McGladrey LLP

One South Wacker Drive, Suite 500
Chicago, IL 60606
www.mcgladrey.com

McGladrey

November 3, 2014

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

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

Dear Office of the Secretary:

McGladrey LLP appreciates the opportunity to offer our comments on the PCAOB's August 19, 2014 Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*. We support the PCAOB's decision to evaluate whether existing PCAOB standards relating to accounting estimates and fair value measurements can and should be improved.

Single Comprehensive Standard

We are generally supportive of a single, comprehensive standard that addresses all accounting estimates including accounting estimates involving fair value measurements. Given the variability and range of complexity and estimation uncertainty among accounting estimates, however, a comprehensive standard should be principles based. Further, the principles of AU 336 governing the use of a specialist should be preserved regardless of whether a single comprehensive standard is developed.

If a new standard is developed, we believe that the three approaches common to both standards (i.e. testing management's process, developing an independent expectation, and reviewing subsequent events) should be retained. However, when there is high estimation uncertainty, it is more appropriate to test management's process than develop an independent expectation because the range of reasonable measurements may exceed materiality.

Estimation Uncertainty

Accounting estimates vary widely as to the level of estimation uncertainty involved in the estimation process. It is important that varying degrees of estimation uncertainty be contemplated in the development of a new standard. The Financial Accounting Standards Board recognized the varying degrees of estimation uncertainty when it established the fair value hierarchy and established the requirement for entities to classify their fair value measurements in accordance with the hierarchy. Level 3 fair value measurements require more extensive disclosure than Level 1 or 2 fair value measurements. A fair value measurement is classified as Level 3 if any of the significant inputs are unobservable. An input is unobservable when it is not developed using market data, and instead is based on management's own assumptions. In situations where objective audit evidence to support a significant assumption does not exist, the auditor's attention should be focused on whether management's process for determining the estimate has been applied in a manner consistent with prior periods and the adequacy of the disclosures surrounding the estimate.

In some situations, there may be multiple sources of market data to support a significant assumption. While multiple sources of market data are often within a narrow range, even a relatively small change in an assumption can have a relatively large impact on the resulting measurement. In other words, alternative values for a specific assumption that are within a reasonable range for that assumption may result in variability of the resulting accounting estimate that significantly exceeds materiality. This is another example of a situation that should be contemplated in the development of a new standard.

Use of a Specialist

According to AU 336, a specialist is a person (or firm) possessing skill or knowledge in a particular field other than accounting or auditing. Many accounting estimates require skills or knowledge other than accounting or auditing. For example, the valuation of real estate requires knowledge of market conditions within a particular geographic area and for particular types of real estate (*e.g.,* commercial property, residential property). The determination of the liability for a defined benefit pension plan requires actuarial skills and the pricing of investment securities involves knowledge of daily market activity and many types of financial instruments, which continually evolve in nature and complexity. For a Level 3 security, knowledge of how market participants would determine fair value in the absence of observable inputs is also necessary.

When using the work of a specialist in the audit of an accounting estimate, auditors historically have applied AU 336.12 which states that, while the auditor obtains an understanding of the methods and assumptions used by the specialist, the appropriateness and reasonableness of methods and assumptions and their application are the responsibility of the specialist. Further, the auditor also is required to make appropriate tests of data that has been provided to the specialist by management. As it relates to fair value measurements, AU 328 instructs the auditor to apply AU 336 and reiterates that the reasonableness of the assumptions and the appropriateness of the methods used and their application are the responsibility of the specialist. We believe the approach in AU 336 is appropriate since a specialist possesses skills or knowledge that the auditor does not have. However, when management has engaged a specialist to develop a fair value estimate, some believe that the auditor should deviate from the traditional interpretation of AU 336 and test the information obtained directly by the specialist and used to develop his or her assumptions as if the assumptions were developed by the specialist based on information provided by management.

It is common for management to engage a specialist to assist in the development of accounting estimates. In many cases, the specialist is bound by ethical standards to maintain objectivity in the performance of their work. Further, specialists often obtain data from sources external to the entity. For example, financial institutions generally engage real estate appraisers to determine the fair value of collateral for measurement of loan impairment on collateral-dependent loans. Although the real estate appraiser was hired by management, we do not believe it is necessary for the auditor to test the data that the appraiser obtained, for example, through a multiple listing service. In addition, after having evaluated and concluded that the appraiser is competent and objective and obtained an understanding of the appraiser's methods and assumptions, the auditor should be entitled to use the appraiser's work unless the auditor believes the appraiser's valuation is unreasonable.

Pricing Sources

In the case of investment securities, many entities engage a third-party pricing source to provide fair value estimates. In the case of Level 1 securities, the third-party pricing source simply passes through the exchange-traded price. We do not believe that this is an accounting estimate or that the pricing source is a specialist in this circumstance. In situations where a particular investment is not traded on an exchange, then a pricing source provides a fair value estimate. These fair value estimates may be determined in a variety of ways including broker quotes, actual sales of similar securities and using proprietary models.

Some pricing sources provide valuations for millions of Level 2 and 3 securities to anyone who pays for their service. As a result, these valuations are not provided with any single user entity in mind. Instead, the pricing source is providing valuations to many market participants, based on their knowledge of the market and their expertise, and without reference to whether the purchaser of the pricing information is a buyer or seller of the securities. In this case we believe the pricing source is acting as a specialist and there is little incremental benefit obtained from the auditor obtaining the proprietary models and testing the underlying assumptions (if that is even possible). Instead, we believe that the auditor should evaluate the competence and objectivity of the pricing source and obtain an understanding of the general methods and assumptions used by the pricing source to develop the estimate.

When determining the fair value of investment securities for which there is observable data (*i.e.,* Level 2 securities), there are often multiple pricing sources. We believe that when multiple pricing sources provide values that are within a narrow range, and the client's recorded value lies within that range, this constitutes sufficient appropriate audit evidence regarding the reasonableness of the fair value estimate.

When an entity engages a third party to prepare a valuation of a "hard-to-value" investment security exclusively for that entity, that third-party is a specialist. The auditor should evaluate the competence and objectivity of that specialist. Further, the auditor should obtain an understanding of the methods and assumptions used by the specialist. If the specialist obtained data from management, the auditor should test that data. However, having concluded that a specialist is competent and objective, the auditor should not be required to test data the specialist obtained from external sources. This view is consistent with paragraph 8 of AS No. 15 in that evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

Pricing Source Constraints

Many pricing sources have improved the level of transparency around their fair value estimation process in the last few years. However, there remain significant limitations in terms of the amount of data that the pricing sources can realistically make available to the large number of entities using their services. The practical limitations of the availability of data from pricing sources should be considered in the development of a new standard. If a new standard specifies procedures to evaluate evidence obtained from third-party sources, those procedures should be practical and achievable in light of the abilities of third parties to provide such information/data.

Specific Procedures in Response to a Significant Risk

When there is high estimation uncertainty leading to a significant risk, ISA 540 requires the auditor to perform additional procedures (*e.g.,* consideration of alternative assumptions that management considered and rejected). We disagree with the staff's belief that the procedures explicitly outlined in ISA 540 are "inherent in the requirements of Auditing Standard No.13." We believe that these procedures should be explicitly stated in any new standard.

We appreciate this opportunity to provide feedback on the consultation paper and would be pleased to respond to any questions the Board or its staff may have concerning our comments. Please direct any questions to John Keyser, National Director of Assurance Services, at 614.456.2805.

Sincerely,

McGladrey LLP

McGladrey LLP