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Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

3 November 2014

Re: Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements

Dear Ms. Brown:

Ernst & Young LLP (Ernst & Young) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on the *Staff Consultation Paper – Auditing Accounting Estimates and Fair Value Measurements* (the Consultation Paper). We are encouraged that the PCAOB has initiated this potential standard setting initiative with a staff consultation and believe it is a constructive way to seek initial stakeholder input earlier in the standard setting process, particularly in this complex area of auditing.

We support the PCAOB's efforts to evaluate whether existing standards on auditing accounting estimates and fair value measurements can and should be improved. We agree that "changes in financial reporting frameworks," "changes in methods" and the "growing reliance on the work of third parties" are reasons for taking a fresh look at the auditing standards[1] in this important area. We believe efforts to make improvements to the PCAOB standards in this area should seek to do all of the following:

- Align them with the risk assessment standards and eliminate duplicate risk assessment guidance
- Provide further clarity on which auditing standards apply in a given circumstance
- Provide improved guidance for addressing areas of significant risk in accounting estimates and fair value measurements
- Clarify how the auditor might consider and document potentially contrary information when evaluating the reasonableness of an accounting estimate or fair value measurement
- Clarify how the auditor might weigh the relevance of the various possible estimates or implied range of possible estimates as part of evaluating the reasonableness of the recorded estimate

We believe these objectives are consistent with the discussion at the recent meeting of the Standing Advisory Group.

1 Consultation Paper, page 9

Our views regarding the staff's consideration of possible changes to the existing auditing standards are included below, organized into the following sections:

- Adoption of a Single Standard
- Management's Use of a Specialist
- Evaluating Reasonableness of an Accounting Estimate or Fair Value Measurement
- Use of Third Party Pricing Services
- Other Matters

Our views are designed to provide the staff with early input on potential implementation challenges we see with a few of the alternatives included in the Consultation Paper. We would be pleased to meet with the staff to further discuss the following views as well as how current audit practices have evolved in auditing accounting estimates and fair value measurements.

Adoption of a Single Standard

One of the alternatives included within the Consultation Paper is developing a single standard that would supersede AU sec. 328, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), AU sec. 342, *Auditing Accounting Estimates* (AU sec. 342), and much of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU sec. 332). Although we believe there is opportunity to improve existing auditing standards as stated above, we are concerned that a single standard would not be able to effectively and fully consider the wide array of accounting estimates and fair value measurements that need to be addressed, and which may result in significant unintended consequences (e.g., guidance intended for auditing fair value measurements developed by third party pricing services is interpreted as applicable to a broad range of other estimates). Additionally, we are also concerned with the potential requirement to apply the procedures for testing the assumptions developed by a company specialist specified in AU sec. 328 more broadly to all accounting estimates.

Proposed alternative

We believe the use of a single standard to audit every accounting estimate and fair value measurement currently required by the existing accounting framework may not be the best approach. Rather than a single standard, we believe that multiple standards, or perhaps a single broad principles-based standard accompanied by more detailed auditing supplements tailored to the different facts and circumstances inherent in the specific estimate and valuation areas, may be a more constructive alternative.

The current accounting framework for developing accounting estimates and fair value measurements incorporates a wide range of estimate and valuation areas, valuation concepts, valuation methods, assumptions, other data inputs, and many of the resulting accounting estimates and fair value measurements reflect significant estimation uncertainty. Likewise, efforts to audit these accounts and activities can be quite varied and in our view, as discussed below, there can be a substantive difference between auditing a litigation reserve or a long-term asset retirement obligation and auditing a less liquid financial instrument.

Different objectives

We believe the different accounting objectives for a fair value measurement and an accounting estimate under the existing accounting framework illustrate our view that the development of a single auditing standard is not the most appropriate approach. The objective of developing a fair value measurement is to determine the price at which an orderly transaction would take place between market participants under the market conditions that exist at the measurement date. Management assumptions about unobservable inputs are to reflect assumptions that market participants would use in developing the fair value measurement, rather than entity specific considerations. In contrast, an accounting estimate may be based on objective and subjective factors and frequently require significant management judgment about entity-specific factors such as future events, potential courses of action or historical experience.

In consideration of the different accounting objectives, current auditing standards indicate an important, and we believe appropriate, distinction in the auditor's objective when auditing a fair value measurement compared to an accounting estimate. AU sec. 328 states the auditor "should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP."[2] AU sec. 342 states the auditor "is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole."[3] As such, we would recommend that the Board pursue an approach that would look at the audit of estimates and the audit of fair values separately.

Third-party pricing services

Another illustration of potential problems arising from a single standard approach relates to third-party pricing services, an area of significant focus in the Consultation Paper. In our view, this is but one important area within the broad universe of accounting estimates and fair value measurements. We are concerned that the focus on third-party pricing services and "unobservable inputs" may result in the development of an auditing standard that does not deal effectively with other accounting estimates that are based, for example, on an entity's historical experience or that of the industry in which it operates. If the staff elects to proceed with developing a single standard, guidance related to narrow topics, such as third-party pricing services and industry-specific considerations for certain accounting estimates (e.g., asset retirement obligations, environmental reserves, oil and gas reserves) should be provided as supplemental application guidance, rather than in the potential new standard.

Management's Use of a Specialist

The Consultation Paper discusses a potential requirement for the auditor to test information developed by a company's specialist related to accounting estimates as if it were produced by the company. We have several concerns about such a requirement, and believe that AU sec. 336, *Using the Work of a Specialist*, has an appropriate approach to using the work of management's specialist as audit evidence. However, before outlining some of our concerns, we provide a proposed alternative for your consideration.

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[2] AU sec. 328, paragraph 3

[3] AU sec. 342, paragraph 4

Proposed alternative

We believe the procedures related to management's use of the work of a specialist in AU sec. 336 represent an appropriate model when using the work of management's specialist as audit evidence. We also encourage the staff to consider International Standard on Auditing (ISA) 500, *Audit Evidence* (ISA 500) when identifying potential revisions to the standards. ISA 500 incorporates the requirements in AU sec. 336 to (1) evaluate the professional qualifications of the specialist, (2) evaluate the relationship of the specialist to the entity, (3) obtain an understanding of the nature of the work performed or to be performed by the specialist, and (4) perform procedures related to evaluating the findings of the specialist,[4] but provides additional application guidance for the auditor. For example, while AU sec. 336 includes a requirement to evaluate the qualifications of a specialist,[5] ISA 500 (which includes this same requirement), provides several paragraphs of additional application guidance for how to perform this evaluation.[6]

Risk of dissuading the use of specialists

One concern about the requirements proposed in the Consultation Paper is that they would discourage the use of specialists by not recognizing the reduction in risk resulting therefrom. The use of a qualified specialist is frequently necessary to develop various accounting estimates and fair value measurements due to "the specialized nature of the subject matter, the technical nature of the models required, and/or the unusual or infrequent nature of the condition, transaction or event."[7] Accordingly, it is our view that management's decision to engage a specialist in these circumstances generally results in a more accurate application of the relevant financial reporting framework and a corresponding decrease in risk of misstatement in the financial statements. It would then be expected that the nature and extent of audit procedures to be performed would be reflective of this decreased risk.

ISA 500 recognizes this by including the concept that a company's failure to employ or engage specialists when requiring expertise in a field other than accounting or auditing increases the risk of material misstatement.[8] The potential requirements described in the Consultation Paper, however, do not appear to recognize the potential decrease in risk of material misstatement resulting from management's use of a specialist, and suggest adding incremental requirements for the auditor to test the information provided by the specialist as if it were produced by the Company.[9]

Risk of treating all specialists the same

Another concern is that the potential requirement described in the Consultation Paper would appear to have all specialists be treated the same, whether employed or engaged by management, regardless of the results of the auditor's evaluation of the relationship of the specialist to the company required by AU sec. 336.[10] As described in AU sec. 336, "when a specialist does not have a relationship with

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4 AU sec. 336, paragraphs 8 – 12

5 AU sec. 336, paragraph 8

6 ISA 500, paragraphs A37 – A40

7 ISA 540, paragraph A29

8 ISA 500, paragraph A34

9 Consultation Paper, page 38

10 AU sec. 336, paragraph 10

the client, the specialist's work usually will provide the auditor with greater assurance of reliability."[11] The potential requirement described in the Consultation Paper contradicts the reduction in risk resulting from using an external specialist who is further removed from potential management bias.

We also anticipate substantial application challenges with testing the information provided by external specialists as if it were produced by the company. The models used by specialists frequently are proprietary, which limits the auditor's access to certain information. Moreover, by their nature, specialists are engaged by management and auditors due to their special skill or knowledge in complex or subjective matters. As described in AU sec. 336, "the auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation."[12] In light of this, the auditor may not have the expertise to evaluate the information provided by the specialist except within the context currently described in AU sec. 336.

Given these challenges and constraints, the auditor may be more likely to engage another specialist to develop an independent estimate, rather than test the accounting estimate or fair value measurement developed by the company's specialist. Consequently, the company would incur both the costs of engaging a specialist to develop the accounting estimate and the auditor's costs to engage or employ a separate specialist to develop an independent estimate, perhaps without a corresponding increase in audit quality.

It is our experience that management's use of qualified specialists has served to reduce overall risk in the financial reporting process, particularly in areas that may require special skill or knowledge. We believe users of the financial statements would be better served by auditing standards that better describe how auditors can use the work of qualified and objective third-party specialists rather than to dissuade, or make more challenging, their use.

Other opportunities for improvement

There may be other opportunities, rather than amendments to the auditing standards, to improve an auditor's insight into the processes and procedures of valuation specialists. Currently, there is a project being led by several not-for-profit valuation professional organizations, to develop a proposal, in response to concerns expressed by the Securities and Exchange Commission, to create a "substantive professional infrastructure" governing the preparation of valuation estimates for "public interest" purposes. This proposal would address:

- Certification and renewal including education, experience and exam requirements
- Performance standards
- Quality review and discipline

It is our view that this project is a worthwhile initiative that could further enhance the auditor's ability to evaluate the qualifications and work of a specialist.

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11 AU sec. 336, paragraph 11

12 AU sec. 336, paragraph 6

Evaluating Reasonableness of an Accounting Estimate or Fair Value Measurement

We have several concerns related to the staff's indication that an amended or new standard may emphasize "that [an independent] estimate is limited to outcomes within the range that are supported by sufficient appropriate audit evidence."[13] These concerns are outlined below.

Estimation uncertainty

We are concerned that such a statement may imply that estimation uncertainty is a function of the nature and extent of audit procedures, rather than an intrinsic characteristic of the estimate itself. We do not believe it is always possible, particularly with accounting estimates and fair value measurements that have higher estimation uncertainty and for particular industry-related estimates (e.g., certain insurance reserves, mortgage servicing rights), to narrow a range of reasonable outcomes below the auditor's established materiality threshold. While the wide range may serve to confirm higher estimation uncertainty and potentially a significant risk, we do not believe this should preclude the auditor, after performing sufficient appropriate procedures, including evaluating whether there are indicators of possible management bias, from concluding that management's accounting estimate is reasonable.[14]

We also do not believe the auditor could reasonably be expected to eliminate inherent estimation uncertainty through the performance of additional audit procedures. Extant guidance in AU sec. 328 states "The auditor is not responsible for predicting future conditions, transactions, or events that, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures."[15] Therefore we do not believe that the subsequent outcome of a fair value measurement or an accounting estimate that deviates significantly from the recorded amount is an indicator of an audit failure. We recommend this guidance be retained in any revisions to the existing standards and be equally applicable to fair value measurements and accounting estimates.

Purpose of the auditor's procedures

We have additional concerns about the implications of the statement described above on the purpose of the auditor's procedures when evaluating the reasonableness of an accounting estimate. As described in the Consultation Paper and reflected in AU sec. 342, when evaluating the reasonableness of an accounting estimate, the auditor should obtain an understanding of how management developed the estimate and, based on that understanding, use one or a combination of (1) review and test the process used by management to develop the estimate, (2) develop an independent expectation of the estimate to corroborate the reasonableness of the estimate, or (3) review subsequent events or transactions occurring prior to the date of the auditor's report to evaluate the reasonableness of the recorded estimate.[16]

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[13] Consultation Paper, page 41

[14] ISA 540, paragraph .A94

[15] AU sec. 328, paragraph 5

[16] AU sec. 342, paragraphs 9-10

Whether using different assumptions to evaluate the sensitivity of the recorded estimate to alternative assumptions, or developing an independent estimate as part of using a combination of approaches, these procedures frequently can result in amounts that vary widely from the recorded estimate. While the auditor may choose to do so, we do not believe that executing one or a combination of the alternative approaches outlined in AU sec. 342 should be done with the intention of developing a range of reasonable estimates, nor do we believe the amounts calculated in these procedures implicitly suggest potential bias that is required to be evaluated as described in Auditing Standard No. 14, Evaluating Audit Results (AS 14).[17] We believe the alternative approaches described in AU sec. 342 are to aid the auditor in evaluating the reasonableness of the recorded estimate and that potential bias is one consideration when evaluating overall reasonableness.

Proposed alternative

If the staff believes that widely varying estimates using alternative approaches described in AU sec. 342 imply a range of possible estimates, we believe auditing standards should describe how the auditor should weigh the relevance of the various possible estimates or implied range as part of evaluating the reasonableness of the recorded estimate.

Using independent estimates in combination with other evidence

We also are concerned that such a statement would limit the auditor's ability to use an independent estimate in combination with one or more other approaches to evaluate the reasonableness of the recorded estimate. Frequently, management engages third-party specialists to develop complex accounting estimates and it is not necessary or feasible for the auditor to develop an independent estimate with the same level of detail as was employed by management's specialist. With this understanding, the auditor may use its independent estimate in combination with evidence provided by other approaches (including evaluating the work of the management specialist under AU sec. 336) to evaluate the reasonableness of the recorded estimate. We do not believe current auditing standards require the auditor to achieve a required level of evidence from a particular approach outlined in the current standards.

Use of Third-Party Pricing Services

As stated above, we believe it is important to get the balance right on how proposed changes in standards address the use of third-party pricing services and not unduly focus on them within the broad topic of auditing accounting estimates and fair value measurements. We agree with the staff's statement in the Consultation Paper[18] that third-party pricing services used by the auditor to obtain information that is developed for, and widely available to, the public should be differentiated from a third-party source used to generate an estimate specifically for the entity or for the auditor (i.e., a specialist).

Third-party pricing services generally provide independent pricing information free of influence from any one issuer (i.e., the same price is released to all customers without bias), and we believe that this distance from management bias could increase the relevance and reliability of the information and

[17] AS 14, paragraphs 25 - 27

[18] Consultation Paper, page 43

would be considered sufficient appropriate audit evidence. As a result, we do not agree with certain potential requirements described in the Consultation Paper to address the use of third-party pricing services, as detailed in the sub-sections below.

Use of the Same Third-Party Pricing Service

In the Consultation Paper, the staff indicates that if the third-party source used by the auditor is the same as the third-party source used by the company, the auditor should evaluate the audit evidence as if it were produced by the company, including testing data and evaluating the reasonableness of significant assumptions.[19] While auditors may use a different third-party pricing source to corroborate the price management obtained from its pricing source, we do not believe there should be an implicit requirement to do so. Auditors should be permitted to evaluate the relevance and reliability of the price obtained by management and to evaluate the need to perform additional procedures to obtain sufficient appropriate audit evidence in accordance with Auditing Standard No. 15, *Audit Evidence* (AS 15).

We believe extant guidance in AU sec. 332 also provides an appropriate model the auditor can use to determine whether additional procedures may be appropriate.[20]

Evaluating Audit Evidence (Relevance and Reliability)

We do not believe that requiring the auditor to evaluate the methods and assumptions used to determine the pricing for all classes of financial instruments is necessary. Financial instruments that are priced based on recent trading or observable market transactions for similar instruments and require no significant unobservable inputs to their valuation generally exhibit lower estimation uncertainty. These types of financial instruments may be subject to more simplistic models that are more closely aligned to observable market information and the auditor could perform simple procedures to substantiate the resulting pricing. Under these circumstances, the auditor could refer to AS 15 as the authoritative literature on the auditor's responsibility for evaluating the information.

However, for financial instruments priced using significant unobservable inputs, or that otherwise exhibit higher estimation uncertainty, it may be appropriate for the auditor to perform additional procedures to understand and evaluate the relevance and reliability of the information obtained from the third-party pricing service. When determining the additional procedures to perform, the auditor considers various factors, including, but not limited to, those provided in the Consultation Paper.[21] The procedures ultimately selected by the auditor should be tailored to the overall circumstances.

We encourage the staff to align potential revisions to the standards on this topic with the existing guidance in the PCAOB's risk assessment standards. Further, as the staff acknowledges in the Consultation paper, there may be limitations in testing data obtained from certain third-party sources for completeness and accuracy[22] (e.g., while issuers and auditors are generally given the opportunity

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[19] Consultation Paper, page 44

[20] AU sec. 332, paragraph 38

[21] Consultation Paper, pages 45-46

[22] Consultation Paper, page 40

to obtain an understanding of a third-party pricing service's valuation process, they may not be permitted access to proprietary information). We also encourage the staff to consider these limitations when identifying potential revisions to the standards.

Other Matters

Understanding Processes Used to Develop Accounting Estimates

We recommend that the staff provide additional clarification regarding the potential requirement to obtain an understanding of the processes used to develop accounting estimates, as it relates to the extent to which the company uses a third party or information provided by a third party in developing the accounting estimates.[23] This could be interpreted as a requirement for the auditor to obtain an understanding of and test the internal control environment of the third party. We do not believe such a requirement is necessary as the third party providing the information is not an integrated part of the company's information system. We believe the current construct for evaluating relevance and reliability of evidence described in AS 15 continues to be appropriate in these circumstances.

Evaluating the Company's Method Used to Develop an Accounting Estimate

The Consultation Paper suggests the auditor should evaluate whether the methods used by the company are accepted within the company's industry.[24] This language differs from the existing requirement in AU sec. 328, which states that the auditor should *consider* whether the valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.[25] It is our view that a requirement to draw a conclusion on whether the method is "accepted" within the company's industry could lead to challenges in practice. What is meant by "accepted"? What standards, criteria or framework should be employed in making this determination? The approach might also lead to some unintended consequences, such as impacting management's ability to use a method that might be viewed to be outside of the industry norm, but which may be a more appropriate application of the financial reporting framework to the entity's specific facts and circumstances. While we agree that accounting practices in a company's industry is an important data point when evaluating the appropriateness of the company's method, we believe this factor should be balanced with others that may be applicable to a particular estimate.

Identifying Significant Assumptions

The Consultation Paper describes a potential requirement to identify significant assumptions not identified by management. As acknowledged within AU sec. 328, the purpose of evaluating significant assumptions is to determine whether "the significant assumptions used by management in measuring fair value taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures,"[26] and "the objective of the audit procedures is not to provide an opinion on the assumptions themselves."[27] ISA 540 requires that the auditor evaluate "whether the

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[23] Consultation Paper, page 24

[24] Consultation Paper, page 33

[25] AU sec. 328, paragraph 18

[26] AU sec. 328, paragraph 28

[27] AU sec. 328, paragraph 32

assumptions used by management are reasonable in light of the measurement objectives of the financial reporting framework,"[28] as well as "how management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the estimate."[29]

We recommend the staff consider these requirements as an appropriate model for the auditor's responsibilities associated with significant assumptions.

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As the staff considers comments received, we encourage consideration of whether amending the auditing standards will address all challenges in these potentially complex areas. For instance, calls for additional transparency about accounting estimates, including fair value measurements, may be better addressed through changes to the financial reporting framework and disclosures.

We would be pleased to discuss our comments with members of the Board or its staff.

Respectfully submitted,

Ernst + Young LLP

cc:

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28 ISA 540, paragraph 13(b)(ii)

29 ISA 540, paragraph 15(a)