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Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: Staff Consultation Paper: Auditing Estimates and Fair Value Measurements

Members of the Board,

I appreciate the opportunity to submit my comments to the Board with respect to the *Proposed Auditing Standards – Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*. I retired from public accounting in 2007 after 27 years at Deloitte & Touche LLP and am currently a full-time faculty member at the University of Notre Dame teaching undergraduate and graduate courses in accounting and auditing.

Public perception to the contrary, the Board does not have unlimited resources. As I have stated on previous occasions, I believe it is unfortunate that the Board elected to exercise its standard setting role related to generally accepted auditing standards directly rather than indirectly as the Securities and Exchange Commission has done with respect to the establishment of generally accepted accounting principles. The Board's staff is now beginning a process of reconsidering old auditing standards that the AICPA and IAASB revised more than two years ago; auditors of private companies are now conducting their third annual audits under these new, AICPA/IAASB standards. In fairness, however, to the extent the new standards required auditors to improve their audit procedures, those auditors are already applying the improved practices in audits of registrants; in my experience, audit firms do not establish different audit approaches for different regimes but strive to meet the most stringent of competing standards. Accordingly, the audits inspected by the Board's examiners in the 2013 inspection cycle should already reflect any such changes in procedures required because of the revised AICPA and IAASB standards.

I do not believe a project to rewrite or combine standards AU 328 and AU 342 is an effective use of the Board's limited resources. The Board could accomplish its goals by adopting AU-C 540 as permitted by Section 103(a) of the Sarbanes-Oxley Act of 2002 and considering the additions necessary to make that published standard more effective for audits of registrants. Furthermore, I recommend the Board's staff consider all the standards issued under the IAASB/AICPA's Clarity Project and adopt those it considers appropriate rather than spending the next several years going through an exercise of amending or rewriting other old or outdated auditing standards. By relying on the private sector to do the "leg work" in the standard setting arena, as the SEC does for generally accepted accounting principles, the Board could concentrate on issues broader than individual auditing standards and the staff could focus on any necessary incremental additions to AICPA/IAASB standards. For example, the AICPA Clarified Standards are not adequate for audits of internal control. If the Board were to adopt the Clarified Standards in the area of auditing estimates and fair value measurements, the staff would be free to focus its efforts on the adequacy of AS No. 5 with respect to the auditing of controls over estimates and fair value. I believe this would be a much more efficient and focused use of the Board's resources. Furthermore, over time, the experiences of the Board's inspection teams would serve to identify shortcomings in the basic, Clarified Standards the Board could address by publishing add-ons to the Clarified Standards. The Board could publish "Staff Auditing Bulletins" rather than undertaking complete re-writes of those standards as the SEC does with its Staff Accounting Bulletins that serve to interpret and enhance financial reporting standards.

This approach would also simplify the education and training of auditors both in school before they enter the profession and at their firms as their careers progress. The existence of competing, parallel standards for public and private companies adds unnecessary complexity to the education of college students for entry into the profession. Competing standards may also add to the perception that the PCAOB is an adversary of the profession. During my years in the profession, I did not view the SEC as an adversary; we all respected its people their expertise and their professionalism. In practice we viewed the need to have financial statements conform to Regulation S-X or some accounting treatment conform to a particular SAB as a sign of the superior quality of public reporting over private reporting. I believe the Board could achieve the same perception with respect to audits of public companies over audits of private companies.

On another matter, as noted above I have been teaching full time since 2007. Complexities of Fair Value reporting, the financial crisis, and changes in structures of firms have happened during these past seven years. Students still must meet minimums to sit for CPA exam, but those minimums have not changed appreciably to meet the increased complexity of accounting and auditing. Students can complete their college educations and take the CPA examination without any meaningful training in derivatives, hedging, fair value reporting or other complex areas whether it be accounting for them or auditing them. The Board has published no standards or other guidelines that specify the amount of training necessary to perform anything from a walk-thru to substantive testing.

Senior technical personnel in firms are competent in areas such as accounting for financial instruments or auditing fair value estimates; they have developed those competencies over years of service. Those professionals are the ones who teach the continuing education courses, but they do not conduct the audits themselves. Experienced personnel in firms attend continuing education but my experience is that those courses do not require demonstration of any mastery of the material covered. PCAOB inspections and firm internal inspections may identify individuals who do not demonstrate sufficient technical proficiency for a given area, but those identifications are after-the-fact. The PCAOB should consider undertaking a project to identify and evaluate the "best practices" its inspection teams have seen with respect to training for assignment in certain industries and technical areas not only as supervising partners, but also as auditors performing substantive tests and tests of controls.

My responses to selected questions are set forth in the enclosed appendix. I appreciate the opportunity to offer my comments.

Sincerely,

S/ James L. Fuehrmeyer, Jr.

James L. Fuehrmeyer, Jr. MBA, CPA
Associate Teaching Professor

Appendix – Responses to staff questions

1. Does the information presented above reflect aspects of current audit practice? Are there additional aspects of current practice, of both larger and smaller audit firms – including centralized testing, the use of third parties, or specific challenges to auditing accounting estimates and fair value measurements – that are relevant to the staff's consideration of the need for standard setting in this area?

The practices noted by the staff are consistent with my experience. Additionally, I believe that audit firms with sufficient personnel to do so have instituted training and experience requirements for those directly responsible for conducting audit procedures related to fair value and estimates as well as those who review that work. However, I also suspect it is rare that those auditors who perform audit procedures on the internal controls over fair values and other estimates possess levels of expertise similar to those who perform substantive tests of those same areas. Furthermore, the involvement of these national level specialists is dependent on those performing audits determining that they need to consult with them. In response to this, firms have instituted continuing education courses to familiarize their audit personnel with these complex areas but, in my experience, there is no meaningful process to ensure these auditors demonstrate proficiency with the subject matter.

2. The staff understands differences may exist in the use of centralized or national-level pricing desks at audit firms. The staff is interested in current practice for interaction between national-level pricing desks and engagement teams. For example, how (and by whom) are national-level pricing desks supervised given the engagement partner's responsibility under the risk assessment standards? How should these considerations affect auditing standards?

As an engagement partner and quality control reviewer, I supervised many professionals including valuation specialists, financial instrument specialists, actuaries, tax specialists, internal control specialists, computer technology specialists, and fraud specialists. The tone of the staff's question implies that an engagement partner must be a specialist in all these areas in order to carry out his or her responsibilities under AS No. 10. The engagement partners must rely on their firm's ability to hire appropriately skilled specialists and on the firm's internal quality control structure in which other partners or senior technical personnel within those specialties supervise and review the work of the firm's specialists. With respect to consideration in auditing standards, the Board could adopt AU-C 620, "Using the Work of an Auditor's Specialist", and augment that standard with any additional requirements it believes applicable to registrants, particularly with respect to the specialists' participation in the audits of controls.

3. What other issues relevant to the need for standard setting should be considered by the staff?

The stated purpose behind H.R. 3763 is "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes". I submit that the primary means to improve accuracy and reliability is to improve the quality of the information before it gets to the auditor. The staff is properly focused on improving the quality of independent audits, but those audits are additive to the quality of registrants' financial reporting systems. The auditor and the PCAOB can have a positive impact on that level of quality in registrants' systems by demanding better processes and controls over complex estimates, particularly at registrants who engage in practices beyond the expertise of their personnel. The staff states in footnote 23 that the three most difficult areas for auditors are fair value measurement, audits of internal control, and financial statement disclosure. I believe the auditors' effectiveness in these areas is directly dependent on the competency of management.

Accordingly, I believe the staff should consider the adequacy of AS No. 5 with respect to tests of controls related to fair values and estimates. In particular, the staff should consider whether the absence of personnel who are qualified to make fair value and other complex estimates, or who have sufficient experience to supervise third parties who perform those functions for the registrant, are indicators of a material weakness.
Furthermore, the staff should consider whether there should be particular expertise required of those who perform tests of ICFR related to fair value and other complex estimates. State requirements to take the CPA examination

vary but none requires coverage of specific topics such as accounting for complex financial instruments or auditing fair value estimates. Though most states now require 150 hours of college credits, many students meet those hours with high school advanced placement courses in non-business disciplines. Some states require more hours of accounting courses than others but many left the accounting and business hours component unchanged at the time they adopted the 150-hour requirement. Even when there are requirements in those areas, the passing score on the CPA exam is still a 75. While this may be sufficient to enter into the profession, if there is no actual improvement beyond the basic level of expertise and education throughout the career, it is not clear how this is sufficient to conduct audits of registrants particularly audits of complex areas.

4. Do accounting estimates and fair value measurements have sufficiently common attributes that the audit procedures should be included within a single standard? Are there limitations to the approach of having a single standard address both auditing accounting estimates and fair value measurements?

As the Board notes, there are differences in complexity; Level 3 financial instruments are inherently more difficult to audit than the allowance for doubtful accounts not only because the fair value models contain more variables but because the volatility in those estimates caused by small changes in those variables can materially impact the registrant's financial statements. The balances and transactions related to complex financial instruments are generally very large and the variables involved can change abruptly; they are outside of everyone's control. Sometimes, as with the recent revelations about manipulations of LIBOR, those variables are not only volatile but potentially unreliable.

However, even the simplest accounts have inherent difficulties. I suspect the Board's inspection teams rarely examine the audit work related to property and equipment. The amount recorded for straight-line depreciation of a major piece of equipment that has a 20-year life is dependent entirely on that estimated useful life and the equipment's estimated salvage value. While most auditors would consider auditing depreciation expense an easy area, I submit there is no objective, reliable evidence to support management's assertion that the useful life of that item will be 20 years. The fact that in prior years the registrant used similar items of equipment for 20 years is not proof that it will use this item for 20 years. An inspector examining this audit area could reasonably conclude that the auditor had no evidence beyond inquiry of management to support its conclusion that the depreciation expense recorded for this item is appropriate. That being said, it is still more difficult to audit financial instruments than to audit property.

While procedures related to all estimates could be included in a single standard, having them in separate standards would give more attention to auditing fair value. Additionally if the Board went down the path of adopting AU-C 540 it could readily add an enhanced standard to address the procedures required for audits of fair value and similar complex areas. While relatively straightforward estimates such as useful lives or allowance for doubtful accounts receivable might lend themselves to efficient testing by means of the auditor developing its own estimate, I believe that in the interest of improving financial reporting and increasing the quality of audits, the standard should require that the auditor test management's process for developing complex estimates. An additional requirement such as this if presented in a separate enhancing PCAOB standard would clearly highlight what the Board expects of auditors who serve registrants and would clearly set forth the additional work that would be required to audit a private company in the process of becoming a registrant for the first time.

5. Are there considerations affecting accounting estimates relative to the financial reporting frameworks, such as recent changes to revenue recognition, that the staff should specifically take into account in developing a potential new standard?

The accounting framework is becoming more subjective as it evolves away from simple historical cost. For example, variable consideration in revenue contracts under the new standard will include management's determination of the amounts it expects to receive. This involves the assignment of subjective probabilities to various outcomes that will be difficult for the auditor to verify. The FASB emphasizes relevance of information suggesting it is more important than the absolute verifiability of that information. The FASB appears willing allow for more subjectivity in financial statements in the interest of increased availability of information.

I believe the FASB will increase the number of instances that require management to make estimates based either on its expectations or its intent, both of which do not readily lend themselves to the sort of objective audit procedures the Board has in mind. However, information based on management's expectations or intent is still relevant as the ultimate realization of those estimates gives users information about management's ability as well as its character. Auditors should be required to perform retrospective analyses of estimates to monitor how those estimates have been realized, to develop information about management's ability to make estimates, and about the biases inherent in those estimates. I submit that management that is consistently low or consistently high in its estimates is less risky than one who swings between high and low when it suits its purpose in achieving desired earnings targets.

6. Are there other considerations relating to the alternatives explored, including other alternatives not discussed in this paper, that the staff should consider in connection with this project?

The staff has not discussed the alternative proposed above, namely that the Board adopts AU-C 540 and the staff develops an enhancing standard to accomplish the desired level of auditor proficiency for public companies. The staff discussion speaks to eliminating redundancy and confusion as well as promoting more consistent auditor performance; building off the AICPA standards appears to be a more logical means of accomplishing that and should be presented to the Board as an option for its consideration.

7. Omitted

8. If AU sec. 332 were to be superseded, are there elements that should be retained? With respect to derivatives and securities, are there enhancements related to auditing assertions other than valuation that the staff should consider?

The Board should adopt AU-C 501 and add to that standard as necessary. Additionally, the Board should reconsider AS No. 5 and add specific requirements for tests of controls of derivative financial instruments and other complex areas. In particular, the Board should consider requiring interim period audits of controls and substantive testing of complex fair value estimates. These complex instruments can have a serious impact on quarterly financial reporting. While auditors do not have to report on controls as of the ends of quarters, the Board should consider requiring auditors to test controls over these and other complex instruments at the ends of one or more quarters. For example, registrants must report derivative instruments at fair value at the ends of each of the interim quarters and the controls over that reporting should be no different at those periods than they are at the end of the fiscal year. Identifying weaknesses and reporting them to the Audit Committee earlier would help improve annual financial reporting.

9. Are there considerations relevant to auditing accounting estimates and fair value measurements including other regulatory requirements specific to certain industries that the staff should take into account?

The staff should consider AU-C 9500, "Audit Evidence – Auditing Interpretations of Section 500" with respect to the audits of accounting, disclosure and control of uncertain tax positions. These are often highly material, sometimes emotional accounts and the impact of third party tax advisors and outside counsel is significant. Auditors' interactions with these parties are difficult at times due to the impact of attorney-client privilege and the shadow of the Internal Revenue Service; both put additional pressure on management to withhold information from auditors. In its standard, the AICPA discusses the difficulties in auditing these accounts and the occasional need to consider the existence of a scope limitation. Such a situation would put even more pressure on auditors of registrants due to their inability to issue a qualified opinion for filing with the SEC.

10. Should the requirements for identifying and assessing risks of material misstatement with respect to accounting estimates and fair value measurements – including risk assessment procedures – be included in Auditing Standard No. 12 or be separately set forth in a potential new standard on auditing accounting estimates?

In comparison, the AICPA includes general risk assessment in AU-C 315, "Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement" and includes risk response in AU-C 330, "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained". It then includes specific risk and responses related to estimates and fair value in AU-C 540. As noted above, the Board could save considerable time by adopting the AICPA Clarified Standards and augmenting them with specific additional procedures it believes necessary for audits of registrants.

11. Omitted

12. Is the potential amendment to Auditing Standard No. 12 described above clear and appropriate for both accounting estimates and fair value measurements? Are there other matters relevant to understanding the process used to develop accounting estimates or fair value measurements that could be included in Auditing Standard No. 12?

The requirements in AU-C 540.08 related to risk assessment and understanding the process are more extensive than the proposed amendment to AS No. 12. As suggested above, the Board should adopt AU-C 540 and augment it if necessary. In particular, the Board should require the auditor to evaluate the competency of registrant personnel and/or third parties who prepare these estimates and the competency of management personnel who supervise them.

13. In circumstances where the company uses information obtained from a third party, are there matters— such as information systems at third parties, controls that management has over the work of third parties, and controls at third parties— not currently addressed in AU sec. 324, Service Organizations, or other standards that the staff should consider?

The staff should address those circumstances where the registrant uses information obtained from attorneys and from tax advisors. Deficiencies in audits of fair value of financial instruments and of complex estimates frequently appear in PCAOB inspection reports; deficiencies in auditing uncertain tax positions or in evaluating attorney's evaluations of litigation exposures seem to be less common. The staff should also consider the adequacy of AS No. 5 and the auditors' tests of controls related to these estimates.

14. Is the potential amendment to Auditing Standard No. 12 described above clear and appropriate for both accounting estimates and fair value measurements? Are there other factors that would be relevant in the auditor's evaluation of the degree of complexity of judgment in the recognition or measurement of an accounting estimate or fair value measurement (e.g., the use of a third party for the determination of a price)?

See the response to Question 12, above.

15. Omitted

16. Are there certain types of accounting estimates or fair value measurements that should be presumed to be significant risks?

The auditors should presume a significant risk in all situations where the registrant does not have appropriate in-house expertise. While some might suggest that certain estimates are inherently more complex and auditors should presume they are significant risks, I believe this should remain a matter of auditor judgment.

Derivatives vary in complexity from "plain vanilla swaps" to residual tranches of asset-backed securities. Larger registrants and audit firms would likely not consider the former as risky; conceivably, for a smaller entity with access to fewer financial instrument specialists, they could be. However, even relatively simple estimates can be risky if the registrant's accounting personnel or processes are inadequate. Riskiness is a function of the registrant's abilities and its internal controls; auditors' assess that riskiness based on prior experience with the registrants' capabilities. One could presume every financial reporting area is a significant risk until the registrant demonstrates the ability to properly control and account for that area.

17. Are there considerations particular to the timing and extent of these procedures (e.g., interim audit procedures), beyond the requirements of paragraphs 42–46 of Auditing Standard No. 13, that the staff should consider including in a potential new standard?

In my experience as a quality control reviewer in the years 2004 through 2006, auditors identified more errors testing controls in accordance with AS No. 2 than they did performing substantive tests of accounts in the years prior the issuance of that standard. The staff should consider expanding AS No. 5 to require interim period testing of internal controls over certain accounts including, but not limited to, material estimates and fair value measurements. For many of these items, particularly fair value measurements, the recorded amounts fluctuate from period to period often materially. Though the total gains or losses on these items will become apparent upon their maturity, in the meantime they are subject to error and manipulation. Quarterly financial reporting is important in financial markets and is a direct function of the quality of management and the processes it establishes to generate those reports.

18. Omitted

19. Should a potential new standard include specific audit procedures related to auditing disclosures of accounting estimates (e.g., disclosures on levels within the fair value hierarchy)?

No. I do not believe that improperly classifying a financial instrument whose fair value measurement is reasonable is an error that makes the financial statements misleading or in any way unfair. However, I do believe that a material misclassification could be an indication of a significant deficiency in internal control if it is indicative of a lack of competence on the part of those employees and management who prepare and who review such disclosures.

20. Given the existing requirements related to testing controls in Auditing Standard No. 13 (and Auditing Standard No. 5, as applicable), would specific requirements on testing internal controls over accounting estimates be useful (e.g., evaluation of design and operating effectiveness of key review controls over accounting estimates)?

AS No. 5, AS No. 12 and AS No. 13 all speak to the need to evaluate the competency of registrant personnel and third parties who prepare estimates, supervise those who prepare them, or who exercise control over them. However, those standards do not address the qualifications of the auditor who tests the accounts or the controls over them.

The staff should consider the experience of the Board's inspection teams in their examinations of complex estimates and fair value measurements to identify both common and best practices among the firms related to training and evaluation of individual auditors. For example, while many firms have designated specialists who review complex mathematical models related to Level 3 financial instruments, those same firms might use inexperienced staff or internal auditors to perform walk-thru procedures and to test controls over the assumptions and data used in those models. The Board should consider amending AS No. 5 to require fair value measurement or similar expertise and training of those who test or document internal controls over these areas including those who perform walk-thru procedures.

Fair value estimates necessarily include unverifiable inputs as they require the registrant to consider what market participants would do – whoever they might be – and to assume an arms-length transaction with an unknown willing buyer. Clearly, more judgment and more expertise is required to audit fair value estimates of Level 3 financial instruments and more emphasis must be placed on the quality of the registrant's personnel and the quality of its internal control related to those estimates. I believe auditors should be required to audit management's processes and controls related to more complex estimates (such as Level 3 financial instruments and goodwill) evaluate those controls, and report on them to those charged with governance.

Finally, as noted earlier, in my experience auditors detected more misstatements when they tested internal controls in accordance with AS No. 2. The staff should consider reinstating some of the requirements of that standard with respect to these complex estimates and fair value measurements. Auditors did spend more time testing controls in accordance with AS No. 2 and I believe the benefits associated with that increased time in these particular areas may outweigh the costs.

21. Should a potential new standard include specific audit procedures that would be applicable when the auditor identifies and assesses a risk related to accounting estimates as a significant risk? If so, are there factors regarding measurement uncertainty or any other characteristics relevant to staff considerations of potential audit requirements?

Other than tests of controls at interim periods, I do not believe the Board should specify specific audit procedures. The staff's question seeks to determine how best to audit estimates that are inherently imprecise. Despite what registrants may state about the complexity and variability of estimates, particularly Level 3 fair value estimates, users appear to act as if they expect these amounts and disclosures to be precise or "correct". These are estimates and whatever they are, they are not "correct". The staff should be careful that it is not enticed into making standards that require auditors to more precisely audit what are in reality fictional numbers. The Board should not adopt standards for estimates written as if auditors are dealing with re-computations of known numbers.

That being said, auditors must be required to test inputs to their sources. Even if auditors develop their own estimates, they eventually must use data that is specific to the registrant and therefore comes from the registrant.

22. Are there specific factors that affect the auditor's selection of approaches related to testing accounting estimates? What considerations would be appropriate for the auditor to take into account when determining which approach (or combination of approaches) for testing accounting estimates should be selected?

Management qualifications should dictate what auditors do. If management is not fully capable of making complex accounting estimates or fair value measurements, then the auditor must develop its own estimate and consider the need to report the existence of a material weakness. If management is highly competent, and the auditors' experience confirms that competency, the auditors should focus on tests of controls and management's supervision of those processes that generate complex estimates. In all cases, however, auditors should be required to test that data used in those estimates.

23. Aside from testing management's process, developing an independent estimate, or reviewing subsequent events and transactions as further discussed, should a potential new standard allow for or require other approaches to testing accounting estimates? If so, what other approaches would be appropriate?

The Board should require that auditors test controls and processes for performing fair value measurements and making complex estimates, including tax and litigation estimates. Furthermore, the Board should require such control testing of new fair value measurements or complex estimates, including new litigation or new uncertain tax positions, as of the first quarter-end in which the situation arises.

24. Omitted

25. Are there enhancements to the existing requirements for testing data used by management to develop the accounting estimate the staff should consider?

As I have stated on other occasions, I believe the Board's greatest impact on the profession is achievable through the inspection process, not through the writing of lengthy auditing standards. In response to this question, I would ask "What are the best practices the Board's inspection teams have observed in the past several years?" Through a simple process of education and dissemination of information through Staff Alerts, the Board could have more immediate impact on audit quality each year than it can have through a multi-year process of writing, editing and adopting basic auditing standards.

26. Are the potential requirements described above for evaluating whether the company's method used to develop accounting estimates appropriate for both accounting estimates and fair value measurements?

The requirements listed are consistent with those outlined in AU-C 540.A72 to .A74, though not as comprehensive.

27. In circumstances where the financial reporting framework does not specify the use of a particular valuation method, is the consideration of methods accepted by the company's industry relevant? Are there other criteria that auditors could use to evaluate the appropriateness of the company's method used to develop accounting estimates?

If the FASB's or IASB's financial reporting framework does not specify a method, and does not specify that a reporting entity use a method that is considered the "best practice" in its industry, it is difficult for the Board or the auditors to specify that the reporting entity use a particular method. Auditing standards currently require that when management has alternatives, the auditor must report to the Audit Committee the existence of those alternatives; how the entity's reports compare to other, similar entities; and the implications of the entity's choices for financial reporting. As I have said elsewhere, improving the quality of information provided to users must start with management and it is the Audit Committee's responsibility to push management to improve quality in areas such as this.

28. Would a requirement for the auditor to determine which assumptions used by management are significant assumptions present difficulties in practice? Should the staff consider a requirement for the auditor to identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate?

I believe if an auditor is evaluating management's estimate, the auditor will have some basis on which to decide whether it believes management's assumptions and its model are reasonable. If an auditor has the expertise to make that assessment, the auditor must believe that there is a reasonable means of developing the model and the assumptions. To the extent management did not identify or use appropriate assumptions or modeling techniques consistent with the auditor's expectation, the auditor must identify that management's model and/or assumptions are deficient. Accordingly, I do not understand how an auditor could identify assumptions that should have been but were not used by management if management's model is reasonable. This requirement has the potential to develop into a requirement that the auditor identify and document all possible assumptions that could have been used in the model and were appropriately not used in the model. It could also lead to the requirement that auditors perform alternative calculations or develop alternative models in situations where management has flexibility under GAAP to choose its model. If management has the flexibility to choose among alternatives, what purpose does the auditor's documentation of alternative assumptions serve? How does this add to audit quality – other than adding more documentation?

29. Omitted

30. Are the suggested factors described above appropriate for evaluating the reasonableness of significant assumptions? Are there other factors the auditor should assess when evaluating the reasonableness of significant assumptions relevant to accounting estimates?

In the body of the Staff Consultation Paper, the staff has not made reference to AU-C 620, *Using the Work of an Auditor's Specialist*. Matters being considered by the staff in this paper have been addressed in that standard. Again, the Board could save considerable time, energy and resources if it adopted that standard and issued any additional guidance it believed necessary for the audits of registrants.

31. Is the potential requirement described above appropriate for all types of accounting estimates? Are there other considerations that should be taken into account in applying this requirement to accounting estimates?

One estimate that the profession and the Board have yet to tackle is the estimated liability for a lawsuit or similar potential claim. Both registrants and auditors rely on the letters from outside counsel that either state that counsel is unable to estimate an exposure or range of loss for a matter, or that the registrant's exposure to liability will not exceed some amount. Those opinions provided by outside attorneys ultimately drive material estimates for all registrants at some point in time. Neither auditors nor management has any ability or knowledge on which to base a challenge of those legal opinions. If the registrant were developing an estimate related to litigation exposure, the Board would expect the auditor to obtain and test the information used by management to develop its estimate including its past experience with these or similar claims. There are no such expectations with respect to tests of the processes used by outside counsel to develop its estimate or express its opinion. The Board should consider whether it expects auditors to challenge and attempt to test information underlying opinions from outside counsel and if not, whether there are other professions (e.g., the medical profession) whose reports and conclusions auditors could accept without challenge.

32. Are the potential requirements described above for developing an independent estimate, including the potential requirements regarding testing data and assumptions, clear and appropriate for both accounting estimates and fair value measurements? Would these requirements present challenges for certain types of accounting estimates and fair value measurements?

I expect that when an auditor tests management's estimate and notes assumptions that are outside the bounds of reasonableness, the auditor either performs its own calculation to ascertain the extent of potential error in the estimate, or requires management to re-perform its calculations using assumptions that are more reasonable. Accordingly, whether the auditor develops its own estimates or tests management's model, it must perform the same tests. That is, the auditor must test the data underlying the estimate and test the reasonableness of all variables and assumptions that enter into the development of the estimate.

In the discussion, the staff gives the example of an auditor obtaining mortality rates from a third party. In my experience, registrants use third party actuaries to develop their pension obligations. Auditors also use actuaries, either their own professionals or a third party actuarial firm, and those professionals challenge the inputs used by the registrant's actuary, including the various standardized mortality tables. Also in my experience, the most common sources of error are either inappropriate management assumptions (such as rates of compensation increase or discount rates) or erroneous payroll and retiree data provided to the registrant's actuary by the registrant. The key requirement must be the audit of the data underlying any estimate and ultimately all such data has its source in the registrant's systems and records.

33. Are there additional considerations that should be addressed with respect to information obtained by the auditor from a third-party source?

Again, the staff should consider the requirements of AU-C 620, *Using the Work of an Auditor's Specialist*. The AICPA and IAASB have addressed matters the staff is considering in this section of the paper. The guidance in this standard is applicable to use of information developed by third party specialists.

34. Are there factors that the staff should consider when developing potential audit requirements for testing the reliability and relevance of data independently derived by the auditor or obtained from other sources?

Ultimately, even if auditors develop their own estimates, the data they use has to come from the registrant. Information on a registrant's projected cash flows, which will form the basis for many estimates, cannot come from any source other than the registrant. Accordingly, the auditor must ultimately identify and test that data. Variables used by the auditor in developing its own estimates (discount rates, growth rates, prepayment speeds and so on) must come from independent sources and those sources have to be evaluated. The auditor must even challenge data developed independently from sources outside the audit firm; one need only recall the recent manipulation of a purportedly reliable benchmark such as LIBOR.

35. Are there other matters relevant to developing a range that a potential new standard could address (e.g., requiring a sensitivity analysis)?

First, auditors should perform both a sensitivity analysis and a retrospective analysis of registrants' estimates. The former will heighten the auditors' sensitivity to the risks inherent in management's estimates; the latter will highlight any changes in management's inherent biases or in its methodologies for generating estimates.

Second, the Board should comment on Financial Accounting Standards Board proposed accounting updates whenever it has the opportunity. I continue to believe that improving the quality of financial information must start with improving registrants' financial reporting processes. I believe that many investors take estimates at face value and ascribe a level of reliability to them that is not commensurate with the underlying uncertainty. Requiring management to develop and disclose reasonable ranges for these complex estimates would begin to raise the level of awareness of users of financial statements and help them to understand that what they see in financial statements is not a "true and correct" picture of a registrant's financial position or the results of its operations. Citigroup's 2013 annual report disclosed that it had net income of nearly $14 billion. It also has nearly $1 trillion of Level 2 & 3 assets and nearly $1 trillion of Level 2 & 3 liabilities. Management and the auditors could be 99% correct on both sides of the balance sheet and the items that are missed could wipe out all that entity's income for the year.

36. Are the potential requirements described above for evaluating audit evidence from events or transactions that occur subsequent to the measurement date through the date of the auditor's report, appropriate for both accounting estimates and fair value measurements?

The Board should require that auditors perform a retrospective review of management's estimates. That requirement is set forth by the AICPA in AU-C 540 paragraphs .09 and .A41 and the Board should expect that auditors are already performing that procedure in audits of registrants.

37. Are there additional factors that should be taken into consideration when evaluating the relevance of the audit evidence obtained from events or transactions that occur subsequent to the measurement date through the date of the auditor's report?

The Board should require that auditors test registrants' controls related to financial reporting around subsequent events. At the time the Board issued AS No. 5, consideration of subsequent events was primarily an auditor's responsibility. That responsibility has since been shifted to management through the issuance of Statement of Financial Accounting Standards No. 165 (ASC 855). The Board's standard for audits of internal control focuses on testing subsequent changes to controls; AS No. 5 should be updated to require that auditors test management's controls over the identification and reporting of subsequent events.

38. Would the potential requirements described above address procedures performed by audit firms that use a centralized testing approach? Would these requirements create issues in practice for smaller firms?

The staff should consider recommending that the Board adopt AU-C 500 "Audit Evidence". Paragraphs A35 and following of that standard set forth appropriate requirements for evaluating management's specialist. Smaller firms would be required to comply with those audit standards whether they served a registrant or a private company. The staff would then need to consider the need to augment that standard with any specific requirements applicable to audits of registrants, including requirements related to controls and audits of controls.

39. Should the potential new standard require the auditor to use a third party that is different from the third party used by management? Would such a requirement present challenges for certain types of accounting estimates and fair value measurements?

Yes, I believe this could be an independence issue. If the auditor uses the same third party as its audit client, the auditor is auditing its own work. This is no different from the situation where an auditor has its own in-house valuation experts who, as part of the firm's "advisory practice", provide valuation services to the firm's audit clients.

40 through 43. Omitted

44. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this consultation paper? Are there any unintended consequences that might result from the alternatives?

As I commented earlier, I believe there is a cost to the Board in terms not only in the effort required to set standards but also the timing of that process. I firmly believe the Board would be a more effective regulator if it relied on the AICPA to set the basic level of standards, as it must do for private enterprises, adopted those standards as published, and then spent its time and effort enhancing those standards with additional requirements applicable to audits of registrants.

45. Omitted