



July 20, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803
Via E-mail: comments@pcaobus.org

Re: Request for Public Comment – Staff Consultation Paper No. 2015-01, *The Auditor’s Use of the Work of Specialists* (May 28, 2015)

Dear Office of the Secretary:

Thank you for the opportunity to comment on the PCAOB’s Staff Consultation Paper 2015-01, *The Auditor’s Use of the Work of Specialists*. As an independent securities valuation specialist with over twenty years’ experience in financial reporting, securities valuation, and the use and application of fair value measurement, Harvest Investments, Ltd. welcomes the Board’s attention to the work of specialists and concurs with its general assessment that the requirements now governing the work of specialists are in need of revision. Through its activities and publications, the PCAOB has already helped foster an environment favorable to the extension of better practices throughout the finance and audit communities. We have also noticed that many of our audit clients have made great strides in their oversight of valuation issues and processes – a development that attests to the importance of those factors within current financial reporting and fair-value accounting, and also signals a general preparedness for additional guidance.

In what follows, we offer our comments on several of the specific questions posed by the Board, numbered sequentially below. Again, we agree with the Board’s decision to revise the standards that have governed the work of both employed (*AU 10*) and engaged specialists (*AU 336*). Our comments are premised upon our extensive experience with the regulatory and contextual challenges of fair-valuation, and also on our resulting assessment of the strengths and weaknesses of the current regulatory and professional environment. We hope the Board will find them helpful to its deliberations.

Question #4 – On Accounting Firms’ Use of an Auditor’s Employed Specialists:

We have observed that concerns about confirmatory bias and auditor deference to management have surfaced during the Board’s Standing Advisory Group meetings.¹ In our estimation, these concerns are both reasonable and appropriate, since an employed specialist has a stake in the audit, whereas an engaged specialist does not. The Board has also rightly stressed the analytical importance of maintaining skepticism and independence within the audit and valuation processes in order to ensure adequate transparency and objectivity, as well as to avoid risk. Because the literature shows that confirmatory bias can function both intentionally and unintentionally, we think that it would be very difficult (if not impossible) to avoid it within a system in which valuation and audit take place under the same aegis, even if functionally separated. Our general review of the scholarly literature on the topic has confirmed what our professional experience had already indicated: namely, that confirmatory bias is hard to circumvent through better policing of auditors and their employed specialists. At the same time, however, we acknowledge that working with an engaged specialist also presents challenges, since overall audit Q&A may be diminished. Nevertheless, we think that the risks associated with persistent findings of confirmatory bias and related managerial pressure are more substantial, given the possibilities for pressure to confirm a client’s values.

Question #5 – On Accounting Firms’ Use of an Auditor’s Engaged Specialists

With respect to engaged specialists, the guidance set by AU sec. 336 has not been substantially updated since 1994; since that time, as the Board notes (p. 3), both the use and importance of specialists have increased. This same period witnessed a significant expansion in investment complexities and therefore also in the range of methods, inputs, and documentation used by specialists. Disclosure requirements have not always kept pace with these developments, making it difficult at times for an auditor or client to obtain an adequate assessment of a specialist’s knowledge, skill, or reasoning. Because of these shifts, there has been a “learning curve” for many in the use, supervision and evaluation of a specialist’s work.

In acknowledgment of these factors, Harvest applies a consistent, documented approach, so that all inputs as well as the reasoning behind all inputs are clearly available for each price, ensuring the consistent independence and transparency of our findings and evidential matter. In accordance with AU sec. 336, our qualifications and deliverables are clear. Further, we offer voluntary annual due-diligence reviews on-site as an optional service to our clients, which aids in planning and also in coming to agreement on the work delivered. Our standard report includes Harvest prices, models, and levels, as well as links to the various methodologies used. We make all inputs available to our clients so that they are able to collect and review them; in this way, our methods and results constitute an open rather than proprietary book, in which one can find clear documentation of and rationale for each input. As an engaged specialist, we have found that such measures, which ensure a high degree of transparency within our valuation processes, are also helpful in variance resolution and in guarding against possible management biases and material misstatements.

¹ Cf. Helen Munter’s comments at the 2 October 2014 PCAOB SAG meeting, pp. 22ff, http://pcaobus.org/Standards/SAG/Documents/10022014_SAG_Transcript.pdf

Question #7 – On Whether Standards Need Improvement

The Board asks whether there are additional issues that should be considered in connection with the need to improve current standards (*Section IV, Question 7*). We applaud the Board’s attention to the significance of understanding both the qualifications of specialists and the methodologies (including inputs) that are used in order to assess fair value processes appropriately and to limit the risks of material misstatement. We have observed a marked improvement among our audit clients when it comes to their review of our work, and this is very encouraging. We do, however, think that scrutiny of inputs and approaches should be consistent across all of the various types of specialists and/or pricing services in the industry. Additionally, we would like to highlight two areas that could be addressed in order to limit risk in fair value practices and avert another financial crisis:

- First, misconceptions remain that certain types of investment holdings are “low risk” or “easy to value.” Such holdings are often passed over entirely or sampled inappropriately. For example, alternative investments can be mistaken for mutual funds because deciphering their features can be difficult, leaving them untested in audits. Similarly, some bond portfolios are not appropriately tested, because of the perception that there is little or no valuation risk. Testing and samples should both be based on a vigorous assessment of structural features; otherwise, the financial reporting industry is left yet again at risk of material misstatement. Harvest’s valuation and sampling methods involve a review of 200 data-points in order to understand an item, define its risk, and determine an appropriate approach to its valuation. We do this specifically because the only bonds that are truly “easy-to-value” are high-grade, fixed rate bullets. We underscore this point about valuation because it bears on the conditions under which a financial crisis can (and did) develop and spread: mistaken values are highly correlated to general instability. To underscore the importance of adequate testing and sampling, we offer the following specific observations:
 - a. Harvest sees unreasonable variances in the fair values of many bonds each year. For example, we frequently see mispricings of the agency mortgage pools we review; these are a core investment for banks, the foundation of our financial system. Further, we see variances in auction rate bonds 45% of the time, in lower grade non-agency CMOs 37% of the time, and in newly issued non-agency CMOs 23% of the time.
 - b. Testing within the parameters of an extended low-rate/tight-spread environment will simply not give an adequate picture of what could happen were that environment to change. For example: between May and October of 2007, we saw spreads on “low risk,” “easy to price” high grade corporate bonds increase by 40-60%, while more complex products lost large percentages of their overall values. Our prolonged low interest rate environment has encouraged “common” issuers to add complexities to their bond structures through the use of multiple calls, variable coupons, and other options in order to make the issuances profitable. These features cannot be identified without digging into the

asset's structure, and sudden market movements cause large price variances in such structures that could result in material misstatements, as we experienced in the financial crisis.

- Second, the ASC 820 (formerly FAS 157) level hierarchy already exists to address and highlight how observable an item's valuation inputs and resultant values are in the marketplace, in order to assess the risk of potential misstatements and call investors' attentions to such risk. Even so, we believe that the leveling hierarchy is in need of further clarification. As the present guidance clearly stipulates, "[t]he level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability."² Yet even though the standards clearly state that appropriate designation of levels depends on the lowest level input used in a valuation, some within the financial reporting community will default to a level 2 designation on a significantly wide range of instruments simply based on issuer sector or pricing source, rather than on the basis of the relevant inputs. Level designations have been and remain an area in need of improvement, not least because an investor would want to know about any exposures to level 3 investments. Again, ASC 820 was formulated to highlight and document such risks and exposures. When it comes to actual practice, however, we remain concerned that the levels of each input are frequently not being calculated at all, or that they are not being calculated correctly. For these reasons, we suggest more clarification in this area.

Question #8 – Understanding Specialists' methods

The above remarks on the importance of understanding a security's structural features as well as the inputs used to value such structures are also relevant to the Board's queries concerning the degree to which a specialist's methods are, or need to be, understood (*Section IV, Question 8*). On the one hand, there is a "factual" question of whether or not something is understood – for example, whether inputs and methods are adequately grasped. On the other hand, there is a "situational" question about how context affects what is understood, as the problem of confirmatory bias clearly illustrates. The accelerating use of specialists underscores some important features of our present audit and accounting system – that it is complex, increasingly diversified, and also highly collaborative. Both factual and situational matters are at stake, and we applaud the Board's efforts to integrate both features under the new regulations.

In connection with its concern for situational risks of material misstatement, the Board notes that a "company's specialist might be influenced by the same factors that may cause bias in other personnel of the company who are involved in preparing the company's financial statements" (p. 22). Harvest concurs, and would also suggest that an auditor's employed specialist is subject to the same, if not greater, influence due to client pressure to confirm client data rather than to question or dispute it.

² FASB *Statement of Financial Accounting Standards No. 157*, p. 12 (www.fasb.org)

Additionally, we advise that an over-emphasis on models may distract from other equally important aspects of valuation. To underscore a point made earlier, we strongly recommend that the focus be on inputs as well as the clear documentation of the basis for and reasoning behind each input. In our experience, 99% of all meaningful variances we discover are due to inappropriate inputs. Further, we think that valuation experts should be obliged to assess both the documentation and the reasoning behind each input, since doing so is essential for accurate valuation and proper placement within the fair-value hierarchy.

Question #10 – Auditor’s Procedures re: Engaged and Employed Specialists

With regard to the question of whether an auditor’s oversight procedures should differ when dealing with an employed versus an engaged specialist (*Section V, Question 10*), we agree that they should be held to similar standards and would like to raise the following concerns about the range of approaches, capabilities, and methods presently gathered under the rubric of the term “specialist.” We recommend that the Board carefully consider the qualifications of both the engaged and employed specialists involved in the fair value process. All engaged specialists should have appropriate backgrounds and experience, and be aware of the relevant financial reporting requirements; employed specialists should have similar qualifications. While many internally employed valuation teams and pricing desks are excellent, some rely heavily on the work of inexperienced interns. In addition, some pricing desks rely on third-party pricing vendors without fully understanding their methods, documentation, or inputs. The use of pricing sources without a grasp of the underlying methodologies used to generate prices is worrisome: if the methodologies are not understood, then neither are the inherent valuation risks. The role of an auditor is to provide an objective, independent assessment of that which is being audited; similarly, the word “accountability” underscores the general social value of the obligation to be answerable for the accuracy of one’s information.

Question #19 – Appropriateness of Specialist Definitions

In its Staff Consultation Paper, the Board defines an “auditor’s specialist” as “a specialist who performs work to assist the auditor in obtaining sufficient appropriate audit evidence” (p. 34). Regarding its query about the appropriateness of this definition (*Section V, Question 19*), we respectfully recommend that the Board consider the following:

- 1) There are substantial, significant differences among the types of specialists that this general definition would accommodate. Any general definition of an auditor’s specialist would need to address the differences among sources, procedures, and practices directly.
- 2) If the definition of an auditor’s specialist were to exclude pricing services and vendors that provide “information that is routinely and commercially available for a fee,” the following issues should be of paramount concern and attention:

- a. *Independence*: If pricing services that provide “information that is routinely and commercially available for a fee” are not included within the definition of a specialist, it will be essential for the audit review to include a secondary, independent source. Given that the vast majority of all client prices that Harvest sees come from the same pricing service, testing through an independent source will be critical when it comes to identifying errors and material misstatements; otherwise, little will have been accomplished in the reporting of fair value since the financial crisis.
 - b. *Mispricing*: Harvest sees errors in the prices and values we test across all financial sectors, many of which are held by our financial institutions, money market and mutual funds. This means that vulnerabilities exist in the very places where middle-class Americans invest for college savings and retirement.
 - c. *Transparency*: If pricing services providing “information that is routinely and commercially available for a fee” are not treated as specialists, those services must be able to disclose valuation inputs and the documentation behind those inputs. In addition, as we stated earlier, we remain concerned that testing within an extended low-rate/tight-spread environment cannot give an adequate picture of what could happen were that environment to change. If the methods, inputs and documentation are not readily available, the progress made over the last eight years with respect to transparency will be jeopardized.
 - d. *Flawed Inputs*: The complex algorithms used by automated pricing services break down, given changes in rates, curves, and/or market conditions. The inappropriate methodologies and inputs of 2007 (stale ratings, etc.) resulted in inflated prices of mortgage securities, asset-backed securities, and pooled trust preferreds. The profoundly distressing economic results of that valuation system must not be forgotten.
- 3) Any new definitions should be formulated in line with the lessons learned from the financial crisis, to help ensure the integrity of future practices. Those in place prior to 2007 did not prevent reliance on single valuation sources and non-transparent methods, a situation that did not work out well for investors. In order to attain the degree of skepticism, transparency and independence that the Board is clearly seeking with its proposals, we strongly recommend that the Board address our concerns about the inclusivity of its definitions with regard to pricing.

Again, because the differences among specialists and pricing sources are considerable, and because those differences relate to larger issues of transparency, accuracy, and risk of material misstatements, we recommend that the Board take these considerations into account when finalizing these key definitions.

Question #24 – Obstacles to Documentation and Compliance

The Board raises the question of whether there are any obstacles to documentation and compliance regarding its potential requirements (*Section VI, Question 24*), and also provides a series of proposed requirements (pp. 37-8, points a-g) with respect to the kind of written agreement that should obtain

between an auditor and an auditor's specialist. We respond to them in sequence, below, drawing upon our experience working with auditors as well as our current practices and policies:

- a) *On the responsibilities of an auditor's specialist and the clear statement of objectives, nature/timing/extent of the work, and potential issues of control or other matters that could affect the work:* we agree that these matters should be directly addressed. Compliance would not be burdensome, and could be addressed via due diligence and/or an additional page in every Harvest report.
- b) *On accounting estimates and fair value:* we note that testing a specialist's independent inputs and methods has become increasingly expensive. Market data and tools, along with licensing fees (e.g. for CUSIP) have all risen in cost.
- c) *On company-provided or third-party information and the review of a client's work:* Harvest does not generally engage in such activity; rather, we manufacture all of our prices and values independently.
- d) *On the inclusion of relevant financial reporting requirements:* we agree that this is essential. A specialist qualified for financial reporting should always be aware of and comply with guidance, and should be able to provide this information clearly and up-front.
- e) *On the clarity and availability of information:* Harvest agrees that the nature and extent of audit information provided by an auditor's specialist should always be clear and available to the auditor. For example, the inputs and documentation in our IPR-SEC and PVAR reports are provided in great detail so that methods can be tested and variance resolution can be addressed.
- f) *On issues of timing and the possibility of changes or adjustment to the work undertaken by a specialist working with an Engagement Team or Partner:* we agree that all of these matters should be very clearly communicated. It is both appropriate and necessary for all parties to be aware of possible pitfalls or reasons for delay.
- g) *On professional skepticism:* Harvest agrees with the Board in emphasizing professional skepticism, a questioning mind and the critical assessment of evidence. Price and level variances can both raise issues that are difficult for an auditor simply to "resolve," especially in the face of client pressure. In our opinion, documentation is key, and in case of variance and/or contradiction, the most rigorously documented information should be used.

Question #26 – On what Information a Specialist should Provide

With regard to the Board's query about the information provided by an auditor's specialist to the auditor (*Section VI, Question 26*), it is our view that a specialist should make available all valuation inputs as well as the basis and documentation for each input. This is already Harvest's policy, independently of a specific auditor's request; however, not all specialists and pricing sources do this, nor do all auditors necessarily request this amount of information. Our reason for providing it to auditors is based on the principles of transparency, objectivity and intelligibility that we think are essential to an accurate and meaningful valuation process. Our clients have responded favorably to this level of disclosure, using our information to get a better understanding of our methods and assumptions and also to address variance resolution.

Question #27 – Proposed Requirements and Auditor Review of Independent Estimates

With respect to auditor responsibility regarding a specialist’s independent estimate (*Section VI, Question 27*), we think that the potential requirements look very reasonable. Our IPR-SEC report, for example, was created especially to satisfy the existing requirements. We would also like to applaud the Board for addressing the “basis for selecting the methods and assumptions used” in developing an estimate (p. 41, b.3), because we believe that doing so will help to ensure enhanced transparency and accuracy. In current practice, observable documentation for inputs is simply missing from many pricing vendors.

Question #29 – Auditor Evaluation of Specialists’ Work

Over the past few years, Harvest has seen great progress in client review of our work: clients are now focusing on our methods and assumptions in order to understand the methodologies and rationales behind our inputs, especially when it comes to more complex items. They have also become increasingly engaged with in-depth input review in order to assess and resolve variances, which helps to identify risk areas within the fair value of each portfolio. All of this is very encouraging: in firms ranging from large to small, we see much more engagement with hard market data, as well as an increasingly robust sense of professional skepticism and a clear commitment to understanding argumentation and evidence. Even so, we caution that we still observe frequent mispricings, even of generic items. We therefore encourage the Board to focus on structural nuances with regard to testing and sampling as well as the use of ASC 820 levels as indicators for risk in fair value.

Question #31 – On the Appropriateness of Potential Requirements

Harvest thinks that the type of review proposed is generally appropriate for all audits.

Question #32 – On Auditor Evaluations of Relationships between Engaged Specialists and Clients

In our experience as engaged specialists, some auditors and clients will request background investigations and/or annual disclosures regarding contributions and gifts. We provide these as requested.

Questions #33, 35, 39 – On Whether a Reasonable Investor Test is Feasible for a Specialist

Harvest both understands and appreciates the Board’s concerns about disclosure and maintaining objectivity. Already, we ensure that our company does no work for a direct client unless our audit client permits. We would be willing to consider instituting an Employee Background Investigation Policy that would disclose relevant financial, employment and/or business relationships or other significant information to address the Board’s concerns.

Question #34 – On Engaged Specialists and Independence

Some of the provisions contained in 17 CFR 210.2-01 (Qualifications of accountants)³ are already consistent with Harvest’s approach regarding the importance of independence. For example:

- At no time does a single person have control over any full portfolio review
- Controls and checks are carried out by multiple analysts or managers so that consistently high quality is maintained
- Individual analysts only address certain sectors, not the portfolio as a whole

We have no objections to additional measures or procedures for safeguarding independence and objectivity, and averting conflicts of interest.

* * *

By way of a general response to the Board’s questions about the economic impact of its proposed regulations (*Section VIII*, pp. 52-4), we offer the following comments, underscoring a concern expressed in our response to *Question 24b*, above. In relation to the Board’s desire that its recommendations “be scalable and result in the same requirements for evaluating the work of employed and engaged specialists, which would create consistency in practice among accounting firms of all sizes” (*Section V, Question 11*, p. 29), Harvest notes that economies of scale pertain within the audit and valuation fields, which means that smaller firms may easily incur additional costs because they cannot obtain the same audit evidence. Data and access to data have become very expensive, and explicit acknowledgement of and attention to that fact is warranted. In our experience, smaller audit clients in particular have difficulty in confirming all data, simply because doing so can require either expensive systems and/or a high level of financial knowledge. Such clients usually do not have much trouble tracing some spreads and yields; however, independent confirmation of all appropriate inputs (i.e., pre-payment and default/loss assumptions on a whole loan CMO, for example) remains more difficult. This state of affairs is in no small part due to costs.

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In closing, we thank the Board for the opportunity to comment on this Staff Consultation Paper, and for its time in reviewing our arguments and concerns. If the Board would be interested in discussing any of our views in more detail, we are at its disposal: please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.

³ <https://www.law.cornell.edu/cfr/text/17/210.2-01>