

November 3, 2014

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

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

To the Staff of the Office of the Chief Auditor:

Interactive Data appreciates the opportunity to comment on Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*, published August 19, 2014 by the staff of the PCAOB's Office of the Chief Auditor.

Interactive Data provides independent evaluations to both auditors and end clients as an input in their valuation process for assets and liabilities required to be measured at fair value. We believe our extensive experience as a third party evaluations provider serving more than 5,000 global organizations can give rise to useful insights concerning the practices and processes that result in high quality evaluations. We believe that this experience closely aligns us with the auditing objective of assessing the reasonableness of valuations in financial statements. Because Interactive Data is not an accounting firm or auditor, we are not well positioned to comment in depth on specific accounting standards or frameworks.

We have focused our comments on the questions regarding "Use of Third Parties", appearing on pages 43 through 46 of the Staff Consultation Paper.

In summary, Interactive Data believes that:

- Auditors should not be automatically required to use a different third-party pricing source than company management used to develop fair value estimates. Rather, we believe that comparing estimated values with observable market data, where available - trades, dealer quotes, and other relevant observable information, including comparables - is the most effective and objective approach for testing the reasonableness of fair value estimates.
- It is appropriate for the PCAOB to require that auditors consider the experience and expertise of the third party pricing source relative to the type of asset or liability being valued, as well as the methods used by the third party in the specific circumstances, including whether the methodology conforms to applicable financial reporting frameworks. We also agree with the staff's proposal for evaluating the relevance of the

evidence obtained from the third party pricing source, which is consistent with the principles set forth in ASC Topic 820.

- Beyond the factors listed in the Consultation Paper, we suggest that additional factors may assist auditors in determining reliability and relevance of third-party evidence, such as:
 - The number and experience of evaluators at the third party pricing source.
 - The extent of documented controls applied by the third party in its evaluation process.
 - The third party's procedures for, and historical results from, responses to security-level challenges to their evaluated prices.
 - The use of a rules-based, risk-driven sampling approach by auditors for validating a company's fair value estimates.
- A new or amended standard should reinforce existing practice in which specialists are retained to value specific assets or liabilities on a unique or custom basis for their client, while third-party pricing services sell valuations and related data to the public on a uniform basis for each instrument they evaluate.
- A new standard should induce auditors to take account of differences in valuation approach employed by third-party pricing sources. In particular, we believe consensus pricing (i.e., mechanically averaging or otherwise aggregating prices obtained from a survey of dealers or other market participants) has been demonstrated to be vulnerable to inaccuracies, or even manipulation, especially when non-executable quotes are included in the survey.

Background on Interactive Data

An independent source of evaluated prices, Interactive Data Pricing and Reference Data LLC ("Interactive Data") is a Registered Investment Adviser with the SEC under the Investment Advisers Act of 1940 and has been in the evaluations business for more than 40 years. The company provides global security evaluations designed to support financial institutions' and investment funds' pricing activities, research, and portfolio management. We offer evaluations for approximately 2.7 million fixed income securities (including security-based swaps and loan products), as well as our Fair Value Information Services for international equities, options and futures, and valuations for complex structured products and OTC derivatives.

In recent years, we have invested considerable resources to expand our coverage and provide our clients with greater insight and transparency into the inputs used to derive our evaluated prices, as well as help automate and streamline key valuation processes. Interactive Data Pricing and Reference Data has built a strong presence within the U.S. mutual fund marketplace and



currently counts 50 of the top 50 U.S. mutual fund companies as customers as well as 16 of the top 16 custodian banks, 48 of the 50 largest U.S. banks and 33 of the top 50 hedge funds.

Interactive Data maintains active collaboration with auditors and the asset management industry through Working Groups we have organized to discuss valuation and price validation matters. Members of our staff also have participated on the Pricing Sources Task Force within PCAOB's Standing Advisory Group.

Use of Multiple Pricing Sources

On page 44, the staff expresses concern that instances where the auditor and the company use the same third-party pricing source may raise questions about whether the auditor could arrive at an independent estimate. To address such situations, the staff asks in Question 39: "Should the potential new standard require the auditor to use a third party that is different from the third party used by management? Would such a requirement present challenges for certain types of accounting estimates and fair value measurements?"

We believe that the most effective approach, where possible, is to compare estimated values with observable market data: trades, dealer quotes, and other relevant observable information including comparables. We do not believe that requiring the auditor to use a different pricing source than management used would automatically contribute to improved relevance or reliability of accounting estimates. As the SEC stated in its recent Valuation Guidance, "pricing services employ a wide variety of pricing methodologies in arriving at the evaluated prices they provide, and the quality of those prices may vary widely."¹ Information from another third-party pricing vendor is additive to the assessment process only if the second vendor's process or input data are equivalent to or better than the first. Otherwise, the additional data may either mask a problem with the estimate or incorrectly identify securities that require further review. Instead, we recommend that a new standard require auditors to use market information where available (including indirect market observations) to test management's fair value estimates, including those sourced from third parties.

A requirement that auditors obtain prices from a different third party source could, we believe, have the unintended consequence of leading the industry to believe that reasonableness of fair value estimates can be assessed simply by comparing prices from different third-party vendors. The vendor-comparison approach to price validation – along with the kindred median-among-vendors approach to fair value estimation – became established during a period when information about fixed-income market activity and pricing vendors' assumptions and inputs was less readily available. Today, such information is increasingly available to companies and auditors. Public sources of transaction data include FINRA TRACE[®] for U.S. corporate bonds,

¹ SEC Release No. 33-9616, "Money Market Fund Reform; Amendments to Form PF" (July 23, 2014).
<http://www.sec.gov/rules/final/2014/33-9616.pdf>



EMMA™ for U.S. municipal bonds, and FINRA Securitized Products Dissemination ServiceSM (SPDSSM) for U.S. agency pass-through mortgage-backed securities. For U.S. structured bonds, FINRA-Interactive Data Structured Products Aggregate Reports display aggregated daily trading and average price by category.

The staff correctly observes that pricing sources are increasingly providing products that could provide auditors with insight as to how prices or estimates are developed. Of the large investments in technology that Interactive Data has made over the past four years, a significant portion has gone toward creating new platforms that enable our evaluations staff, our clients and their auditors to more easily view our evaluated prices alongside relevant market data such as trades and dealer quotes for the security in question or similar securities, and to conduct periodic testing of fair value estimates for fixed-income securities grouped in portfolios. A forthcoming enhancement will categorize and count inputs by type, producing scores to assist clients with both quality assessment and the classification of individual security holdings within the Topic 820 fair value hierarchy and related disclosures.

Reliability and Relevance of Third-Party Information

On pages 45-46, the Staff Paper sets out potential requirements for evaluating evidence from third-party pricing sources. Under the staff's proposed approach, the auditor would first gauge reliability - taking into account the third party's "experience, expertise (and) methods used" in the specific context - and then evaluate the relevance of the third-party information.

Interactive Data agrees with both the thrust of the Staff Paper section headed, "Evaluating Audit Evidence from Third-Party Sources," and with the suggested wording of a new standard presented on pages 45-46 that would address this topic. We believe it is appropriate for the PCAOB to require that auditors consider both the experience and the expertise of the third party relative to the type of asset or liability being valued, as well as the methods used by the third party in the specific circumstances, including whether the methodology conforms with applicable financial reporting frameworks. We also agree with the staff's proposal for evaluating the relevance of the evidence obtained from the third party pricing source, which is consistent with the principles set forth in ASC Topic 820.

Question 40. Would the factors noted above help the auditor in evaluating the reliability and relevance of evidence obtained from third-party pricing sources? Are there other factors that are applicable in determining the reliability or relevance of evidence obtained from third-party pricing sources?

Reliability

In addition to the factors listed on pages 45-46 of the Staff Paper, Interactive Data believes that the following three factors may assist auditors in determining reliability:

- *The number and experience of evaluators at the third party pricing source.* Financial reporting standards require that fair value measurements employ "the assumptions that

market participants would use.”² However, auditor’s engagement teams typically are not deeply trained or experienced in valuation techniques.³ As noted above, pricing sources have varying levels of evaluations staff size, market experience and valuation expertise. Therefore, it is advisable to require that auditors take such differences into account when assessing reliability of third-party information.

- *The extent of documented controls applied by the third party in its evaluation process.* Such controls can include, among other things, procedures for validating market data and other externally sourced information, supervisor and management review of evaluated prices, and procedures for identifying suspect data and resolving possible outliers. Assessing the existence, rigor, application and efficacy of such controls can help an auditor discern reliability of third party information.
- *The third party's procedures for, and historical results from, responding to security-level challenges to their evaluated prices.* Market participants, including evaluation service clients, comprise an essential source of market information for estimating fair value of securities. A formal challenge process is a structured channel through which client companies can present third-party pricing services with relevant information (e.g., trades not subject to reporting and public dissemination) that the third party might otherwise have no access to. The existence and active operation of a challenge process is therefore, in our opinion, a useful indicator of reliability of a third-party pricing service. In addition, composite records of a third party source’s historical responses to price challenges from its clients can provide insight into the quality of the third party’s fair value estimates over time. For example, a consistently high rate of adjusting prices in response to challenges can indicate that the service’s original prices were not of high quality. We believe that a third party’s challenge process and outcomes are among the factors auditors should consider when determining reliability.

Relevance

For determining relevance of third-party pricing information during an audit, in addition to the factors outlined in the box on pages 45-46, Interactive Data recommends that a new standard both:

² FASB ASC subparagraph 820-10-35-9: “A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest.”

FASB ASC subparagraph 820-10-05-1C: “Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, a reporting entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value.”

³ “Auditors are trained in financial accounting and auditing not valuation techniques/skills.” Lisa Milici Gaynor and Jacqueline S. Hammersley, “Auditing Accounting Estimates and Fair Value Measurements: Academic Perspective”. Presentation delivered at meeting of the PCAOB Standing Advisory Group, October 2, 2014.

1. Embrace a rules-based, risk-driven sampling approach.

We believe the goals of Auditing Standard 12, “Auditing Standard No. 12: Identifying and Assessing Risks of Material Misstatement,” would be best served by directing auditors to focus their attention on those areas of financial reporting that pose the highest risks to reliable financial reporting.⁴ With regard to fair value measurements, the highest risk areas might include complex securities, thinly traded securities, and instruments for which no current market data is available.⁵

Numerous fixed-income instruments are neither actively traded nor actively quoted. Such instruments may be valued based on comparable securities for which current market data is available. Estimating fair value for such securities requires making judgments regarding the criteria for identifying comparables and the appropriate price or yield spread to apply between a comparable and the security in question. In such instances, it is impractical for an auditor to test exhaustively each individual fair value estimate and assess all associated input data. Consequently, a selective, risk-driven approach is likely to be both more effective and more efficient than an effort to validate every security price reflected in a company’s financial statements. The selective approach requires that the auditor develop an understanding of the assets, liabilities, and third-party data in order to assess which data is most relevant for assessing accounting risk. This spares both auditors and third parties wasted effort processing large amounts of data that may have little value for assessing the risk of material misstatements.

2. Recognize that market information, including price quotations from market participants, may have differing degrees of relevance to fair value.

For any security or category of securities, market quotations from different participants, and even reported trades, may not all be equally representative of fair value. Interactive Data believes that evaluation best practice includes assessing each incoming market data point against the complete

⁴ The Securities and Exchange Commission, in Interpretive Release 33-8810, “Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934”, stated: “...(T)his principles-based guidance enables management to tailor its evaluation so that it focuses on those areas of financial reporting that pose the highest risk to reliable financial reporting. We believe that a tailored evaluation approach that focuses resources on areas of highest risk will improve, rather than degrade, the effectiveness of many company’s evaluations and improve the timeliness of material weakness disclosures to investors.” Although directed toward company management (financial statement preparers), we believe the principles are equally relevant for auditors.
<http://www.sec.gov/rules/interp/2007/33-8810.pdf>

⁵ Jason K. Plourde, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Remarks before the 2011 AICPA National Conference on Current SEC and PCAOB Developments (<http://www.sec.gov/news/speech/2011/spch120511jpk.htm>) “For example, more complex and less actively traded securities may have a higher assessed risk of misstatement due to the uncertainties about their value and larger possible ranges of values that market participants may attribute to them. Within Level 2 securities, there may be a difference in management’s process for valuation of securities that trade less actively because of the different assessed risk of material misstatement. ICFR (internal control over financial reporting) should be responsive to increasing risk of misstatement (including misstated disclosure) in more complex securities and those securities that are not actively traded.”

set of other available data for the same or similar securities, in an effort to prevent outliers from affecting the fair value estimate. Interactive Data believes that a new standard should aim to encourage auditors to consider a third party's procedures for assessing market information when assessing the relevance of evidence obtained from third-party pricing sources.

Question 41. Are there other approaches to testing evidence obtained from third-party pricing sources that the staff should consider?

We suggest that the staff consider recommending back-testing fair value estimates against observable market data, where available. Ideally, the evaluated price for a specific security is compared over a specific time interval with reported transaction prices for the same instrument. Before comparing prices, the trade data should be filtered and organized to match key parameters of the corresponding third-party evaluations: trade size (retail or institutional lot), trade type (dealer buy trades compared with bid-side evaluations, dealer sell compared with offer-side, etc.) and date and time of day if applicable. Statistical examination of the differences between evaluated prices and transaction prices can provide insights into the degree to which the third-party information reflected observable market activity. If trade information is not available for the specific issue in question, similar types of testing can be performed using market quotes, activity on other bonds of the same issuer, or activity on comparable instruments.

Question 42. How could a potential new standard differentiate between a third-party pricing source and a specialist?

Both the Staff Paper and existing audit standards distinguish between specialists and other types of service organizations, including pricing services⁶. Interactive Data believes that a new or amended standard covering fair value measurements should maintain this distinction. In particular, a new or amended standard should recognize the current differences between the roles each type of third party performs, and the responsibilities each assumes, whether engaged by companies or by auditors.

Interactive Data provides evaluated prices to assist our clients in estimating fair values for assets and liabilities required to be measured at fair value under applicable financial reporting frameworks. As the Staff Paper observes, pricing services provide uniform price information and other data about financial instruments to the public for a fee. Fair value estimates produced by pricing services are not “bespoke”; instead of engaging the third party specifically to develop an

⁶ AU 328, Auditing Fair Value Measurements and Disclosures, section 12, states in part:

When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example: . . .

- The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. . . .
- The extent to which the entity engages or employs specialists in determining fair value measurements and disclosures.

estimate, a company or auditor obtains information that is developed for, and widely available to, the public.

Specialists, on the other hand, are often engaged by a company and/or an auditor to develop independent estimates or assist in evaluating a company's estimate. AU sec. 336, *Using the Work of a Specialist*, defines a specialist as: “a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.” That standard goes on to mention appraisers among several types of specialists, and valuation among types of matters on which an auditor may consider using the work of a specialist.

This difference has important implications for the degree of interdependence between information available to the company and information available to a pricing provider or specialist, and for the procedures, controls and disclosures applicable to information obtained from each kind of third party.⁷ In addition, specialists may assume expert liability for information they provide to their clients, whereas pricing services typically do not.

When framing a new standard, we recommend that the PCAOB be mindful of the differing degrees of responsibility that specialists, on the one hand, and pricing services, on the other, currently assume when providing information for fair value measurements. Along with reinforcing existing practice in which specialists create fair value estimates on a unique or custom basis while pricing services sell valuations and related data to the public, the standard could recognize that auditors may require more detailed disclosure of assumptions and models in connection with fair value estimates obtained from specialists than from other third-party sources.⁸

⁷ Plourde, op cit.: “Management may need to perform different procedures and controls when considering the information obtained from pricing services regarding the fair value of financial instruments, than the types of controls it performs when considering information obtained from other specialists, such as those that provide information about the fair value of intangible assets in business combinations or about pension liabilities. For example, management may be more involved in the initial determination of assumptions used by an actuary to value its pension liability than in determining the assumptions that are used to value a financial instrument. Further, there may be more information routinely provided by other specialists such as actuaries regarding their methodology. Existing financial statement disclosure requirements in these areas may require management to reveal more detailed disclosures about assumptions and inputs than it would in the fair value context. For example, the discount rate and the expected long-term rates of return on plan assets for a pension liability are required to be disclosed.”

⁸ Among other reasons, a valuation produced by a specialist might be more sensitive to changes in assumptions than a valuation from a pricing service, whose model may be fitted with observable market data.

Question 43. Would the potential requirement address the various methods used by third-party pricing sources for determining fair value measurements of financial instruments (e.g., use of consensus pricing and proprietary models)?

We believe there are sound policy reasons in favor of addressing third-party valuation methods within a potential requirement. While sensitive to the evolving nature of valuation practices and the beneficial force of innovation, we believe the following observations should be considered when formulating the new standard.

Consensus Pricing

In its simplest iteration, consensus pricing aggregates or averages prices submitted by dealers or other market participants, without performing rigorous checks on the validity of such submissions. Screening or filtering of price submissions flowing into a consensus price is often of a mechanical nature, focusing on the removal of statistical outliers. Such a methodology contrasts with Interactive Data's evaluated pricing approach, in which each piece of incoming information is regarded as a distinct input that must be validated and its significance determined by an evaluator. We believe that the diversity of market data creates an important role for human oversight in the analysis, weighting, and synthesis of such data for the creation of fair value estimates.

Additionally, we believe the consensus pricing approach is vulnerable to bias, or even manipulation, by certain market participants submitting raw data to the third party. This risk is illustrated by recent civil and criminal complaints alleging manipulation of widely used survey-based benchmarks for interest rates⁹, swap rates¹⁰, foreign exchange rates¹¹, and other financial measures.

Interactive Data recommends that a new standard induce auditors to be sensitive to these differences in valuation approach. That could include applying additional tests and controls for assessing fair value measurements derived from consensus pricing - as is currently the case for other types of estimates that present relatively high risk of material misstatement.

⁹ European Commission, *Introductory Remarks on Cartels in the Financial Sector*, December 4, 2013

http://europa.eu/rapid/press-release_SPEECH-13-1020_en.htm

United States Department of Justice, *ICAP Brokers Face Felony Charges for Alleged Long-Running Manipulation of LIBOR Interest Rates*, September 25, 2013 <http://www.justice.gov/opa/pr/icap-brokers-face-felony-charges-alleged-long-running-manipulation-libor-interest-rates>

"The Libor Settlements," *The Wall Street Journal*, February 13, 2013

<http://online.wsj.com/articles/SB10001424127887324616604578302321485831886>

¹⁰ Collyer Bristow LLP, "Claims for ISDAfix manipulation". Lexology.com, October 23, 2014

<http://www.lexology.com/library/detail.aspx?g=f443ea5a-7afd-4eff-9de5-eb9b6a32c53f>

¹¹ U.K. Serious Fraud Office, "Forex investigation," July 21, 2014

<http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2014/forex-investigation.aspx>

Jaimie McGeever, "Banks Boost FX Settlement War Chest to as Much as \$6.5 bln," *Reuters*, October 31, 2014

<http://www.reuters.com/article/2014/10/31/fx-investigation-banks-idUSL5N0SQ52D20141031>

Proprietary Models

There is a common misconception that proprietary pricing models are synonymous with automated pricing driven by unobservable assumptions and inputs. In reality, proprietary models do not always signify a “black box” approach. Evaluated pricing, which relies principally on observable data, frequently employs proprietary models to support the evaluation process. Interactive Data views proprietary models as tools that make possible the disciplined incorporation of market data into the valuation process. Our evaluators utilize such tools to effectively group securities and apply observable data, such as reported trade prices, to produce market-based estimates of fair value. We advise that any guidance related to the use of proprietary models capture the distinction between automated “black box” approaches and models or tools used as a component of a process primarily based on observable market data.

Summary

Interactive Data appreciates the opportunity to present our views on a potential new standard for Auditing Accounting Estimates and Fair Value Measurements. We support the staff’s proposals to develop a new standard that would consolidate and augment provisions from a number of existing audit standards that address this subject. We believe the goals of reinforcing best practices in auditing fair value estimates and evidence obtained from third party sources, updating existing standards and removing perceived inconsistencies, and further integrating the requirements of the existing standards with those of the risk assessment standards would be best served by a new standard that:

- Encourages auditors to compare estimated values with observable market data when testing fair value estimates for reasonableness (rather than requiring use of a different third-party pricing source than management used to develop fair value estimates).
- Requires auditors to consider the number of evaluators, experience and expertise of, and the pricing methods used by, the third party, relative to the type of asset or liability being valued.
- Includes a number of factors (in addition to those listed in the Consultation Paper) that may assist auditors in determining the reliability and relevance of third-party information -- such as the number and experience of evaluators employed by a third party pricing source; documented internal controls over the third party’s evaluation process; the third party’s pricing challenge process and aggregate historical results of challenges submitted to it; focusing substantive fair value testing on carefully selected samples of assets and



liabilities that present relatively high levels of accounting risk; and recognizing that market quotations may differ in degree of relevance to a security's fair value.

- Maintains existing distinctions between the roles and responsibilities of specialists and other types of service organizations (including pricing services).
- Encourages auditors to take account of differences in valuation approach employed by third-party pricing sources.

We look forward to working with the staff, the PCAOB and the auditing profession on this important issue.

Sincerely,

A handwritten signature in black ink, appearing to read "Andrew Hausman".

Andrew Hausman
President, Interactive Data Pricing and Reference Data
Interactive Data Corporation