Duff & Phelps

Mr. Martin F. Baumann
Chief Auditor
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

November 3, 2014

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

Dear Mr. Baumann,

We welcome your invitation to comment on your Staff Consultation Paper: *Auditing Accounting Estimates and Fair Value Measurements.* As the leading provider of independent valuation support to public registrants and investment company managers, we have unique insight and experience with respect to the rigor and support preparers of financial statements utilize in estimating fair value and the scrutiny auditors apply in auditing fair value measurements.

Our role in the financial statement preparation process is distinctive. We support management teams to enhance their internal control process with respect to estimating fair value and/or we assist management teams with fair value analyses that serve as an input for consideration by management in preparing their financial statements.

Management is responsible for the assertions contained in the financial statements and cannot abdicate this role to a third party. However, management can enhance their process by obtaining support from experienced valuation professionals. For example, it has become best practice of the largest Private Equity and Hedge Fund investment managers to validate fair value estimates using a qualified, experienced third party. Investors have come to rely on enhanced internal control systems which appropriately include specialized valuation expertise. Further, traditionally management has sought assistance from third party valuation specialists in complying with financial reporting requirements related to business combinations, impairment testing and share-based compensation, among others. In either case, the valuation professional is engaged to assist management in fulfilling management's responsibility of preparing financial statements.

Our comments are derived from years of experience supporting management with their valuation estimates. In 2013 alone we performed more than 10,000 engagements for 4,600 clients including 50% of the largest Private Equity Funds and Hedge Funds, 57% of Fortune 100 companies, and more than one-third of the S&P 500. Our personnel support industry

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efforts to enhance consistency and transparency, including participation on FASB's Valuation Resource Group, various AICPA and TAF (The Appraisal Foundation) task forces and working groups, and other industry bodies such as the International Private Equity and Venture Capital Valuation Board, and the International Valuation Standards Council.

Our goal in responding to your invitation to comment is to provide our expertise and experience as you consider changes to audit standards which, in turn, will guide the accountability of auditors in exercising their role in capital markets - ensuring that financial information meets the needs of investors and is provided on a reliable, high-quality, consistent, transparent and cost-effective basis.

General Comments:

1. We understand that, through its oversight activities, the PCAOB has observed significant audit deficiencies with respect to auditing of fair value measurements. While such cases are facts- and circumstances-specific, the magnitude of the discrepancies observed does raise the question as to what is broken:
   a. Is the judgment required by FASB ASC Topic 820 too vague?
   b. Is existing audit guidance unclear?

   Increasingly, we have observed auditors urging their clients to use mathematical models which may support an estimate of value and may be easier to audit, but which do not necessarily reflect market participant assumptions and therefore may be inconsistent with ASC Topic 820.

   In some cases, audit deficiencies may result from inadequate documentation of fair value estimates by management which may further magnify itself into inadequate audit testing and/or documentation. Our experience demonstrates that those preparers of financial statements who have an enhanced internal control process and strong internal documentation procedures are better able to articulate fair value compliant with ASC Topic 820, even with the significant judgment required.

   The FAF's post implementation review for SFAS 157 (ASC Topic 820) concluded that the accounting standard is functioning as intended. While some industries question this conclusion, it would appear as though FASB is not intending to modify ASC Topic 820. Therefore, to reduce audit deficiencies it would appear that clearer audit guidance is needed.

   As the PCAOB considers modifications to audit standards, we suggest the following for consideration:

   A. Enhanced internal control processes with respect to valuation often include the use of a qualified, experienced third-party valuation provider to assist management's process of fair value estimation and conclusions. Therefore, audit standards should include guidance on how auditors can conclude on the effectiveness of: 1) management's internal controls when using the work of a third-party specialist; as well as 2) how such third-party specialist contributes to enhancing the internal control system, where applicable.

B. Because of the judgment required with fair value measurements, mandating specific mathematical models, either by audit standards or by individual auditors, may be inconsistent with ASC Topic 820's requirement to use market participant assumptions and judgment. Therefore, audit standards with respect to substantive testing should be aligned with the judgment required by ASC Topic 820 and should not be focused on the ease of auditing (an example would be the use of Option Pricing Models for Investment Managers).

C. Historically, as markets were more liquid, certain securities were valued using "pricing services."[1] Practice with respect to so-called pricing services is inconsistent. Again, as part of the internal control process or valuation procedures of a registrant, it should be made clear that management is responsible for fair value estimates and cannot blindly accept third-party prices. Broker quotes, for example, should be based on actionable contemporaneous market activity. If management cannot demonstrate that such third party sources are actionable and contemporaneous, then management should be undertaking additional procedures to support their fair value estimate. Therefore, audit standards should ensure that pricing services (which are generally separate and distinct from the valuation support described in B above), cannot be blindly accepted by either management or the auditor.

D. It is important for any new standard to bear in mind the specific responsibility of the auditors and to operate within those parameters. The requirements of the standard should not impose audit procedures that should be the responsibility of management.

2. The Consultation Paper (page 8) states that "The complex nature of some financial instruments creates challenges in determining their value, which can be based primarily on unobservable inputs (that is, inputs not corroborated by market data)." While we agree that fair value estimates using Level 3inputs can be challenging, the requirement in ASC Topic 820 to calibrate valuation inputs with valuation techniques is a powerful tool that is not consistently used. Management that utilizes the services of an experienced, qualified third-party valuation specialist is often in a better position to calibrate Level 3 inputs with available market data, thereby enhancing the rigor of the fair value judgments. In most cases, calibration does allow unobservable inputs to be corroborated by market data.

[1] http://www.sec.gov/news/speech/2011/spch120511jkp.htm

3. As you consider modifications to audit standards, it is important to distinguish between a specialist (used by the auditor to assist in obtaining audit evidence) and a valuation specialist used by management of a registrant to enhance a registrant's internal control process and/or the rigor of management's fair value estimates. Again, management is responsible for the assertions in the financial statements, and while they can obtain assistance from experienced qualified specialists, management is ultimately responsible for their own fair value measurement assertions.
4. The PCAOB staff has recommended several alternative approaches to enhance audit guidance resulting in fewer audit deficiencies. As our role is primarily to assist management in supporting their fair value assertions, we do not have a strong preference for the ultimate course of action. However, as discussed above, we believe additional guidance is necessary.

Responses to Specific Questions

- **Questions 12-13 (page 24).** We agree that the potential amendment is appropriate. However, careful consideration should be given with respect to AU sec. 324: in many cases, a third-party valuation specialist is working as an extension of management and thus it would not be necessary to evaluate the information systems of every third party. Also, in many of the more traditional roles in which a third-party valuation specialist assists management, the deliverable to management typically includes information (often in the form of a report) explaining the processes and procedures undertaken in accordance with ASC Topic 820's fair value measurement framework. Further, in those cases, management additionally relies on its own internal control systems in the process of evaluating and incorporating fair value estimates provided by the third party into their own financial statements.

- **Question 20 (page 28).** In many cases, a third party is used by management as an enhancement to their internal control process. Therefore, it would be appropriate to provide guidance on how to test internal controls which include the use of an experienced, qualified third-party valuation specialist.

- **Question 25 (page 31).** Given that ASC Topic 820 requires the use of judgment and market participant assumptions, it is appropriate to provide audit guidance in this context. Data should be tested consistent with the way market participants use and vet data when undertaking a transaction.

- **Questions 26-27 (page 34).** We believe another important criterion to consider in method selection is whether the method would be used, and how it would be used, by market participants transacting with respect to the subject asset, liability, or the appropriate higher level of asset/liability aggregation. The entire fair value measurement framework is premised on the appropriate selection of relevant market participants, and this would impact the fair value assumptions and estimation. For example, market participants may not necessarily employ option models when putting into place contingent consideration structures or investing in financing rounds of early stage private companies, but rather, may in many cases rely on a scenario analysis.

- **Question 31 (page 38).** Management's use of an experienced, qualified valuation specialist to support them in their fair value estimates provides increased rigor in a cost-effective manner. We believe that the proposed requirement that the "auditor should test the information provided by the specialist as if it were produced by the company" is consistent with current practice and the requirement that management stand behind all financial statement assertions. However, we think that the auditors doing such testing should be required to either themselves possess the skills to develop the fair value estimates, or employ specialists as part of the audit team to assist with such testing. Without having this assurance in place, the testing process would neither be productive, nor cost effective.

- **Questions 32-35 (page 41)**. Because fair value measurements require judgment and require the use of market participant assumptions, it may be not be possible for an auditor to develop an "independent" assessment of value that is as good as, or better than management's assessment of value (assuming management has a rigorous, U.S. GAAP-compliant valuation process). ASC Topic 820 requires a fair value point estimate; however market participants (outside of a specific transaction) often view value as a range. Therefore, audit guidance should focus on providing auditors with the know-how to assess management's estimate of value within a reasonable range and not superimposing auditor judgment over management's view. It should also be clear that management should have a clear, robust and appropriately documented valuation process and basis for conclusions. For example, the private equity industry has developed self-regulatory valuation guidelines (www.privateequityvaluation.com) to assist management in ensuring robust valuation estimates. In other settings requiring fair value for financial reporting, there exist industry best practice valuation and accounting guides produced by task forces organized by the AICPA and The Appraisal Foundation.

- **Questions 38-43 (page 44-46).** Use of Third Parties. We agree that it should be clear that third-party sources used by auditors to assist in developing audit evidence should be evaluated separately and distinctly from third parties used by management to enhance their valuation process and conclusions. Audit guidance should clearly delineate between specialists used by auditors for audit purposes and specialists used by management for financial statement preparation purposes. Neither the auditor, nor management, should blindly rely on broker quotes, fund administrators, nor other providers of value without understanding the assumptions and techniques used to develop the fair value estimate and the experience of the third party.

- **Questions 44, 45.** Because of the number of identified fair value audit deficiencies, many auditors have begun mandating their clients to use mathematical models (which may not be consistent with market participant assumptions as dictated by ASC Topic

820) to drive the fair value estimation process. As a result, the internal administrative costs of the audit client have increased and the time required to perform an audit has increased. Many would argue that these additional costs bring little, if any added value. Therefore, audit guidance, which assists auditors with dealing with the challenge of auditing judgment inherent in ASC Topic 820, should, over time, create efficiencies in the financial statement preparation and verification process.

We appreciate the opportunity to provide the Staff our thoughts on this important initiative. Our comments have been, by design, relatively brief and high level. We would welcome the opportunity to provide the Staff with additional information on how management uses third parties to assist in their fair value estimates and the multitude of ways that auditors evaluate such enhancements to managements control process.

Please let us know how we can be of further assistance.

Best regards,

David L. Larsen
Managing Director