



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

Nov. 3, 2014

Re: Request for Public Comment – Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (August 19, 2014)

Dear Office of the Secretary:

Harvest Investments, Ltd. appreciates the opportunity to comment on the PCAOB’s Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*. As a securities’ valuation firm with more than 20 years of experience in financial reporting, we welcome the Board’s efforts to bring more clarity and accuracy to the valuation and auditing process. We applaud the efforts made by the PCAOB and many auditing professionals with regard to auditing fair value estimates. However, Harvest agrees that improvements could be made in these areas, especially in light of the vulnerabilities revealed by the recent financial crisis, which underscored the need for more accurate and independent valuation methods and processes. While we think that the Board’s concerns about third-party sources are in many respects appropriate, we caution against a view emphasizing third-party standing over the primary valuation concerns, which we believe are more fundamental. Further, we recommend that the Board provide better definitions of and be attentive to both the differences among third parties (pricing desks, central pricing sources, and specialists), and also the similarities in the way that they are used by auditors and management. Not all third parties are created equal, and the methods by which they arrive at their valuations vary considerably; consequently, the valuation information provided by each is also subject to variations in quality and independence. For these reasons, we think that it is important to hold the valuations themselves to similar standards of scrutiny, regardless of source. Third parties play an increasingly significant and important role in the valuation process, given market complexities. Therefore, it is appropriate to ensure that the quality of the information they provide is proportional to their value within the financial system as a whole.

Observed Deficiencies in Fair Value Measurement in Particular

In this Paper, The Board states that “deficiencies have been noted in audits performed not only under the standards of the PCAOB, but also under the standards of other standard setters around the world” (p. 3). This observation suggests systemic rather than isolated problems in arriving at

accounting estimates and fair value measurements. Harvest notes that the valuation deficiencies exposed by the financial crisis were in place for decades. Use of the least expensive sources for investment prices, paired with inexperience and misconceptions regarding investment valuations, were characteristic of several successive generations of auditors and audit clients. Harvest further notes that the tools and professional skills required to produce an acceptable level of quality in investment valuations were initially built up and designed for the high margin underwriting and trading industries. Utilizing them effectively for the financial reporting community with its much lower margins is challenging.

While Harvest's experiences indicate that many in the audit community have made great strides in fair value and financial reporting in recent years, we agree that deficiencies remain. In particular, we are concerned about the risks of a confirmatory bias, which we believe stems from the same patterns of fair value practice which led us to the financial crisis. Harvest also agrees that the best remedy is improved guidance in this area, which would increase transparency and consistency with regard to fair value by all parties engaged in the auditing process. While Harvest has contact with many auditors who are diligent about the fair value process, we see others who are either too inexperienced to navigate the challenges or remain unconvinced of a potential material risk in fair value (the nuances of which are not always correlated with the size of the audit firm). In such situations, auditors utilize an "expedient," whereby they apply an "evaluation" of management's approach rather than an independent re-valuation procedure.

Consequently, Harvest believes that the greater the awareness of all parties involved in the audit process, with respect to the methods and assumptions used in determining and challenging fair value, the better off the financial system as a whole will be. Regardless of whether a third party valuation is used or not, we support the Board's efforts to address such deficiencies and inconsistencies, and we agree that the improvement of existing standards is warranted and appropriate.

Third-Party Risks and Third-Party Value

Harvest Investments, Ltd. appreciates the Board's concern about the accelerating use of third parties for valuation purposes, and the use of centralized firm pricing desks. We also support the Paper's considerations with regard to different types of third parties. In our view, it is important that the information obtained by auditors from third party sources is understood by the auditors, and that the methods and assumptions used in price development (and the basis for their determination) are transparent. Currently, the valuation methods used by specialists are subject to a greater degree of scrutiny than those used by national pricing desks, broker-dealers, and other pricing sources. The Board asks whether its understanding of current audit practice regarding these different pricing sources is adequate (Questions 1 & 2), and whether there may be additional issues regarding the use

of third parties that should be taken into consideration in the drafting of a new standard (Question 13). Harvest notes that we see various pricing sources are all being used like Specialists, regardless of whether that source is a third party pricing service, a broker-dealer, or an internal pricing desk. For example, the information provided by “Big Box” pricing sources is often used uncritically within financial statements (by both management and auditors). Harvest notes that such sources, which were designed to meet daily pricing needs, have too many instances in which they do meet the quality standards of financial reporting, even on “easy to price” securities that are widely held in financial institutions. While we agree that different approaches may be warranted for different types of pricing information, we think that, regardless of pricing source, management and auditors should understand the individual inputs and assumptions (and the observable basis for arriving at each) that factor into the fair value measurements they receive. Harvest observes some third party pricing sources “proving the accuracy” of a value by back-filling inputs, and we note that this is not the same as providing transparency into the original process. We recommend that the valuation information used in the development of all third party prices be held to similar standards in order to minimize the risks of material misstatements and confirmatory bias. Based on our experiences, we think that all pricing sources should be vetted and treated like Specialists, because we see too many instances in which they are all being used as such by management and auditors.

As the Board notes, valuation can be a difficult matter, especially in cases of complex securities with less observable/documentable inputs. If pricing information is passed from source to source without any corresponding efforts to understand how and why that information was first developed (and by whom), the risks of material misstatement and confirmatory bias increase. To meet the requirement of independence in valuation and to avoid the costs associated with the proliferation of recurrent or faulty valuation information, a more stringent process is required. An auditor must not only collect the inputs and assumptions used in price development, but also observe and understand the source’s basis for arriving at each. In order to assess whether a valuation is independent, it is first necessary to understand how that valuation originated. This is not a matter of chickens-and-eggs, but rather a clear case of priority. Such knowledge requirements on the part of auditors are notably relevant in order to meet the Board’s requirements regarding the independence of fair value measurements in particular, and accounting estimates in general.

In response to the Board’s Question 14 concerning factors relevant to the auditor's evaluation of the degree of complexity of judgment in the recognition or measurement of an accounting estimate or fair value measurement, we recommend that the new proposed standard emphasize the importance of understanding the methodologies used to develop the complex inputs, which determine the fair value prices, regardless of third party type. In some cases, an independent analysis of the severity of each input might be warranted. Given the pressures felt by audit firms to keep costs in check and limit client conflicts over investment valuations, Harvest notes that valuations produced by the centralized pricing desks of audit firms, whose role it is to juggle the cost as well as the quality, may have more of a confirmatory bias than those provided by other sources. This is an additional reason

to treat these desks with at least the same rigor as a third party. Presuming an adequate framework for interpreting and understanding third party valuations, we think that the possible risks presented by the use of well-vetted third parties are currently fewer than those presented by the confirmatory approaches used by some audit firms.

Cost and Benefit Issues

As a third-party valuation specialist, Harvest Investments, Ltd. has considerable knowledge of the processes involved in fair-value measurement, as well as the costs. Harvest notes that there is significant economic pressure on auditors to reduce their hard dollar expenditures, soft dollar professional hours, and client relationship-damaging conflicts that relate to investment valuations. Audit firms who increase costs in this area suffer competitively as their clients adjust to the new reality. Over many career-spanning decades, both management and auditors have built a baseline consensus and tradition of fees, attitudes, and procedures. That system is heavily resistant to and skeptical of the need to build a relatively costly new infrastructure capable of producing valuations with enough integrity to protect investors and to support our financial system. Given their profit limitations, audit firms face significant resistance to spending on valuations and are tempted to resort to procedures which circumvent key components of quality due to either ignorance or pressure. Harvest also notes that audit firms have been charged with two responsibilities that can be costly. First, the audit firms must build an acceptable internal infrastructure for producing valuations of an acceptable quality, which (in theory) are passed through to their clients. Second, the audit firms must apply pressure to their clients to build a similar infrastructure of their own. Therefore, audit firms are effectively trying to add this new cost to their clients twice, creating significant pressures and temptations to use procedures and information that may not meet the required quality standards.

Harvest observes many auditors applying sampling techniques to limit expenditures. While we believe material risks can be best avoided with an audit that includes an annual re-valuation of an entire portfolio, we agree that sampling is especially useful in testing processes. Auditors can obtain a deeper understanding of the valuation process used for various types of items by “digging in” on a sample of each. Harvest notes that such a sample should include items in each major asset category and also those with higher risk. Because our historic experience has been that samples can be a poor representation of the inherent risks in a portfolio, Harvest suggests that guidance be provided in this area. Guidance could highlight specific issuer sectors and areas of risk, such as items with underlying holdings, derivative features, lower ratings, no ratings, linked returns, complex structures, callable step up notes, and other non-bullet structures. Given clear audit guidelines, we believe a sampling approach of this sort could help control costs without jeopardizing transparency in the methods used to assess the fair value of a portfolio.

Additionally, Harvest would like to register concern over the significant amount of hours being applied to the area of ASC 820 level assignments. While we appreciate the need for ASC 820 hierarchical leveling and the transparency it sheds on valuation risk, we have been experiencing as many heated discussions regarding variances in ASC 820 levels as we have regarding the values themselves. The current guidance calls for levels to be indicative of the lowest level input used in a valuation; however, our experience suggests that both management and auditors use a practical expedient to level their portfolios. It is Harvest's opinion that there is pressure to record "borderline" items at Level 2 in the ASC 820 fair value hierarchy rather than dropping them to Level 3, due to the added documentation and negative perception of Level 3 securities. Based on these experiences, Harvest believes that guidance in this area could help reduce soft dollar hours and inherent client pressures regarding leveling in today's system, while improving consistency and transparency. Absent adding a 4th ASC 820 level, which Harvest would support, guidance could either dictate characteristics inherent in the various ASC 820 levels or provide examples of security types in each level. Any such language or examples should address the security features that cause any single input in a valuation model to be difficult to document with observable market information (limited liquidity, embedded options, lack of or lower ratings, complex cash flows, lack of trading in observable comparable assets, etc.). It is our belief that guidance of this sort would lessen soft dollar hours in this area, while providing consistency in practices and transparency into valuation risk.

Given the growing complexities in the financial markets and the profoundly interconnected nature of today's financial system, Harvest supports additional guidance in the area of fair value. We believe that such guidance will aid those participating in financial reporting with more knowledge about these complexities and interconnections, improving the system as a whole.

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In closing, we thank the Board for the opportunity to present our views on this Staff Consultation Paper. If the Board would like to discuss any of our comments further, we are at its disposal. Please contact Susan DuRoss (312-823-7051).

Sincerely,

Harvest Investments, Ltd.