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

Staff Consultation Paper
Auditing Accounting Estimates and Fair Value Measurements

Dear Madam Secretary:

KPMG LLP is pleased to submit its comments about the Public Company Accounting Oversight Board's (the PCAOB or the Board) Staff Consultation Paper - *Auditing Accounting Estimates and Fair Value Measurements* (the Paper). We welcome the opportunity to work with the Board, PCAOB staff (the Staff), and other stakeholders to improve audit quality through enhanced auditing standards.

We believe that, conceptually, the process that management uses to prepare accounting estimates, including fair value measurements, has common attributes that would enable the PCAOB to meaningfully address auditing of estimates under a single standard. Therefore, we generally support the approach being considered by the Staff to develop a single standard about auditing accounting estimates, including fair value measurements (the potential new standard), that would supersede certain existing auditing standards referred to in the Paper (specifically, AU 342, *Auditing Accounting Estimates*, AU 328, *Auditing Fair Value Measurements and Disclosures*, and AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*). While global auditing and accounting standard setters, including the PCAOB, have shifted toward principles-based standards, we do have a concern, however, that application may prove challenging if there is not a certain level of specificity in the potential new standard, given the differences among accounting estimates, including fair value measurements, that underpin financial reporting.

In addition, we believe that a potential new standard should take into consideration the availability of large amounts of data and how that data informs auditor judgment from the perspective of risk assessment and attainment of audit evidence. Our observations below reflect our experience analyzing large amounts of data related to financial instruments. However, we believe there are other areas where large amounts of data may be used in auditing accounting estimates. Developing a potential new standard that not only is comprehensive enough to address all types of accounting estimates, including fair value measurements, but also considers how large amounts of data informs auditor judgments, will likely take a significant amount of time. Therefore, we believe that the Staff should explore amending certain auditing standards to provide auditors with sufficient clarity surrounding the relevance and reliability of third-party information in the near term, while continuing to seek input relevant to accounting estimates, including fair value measurements.

General Views about a Potential New Standard

We believe that an issuer's processes for developing the majority of accounting estimates, including fair value measurements, required by a financial reporting framework are conceptually similar to what is required of the auditor. Like management, the auditor identifies the specific information that is required (i.e., the data and assumptions), identifies a source of the information considering relevance and reliability, and determines how the information will be used (i.e., the method). Because of these similarities, we believe developing a single standard is the preferable approach to follow. However, we believe there are certain items the Staff should explore or consider when developing the potential new standard:

1. AU-C 540, *Auditing Accounting Estimates*, *Including Fair Value Accounting Estimates, and Related Disclosures*, builds on the requirements and application guidance of the risk assessment standards, which is a stated objective of the Staff in the development of a potential new standard.[1] We recommend that the Staff consider the specific items noted below from that standard when developing the potential new standard:

    a. AU-C 540 contains application guidance to bridge certain terminology differences between the auditing standards and the financial reporting framework.[2] For example, the PCAOB's auditing standards use "methods, models and assumptions" without defining the terms, whereas the fair value accounting standard uses terms such as "approaches, techniques, and inputs."[3] Clarifying the definitions and refraining from introducing new and undefined terms, such as '*hard to value financial instruments*,' will permit the auditor to evaluate management's conformity with the financial reporting framework while meeting the Staff's expectations for increased auditor performance in the area of accounting estimates, including fair value measurements.

    b. We agree that the testing approaches as described in the PCAOB's existing auditing standards remain appropriate. However, the Staff might consider an approach similar to AU-C 540, which directs the auditor to undertake one or more procedures to respond to the identified risk, rather than providing more direction on the application of any one testing strategy. We believe the focus

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[1] Page 21 of the Paper.
[2] For example, see paragraphs A30 and A31 of AU-C 540, which address assumptions or inputs.
[3] Accounting Standards Codification (ASC) 820, *Fair Value Measurement*

should be more on the nature, timing, and extent of evidence responsive to the risk rather than increased emphasis on how to execute a testing approach.

2. We do not believe that all accounting estimates, including fair value measurements, should be presumed to always represent a significant risk, but rather urge the Staff to consider whether there are certain indicators that, if present, would point to a rebuttable presumption of a significant risk. If a significant risk has been identified, the Staff should consider providing auditors with specific requirements necessary in the circumstances.

3. Because of the inherent estimation uncertainty in certain accounting estimates, available audit evidence may be insufficient to reduce estimation uncertainty to a level commensurate with financial statement materiality. The Paper indicates that the Staff is considering emphasizing in the potential new standard that an independent estimate developed by the auditor is limited to outcomes within the range that are supported by sufficient appropriate audit evidence.[4] We are concerned that the inclusion of such a statement in the potential new standard may imply a level of precision that is not attainable. As noted above, the precision of the range is the result of inherent estimation uncertainty, and we believe that no one point within an acceptable range is necessarily distinguishable from another. Therefore, the potential new standard should acknowledge the variability and imprecision that exists within inherently imprecise estimates.

4. The Staff have suggested in the Paper that a potential new standard might require the auditor to evaluate whether the evidence obtained, at the asset or liability level (e.g., at the individual security level), is relevant to the fair value measurement, which includes determining: (a) whether the fair values are based on trades of the same instrument or active market quotations; (b) when the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable; (c) when there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed represent the assumptions that market participants would use when pricing the asset or liability, if applicable; or (d) when the fair value measurement is based on a broker quote, whether the broker quote is from a market maker who transacts in the same type of financial instrument and is binding or nonbinding, with more weight placed on quotes based on binding offers.[5] We conceptually agree that the auditor has to obtain relevant audit evidence, however we are concerned with the Staff's suggestion that this level of detail is necessary at the individual security level to establish relevance, since we do not believe that such an approach is operational, and it does not appear to be justified from a cost/ benefit perspective, as it relates to audit quality.

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[4] Page 41 of the Paper.

[5] Pages 45 and 46 of the Paper.

Centralized Testing of Third-Party Pricing Vendor Information Used as Audit Evidence

We commend the Staff for exploring ways a potential new standard might address circumstances where auditors obtain information from third parties, such as pricing vendors who provide evaluated prices of financial instruments. As discussed earlier, we live in a time where the ability to obtain large amounts of data, like pricing data from independent third-party pricing vendors, is a reality. Accordingly, a potential new standard should contemplate the persuasiveness of the evidence that large amounts of converging data can provide financial statement preparers and auditors.

Since August 2012, we have obtained and analyzed, on a monthly basis, pricing data for approximately 4.7 million fixed income securities that are priced by one or more of the four major third-party pricing vendors. The evaluated pricing information that has been obtained represents the population of pricing data available from the four major third-party pricing vendors. An objective of our analysis over the last two years was to understand and support, through empirical evidence, the relationship between price convergence (we have defined convergence to mean generally three or more prices within a specified range relevant to an asset class, over a specified period) and reliability of audit evidence. Further, we also sought to understand the valuation methodologies and techniques, including descriptions of inputs, used by the third-party pricing vendors and evaluated whether such methodologies and techniques are consistent with the principles of ASC 820, which is similar to the requirements suggested in the Paper.

As a result of our analysis, we have the following observations that we believe should be considered in developing a potential new standard:

- Applying our definition of convergence as described above, over 80 percent of the fixed income securities priced by multiple third-party pricing vendors converged over a rolling six-month period (our test period). Based on the extent of our analysis, we do not believe performing additional audit procedures on converged prices would improve audit quality.

- Central to any reliability conclusion is the fact that each of the third-party pricing vendors' evaluated prices are developed independently from any one issuer's financial reporting process, and of the other pricing vendors, using sufficiently similar methods and inputs. This is significant because the process is free of management bias and the similarity of methods and inputs supports effective comparison (e.g., convergence of pricing) of the data. Therefore, when the converged evaluated price includes management's price source, we believe that the reliability of the evidence is not diminished.

- In an over-the-counter market, convergence of prices provided by more than one third-party pricing vendor is indicative of liquidity in the financial instrument, and generally results in lower price estimation uncertainty. The liquidity and demand for these securities reduces the estimation uncertainty.

- When there is a high degree of correlation between the prices of a security provided by third-party pricing vendors, we believe the evidence corroborates that market data is readily observable and that the vendors are considering similar inputs in a consistent manner. Information provided by third-party pricing vendors provides transparency into market information not otherwise available to investors, issuers, and auditors. As is evident through our data analysis, in the vast majority of cases the third-party pricing vendors are processing market data in a consistent fashion to produce converged evaluated prices. The consistency of the observed convergence ranges also illustrates a similar weighting of the available information in the evaluation process. Therefore, if third-party pricing vendors' prices converge, we believe that audit testing of specific valuation inputs is not necessary to establish the reliability of the information.

Based on our experience, centralized testing of third-party pricing data can provide relevant reliable information to an engagement team that will validate initial risk assessments and provide a final valuation conclusion. Moreover, performing these audit procedures centrally provides consistency in these conclusions, which we believe improves overall audit quality.

Management's Use of Specialists

We believe that AU 336, *Using the Work of a Specialist*, provides the auditor with a sufficient framework to evaluate the work of management's specialist. The existing framework includes a requirement for the auditor to understand the methods and assumptions used and to make appropriate tests of data provided to the specialist, taking into account the assessment of control risk among other requirements. The assessment of control risk is appropriately directed toward management's oversight of specialists and selection of assumptions. Therefore, we agree that the PCAOB should clarify in the potential new standard that management is responsible for all assumptions.

As noted in the Paper, the Staff is considering expanding the requirement under AU 328 related to testing assumptions developed by management's specialist, such that it would apply more broadly to information provided by specialists for accounting estimates.[6] We believe that a requirement for an auditor to test information developed by management's specialist in all cases as if it were produced by the company is not necessary. The extent of such testing should be based on the auditor's risk assessment including an assessment of the specialist's independence and objectivity.

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[6] Page 37 of the Paper.

Other Matters

Evaluating the Issuer's Methods Used to Develop an Accounting Estimate

We are supportive of a requirement for the auditor to evaluate the issuer's methods used, including evaluating whether the methods are in conformity with the financial reporting framework. However, we question a requirement to evaluate whether management's methods are '*accepted within the company's industry*,'[7] as facts and circumstances for a specific issuer may be more relevant than the facts and circumstances for the issuer's industry.

We encourage the Staff to consider paragraph 8 of AU-C 540 and the related application guidance which directs the auditor to first consider whether a method is prescribed by the financial reporting framework and then consider professional judgment and industry guidance.[8]

Identifying Assumptions Not Used by Management

We believe that the Staff should consider a requirement similar to paragraph 15(a) of AU-C 540, which requires the auditor to evaluate 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 accounting estimate, rather than require the auditor to '*identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate.*'[9] The potential requirement described in question 28 of the Paper, as currently written, would be impractical to apply, since there are a multitude of assumptions not used by management.

Timing and Extent of Audit Procedures

With respect to the timing and extent of audit procedures, the Staff should consider adding specificity to the potential new standard about which assertions may be appropriate to test at other than period end, and the nature and extent of work necessary to extend a conclusion, including the precision necessary to extend a conclusion from interim to period end. In practice, we have found that the extent of procedures necessary to extend the conclusion is the same as that required by the original conclusion, which impacts the benefit of concluding before the measurement date.

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[7] Page 33, potential amendment (a), of the Paper.
[8] Paragraphs A24 and A25 of AU-C 540.
[9] Question 28 of the Paper.

Specificity in Description of Requirements

Several of the suggested requirements in the Paper use “test” or a variation of that word to direct auditor performance.[10] If the Staff expects specific procedures to be performed, a potential new standard should be more explicit in the description of the requirements.

Potential Amendments to Existing Standards

Much of the Paper is focused on third-party information used by both management and auditors. We believe there would be a benefit to audit quality if the Staff considered a near-term amendment to certain standards, such as Auditing Standard No. 15, *Audit Evidence*, to provide more clarity about the expectations regarding the relevance and reliability of audit evidence obtained from third parties.

Question 13 of the Paper asks whether the auditing standards sufficiently address matters such as the information systems at third parties, controls management has over the work of third parties, and the controls at third parties, when an issuer uses information obtained from a third party. We agree that once third-party information is housed in an entity’s information system, internal controls are relevant. However, we don’t believe it is necessary to test internal control over financial reporting that extends beyond the boundary of the entity’s information system. Issuers often use information commercially available in the preparation of their financial statements. If such information is commercially available from a reputable source, and used by management without bias, the auditor should be able to use the information without testing it as though it had been produced by the entity.

Concluding Remarks

We would welcome the opportunity to present to the Board and Staff our third-party pricing vendor data analysis in further detail, explore other opportunities where large amounts of data and its analysis may be used as audit evidence when auditing accounting estimates, and expand on our views of how centralizing certain audit procedures currently required to be performed at the engagement team level would improve audit quality.

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[10] See, for example, pages 27 and 38 of the Paper.

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We appreciate the Board's and Staff's careful consideration of our comments. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann (212-909-5770 or gherrmann@kpmg.com) or Ilene Kassman (212-909-5667 or ikassman@kpmg.com).

Very truly yours,

KPMG LLP

cc:

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