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

November 3, 2014

RE: PCAOB Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements*

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements* (the "Staff Consultation Paper"). We commend the Board and its staff for its use of a staff consultation paper, as we believe it can be an effective mechanism for obtaining feedback from stakeholders early in the standard-setting process. We further commend the Board and its staff for its continued outreach, including the Standing Advisory Group ("SAG") public meeting held on October 2, 2014.

Overview

The Staff Consultation Paper discusses certain challenges related to auditing accounting estimates, including fair value measurements; describes the staff's preliminary views concerning the potential need for change; and presents potential revisions to the PCAOB's auditing standards. In particular, the staff is considering developing a single auditing standard related to auditing accounting estimates and fair value measurements that would supersede AU 328, *Auditing Fair Value Measurements and Disclosures* ("AU 328") and AU 342, *Auditing Accounting Estimates* ("AU 342"), and certain or all of AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* ("AU 332"). The Staff Consultation Paper outlines a single standard that could be designed to:

- Align with the PCAOB's risk assessment standards;[1]
- Generally retain the approaches to substantive testing from AU 328 and AU 342, but include audit requirements that would apply to all accounting estimates, including fair value measurements;
- Establish more specific audit requirements relating to the use of third parties in developing accounting estimates, including fair value measurements; and
- Create a more comprehensive standard related to auditing accounting estimates, including fair value measurements, to promote greater consistency and effectiveness in application.

We support standard-setting in this area, including the concept of a single auditing standard to address the auditing of accounting estimates, including fair value measurements. We believe that it is important to acknowledge that, in developing a single auditing standard, there may be a need for more specific guidance related to specific types of accounting estimates, including fair value measurements. Our view is reflective of the fact that fair value measurements are a type of accounting estimate; therefore, the overall audit principles should be similar. However, the way in which estimates of fair value measurements are developed may differ from how other types of estimates are developed, and these differences could affect the nature and extent of the audit procedures to be applied. For example, an estimate of the price of a

[1] See PCAOB Auditing Standards No. 8 through No. 15.

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security may be based on the consensus of what buyers in the marketplace are willing to pay for the security. The nature and extent of the audit procedures over this type of estimate would be different compared to audit procedures when a specialist uses company specific assumptions (as a proxy for market participants) to develop an estimate related to goodwill or intangible assets.

We believe that any enhancements to the existing auditing standards should be principles-based to adapt to the continuing evolution of accounting standards and estimates and consider the inherent uncertainty of accounting estimates, including fair value measurements. Therefore, we believe that enhancements to the related auditing standards should:

- Reflect the auditor's risk assessment when determining the sufficiency and appropriateness of the cumulative nature of audit evidence;
- Promote audit quality and work to narrow, or at least not expand, any expectation gap;
- Consider the wide range of accounts that include some level of estimation uncertainty and the varying levels of complexity and risk associated with different accounting estimates;
- Recognize that accounting estimates may be subject to a significant degree of measurement uncertainty; and
- Be operational under the current and future constructs of the capital markets and relevant market participants.

We are supportive of the overall project and agree with much of the direction in the Staff Consultation Paper. For example, we are supportive of aligning a potential new standard with the Board's risk assessment standards and the direction of the amendments being considered to those standards. In this letter, we have included certain suggestions around some of the specific requirements described in, or implied by, the Staff Consultation Paper to address what we see as potential practical challenges not only in the audit process but in the overall financial reporting process. We have organized our observations and recommendations into the following topical areas:

- Management's specialists
- Third-party pricing services
- Other matters

Management's specialists

A company's management can utilize specialists to develop estimates that are typically complex or highly subjective in matters that require expertise outside of accounting. Examples include:

- A company with pension, post-retirement, or post-employment benefit plans may use actuaries to develop assumptions, calculate the suggested financial position and expenses, and assist in developing information for the disclosures.
- A company with mineral interests may use engineers to perform geological analyses to estimate the level of reserves.
- A company with environmental exposures may use specialists to estimate the environmental liabilities.

As noted in the Staff Consultation Paper, the staff is exploring whether to include audit procedures to address information developed and provided by a specialist employed or engaged by a company related to accounting estimates. If a company uses a specialist to develop an accounting estimate and the auditor chooses to review and test the process used by management to develop the estimate, the Staff Consultation Paper suggests that a potential new standard could direct the auditor to "…test that information as if it were produced by the company. In this case, the auditor would be required, as applicable, to evaluate the appropriateness of the methods, test the data used, and evaluate the reasonableness of significant assumptions, with respect to the information provided by the specialist."[2]

We believe there is an important distinction between a specialist engaged by the company and a specialist employed by the company.[3] To the extent that a specialist is employed by the company, we agree that information provided by that specialist should be viewed, and tested, as having been produced by the company. We also agree that audit procedures are necessary when a company engages a specialist, but we believe that the nature and extent of such procedures should be different than when the specialist is employed by the company. We believe there is a fundamental difference because specialists engaged by the company are typically more objective, bring a wider range of experience, and may operate within a set of professional standards. We focus our comments in this section on specialists engaged by management.

Test the information

We are concerned with a potential framework wherein information provided by a specialist engaged by management is treated as if it were produced by the company. First, such a requirement (to "test") would appear to be different from a separate requirement in the Staff Consultation Paper which says, "[w]hen the auditor obtains data and significant assumptions from a third party, the auditor *should evaluate the relevance and reliability* of the data and assumptions in accordance with the requirements of Auditing Standard No. 15, *Audit Evidence* ("AS 15")."[4] We believe the principles in AS 15 to evaluate relevance and reliability are appropriate when considering information obtained from third-parties, regardless of who has engaged that third-party. Second, we understand "information" to encompass data, models, and assumptions. As such, when a specialist engaged by management obtains information from another third-party, the Staff Consultation Paper's use of the words "test information provided by the specialist" could be read to mean that the auditor is required to test information provided by that other third-party as well. While we acknowledge the requirements to evaluate relevance and reliability may differ depending upon the risk assessment and the third-party, for the reasons we stated above, we do not believe that the requirements to audit the information from specialists engaged by management should be the same as if the company produced the information.

Use of AU 336

Currently, when management engages a specialist and the auditor intends to use that specialist's work, the auditor evaluates the specialist and their work under AU 336, *Using the Work of a Specialist* ("AU 336"). We believe that it is important to maintain the auditor's ability to utilize AU 336 to obtain sufficient appropriate audit evidence when management engages a specialist; however, we would not be opposed to enhancements to AU 336. To that end, we note the staff's intention to issue a staff consultation paper on the use of specialists, and agree with the staff that there is linkage between the specialist project and this project[5]; therefore, we believe it is important to consider the objectives of both projects concurrently.

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[2] See *Staff Consultation Paper*, page 38.

[3] There are also specialists employed or engaged by the auditor. Auditors' specialists are not discussed in this response.

[4] See *Staff Consultation Paper*, pages 40-41. (Emphasis added)

[5] See *Standard-Setting Agenda, Office of the Chief Auditor*, September 30, 2014, page 5.

Separate from enhancements to AU 336, we believe that the proposed requirement to test information provided by specialists engaged by management as if the information was prepared by the company will negatively affect an auditor's ability to use the work of a specialist engaged by management under AU 336. For example, while a specialist engaged by management provides the auditor with sufficient access to allow the auditor to "obtain an understanding of the methods and assumptions used by the specialist,"[6] that specialist may not be able or willing to provide the supporting information to enable the auditor to "test the information" as if it were produced by the company. As such, we believe the requirement could in essence limit, or in certain circumstances potentially eliminate, the auditor's ability to test the process used by management to develop the estimate[7] for many estimates for which management engages a specialist. Absent the occurrence of relevant subsequent events or transactions occurring prior to the date of the auditor's report,[8] this could essentially require the auditor to develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.[9] In this situation, a company could essentially be forced to work with two different specialists for each estimate – the specialist engaged by management to assist in management's development of an estimate, and the auditor's specialist who is assisting in developing an independent expectation to corroborate the reasonableness of management's estimate. This may result in unnecessary distractions for management during the financial reporting process and create resource constraints within the specialist community. For example, having two objective third-party actuaries separately calculating each company's pension liabilities, as opposed to the auditor's actuary focusing on understanding and evaluating the relevance and reliability of the information that poses a risk of material misstatement, will most likely not be effective or efficient.

Additional challenges may exist when applying the proposed requirement to attorneys engaged by the company that are not in the scope of AU 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*. Companies may engage attorneys related to the development of estimates, but their engagement is typically not related to valuation. Their engagement is more of a subjective nature, and the practicality of testing the data provided by attorneys may be complicated by the nature of those engagements.

Rather than limiting or potentially eliminating the auditor's ability to test the process used by management to develop an estimate when management engages a specialist, we suggest that the staff develop additional guidance for the auditor to consider when testing the process used by management. Such guidance could emphasize the need to challenge the models and assumptions, and more clearly describe the auditor's consideration of alternatives and contradictory evidence.

This guidance could also acknowledge that there are different types of specialists who operate within different environments. Certain specialists, such as actuaries and real estate appraisers, currently operate within professional standards frameworks that could be considered when determining the level of additional audit work required of the auditor. We believe that the ongoing development of professional standards within the different specialist communities, including fair value measurements, provides additional benefits to the capital markets, and we believe that any proposed auditing standard should take the development of professional standards related to specialists into consideration.

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6 See AU 336.12.

7 See AU 342.10a.

8 See AU 342.10c.

9 See AU 342.10b.

If, however, the staff pursues a requirement that the auditor test the information provided by specialists engaged by the company as if it were produced by the company, we believe that it will be critical to perform a robust cost/benefit analysis involving all key stakeholders, including third-party specialists.

Third-party pricing services

We agree with the distinction made in the Staff Consultation Paper that there are different types of third-party pricing sources, some of whom provide information "that is developed for, and widely available to, the public" and some of whom provide information "that is generated specifically for the auditor," and we applaud the staff for their consideration of "an approach in the potential new standard that could potentially recognize some of these differences."[10] We believe that, in addition to this distinction, it is important to further distinguish between third-party data providers, who provide market information, and third-party pricing services, who provide an independent estimate that is not unique to any individual company and is based on market information. Based on this distinction, we agree that the audit evidence obtained from different third-party sources (specialists, third-party pricing services, and third-party data providers) should be subject to different audit requirements. Regardless of the third-party source, we believe the principles in AS 15 to evaluate relevance and reliability are appropriate. Below, we discuss our observations on third-party pricing services.

The auditor's use of third-party pricing services

We believe that the use of third-party pricing services can be a relevant and reliable source of pricing for certain financial instruments and is consistent with GAAP.[11] We also believe that information obtained from third-party pricing services at times can provide sufficient appropriate audit evidence related to management's valuation estimates when appropriate procedures are performed to assess the capabilities of the third-party pricing service. Third-party pricing services provide independent pricing information free of influence from any one company, and we believe that the absence of this influence enhances the relevance and reliability of the information. Additionally, given that the estimates provided by a third-party pricing service are used every day by market participants, and are subject to price challenges by these same market participants, there appears to be a monitoring inherent in the process.

Our view is that a standard developed to address the requirements in evaluating information obtained from third-party pricing services would need to allow for flexibility in determining the nature and extent of procedures necessary to assess the relevance and reliability of evidence provided by third-party pricing services, rather than suggesting a 'one-size-fits all' approach. It is unclear from the Staff Consultation Paper, but it appears that the direction the staff is considering would in essence require the auditor, among other matters, to conduct a 'deep dive' analysis of the price received from the third-party pricing service regardless of the risk of material misstatement.

If this is the case, we are concerned with the implication in the Staff Consultation Paper, as described on page 44, that the same level of testing is necessary to evaluate the relevance and reliability of pricing of each security provided by a third-party pricing service. We believe an effective risk assessment, including a stratification to identify the different types of securities within an investment portfolio that represent differing degrees of risk of material misstatement, can be effective in developing an appropriate audit approach. Identifying the types of securities held within an investment portfolio helps to identify those securities that inherently present a higher risk of valuation misstatement and warrant an auditor obtaining

[10] See *Staff Consultation Paper*, page 43.

[11] See ASC 820.10.35.54k.

additional audit evidence. Conversely, it also helps identify those securities that have inherently less risk of valuation misstatement. For example, a security appropriately classified as "Level 3" under the GAAP hierarchy will present a different valuation risk than a security appropriately classified as "Level 1;" therefore, the nature and extent of the audit procedures required to obtain sufficient appropriate audit evidence to support these different examples of a fair value estimate should differ.

The Staff Consultation Paper discusses a potential requirement that, "[w]hen there are no transactions either for the asset or liability or comparable assets or liabilities, [the auditor should determine] 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."[12] Such an approach, and the precision implied, appears to be inconsistent with the staff's stated goal of aligning a new standard with the Board's risk assessment standards. We also believe that such a requirement would be operationally impracticable, from the point of view of both the auditor and the third-party pricing service and, by extension, to companies and financial statement users. We agree that a lack of transactions for the asset or liability or comparable assets or liabilities may increase the risk of material misstatement and additional procedures are most likely warranted but as discussed further below, other alternative procedures may be sufficient and appropriate.

Limitations

We believe that there are current constraints associated with the information provided by third-party pricing services that would affect the auditor's ability to perform the proposed audit procedures. Generally, third-party pricing services have not developed an automated process to be in a position to provide the information suggested in the Staff Consultation Paper on a security-by-security basis in a consistent manner. Much of the necessary information is either not currently available or would need to be manually extracted from third-party pricing services' tools. Based on our conversations with various third-party pricing services, we also believe that some third-party pricing services are prohibited from revealing certain of the data used in developing their price due to legal or contractual confidentiality reasons agreed to with certain of their sources of market information. The information needed to determine whether fair values are based on transactions of comparable assets or liabilities is generally available at an aggregated level, via a third-party pricing service's methodology documentation for the product, and at a security level via a 'deep dive,' for which third-party pricing services may limit the number that their customers, including companies and auditors, may request.

The Staff Consultation Paper also indicates incremental procedures related to relevance to be performed on indicative broker quotes. Even with the constraints listed above, third-party pricing services generally provide greater transparency related to the relevance considerations outlined in points a - c on pages 45 and 46 of the Staff Consultation Paper than do brokers. In our experience, brokers typically will not disclose this level of information in their interactions with auditors. Therefore, additional challenges exist in performing these procedures on indicative broker quotes.

As discussed below, we believe a better approach is for the auditor to perform risk assessment procedures to determine when information from third-party pricing services would be considered relevant and reliable when combined with appropriately assessing the capabilities of the third-party pricing service, compared to when information from a third-party pricing service alone is not sufficient appropriate evidence and additional procedures should be performed.

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[12] See *Staff Consultation Paper*, page 46.

Impact of effective risk assessment on the audit approach

We agree that it is important for an auditor to consider the type of model used to develop a fair value measurement obtained from a third-party pricing service. In alignment with the current requirements of AU 332, among other matters, the auditor should obtain evidence by performing procedures such as (i) determining whether the valuation model is appropriate and whether the assumptions used are reasonable and appropriately supported, or (ii) developing an independent expectation to corroborate the reasonableness of the value calculated by the entity.[13] However, we note that there is a spectrum of models that require a varying level of judgment. We believe that the extent of substantive audit procedures should be commensurate with the level of judgment and complexity involved in the model used. For example, certain valuation models (including certain matrix pricing) include inputs which are based on quoted prices, or prices implied by yields, for similar securities. These models are inherently less judgmental and less complex; therefore, the nature and extent of testing should be different to address the valuation assertion.

We recommend an approach that is predicated on the identification and assessment of the risk characteristics of the securities. For securities where prices are based on unadjusted, quoted prices for identical assets or liabilities in an active market, and securities where prices are the result of a less complex or judgmental model, a 'deep dive' into an assessment of the relevance and reliability of the third-party pricing service price at the security level should not be necessary. Assessing the capabilities of the third-party pricing service, along with reviewing pricing data obtained and considering this information in relation to the financial instrument, would most likely provide sufficient audit evidence to conclude that certain security values are not materially misstated. Generally, we believe that prices received from a third-party pricing service whose prices are the result of a less complex/judgmental model represent sufficient appropriate audit evidence to support the valuation assertion in connection with appropriately assessing the capabilities of the third-party pricing service because the auditor can assess the reasonableness of the price.

Securities whose prices are the result of more complex or judgmental models, and securities where the value of the securities are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement, require additional procedures to assess the relevance and reliability of the prices received from third-party pricing services. For example, auditors may decide to develop an independent estimate in order to test the security's valuation or perform a 'deep dive' related to the price obtained from the third-party pricing service.

We believe an appropriate risk assessment can provide the basis for identifying securities that require additional audit evidence and those where third-party pricing itself may be considered sufficient appropriate audit evidence. The risk assessment process could include, for example, consideration of the ASC 820 fair value hierarchy classification by the company and understanding the specific asset types, including their relevant characteristics, held within a company's portfolio.

As discussed in the previous section, if the staff pursues a requirement to perform a security-level 'deep dive' analysis regardless of the assessment of risk of material misstatement, the staff should seek input from other stakeholders, including third-party pricing services, as to their ability to provide the level of information that would be required. We believe it would also be valuable that the staff recognize that existing SSAE 16 reports for third-party pricing services do not cover the development of the fair value estimate for most financial instruments and so, in our opinion, would be insufficient to meet the

[13] See AU 332.40.

requirements implied in the Staff Consultation Paper. We believe that input from third-party pricing services is crucial for the staff to have a full and proper view of the practicability of the potential requirements.

Other matters

Linkage to the risk assessment standards

We agree that it is important to consider the interaction of the PCAOB's risk assessment standards with a potential new standard. We also agree that the staff should propose amendments directly to the risk assessment standards and not integrate the requirements of the risk assessment standards into a new standard. We also support the amendments to Auditing Standard Nos. 12 and 13 as proposed in the Staff Consultation Paper as the only areas of the risk assessment standards to amend.

Requirement to assess whether methods used are accepted in the industry

The Staff Consultation Paper asks whether a potential requirement to "evaluate whether methods are accepted within the company's industry" would be appropriate for both accounting estimates and fair value measurements.[14] While we acknowledge that a similar discussion is included in AU 328[15], we believe that this should not be a presumptive requirement in a new standard as industry considerations may not be relevant for all estimates. Given this, we propose the following suggestion:

> *…The auditor also should evaluate whether the methods are:*
>
> *a.* Accepted within the company's industry***, if applicable***; and…

Requirement to evaluate assumptions not used by management

The Staff Consultation Paper asks whether the staff should "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."[16] We believe that the auditor has a responsibility to determine whether the assumptions that are used to develop the estimate are reasonable and supportable, and to evaluate any contradictory evidence of which they become aware, but not to disprove each potential existing assumption. As a result, it is unclear how the auditor might demonstrate the completeness over their consideration of potential assumptions. In addition, such a requirement seems to go beyond the requirement in ASC 820 in which exhaustive efforts to obtain information about market participant assumptions do not need to be undertaken.[17] We note that AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* ("AU-C 540") contains a requirement 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.[18] Instead of the proposed requirement, we would be supportive of a requirement similar to AU-C 540.15(a).

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[14] See *Staff Consultation Paper*, pages 33 and 34.

[15] AU 328.18c.

[16] See *Staff Consultation Paper*, pages 35-36.

[17] See ASC 820-10-35-54A.

[18] See AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures,* paragraph 15(a).

Providing prescriptive guidance on which method to use

We do not support the development of prescriptive guidance to determine which approach to testing an estimate should be taken in specific circumstances. Auditors should have the flexibility to determine an effective approach which could include evaluating the occurrence of relevant subsequent events that may be difficult to predict. Prescriptive guidance on when to use one method may also limit the auditor's consideration of combining different approaches and may have the unintended consequence of reducing audit quality.

AU 332

The Staff Consultation Paper asks if certain elements of AU 332 should be retained.[19] While certain elements of AU 332 overlap with AU 328 and AU 342, there are other elements that are not currently discussed in AU 328 and AU 342 and which are not described in the Staff Consultation Paper.[20] As such, we believe that a single auditing standard contemplated by the staff should only consider and then supersede AU 332.26-.48, which discuss valuation.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Marc Panucci (973-236-4885) or Derrick Stiebler (973-236-4904) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

[19] See *Staff Consultation Paper*, page 18.

[20] See, for example, AU 332.21 which discusses existence or occurrence.