing standards describe the nature of concerns related to auditing accounting estimates very well in many respects, but we believe that elements of that discussion should appear in the standard itself, including the discussion of the various types of management bias. Understanding the various types of bias is critical to an effective audit and a fuller description is warranted in the standard itself of the widely accepted types of biases that are so well described by the PCAOB. Auditors should be encouraged to actively consider their own biases, as well as those of management.
23. We also struggle to find evidence that technology, including data analytics, has even been considered in the development of these proposals, still less incorporated, and there seems to be no consideration of the interaction of the proposals with reporting on internal control over financial reporting.
24. The PCAOB should also seek to engage with the SEC and others involved in the capital markets, including the wider investor community to ensure that that constituency understands the importance of management providing good quality support for the estimates they develop, on a timely basis, and to discourage the attitude which challenges auditors to prove management's estimate wrong. It should also do what it can to ensure that expectations are not inappropriately raised about the fact that whatever auditors do, estimates remain just that - estimates - and that auditors cannot audit away estimation uncertainty.

Q2: 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?

25. Many smaller companies enter into complex arrangements without understanding the accounting implications of those arrangements. Auditors are expected to obtain the same level of audit evidence as they would in much larger, more mature organisations and management often struggles to provide the necessary support for its estimates that auditors need. This is essentially an accounting issue that might show in the disclosure of boiler plate CAM in audit reports but it is one that auditors and inspection teams still have to address and some public discussion of the issue would be helpful to all concerned.
26. More research is needed to understand the dynamics operating in smaller audit firms dealing with the valuation of sometimes complex financial instruments where there is either no market for the instruments, or unobservable inputs, no details of the model available and/or no firm pricing desk. The PCAOB notes this issue in outline but it is hard to provide examples of 'what good looks like' in this context. Requiring auditors to perform 'additional' procedures, in such cases, including evaluating the appropriateness of the valuation method and the reasonableness of inputs used by the pricing service, without any suggestion as to what those procedures might be, is unhelpful to the smaller companies most likely to be unable to obtain an independent valuation and smaller audit firms without a pricing desk. Different inspections teams may approach the same area in different ways and the absence of public discussion of this issue is worrying. The cost of independent valuations for emerging growth companies can be significant.
27. In our main points above we refer to the fact that the PCAOB's focus on process is not wrong, but that it needs to go further and that it is not enough for auditors to perform their own rough independent calculations in the hope that the output is not too far away from the figures produced by or on behalf of management. Management and auditors need to engage more closely in these particularly difficult areas and auditors need a better sense of management's

ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.

Q3: Are there additional changes needed to improve the quality of audit work related to accounting estimates that the Board should include in its proposal?

28. Improving the quality of accounting will help improve the quality of auditing. As we note above, the PCAOB should seek engagement with the SEC and others involved in the capital markets, including investors, to ensure that all concerned understand the importance of management providing good quality support for the estimates they develop, on a timely basis, and to discourage the attitude which challenges auditors to prove management's estimate wrong.
29. As noted in our main points above, we believe that the standard itself should include a discussion of the various types of management bias, already so well-described by the PCAOB. Understanding the various types of bias is critical to an effective audit.
30. The PCAOB should give further consideration to how developments in technology, including data analytics, can be reflected in these proposals and how the proposals interact with reporting on internal control over financial reporting.
31. We note in our main points above that the proposals could be improved in the particularly difficult areas of proprietary models and pricing services where detail on methodology and data or assumptions are unavailable. Requiring auditors to perform 'additional' procedures, in such cases, even as described, is unhelpful. The PCAOB's focus on process is not wrong in this context, it simply needs to go further and we draw the PCAOB's attention to ICAEW's thinking on the broader but closely related area of PFI and the three 'preparation principles' outlined in our Corporate Finance Faculty's recent [Consultation paper on prospective financial information](#). It is not enough for auditors to perform their own rough independent calculations in the hope that the output is not too far away from the figures produced by or on behalf of management. Management and auditors need to engage more closely in these areas.

Q4: 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)?

32. The PCAOB should give further consideration to how developments in technology, including data analytics, can be reflected in these proposals and how the proposals interact with reporting on internal control over financial reporting.
33. The PCAOB notes that testing management's process is the most common approach to the audit of estimates. It further encourages that approach by requiring auditors to take heed of management's process regardless of which approach is adopted. While auditors are not discouraged from developing their own estimate, there is no express incentive to do so.
34. On the one hand, the PCAOB notes that auditors invariably test management's process where that is an option, that they verify assertions on a piecemeal basis, and over rely on management's process rather than critically assessing the estimate, but it then effectively mandates work on management's process in paragraph .10 and the note to .07. When combined with work on management's process mandated in the context of reporting on internal controls over financial reporting, to take any other approach makes no sense. While we do not disagree with the required work on management's process, the combined effect of this and established practice will further entrench the use of the option to test management's process.
35. Testing management's process as an audit strategy - rather than developing an independent estimate or looking to subsequent events - is not always the best option, particularly where

- the process is weak;
- third party pricing sources or management specialists use proprietary models and/or data to which neither the company nor its auditors have access.

Developing an independent estimate, whether using rules of thumb or more sophisticated modelling techniques, has particular value where differences arise that create a basis for engagement with the company and where firms make genuine efforts to encourage this rather than avoiding engagement through the post-hoc rationalisation of differences. Larger firms increasingly use their own rigorously developed, tested and implemented models to provide high quality independent estimates in such cases and the PCAOB should acknowledge existence of such tools, the importance of their quality, the controls around them and the associated risks, their value to the audit of estimates, the extent of their use and their increasing importance within audit firm methodologies

36. The PCAOB needs to be seen to be encouraging innovation. The use of data analytics in impairment testing is a good example of auditor development of their own estimates, with the facility to flex assumptions and present them graphically on a real time basis. The PCAOB should make it clear that auditors should not automatically test management's process, simply because it is available, regardless of the quality of management's process, or because another route is less straightforward, especially if the alternative route, such as the use of data analytics in the development of an independent estimate, might produce better quality audit evidence. This would demonstrate the exercise of scepticism and reduce the emphasis on corroborative evidence. We have also made this point in our response to the IAASB.

Q5: 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?

37. We do not believe that the PCAOB should seek to address specific changes in accounting standards because the exercise is doomed to failure. Future-proofing auditing standards – against the impact of the extensive changes to the key industries affected by changes to the accounting for leases, for example – can only be achieved by adopting the objectives based requirements towards which the IAASB has started to move.

Q 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

38. There are no additional academic studies or data of which we are aware that the Board should consider.

Q7: 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.

39. The application of requirements applicable to fair value estimates may not, in the long run prove efficient or even effective for the audit of other low risk, simpler estimates.

Q8: The Board requests comment generally on the potential benefits to investors and the public. Are there additional benefits the Board should consider?

40. The benefits to investors and the public will be maximised if the PCAOB continues to engage to raise awareness of the importance of good quality support provided by management for its estimates to auditors on a timely basis, to manage expectations regarding the nature of the

estimates and the fact that estimates are just estimates and that estimation uncertainty cannot be audited away. The benefits will only be realised if management is actively discouraged from challenging auditors to prove them wrong.

41. We note in our main points above the fact that these proposals provide an opportunity for the PCAOB to enhance the breadth and depth of investor understanding of estimates which continue to play an increasingly important role in financial reporting. The PCAOB itself notes that adoption of the auditor reporting standards provides investors the information they have been asking for from auditors and we believe that there is scope for these proposals on estimates to do the same.

Q9: The Board requests comment generally on the potential costs to auditors and companies they audit. Are there additional costs the Board should consider?

42. As the PCAOB notes, an amount of what is proposed is already common practice, especially among larger firms. We believe that the PCAOB should call on the SEC to raise awareness among companies of the need for good quality support by management for its estimates, provided to auditors on a timely basis for these proposals to be effective. Poor quality support provided late in the day for material estimates is not uncommon and the PCAOB should ask the SEC to seek, through its engagement with audit committees, to encourage better behaviour in this regard, and to discourage management from challenging auditors to prove them wrong, but instead to expect and rise to the challenge set by auditors.

Q10: 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.

43. There are no additional academic studies or data of which we are aware that the Board should consider.

Q11: 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?

44. We support the PCAOB's post implementation review work through its Centre for Economic and Risk Analysis. This work, in the long run, will best serve the avoidance of unintended consequences.
45. Of the unintended consequences to which the PCAOB refers, we are most concerned about the procedures relating to third-party pricing sources becoming obsolete as technology and changes in capital markets affect how fair values of financial instruments are developed by these third parties. We believe there is excessive emphasis on this area in the proposals.
46. We are also concerned about the reference to the upcoming implementation of significant changes to accounting for financial instruments and the 'identification of matters that are not addressed by the proposal' as a potential unintended consequence. Changes in the requirements for financial instruments are far from the only significant changes in the pipeline. The only way the PCAOB can future-proof its standards effectively is by setting standards that are principles and objectives based. In the long run, we believe that advances in technology will force this issue.
47. We note in our answer to Q12 below some of the difficulties and potential unintended consequences of the proposals for EGCs and their auditors. One way of mitigating the risk of a reduction in competition in the audit market where audit firms withdraw as a result of having just one or two clients in a complex or regulated area might be to phase the requirements for EGCs. We note that these issues are not confined to EGCs.

Q12: The Board requests comment generally on the analysis of the impacts of the proposal on 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?

48. We believe that EGCs will struggle with internal controls relating to estimates. Some smaller companies enter into complex arrangements without understanding the accounting implications of those arrangements. While this is essentially an accounting issue, it has implications for the control environment and this may be an area that EGCs need to address.
49. There are issues with the valuation of complex financial instruments where there is either no market for the instruments, or unobservable inputs, no available model to evaluate and/or no firm pricing desk. Understanding ‘what good looks like’ in this context is important and consistency of approach across different inspections teams is critical. The cost of independent valuations for EGCs can be onerous.
50. Exempting EGCs from the requirements entirely would not ameliorate the situation but phasing the requirements in might enable EGCs to address these issues effectively. As with all situations in which an audit firm has only one or two clients in a regulated or complex area, justifying the additional work now required may be difficult and such firms might withdraw from such engagements. This clearly has an adverse effect on competition but we do not believe that this is a valid reason, in this case, to exempt EGCs altogether. We again note that these issues are not confined to EGCs.

Q13: Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

Q14: Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

51. We make no comment on these questions.

Q15: How much time following SEC approval would accounting firms need to implement the proposed requirements?

Q16: Would the effective date as described above provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

52. The proposed implementation date is for audits of fiscal years beginning in the year after approval by the SEC (or two years if SEC approval is in the fourth quarter). Moving from a mind-set seeking to ‘corroborate’ management’s estimate, to one that ‘evaluates’ is an important shift and will take time. While this will require some firms to consider and develop internal material that requires dissemination through training, for many firms the proposals broadly represent existing best practice and less time will be needed for implementation.
53. Some larger firms, as the PCAOB notes, are probably doing much of what is proposed already and would not need long to implement the proposals. As we note in our answer to Q12, above, it may be prudent to phase implementation for the audit of EGCs.

Q17: Are the scope and objective of the proposed standard clear?

54. The respective objectives of the PCAOB and IAASB are as follows:

PCAOB: *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*

IAASB: *The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:*

- (a) Accounting estimates, whether recognized or disclosed in the financial statements; and*
- (b) Related disclosures in the financial statements,*

are reasonable in the context of the applicable financial reporting framework

55. We do not believe that there is a significant difference between these two objectives. There is a difference of emphasis – in the case of the PCAOB on bias and in the case of the IAASB on disclosures and reasonableness – all of which are important. We doubt that these differences will have a significant effect on audit inspections or to the audit approach to estimates by auditors, not least because large firm methodologies are increasingly framework neutral.
56. We urge the IAASB and the PCAOB, going forward, to seek to align their objectives more closely than they do now. The differences between the objectives are less real, and less important, than their respective authors might wish them to be.
57. The scope and objective of the proposed standard are clear, but they would be clearer if the unproductive ‘noise’ created by relatively minor wording differences between the two standards were eliminated by their authors.
58. We note similar differences between PCAOB and IAASB definitions of an estimate. The PCAOB defines an estimate as *a measurement or recognition in the financial statements of (or a decision to not recognize) an account, disclosure, transaction, or event that generally involves subjective assumptions and measurement uncertainty* whereas the IAASB definition is *of a monetary amount, prepared in accordance with the requirements of the applicable financial reporting framework, the measurement of which is subject to estimation uncertainty*. The application material also refers to estimates used in disclosures or used to make judgments about whether or not to recognise or disclose a monetary amount.
59. Ditto significant data and assumptions, which IAASB refers to as being data and assumptions *for which a reasonable variation....would materially affect the measurement of the accounting estimate* (A35A). The PCAOB defines significant assumptions as those that are *important to recognition or measurement*. At face value, the PCAOB definition is wider, vague and less clear than that of the IAASB, and somewhat circular. Auditors operating locally under tighter definitions will tend to default to those definitions in an attempt to circumscribe an excessively wide PCAOB definition and these differences too, will make little difference to what firms do.

Q18: 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?

60. We note elsewhere in this response the following challenges in scaling the auditor's response:
- Third party pricing sources: the requirement for auditors to extract information from third party pricing sources in paragraphs A4b and A5c and A7 are unrealistic where pricing services refuse to provide clients or their auditors with detail on methodology, data or assumptions. Requiring auditors to perform ‘additional’ procedures, in such cases, including evaluating the appropriateness of the valuation method and the reasonableness of inputs used by the pricing service, especially when there are no recent transactions either for the financial instrument being valued or for anything similar, without any suggestion as to what those procedures might be, is unhelpful to the smaller companies most likely to be unable to obtain an independent valuation and audit firms without a pricing desk. There is no example of ‘what good looks like’ in this context and different inspections teams may approach the same area in different ways.

- Smaller companies often enter into complex arrangements without understanding the accounting or control implications of those arrangements and may be an area that smaller companies need to address.

Q19: Should the proposed standard limit the auditor's selection of an approach and, if so, under what circumstances?

61. The proposed standard should not limit the auditor's selection of an approach but it should caution against testing management's process unless that is the most appropriate solution. The PCAOB identifies the risk of verifying assertions on a piecemeal basis in such cases, and over relying on management's process rather than critically assessing the estimate.
62. The PCAOB effectively mandates the work on management's process in .10 the note to .07 and while we do not disagree with this, more is needed to ensure that auditors do not always go down that route as a result. The PCAOB should make it clear that auditors should not automatically choose this option simply because it is available, regardless of the quality of management's process, or because another route is less straightforward, especially if the alternative route might produce better quality audit evidence. Where appropriate, this would demonstrate the exercise of scepticism and reduce the emphasis on corroborative evidence. We have also made this point in our response to the IAASB.

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?

63. The proposed requirements for evaluating the company's method used to develop accounting estimates are clear but as noted elsewhere in this response, EGCs are likely to struggle with controls in this area.

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

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?

64. The requirements regarding testing internal data and evaluating the relevance and reliability of external data are thin. The only two references to completeness in the proposals are found in these requirements and we note the increasing importance of data analytics in this area. Some acknowledgement of the existence of such tools as an alternative to sampling, and the importance of the integrity of tools and the controls over their development would not be amiss in this context.

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?

65. IAASB refers to significant assumptions as being where *a reasonable variation in the assumption would materially affect the measurement of the accounting estimate*. The PCAOB refers to those that are *important to recognition or measurement*. The requirements relating to significant assumptions are clear but we note above our belief that the difference between the PCAOB and IAASB definitions of significant assumptions will make little difference to what firms do in practice, and our belief that going forward the PCAOB and IAASB should seek to avoid what are, in substance, differences of little consequence such as these.

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?

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?

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.

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

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

66. We believe that the PCAOB should not discourage auditors from developing independent estimates. We note in our main points above that larger firms increasingly use their own rigorously developed, tested and implemented models to provide high quality independent estimates and the PCAOB should acknowledge existence of such tools, the importance of their quality, the controls around them and the associated risks, their value to the audit of estimates, the extent of their use and their increasing importance within audit firm methodologies. The PCAOB should also emphasise that fact that developing an independent estimate, whether using rules of thumb or more sophisticated modelling techniques, has particular value where differences arise that create a basis for engagement with the company and where firms make genuine efforts to encourage this rather than avoiding engagement through the post-hoc rationalisation of differences. Otherwise auditors seeking to avoid being forced down the testing of management's process route, as a result of a combination of the proposed requirements as set out in paragraphs 11 and 12 in our main points above, will face an uphill battle.

67. Data analytics facilitates these innovative approaches. Demands from companies that auditors use data analytics as part of the audit and the shifts in firm recruitment patterns favouring those with analytical aptitudes, means that the PCAOB should more clearly acknowledge the use of these models in this context and the need to consider the implication of the use of such tools for the nature and extent of audit evidence required from understanding and testing controls.

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?

68. The proposed requirement *for an auditor's range* requires further elucidation for consistent implementation. Auditors are required to 'determine' that a range is 'appropriate' and is referred to AS 2810.13 but this is of limited value in this context and very high level. A common example is the use of discount rates applied to pension liabilities. A range of, say, 6-7% may seem reasonable to auditors, audit committees and the pensions industry but if the range this results in exceeds materiality many times over, auditors are left with attempting to 'determine' an appropriate representative point within the range, or narrowing the range, or deciding that the use of a range is inappropriate altogether. These are significant judgements but there is little guidance to support them. At the very least, the PCAOB might observe that to the extent that the range depends on non-monetary assumptions, particular care is needed when determining the monetary implications. The reporting of critical audit matters is also relevant in this context and we note the PCAOB's intention to make changes in this area.

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?

31. Are there 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?
33. Are there other sources of pricing information for financial instruments that should be addressed in the proposed standard?
69. There are no other factors, matters or sources of pricing information to which we wish to draw attention.
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?
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?
70. The requirements for using information from a pricing service are clear but somewhat unrealistic without reference to the use of centralised pricing desks and the firm's own models.
71. Centralised pricing desks operate differently in different jurisdictions and across firms. Their high level objectives though are similar however they are used, which is to drive consistency and efficiency across different audits and many in larger firms use internally generated or customised pricing models to facilitate the development of independent estimates. Regulators rightly have concerns about the controls around the development of firm models generally but these concerns have been addressed by firms and the models are generally believed to be robust and flexible. Audit teams that use centralised pricing services do need to ensure that relevant documentation regarding firm-wide control in that area is on the file. We note above our belief that the PCAOB should acknowledge existence of such models, the importance of their quality, the controls around them and the associated risks, their value to the audit of estimates, the extent of their use and their increasing importance within audit firm methodologies. Innovation in auditing is critical to the quality of audit.
36. Is the auditor's responsibility when evaluating relevance and reliability of pricing information from multiple pricing services clear?
37. Are there 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?
72. We note in all of these cases the need for auditors to be aware of the implications of bias. We note in our main points above our support for the PCAOB's acknowledgement of the importance of this issue and encourage it to include further material on bias in the main body of the standard.
73. Requirement .A10 relating to unobservable inputs asks a lot, in terms of obtaining an understanding of how unobservable inputs were determined and evaluate their reasonableness taking account of modifications thereto, the assumptions of market participants (whose level of understanding is likely to vary) and whether management appropriately considered 'the information available'. This latter should at the very least be circumscribed by a reference to 'relevant' information.
39. Are the proposed requirements for evaluating audit evidence regarding the valuation of investments based on investee financial condition or operating results 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?

74. We are unclear as to whether this appears to be a US GAAP specific set of requirements. If it is, we would make an observation to the effect that this is inappropriate in this context given the facility to provide a reconciliation to US GAAP.

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

75. There other no matters relevant to understanding the process used to develop estimates that we are aware of.

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

76. Yes, it is appropriate to include how financial statements could be manipulated through management bias in estimates as part of the engagement team discussion. It would also be helpful if the standard itself could outline very briefly the widely recognised different types of bias.

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

77. The additional risk factors to identify significant accounts and disclosures involving accounting estimates are clear.