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Via E-mail: comments@pcaobus.org

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

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

Dear Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting and Oversight Board's (the PCAOB or the Board) Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements* (the Consultation Paper). As set out in the Consultation Paper, we note that audit regulators from various jurisdictions have identified a high number of deficiencies in the area of fair value measurements. To address this issue, we support the PCAOB establishing a project to evaluate the effectiveness of the existing auditing standards in this area. While we believe that a project to enhance the auditing standards will help to clarify the auditor's responsibilities with respect to auditing accounting estimates and fair value measurements, we also believe that further analysis is needed to determine the root causes that have resulted in observed inspection findings to fully address the issue. Furthermore, we support enhancing the auditing standards to clearly communicate, with greater specificity, the expectations of the Board with respect to the performance of risk assessment procedures and the corresponding responses to risks of material misstatement specific to accounting estimates and fair value measurements. For example, we believe greater clarity is needed regarding how an auditor determines the most appropriate approach to responding to the assessed risk of material misstatement (i.e., test how management made the estimate and data on which it is based, use subsequent events to provide evidence about the estimate, or develop a point estimate or range to evaluate management's point estimate).

In general, we are supportive of developing a single standard that is aligned with the PCAOB's risk assessment standards. Such an approach would be similar to that used by the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board, both of which issued a single standard to establish requirements and application guidance relating to auditing accounting estimates and fair value measurements. While we believe the issuance of a single standard is appropriate, there may also be an opportunity to provide incremental guidance relating to specific topics with a narrow focus, such as third-party pricing services, in a separate interpretive practice aid.

Moreover, to fully address the challenges in accounting and auditing accounting estimates and fair value measurements, we believe a comprehensive approach is needed that includes enhancements to the roles and responsibilities of all participants in the financial reporting process to provide greater transparency to users of financial statements with respect to these estimates.

Proposed Potential New Standard

As noted in the Consultation Paper, after consideration of alternative approaches to address the issues raised by inspections staff, the Standards Advisory Group, and other interested parties regarding accounting estimates and fair value measurements, the PCAOB Staff is contemplating developing a single standard for the Board to consider proposing that would supersede AU sec. 328, *Auditing Fair Value Measurements and Disclosures* (AU 328), AU sec. 342, *Auditing Accounting Estimates* (AU 342), and much of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments* (AU sec. 332). As set out in our remarks above, we generally support such an approach due to the overlap of auditing issues between these standards, and we encourage the staff to consider aligning the potential new standard with International Standard on Auditing 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (ISA 540), where appropriate to minimize differences from the ISA, such that any incremental requirements address circumstances unique to auditing in the public company sector. Furthermore, we understand that the IAASB plans to reconsider certain aspects of ISA 540 as part of an upcoming project to address special audit considerations relevant to financial institutions. We encourage the PCAOB to work with the IAASB to coordinate efforts, where such coordination is appropriate.

Identifying and Assessing Risks of Material Misstatement

We agree with the position presented in the Consultation Paper that explains that the risk assessment standards provide the foundational requirements for identifying, assessing, and responding to risk in an audit. Moreover, we believe that the requirements in the risk assessment standards are intentionally principles-based so that they address a broad spectrum of situations and circumstances and, for this reason, we support including the specific risk assessment procedures relating to accounting estimates and fair value measurements within a separate standard that is devoted to that particular topic rather than within the risk assessment standards. For example, ISA 540, paragraph 8, explains how the broad requirement in ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* which requires the auditor to understand the entity and its environment, including its internal control, should be implemented in the context of accounting estimates.

Management's Use of a Specialist

The Consultation Paper explains the staff's view that a potential new standard could include the existing requirement under AU 328 to test assumptions developed by a company's specialist, but apply it more broadly to information provided for accounting estimates such that if a company used a specialist to develop an accounting estimate, a potential new standard could direct the auditor to test that information as if it were produced by the company. Moreover, the Consultation Paper notes that this would mean the auditor would be required 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. While we agree that when the company uses a specialist to develop an accounting estimate the auditor needs to perform work on that estimate, we believe a better way to explain the nature and extent of the work necessary to address the risk of material misstatement is to explain it in the context of obtaining sufficient appropriate audit evidence. For example, if management has used the work of a specialist, the auditor could be required to, based on the significance of the specialist's work, (a) evaluate the competence, capabilities, and objectivity of that specialist, (b) obtain an understanding of their work, and (c) evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion. Evaluating the appropriateness of the specialist's work might include consideration of the relevance and reasonableness of the specialist's findings or conclusions and their consistency with other audit evidence, the relevance and reasonableness of significant assumptions and methods used, and the completeness and accuracy of source data used when significant. This type of approach would be consistent with the guidance in ISA 500, *Audit Evidence*.

As part of obtaining an understanding of the work of management's specialist as set out in item (b) above, the auditor may consider the need for their own specialist. Factors the auditor may consider in making this judgment could include: the nature and significance of the estimate or fair value measurement, including its complexity; the risks of material misstatement; the auditor's knowledge of and experience with the matter; and the availability of alternative sources of audit evidence. We believe that additional clarity about how these factors should be considered in making a determination about the use of an auditor's specialist would be helpful and support consistent application. Moreover, we believe providing such additional clarity could reduce unnecessary duplication of work effort by management and auditor specialists.

Furthermore, we note that the Standard-Setting Agenda of the Office of the Chief Auditor, dated September 30, 2014, includes a project relating to AU section 336, *Use of Specialists* (AU 336), which anticipates the issuance of a consultation paper within the next six months. Given the linkage between the concepts presented in this Consultation Paper with those in AU 336, we believe that the development of a potential new standard to address AU 328 and AU 342 (and potentially AU 332) should be done in conjunction with the consideration of comments received from the consultation on the use of specialists to ensure all interrelationships between the potential new standard and AU 336 are fully vetted and appropriately considered.

Developing an Independent Accounting Estimate as a Range

We recognize that there are different types of estimates and varying levels of complexity and estimation uncertainty. Accordingly, we encourage the PCAOB to develop a principles-based standard that recognizes such variability. In accordance with existing PCAOB standards, to evaluate the reasonableness of an accounting estimate, the auditor obtains an understanding of the process management used to develop the estimate and, based on that understanding, uses one or a combination of approaches including (1) reviewing and testing the process used by management to develop the estimate, (2) developing an independent expectation of the estimate to corroborate the reasonableness of the estimate, or (3) reviewing subsequent events or transactions occurring prior to the date of the auditor's report to evaluate the reasonableness of the accounting estimate.[1] As the degree of estimation uncertainty in making an accounting estimate increases, the auditor, in testing management's process, may consider using different assumptions to evaluate the sensitivity of the accounting estimate, or may develop an independent estimate as part of using a combination of approaches. These procedures can result in amounts that may vary widely from the recorded estimate. The Consultation Paper indicates that, with regard to an auditor developing an independent estimate, the potential new standard could emphasize that the estimate is limited to outcomes within the range that are supported by sufficient appropriate audit evidence. However, such a statement may suggest a level of precision within a range of estimates that may not be achievable in all circumstances.

For example, some accounting estimates with relatively high estimation uncertainty may result in a range of 'reasonable' estimates, which could exceed the established materiality level, such as is the case in developing estimates for certain insurance reserves or mortgage servicing rights. Therefore, we do not believe it would be appropriate to limit the use of auditor judgment in evaluating the appropriateness of management's accounting estimates in this regard. Accordingly, we believe the potential new standard should recognize the inherent imprecision in developing a range of possible estimates.

Identifying Significant Assumptions

In accordance with the requirements in AU 328, in particular paragraphs 33-34, auditors identify significant assumptions that management used in making accounting estimates through understanding management's process and considering whether management has identified the significant assumptions and factors influencing the accounting estimate. As such, those assumptions identified by management would be included in the auditor's identification of significant assumptions, along with any additional significant assumptions the auditor may identify. However, the Consultation Paper questions whether it might be appropriate for the auditor to be required to identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate. We believe such an approach would be difficult to apply in practice, as there may be numerous assumptions not used in the development of management's accounting estimate, and it would be impractical for the auditor to assess the importance of each to the recognition or measurement of the accounting estimate. We believe a more practical approach, similar to the approach in ISA 540, would be to require 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 when there is high estimation uncertainty that gives rise to significant risks.

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[1] PCAOB Interim Standard AU sec. 342, Auditing Accounting Estimates, paragraph 10.

<u>Use of Third Parties</u>

Evaluating Audit Evidence

As recognized in the Consultation Paper, auditors acquire information under varying circumstances from third parties to obtain audit evidence. In some circumstances, the auditor engages a specialist or uses specialists on staff for the purpose of evaluating the appropriateness of the model or developing an independent estimate; in other circumstances, the auditor may obtain information from third-party sources that provide the same information to the public. We believe that when information is provided to the auditor, and that same information is available to the public and is reliable, for example, in the case of level one and easier to value level two securities, the auditor can perform substantive audit procedures to evaluate their pricing and it is not necessary to perform further procedures to evaluate the methods and assumptions used to determine the price of such financial instruments.

However, when financial instruments are priced using unobservable inputs or require the use of significant assumptions and inputs, they are likely to have higher inherent risk. In this circumstance, it would generally be appropriate for the auditor to perform additional audit procedures to understand and evaluate the relevance and reliability of the information obtained from the third-party pricing service. For this reason, we believe the need to evaluate the methods and assumptions used to determine the pricing of financial instruments should vary based on the inherent risk of the instrument.

Relevance and Reliability of Evidence Obtained

The Consultation Paper is proposing additional requirements with respect to evaluating the relevance and reliability of evidence obtained from third-party pricing sources that would require the auditor to perform an evaluation at the 'asset or liability' level. It is unclear whether the intention of the proposed requirements is meant to require the auditor to evaluate the relevance and reliability of audit evidence at an individual security basis (i.e., individual CUSIP number), or whether testing at a higher level would be acceptable. We do not believe testing at the individual security level is necessary in all situations, such as when a portfolio of investments includes items with similar characteristics, and we encourage the staff to consider clarifying this requirement in the potential new standard.

Proprietary Third Party Models

We note the Consultation Paper is considering how a potential new standard could address audit evidence obtained from third-party pricing sources, and that a potential approach would be to require the auditor to evaluate the reliability of the evidence provided by the third-party pricing service, taking into account (a) the experience and expertise of the third party relative to the type of asset or liability being valued, and (b) the methods used by the third party in determining fair value for the specific securities being tested and whether the methodology used is in conformity with the applicable financial reporting framework. While we agree that the auditor should evaluate the experience and expertise of the third party relative to the type of asset or liability being valued, we have concerns about the auditor's, or management's, ability to test the proprietary models used to value certain investment products, due to the confidential nature of the models used by various pricing services. Company management and auditors are generally given the opportunity to obtain an understanding of a third-party pricing service's valuation process and methodology; however, they may not be permitted to access the proprietary information. Consequently, we believe any potential new standard should recognize these limitations.

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We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Chris Smith, National Accounting & Auditing Professional Practice Leader at 310-557-8549 (chsmith@bdo.com) and Susan Lister, National Director of Auditing at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

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