CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

November 3, 2014

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

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

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on the staff of the Office of the Chief Auditor (the Staff) of the Public Company Accounting Oversight Board's (PCAOB or the Board) *Staff Consultation Paper – Auditing Accounting Estimates and Fair Value Measurements* (the Consultation Paper). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

We concur with the Staff's observations in the Consultation Paper that over the past decade there have been changes in the financial reporting frameworks that have increased the use of accounting estimates, including fair value measurements, in the preparation of financial statements, which may have contributed to the Staff's observations that auditing these areas has proven challenging. Given the wide range of issues associated with many accounting estimates, including fair value measurements, there may not be a 'one-size-fits-all' solution to these auditing challenges. It is important to continue to analyze the root cause of these issues, particularly as it relates to the inspection deficiencies observed by the PCAOB and other global standard-setters. Further, enhancements to the auditing standards will require careful deliberation and extensive outreach with key stakeholders to develop an auditing standard that promotes audit quality and is operational (and sustainable) to changes in the evolving capital markets.

The CAQ acknowledges that the PCAOB has issued guidance, performed research, and conducted outreach to inform this project,[1] particularly with respect to the use of third parties in determining certain fair value measurements. We commend the

[1] See page 4 of the Consultation Paper for examples of outreach performed and guidance issued by the PCAOB.

Staff for recognizing the need for change and developing the Consultation Paper (and holding a special Standing Advisory Group meeting[2]) to continue to solicit stakeholder feedback on potential improvements to the current auditing standards.

In this letter, we offer for the Board and Staff's consideration our views regarding the topics outlined in the Consultation Paper, including the Staff's suggested changes to the related auditing standards. Our views are organized into the following sections:

I. General Views on the Staff's Consultation Paper
II. Management's Use of a Specialist
III. Use of Third-Party Pricing Services
IV. Developing a Range of Estimates
V. Other Matters
  a. Understanding the Development of Accounting Estimates
  b. Evaluating the Issuer's Methods Used to Develop an Accounting Estimate
  c. Identifying Assumptions Not Used by Management

We believe that changes in these areas may present challenges that must be carefully considered. Our suggestions are aimed at addressing such challenges, while helping to achieve the objectives of the Staff as articulated in the Consultation Paper.

I. General Views on the Staff's Consultation Paper

The 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 possible revisions to PCAOB auditing standards in response to the need for change. In particular, the Staff is considering developing a single auditing standard (potential new standard) related to auditing accounting estimates and fair value measurements that would supersede AU sec. 342, *Auditing Accounting Estimates* (AU342), AU sec. 328, *Auditing Fair Value Measurements and Disclosures* (AU328), and certain aspects or all of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU332). Based on the Consultation Paper, the potential new standard could be designed to:[3]

- Align with the Board's risk assessment standards;[4]
- Generally retain the approaches to substantive testing from AU328 and AU342, but include audit procedures that would apply to both accounting estimates and fair value measurements;
- Establish more specific audit procedures relating to the use of third parties in developing accounting estimates and fair value measurements; and
- Create a more comprehensive standard related to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application.

The CAQ is supportive of enhancements to the auditing standards related to accounting estimates, including fair value measurements, and is generally supportive of developing a single standard that would align with the PCAOB's risk assessment standards. We note, however, that there is not a 'one-size-fits-all' solution to the issues in these complex areas, and it may be challenging to develop a single auditing standard that would address all issues related to auditing accounting estimates, including fair value measurements. In developing a potential new standard, it may be more appropriate to create overarching principles related to auditing accounting estimates, including fair value measurements, and address certain specific auditing issues or

[2] The PCAOB held a Standing Advisory Group meeting on October 2, 2014 to discuss matters related to auditing accounting estimates and fair value measurements.
[3] Page 5, the Consultation Paper.
[4] The PCAOB's risk assessment standards, Auditing Standards No. 8 through No. 15, set forth requirements relating to the auditor's assessment of, and response to, the risks of material misstatement in the financial statements.

topical areas (e.g., third-party pricing services) in a more targeted manner (possibly through the development of supplemental guidance). For instance, a potential new standard could start with the elements of the existing framework under the current auditing standards (i.e., AU328, AU332, and AU342) and be revised to better align with the PCAOB's risk assessment standards, while emphasizing an understanding of management's processes and the control environment. However, it is important for a potential new standard to acknowledge that all accounting estimates, including fair value measurements, are not the same, and allow for the continued application of the auditor's risk assessment process.

Although we have focused our suggestions below on auditing issues, we believe that similar issues generally confront issuers in measuring and disclosing accounting estimates, including fair value measurements. When measuring and disclosing accounting estimates, including fair value measurements, issuers are currently subject to various financial reporting frameworks (e.g., U.S. GAAP as issued by the Securities and Exchange Commission and the Financial Accounting Standards Board) and internal control frameworks (e.g., the Committee of Sponsoring Organizations of the Treadway Commission (COSO)). In developing a potential new standard, we encourage the PCAOB to consider the extent of the current requirements imposed by issuers' direct regulators, standard-setters, and other stakeholders.

Further, amending the auditing standards may not address all challenges in these potentially complex areas. For instance, calls for additional transparency regarding accounting estimates, including fair value measurements, may be better addressed through corresponding changes to the financial reporting framework. Therefore, we believe a holistic approach that examines opportunities for improvement in the roles and responsibilities of all members of the financial reporting supply chain will best meet the needs of investors and other stakeholders, and we encourage regulators and standard-setters to consider the benefits to users of the financial statements of maintaining alignment.

<u>Overarching Principles</u>

The CAQ believes that enhancements to the existing auditing standards should be principles-based to adapt to the continuing evolution of accounting standards, consider the inherent uncertainty of accounting estimates, including fair value measurements, and seek to align with the expectations of users of the financial statements. Therefore, we believe that enhancements to the related auditing standards should:

- Recognize 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, stakeholders' expectation gap;
- Consider the wide range of accounts (and elements of accounts) that involve some level of estimation uncertainty and the varying levels of complexity and risk associated with different accounting estimates;
- Recognize that accounting estimates, including fair value measurements, may be subject to a significant degree of measurement uncertainty, and such inherent uncertainty will exist irrespective of the level of effort involved in auditing the estimate (e.g., not imply that a level of precision exists in an inherently imprecise measurement exclusively as a result of an audit of that measurement); and
- Be operational under the current construct of (and sustainable to changes within) the capital markets and relevant market participants (e.g., recognizing the auditor's ability to use the work of a specialist, when situations arise that may require specialized knowledge and subject matter expertise not possessed by the auditor).

II. Management's Use of a Specialist

As noted in the Consultation Paper, the Staff is considering expanding the existing requirements under AU328,[5] related to testing assumptions developed by management's specialist, to apply more broadly to information provided for all accounting estimates.[6] As such, if management uses 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 management. 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.[7] This could potentially result in the auditor having to evaluate (and test) the related internal controls of the specialist. We are concerned about the impact this expansion could have on the auditor's ability to apply AU sec. 336, *Using the Work of a Specialist* (AU336), which we believe provides a fundamental basis for evaluating the work performed by a specialist.

Accounting estimates can encompass a wide variety of complex matters, many of which may require knowledge and subject matter expertise in a particular field other than accounting or auditing that could inhibit performing an independent estimate without the assistance of a specialist. In instances when management encounters complex or subjective matters that may require management to engage a specialist, AU336 provides the auditor with a framework to evaluate the work of the specialist,[8] including:

- Evaluating the specialist's professional qualifications;
- Obtaining an understanding of the nature of the work performed or to be performed;
- Evaluating the specialist's relationship to the client, including circumstances that might impair the specialist's objectivity; and
- When using the findings of the specialist:
    - Obtaining an understanding of the methods and assumptions used by the specialist;
    - Making appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk; and
    - Evaluating whether the specialist's findings support the related assertions in the financial statements.

As mentioned, this framework provides a fundamental basis for evaluating the work performed by a specialist used by management, and we believe that the ability to utilize this framework should be maintained. However, we believe that the suggested requirement to test information provided by management's specialist as if the information was provided by management may hinder the profession's ability to use the work of the specialist under AU336, and may go beyond the existing requirements under Auditing Standard No. 15, *Audit Evidence* (AS15). For instance, there may be general limitations associated with information the auditor can obtain from specialists, particularly in instances where a third-party specialist is engaged by management. An auditor's access to the information used by a specialist to assist in the determination of accounting estimates may be restricted due to proprietary and confidentiality concerns of the specialist. This could impact the auditor's ability to *'test the information'*[9] at the level suggested by the Staff. Consequently, this also could impact the auditor's ability to review and test management's processes and procedures in developing accounting estimates, which, absent relevant subsequent events, could lead the auditor to focus more on developing independent estimates. However, the auditor may not have the expertise to develop such estimates (particularly related to complex accounting estimates) and may need to seek the assistance of a second specialist. These specialists may essentially be performing similar tasks, which could result in duplication of efforts and potential audit inefficiencies, without any evidence of a corresponding benefit to financial statement users.

[5] Footnote 2, paragraph 5, AU328.
[6] Page 37, the Consultation Paper.
[7] Page 38, the Consultation Paper.
[8] Paragraph, 3, AU336, states that the guidance in the standard is applicable for situations where management engages or employs a specialist or when the auditor engages a specialist and uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.
[9] Page 38, the Consultation Paper.

The CAQ commends the Staff for acknowledging the linkage between accounting estimates, including fair value measurements, and AU336,[10] and we support the Staff's intentions to issue a separate consultation paper to seek additional public comment on certain matters related to AU336, including key potential audit requirements. However, we believe any enhancements to AU328 and AU342 (and possibly AU332) through the development of a potential new standard should complement and align with (and not conflict with or supersede) AU336, and it may be more appropriate for the Staff to consider conforming amendments to AU336 (if any) in conjunction with developing the potential new standard.

III. Use of Third-Party Pricing Services

We commend the Staff for recognizing that differences may exist in the way a third-party pricing service is used in an audit, and that such differences should be acknowledged in a potential new standard.[11] We believe that the difference between a third-party pricing service and a specialist is generally based upon the capacity in which the third-party pricing service is used within the audit. Our suggestions below are aimed at addressing challenges associated with the use of third-party pricing services, while helping to achieve the objectives of the Staff.

Relevance and Reliability of Audit Evidence

The Consultation Paper suggests several factors the auditor would be required to evaluate when using information obtained from a third-party pricing service. However, it is unclear from the Consultation Paper whether the Staff is contemplating applying this approach generally to all financial instruments without consideration of the varying level of complexity and wide range of inherent risks associated with fair value measurements. It is also unclear from this approach whether information obtained from third-party pricing services can be considered sufficient appropriate audit evidence, in accordance with AS15.

Under Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, the auditor has the responsibility, when determining the nature, timing, and extent of audit procedures, to adjust the audit procedures based on the auditor's assessment of the associated risks. Fair value measurements generally have a wide range of inherent risks, which may require using third-party pricing services in a variety of ways (e.g., providing the auditor with a price based on observable market data or by evaluating assumptions related to unobservable inputs). Financial instruments that are evaluated based on active trading and observable market transactions often have a lower inherent risk. These types of financial instruments may be subject to more simplistic models that are closely aligned to observable market information and the auditor can perform substantive audit procedures to evaluate their pricing. Therefore, we do not believe that requiring the auditor to evaluate the methods and assumptions used to determine the pricing for each of these financial instruments would be necessary. However, financial instruments that are priced using unobservable inputs or that require the use of significant assumptions and inputs may have a higher inherent risk; therefore, it may 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. Consequently, the need to evaluate the methods and assumptions used to determine the pricing of financial instruments varies based on the inherent risk of the instrument, and we encourage the Staff to incorporate alignment of this topic with the existing guidance in the PCAOB's risk assessment standards.

The Consultation Paper also suggests that the auditor could be required to evaluate the relevance and reliability of audit evidence obtained from a third-party pricing service at the 'asset or liability' level,[12] which may be perceived as requiring the auditor to evaluate the relevance and reliability of the audit evidence at an individual security basis (i.e., by CUSIP number[13]). However, it is unclear if performing procedures at this

[10] See the PCAOB's Standard-Setting Agenda, Office of the Chief Auditor, September 30, 2014.
[11] Page 43, the Consultation Paper.
[12] Page 46, potential amendments (b) and (c), the Consultation Paper.
[13] A CUSIP is a 9-character alphanumeric code that identifies a North American financial security for the purposes of facilitating clearing and settlement of trades.

level would result in an incremental benefit to a financial statement user. In many instances, information obtained from a third-party pricing service, some of which may also be publicly available, can provide relevant and reliable audit evidence.

In accordance with AS15, to be 'appropriate audit evidence' the information must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.[14] Third-party pricing services generally provide independent pricing information free of influence from any one issuer (e.g., the same price is released to all customers without bias), and we believe that this absence of management bias could increase the relevance and reliability of the information and would be considered sufficient appropriate audit evidence. Therefore, we encourage the Staff to consider the relevance and reliability of third-party service information under AS15, in developing the potential new standard.

Transparency into Proprietary Information

The Consultation Paper states that third-party pricing services are increasingly providing products that could provide auditors with insight as to how their prices or estimates are developed.[15] However, consistent with our comments above regarding management's use of a specialist, limitations exist on the extent and consistency of information that third-party pricing services currently provide, either to issuers or auditors (i.e., certain non-public proprietary information may not be shared).

Additionally, while issuers and auditors are generally given the opportunity to obtain an understanding of a third-party pricing service's valuation process, they may not be permitted access to proprietary information. Consequently, in developing the potential new standard, we encourage the Staff to consider how the limitations of management or the auditor to 'test' proprietary models used to value certain investment products impacts the extent of work management or the auditor can do to understand a particular model. For instance, the Staff could conduct additional outreach with third-party pricing services to determine how to resolve these data limitation challenges.

Use of the Same Third-Party Pricing Service

The Staff is requesting feedback regarding whether the auditor should be required to use a different third-party pricing service from that used by management.[16] As discussed above, third-party pricing services generally provide independent pricing information that lacks management influence (i.e., management bias), which we believe could increase the relevance and reliability of the information. In some instances, auditors may elect to use a different third-party pricing service from that used by management; however, we do not believe this should be a requirement within the auditing standards. Nevertheless, in instances where the auditor uses the same third-party pricing service as management, the auditor could perform additional procedures to evaluate the relevance and reliability of that information to obtain the appropriate level of audit evidence.

IV. Developing a Range of Estimates

In accordance with AU342, to evaluate the reasonableness of an accounting estimate, the auditor should obtain an understanding of how management developed the estimate and, based on that understanding, use one or a combination of (1) review and test the process used by management to develop the estimate, (2) develop an independent expectation of the estimate to corroborate the reasonableness of the estimate, or (3) review subsequent events or transactions occurring prior to the date of the auditor's report to evaluate the reasonableness of the accounting estimate.[17] Whether using different assumptions to evaluate the sensitivity

[14] Paragraph 6, AS15.
[15] Page 44, the Consultation Paper.
[16] Question 39, the Consultation Paper.
[17] Paragraph 10, AU342.

of the accounting estimate, or developing 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. However, 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.*'[18] We are concerned that such a statement may imply precision within a range of estimates that may not be feasible and could possibly limit the auditor's ability to use an independent estimate in combination with one or more other approaches to evaluate the reasonableness of the accounting estimate.

There are a variety of accounting estimates with high estimation uncertainty where the auditor's execution of one or a combination of approaches, as described in AU342, may indicate a range of 'reasonable' estimates (e.g., certain insurance reserves, or mortgage servicing rights), which could exceed the established materiality threshold. While the range may serve to confirm higher estimation uncertainty, we do not believe this should preclude the auditor, after performing sufficient appropriate procedures, from concluding that management's accounting estimate is reasonable. Therefore, in developing the potential new standard, we encourage the Staff to acknowledge the variability and imprecision that may be inherent within the range of possible outcomes.

V. Other Matters

In addition to the suggestions above, the following sections highlight additional opportunities for enhancements to the potential new standard.

a. Understanding the Development of Accounting Estimates

The Staff suggests, within the Consultation Paper, procedures an auditor may perform to obtain an understanding of how an issuer develops its accounting estimates.[19] This guidance is helpful in defining the auditor's responsibilities; however, we believe it would be beneficial to clarify what procedures an auditor should perform to comply with the phrase '*the auditor should obtain an understanding of how a company develops its accounting estimates*,'[20] particularly when management uses inputs from a third-party source. Without clarification, this phrase may imply that if management relies on information from a third-party source in determining an accounting estimate, the auditor would be required to evaluate (and test) all information used from the third-party source, including the related internal controls of the third party.

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

Consistent with requirements in the existing standards, we are supportive of the Staff requiring the auditor to evaluate whether the issuer's methods used to develop the accounting estimates are appropriate, including evaluating whether the methods are in conformity with the applicable financial reporting framework. We believe these requirements are generally consistent with paragraph 8 of International Standards on Auditing 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (ISA540). However, we question if it is appropriate to require the auditor to evaluate whether management's methods are '*accepted within the company's industry*,'[21] as facts and circumstances of a specific accounting estimate may not always be related to the issuer's industry. For instance, the auditor could be restricted from accepting methods that are considered outside the industry norm, even though these methods may be appropriate in certain issuer-specific circumstances.

[18] Page 41, the Consultation Paper.
[19] Page 24, the Consultation Paper.
[20] Ibid.
[21] Page 33, potential amendment (a), the Consultation Paper.

Alternatively, we encourage the Staff to consider similar guidance to ISA540, which states that when a financial reporting framework does not prescribe a particular method of measurement to be used when developing the accounting estimate, the auditor may use professional judgment in obtaining an understanding of the methods used by the issuer in determining the accounting estimate.[22] Additionally, consideration may also be given to the impact on the risk of material misstatement when management uses a model not commonly used in a particular industry or segment.[23]

c. Identifying Assumptions Not Used by Management

The Consultation Paper requests feedback regarding whether the auditor should be required to '*identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate.*'[24] We believe this may be challenging to apply in practice, as there may be a number of assumptions not used in developing management's accounting estimate, and it could be impractical for the auditor to assess the importance of these assumptions to the reasonableness of the accounting estimate. Alternatively, we believe the Staff should consider the existing guidance within ISA540 that states for situations in which there is high estimation uncertainty, the auditor is required 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.[25]

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The CAQ is supportive of the Staff‘s consideration of developing a potential new standard related to auditing accounting estimates and fair value measurements, and commends the Board and its Staff for advancements made in this important area. However, given the complexities in these areas, there may not be a 'one-size-fits-all' solution to these auditing challenges and it is important to continue to analyze their root causes, particularly as it relates to the inspection deficiencies observed by the PCAOB and other global standard-setters. Further, enhancements to the auditing standards will require careful deliberation and extensive outreach with key stakeholders. The CAQ appreciates the opportunity to comment on the Consultation Paper and would be pleased to discuss our comments or answer any questions that the Staff or the Board may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

[22] Paragraph A25, ISA540.
[23] Paragraph A26, ISA540.
[24] Question 28, the Consultation Paper.
[25] Paragraph 15(a), ISA540.

cc:

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