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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*

Deloitte & Touche LLP (“D&T”) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Staff Consultation Paper — Auditing Accounting Estimates and Fair Value Measurements* (the “consultation paper” or the “paper”), which addresses potential changes to various auditing standards (specifically, PCAOB AU 342, *Auditing Accounting Estimates* (PCAOB AU 342), PCAOB AU 328, *Auditing Fair Value Measurements and Disclosures* (PCAOB AU 328), and certain aspects or all of PCAOB AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (PCAOB AU 332)).

We support the Board’s efforts to evaluate whether the existing PCAOB auditing standards relating to auditing accounting estimates and fair value measurements¹ can and should be improved. We note the Board’s substantive efforts in this area to date and are appreciative of the PCAOB Staff’s efforts to seek further input through the issuance of the consultation paper. We also commend the PCAOB Staff for organizing a special meeting of the Standing Advisory Group (“SAG Meeting”) to discuss matters relevant to the consultation paper and to hear input from a variety of stakeholders. In this letter, we present our overall views regarding the topics outlined in the consultation paper, including the suggested changes to the related auditing standards presented therein. We have also included more granular observations and suggestions that are responsive to certain of the more detailed questions posed in the consultation paper in Appendix A.

BACKGROUND

We agree with the PCAOB Staff that the auditing of accounting estimates, and in particular, fair value measurements, is challenging. We also acknowledge that these are areas in which audit deficiencies occur. As indicated in the consultation paper, and as discussed further at the SAG Meeting, the PCAOB’s inspection findings and those of other audit regulators or audit oversight bodies continue to include a high number of audit deficiencies related to the auditing of accounting estimates, and in particular, fair value measurements.

¹ Throughout this letter, and unless otherwise clear from the context of the discussion, use of the term “accounting estimates” may be read to also include “fair value measurements.” Our approach is consistent with the approach used by the PCAOB in the consultation paper (see footnote 1 on page 3 of the consultation paper).

In connection with these inspection findings, we believe it is important that the underlying causal factors for the findings are fully analyzed and understood (e.g., such causal factors likely include matters such as failure to make appropriate professional judgments and exercise sufficient professional skepticism; insufficient levels of skill, knowledge, or experience of engagement partners and team members (especially for complex estimates); failure to use or ineffective involvement of suitably qualified auditor specialists; insufficient time to properly complete procedures because issuers are challenged to prepare all the necessary information in relatively short time frames driven by filing deadlines; and over-reliance on the involvement of management or auditor specialists). In addition, some of the challenges faced by auditors today are related to situations that are not directly addressed in the extant standards, making it challenging for auditors to determine the appropriate course of action. In making revisions to its auditing standards, we believe it is important for the PCAOB to assess which of the identified causal factors can be effectively addressed through amendments to the auditing standards, and if so how.

We also note and concur with the commentary in the consultation paper about the increasing complexity in the financial reporting frameworks and the many changes in recent years that have resulted in increased use of fair value measurements. We believe such complexity is a significant factor that contributes to the auditing challenges. As discussed further below, the manner in which issuers establish fair values for financial reporting purposes is a matter of significant and growing attention from investors and other stakeholders. Issuers are being pressured to provide high quality fair value measurements that are consistent, well supported, and capable of being audited.

We agree that when auditing accounting estimates, auditors should subject the related significant assumptions, methods used, and underlying data to auditing procedures. However, we do not believe that it is possible, or practical for the same approach to be used for auditing all accounting estimates because not all estimates involve the same level of complexity or the same level of subjectivity in their determination. Differences and challenges also arise depending on the extent to which management uses information provided by a specialist or a third-party information provider, and the extent to which such specialists or third-party information providers will provide access to the information they have developed or visibility into the proprietary processes that they use to develop the information. To assist auditors in improving audit quality, it is necessary for the PCAOB to consider and address these differences and challenges when developing a potential new standard. It is important that the PCAOB's approach be based upon the foundation that "not all accounting estimates are equal" and for revisions to the standards to have the objective of resulting in a framework that is sufficiently flexible so that it can be applied when auditing the wide range of accounting estimates that exist today, as well as those that will exist in the future as the applicable financial reporting frameworks continue to evolve. The more prescriptive the requirements in the auditing standards for addressing accounting estimates, the more challenging it will be for auditors to apply such requirements to different types of estimates in a reasonable manner, and the less likely that the needs of investors will be well served. In our comments below, we expand on the challenges that arise and provide suggestions as to how they may be addressed.

As a general principle, amendments to the auditing standards alone will not be effective in addressing all the causal factors, improving audit quality, and protecting the interests of investors, especially if the changes set expectations for auditors that cannot reasonably be accomplished. An auditor's ability to effectively address the requirements of auditing standards is premised upon the extent to which the corresponding requirements for management or preparers are also clearly established and

communicated, as they relate to both the preparation of financial statements and the maintenance of effective internal control over financial reporting. We therefore encourage the PCAOB to take action and work with others (including the SEC and the FASB) to develop and implement an integrated set of improvements that holistically address the underlying issues identified in the consultation paper. We commend the PCAOB for raising these issues to the forefront and demonstrating leadership in the pursuit of actions to enhance the quality of information provided to the investing public.

OVERALL COMMENTS

Need for Holistic Approach. We acknowledge the auditing challenges related to accounting estimates, including fair value measurements and we note that these challenges also extend to the testing of management's controls over accounting estimates, including controls management should have in place when specialists or third parties are involved in developing accounting estimates. The issues related to accounting estimates and fair value measurements do not however stop with auditing matters. Many of the issues faced by auditors in determining how to audit accounting estimates (in particular complex fair value measurements), and how to test the related controls are similar to the challenges faced by management in not only interpreting and applying the requirements of the applicable financial reporting framework in developing accounting estimates, but also in designing and implementing the necessary financial reporting processes and controls to support the recognition, measurement, and disclosure in the issuer's financial statements.

We also recognize investor concerns and the calls for increased transparency into accounting estimates, in particular fair value measurements. Some of these matters were discussed at the recent SAG Meeting.² Investors have expressed their views that fair value accounting accompanied with robust disclosures provides them with the best information to make decisions; however, we note investor concerns about the lack of robust and transparent disclosures related to accounting estimates that involve significant inputs and assumptions (including whether or not they are developed by a third party.) Investors' interests and concerns appear to extend to all accounting estimates, and are not just limited to fair value measurements. We understand that investors assign high value to the testing performed by auditors of accounting estimates and fair value measurements and accordingly, high quality auditing standards that are capable of being consistently and effectively implemented by auditors are a key aspect of protecting the interests of investors in this regard.

Measurement uncertainty associated with accounting estimates should be a focus of management in preparing financial statement disclosures, and auditors should be required to specifically assess the adequacy of such disclosures. The requirements of the applicable financial reporting framework however provide the framework for an auditor's assessment of the adequacy of an issuer's disclosures. As such, we believe that the concerns of investors and calls for more information and increased transparency into accounting estimates through robust disclosures are best addressed firstly through amendments to the applicable financial reporting frameworks or in the rules addressing the information required to be included in annual and periodic reports that issuers are required to file in accordance with the Securities and Exchange Commission's rules and regulations,³ that is, as opposed

² In particular, refer to the remarks made by Sandra Peters, CFA Institute and Jeff Mahoney, Council of Institutional Investors at the SAG Meeting.

³ To the extent such expanded or additional disclosures become part of the financial reporting framework, and are included in the financial statements, they will of course be subject to the audit of the financial statements and would

to establishing requirements for auditors that are not supported by corresponding requirements in the financial reporting frameworks. The accounting standard setters and regulators therefore also have important roles to play in addressing the challenges related to accounting estimates and fair value measurements and protecting interests of investors.

The interconnected roles and responsibilities of all such financial reporting supply chain participants provides important context for PCAOB standard setting, and as reiterated in various places in this letter, we believe strongly that care needs to be taken such that the auditing standards do not set forth requirements for auditors that extend beyond the related expectations or requirements for management (i.e., avoid the situation that the requirements of the auditing standards become “de facto” requirements for management).

In particular as it relates to accounting estimates and also as mentioned above, it is critically important to understand the roles of specialists and third-party information providers, including the variety of ways in which management uses information provided by such parties in developing the wide range of accounting estimates that exist. We appreciate the concerns about how the underlying information is verified or audited, however some estimates, especially fair value estimates, cannot reasonably be expected to be prepared by management without the assistance from third parties. When management involves third parties, appropriate processes for using the third parties need to exist and the processes and related controls must be subject to audit; however, approaches need to be developed to accomplish this objective in a rational manner.

Given this backdrop, we believe the interests of investors and other stakeholders will be best served by a holistic approach involving a coordinated effort that encompasses a careful but pragmatic examination of the respective roles and responsibilities of all participants in the financial reporting supply chain (including management, auditors, specialists, third-party information providers, accounting standard setters, and regulators), and which involves developing and implementing solutions that can reasonably be expected to be implemented and that will meet the needs of investors and other stakeholders.

Consideration of Alternative Approaches and Recommendation for a Single Standard to Address Accounting Estimates and Fair Value Measurements. We are generally supportive of the PCAOB’s proposal to develop a single standard on auditing accounting estimates and fair value measurements to replace the existing standards. We also agree with the PCAOB’s stated intent that a new potential standard achieves better integration and alignment with the PCAOB’s risk assessment standards, and that the standard retain the approaches in the existing standards for performing substantive procedures.

Because different accounting estimates have different levels of complexity and risk, and there are different requirements established by the applicable financial reporting frameworks as they relate to the recognition, measurement, and disclosure of different types of estimates, we believe the PCAOB should focus on developing a single principles-based standard that contains a framework that is (i) based upon the PCAOB’s risk assessment standards and (ii) capable of being adapted and applied to the specific facts and circumstances that will arise for each different type of accounting estimate. This framework should

also be required to be encompassed within the issuer’s and auditor’s assessments of internal control over financial reporting.

have the objective of focusing the auditor on first obtaining an understanding of management's process and controls and identifying the areas of complexity or sensitivity, thereby enabling the auditor to build a tailored approach to properly assess the related risks of material misstatement, to challenge and evaluate the inputs and output of the estimate and to test the relevant controls. Once the overall framework is established, it could be supplemented by additional and more detailed requirements for particular types of estimates or situations, as considered necessary (e.g., potentially additional requirements relating to the auditing of financial instruments or other fair value measurements and the approach to addressing situations in which investments are valued based on information provided by third parties).

Focus on Internal Control and Consideration of Risks of Material Misstatement Due to Fraud. The consultation paper touches briefly upon consideration and testing of relevant controls and identifying and responding to risks of material misstatement due to fraud in relation to auditing accounting estimates. A potential new standard should focus on providing additional clarity and expanded guidance in these areas, building on the framework in the risk assessment standards, and PCAOB AS 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements* (PCAOB AS 5). Testing relevant controls can be particularly challenging given the nature of the controls that typically address management estimates (i.e., relevant controls are often complex management review-type controls). It is also important that a potential new standard places appropriate emphasis on identifying and responding to the potentially heightened risk of fraud in management estimates that often arises due to their complexity and the subjectivity involved in developing them.

Linkage with Use of Specialists and Third-Party Information Providers. As mentioned above, and discussed in more detail below, there is a high degree of interconnectivity between the issues relating to auditing accounting estimates and use of specialists (including management specialists and auditor specialists) and third-party information providers. We realize that the PCAOB has acknowledged such linkage, and is planning to issue a separate consultation paper addressing specialists. We strongly recommend that the PCAOB address the topics of accounting estimates and specialists together, and that the revisions to the PCAOB's auditing standards be developed in tandem. In this way, commenters on the resulting proposed standards will have the opportunity to assess and understand the collective impact of the changes being proposed, and will be better placed to provide constructive commentary to the PCAOB, thereby facilitating amendments to the final standards to also be considered in combination. It will also be important that the final standards become effective at the same time.

Starting Point and Consideration of Work of Other Auditing Standard Setters. As identified by the PCAOB in the consultation paper, both the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB) have completed projects to overhaul their standards addressing accounting estimates (including fair value measurements); both of which projects resulted in the development of a single standard that are substantially similar to one another (ISA 540 and AU-C 540). We believe that IAASB and ASB standards are a good starting point for a potential new standard addressing accounting estimates. Additionally, in connection with our suggestion above to address use of specialists at the same time as accounting estimates, we note that the IAASB and ASB have placed the requirements for use of auditor specialists and use of management specialists in separate standards.⁴ We

⁴ The requirements and guidance relating to use of specialists by an auditor are addressed in the IAASB's ISA 620, *Using the Work of an Auditor's Expert*, and management's use of specialists are addressed in ISA 500, *Audit Evidence*. The ASB's analogous standards are AU-C 620, *Using the Work of an Auditor's Specialist*, and AU-C 500,

are supportive of this approach as it creates additional clarity for each situation, as well as setting forth an appropriate framework for each. In particular, including the requirements for evaluating management's use of specialists and third-party information providers in PCAOB AS 15, *Audit Evidence*, (PCAOB AS 15) would appropriately provide for the auditor's evaluation of such situations being based on the foundational principle of whether the information provided by the specialist or the third-party information provider constitutes sufficient appropriate audit evidence (which would include evaluating the relevance and reliability of the evidence relative to the context in which it is used).

Need for Practical Implementation Guidance and Possible Approach for Its Development. We note, and are supportive of the PCAOB's prior efforts to obtain insights into the issues relating to the auditing of fair value of financial instruments through its establishment of the Pricing Sources Task Force in 2011.⁵ We believe the effectiveness of a single principles-based accounting estimates standard and the consistency of its application by auditors would be vastly improved if comprehensive implementation guidance were developed to support its application by auditors. Such implementation guidance might demonstrate how the framework could be applied to many different types of estimates of varying degrees of complexity and measurement uncertainty (including fair value estimates and other accounting estimates) and could focus for example, on estimates that are the subject of widespread inspection findings and on unusual new accounting estimates that may arise as a result of revisions to the accounting standards. Additionally, implementation guidance might also address examples of situations in which management uses a specialist or information provided by a third party in developing the estimate, as well when the auditor uses information provided by a third party in developing an independent estimate. The implementation guidance may also provide additional perspectives as to how to use the output of a centralized approach to address information developed by third-party information providers (see comments below for more details on our recommendations in this regard).

To this end, auditors, preparers, specialists, and third-party information providers (including but not necessarily limited to pricing services) could work effectively and productively together to develop implementation guidance based on the framework and requirements established by the PCAOB's new standard. Such implementation guidance should not contain additional prescriptive requirements, but could instead, in the context of specific accounting estimates, focus on consideration of identification and assessment of risks of material misstatement (including fraud risks, the consideration of management bias, and how the auditor might identify and consider contradictory evidence), as well as how to identify and test the relevant financial reporting controls.

To best support the consistent application of a revised PCAOB standard regarding accounting estimates, it would be extremely important for the PCAOB's Office of the Chief Auditor to (i) provide input to the process to develop implementation guidance including the matters that might be addressed and the types of accounting estimates to be covered, (ii) acknowledge the final guidance, albeit non-authoritative, as being suitable for auditors to apply in addressing the requirements of the PCAOB's standards, and (iii) indicate that the guidance may be considered by PCAOB inspectors in assessing how auditors have complied with the PCAOB's standards in auditing accounting estimates.

Audit Evidence.

⁵ However, we don't believe the task force has met since September 2011, and we are unclear as to its current status.

Addressing the Issues Related to Use of Management Specialists and Information Provided by Third Parties. As noted above, the issues related to use of management specialists and information provided by third parties in developing accounting estimates or in independent estimates used by auditors in testing management’s estimates are inextricably linked with the auditing challenges related to accounting estimates. The PCAOB is considering expanded requirements in a variety of areas, including: (1) a requirement that the auditor would be required to test information provided by a specialist “as if it were produced by the company,”⁶ (2) expanded requirements for testing data and assumptions obtained by an auditor from third parties and used in developing an independent estimate,⁷ and (3) more detailed requirements to address situations when the third-party source used by the auditor is the same as the third-party source used by the issuer⁸ and when audit evidence is obtained from third-party sources and used in determining fair value measurements, such as, but not limited to pricing services and broker-dealers.⁹

These complex issues will not be addressed by simply imposing additional obligations on auditors to perform more procedures on work done by specialists or on information provided by third parties. We believe the expanded requirements that are being considered for a potential new standard will likely set expectations for auditors that will go well beyond the expectations for issuer management, and practical challenges will arise that will be difficult, if not impossible, for auditors to resolve. In some cases specialists or third-party information providers view some or all aspects of their work product as proprietary and difficulties exist in relation to auditors (and issuer management) obtaining the necessary access to address requirements such as those proposed in the consultation paper. Even in situations in which information is shared today, there are challenges in that all auditors (and issuers) do not have consistent access to the same information.¹⁰ Third-party information providers would also likely be overwhelmed and unable to individually address requests from all auditors of issuers for the information needed to address the expanded requirements. Requiring the auditor to use a different third-party source than management may not be possible when no alternative third party exists, and addressing the situation by requiring the auditor to evaluate the information as if it was produced by the company¹¹ in those cases may be neither practical nor possible, as the auditor may not have access to the third-party provider to be able to test the information in this way, and depending on the nature of the information, we question whether such testing would really be necessary.¹²

We understand from an investor’s perspective, the desire for increased confidence in the information that is reported in an issuer’s financial statements. We acknowledge the possibility of an expectation gap when the issuer has used the information provided by a third party in developing an estimate which has

⁶ See discussion on pages 37 and 38 of the consultation paper.

⁷ See discussion on pages 40 and 41 of the consultation paper.

⁸ See discussion on pages 43 to 44 of the consultation paper.

⁹ See discussion on pages 44 to 46 of the consultation paper.

¹⁰ As noted in the consultation paper, “pricing sources are increasingly providing products that could provide auditors with insight into how their prices or estimates are developed”; however our experience would indicate that such information is not consistently provided to all auditors and that in many cases when it is provided, it is provided to a centralized group rather than an individual audit engagement.

¹¹ See page 44 of the consultation paper.

¹² Situations in which third-party information is used are not limited to the pricing services examples. For example, if management and the auditor both used published mortality rates from a reputable source in developing an estimated value for a particular obligation, we don’t believe it would be possible (or necessary) for the auditor to have to test the data used and evaluate the reasonableness of the significant assumptions used in determining such rates.

not been tested by the auditor the same way that it would otherwise have been if it had been produced by the entity. We also understand investor concerns about use of management specialists; given that in many cases there are no existing objective means to verify their competence and expertise. Because of their complexity, we believe however, that a significant coordinated effort is necessary to address the broad issues related to accounting estimates, particularly as they become increasingly complex and issuer management uses a wide variety of different specialists or third-party information providers in developing them, and as a basis for the related disclosures in the financial statements.

We recognize of course that the PCAOB is only one player on the team that would need to work together to effect meaningful change; however we encourage the PCAOB to take a leadership role in calling for others, including the SEC, investor groups, preparer groups, specialist groups, accounting standard setters and others to work together to take broad-based action in this area. We stand ready to assist the PCAOB and others in any way we can, including initially providing the PCAOB with detailed examples of different types of accounting estimates, highlighting the related auditing challenges, and providing suggestions as to how they might be addressed. Some matters that we see as possibilities for broad-based actions include:

- Setting forth clear expectations for issuer management when using the work of a specialist engaged by the issuer, or third-party information provided to the issuer in developing accounting estimates, including expectations regarding the nature of the financial reporting controls that issuers should put in place.
- The development and implementation of robust and enforceable accreditation and certification standards for specialists, and for issuers to be required to engage accredited specialists if such specialists will be involved in developing accounting estimates.
- Developing an approach for addressing information developed by third-party information providers whereby information provided to and used by different preparers would be audited at the point of origination rather than the point at which it is used. Such an approach may entail designing an audit engagement that would be similar to that performed by a service auditor when examining and reporting on controls at a service organization, but which could be expanded to more specifically address the processes, controls, and outputs of the third-party information providers (e.g., evaluating the approach used by a pricing service to develop the pricing for select classes of assets, assessing the relevant controls, and testing the application of the approach to a selection of securities within each asset class covered by the engagement). The engagement would result in the issuance of a report that would address such matters, and similar to a service auditor's report could be made available to both preparers and their auditors, so that each could use the report to support conclusions about the relevance and reliability of the information provided and the effectiveness of related controls. An approach like this would also address the fact that it would simply not be practical to require each auditor (and arguably each preparer) to have to audit information provided by a third party and would also help mitigate concerns that not all auditors will be equally qualified to perform such work. We also believe the interests of investors would be better served by having one auditor with the demonstrated competence and expertise perform the work and for such work to be capable of being used by other auditors.

With respect to our suggestion in the bullet above, we note that as it relates to fair value measurements developed using information provided by third-party pricing services, some of the larger auditing firms

have developed centralized approaches whereby various categories of securities are addressed by a combination of vendor due diligence procedures and detailed testing of the pricing of selected securities. We believe that aspects of these approaches might be a useful basis for developing the audit engagement that would result in the report referred to in our remarks above. Consistent with our remarks above, we are ready to play a leading role in working with the PCAOB and others to move forward on this proposal. To that end, we would welcome the opportunity to meet with the PCAOB Chief Auditor and his staff to provide more detailed information on the centralized process employed at Deloitte, and to answer any questions the Staff may have on our approach.

[Considerations Relevant to Use of Specialists and Differences in Extant Standards for Fair Value Measurements and Other Accounting Estimates](#). For many accounting estimates in which management has used a specialist, PCAOB AU 336, *Using the Work of a Specialist* (PCAOB AU 336), currently provides the basis for evaluating the work performed by a management specialist. The application of PCAOB AU 336 provides that the “appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist.” The auditor is required to understand the methods and assumptions used by the specialist, test the data provided to the specialist, and evaluate whether the specialist’s findings support the related assertions in the financial statements.¹³ As such, the standard currently provides for an approach whereby the auditor can, subject to an appropriate assessment of the competence and objectivity of the specialist, not have to test all of the information used by the specialist in the same way as if it was all generated internally by the company.

Fair value measurements are currently addressed by PCAOB AU 328, and the consideration by the auditor of the work done by management’s specialist is different than for other accounting estimates. Footnote 2 of PCAOB AU 328 indicates that “management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management.” The effect of this footnote therefore requires that the auditor understand and evaluate management’s assumptions, the model, and the data, and does not provide for the ability of the auditor to take account of work performed by the specialist in the manner described by PCAOB AU 336.¹⁴ The proposed requirement would include assumptions, models, and data used by management specialists and third-party information providers (regardless of whether management provided the information to the specialist or the specialist sourced or developed the information independently). Addressing this requirement when estimates involve a third party or specialist is currently very challenging, particularly when information provided or models used are considered proprietary by such specialists or third-party sources. Auditor challenges in this area are also evidenced in the high level of inspection findings in this area, including many findings cited in the public parts of PCAOB inspection reports. Expanding the requirements of PCAOB AU 328 to apply to all accounting estimates would not address the challenges that exist today, and would likely increase them significantly.

We believe that alternative solutions need to be explored to address these concerns in a measured and rational manner, rather than significantly expanding requirements for auditors that in many cases would be unreasonable, if not impossible to satisfy. We also believe that notwithstanding the differences in the current standards for fair value measurements as opposed to other accounting estimates, the auditing of

¹³ See PCAOB AU 336, paragraph 12.

¹⁴ See PCAOB AU 328, paragraphs 26-39.

fair value measurements might be effectively addressed going forward through a combination of the approaches suggested in this letter, including the principles-based standard discussed above, the development of alternative means to address the reliability of information through centralized testing performed at its source rather than when it is used, raising the bar on expectations for any management specialists that are engaged by the issuer and the development of practical implementation guidance in the manner described above.

Differentiating Between Specialists and Third-Party Information Providers. The current PCAOB standards do not clearly differentiate between third-party information providers and specialists, including situations when management uses them, or when the auditor uses them in auditing management's process, or in developing independent estimates. We believe that the two are distinguishable from one another, including in the context of fair value measurements,¹⁵ and that the differences should be acknowledged in and taken into account when developing the requirements in a potential new accounting estimates standard.

An important distinction between a management specialist and a third-party information provider relates to the inherent risk that the information is affected by bias. We believe that in general, values determined by third-party information providers are likely inherently less biased than values determined by management specialists. The information provided by a third party that is supplying that same information to a broad range of users is unlikely to be affected by bias that might be motivated by a single user of that information, that is, the breadth of the users of the information tends to reduce the risk of bias in a third-party information provider's process. On the other hand, when management employs a specialist, the risk increases that management bias will be reflected in the estimated value determined by such a specialist as the specialist will likely use information (data and/or assumptions) provided by management. Depending on the level of objectivity and competence of the specialist, the value determined by the specialist is never-the-less still likely to be less biased than if the value was determined by management. Given these differences, management's processes and controls will also vary depending on whether and how a management specialist or a third-party information provider is used, that is, being possibly less rigorous or detailed and focused on the risk of management bias when estimates are determined using information provided by reputable third parties (who supply the same information broadly to other users) than when management engages a suitably qualified specialist to develop an entity-specific estimate. The extent to which controls are in place by management also assists in mitigating management bias in the preparation of management estimates.

Differentiating between specialists and third-party information providers is also dependent on the facts and circumstances, and in some cases the same party might be considered an information provider, while in other situations, that party might function as a specialist. For example, a third-party pricing service center could be an information provider with respect to certain types of fair value measurements that are

¹⁵ We note that the International Auditing and Assurance Standards Board's ISA 500, *Audit Evidence*, includes an example in paragraph A35 that differentiates a management specialist from a third-party information provider as follows: "For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert.... If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence ... is not the use of a management's expert by the entity."

valued using observable inputs (e.g., when providing values for level 1 investments that are determined based on quoted prices). Alternatively, for other types of financial instruments, a third-party pricing service center may function more like a specialist (e.g., when providing values for level 2 or level 3 investments that are not widely held and infrequently traded and therefore hard to value due to the absence of observable market data, or because only limited amounts of information are available).

We believe these factors should be taken into consideration when establishing audit requirements in a potential new standard. The level of audit effort required should be commensurate with the assessment of the related risks of material misstatement, including fraud risks. Additionally, with reference to our recommendations above, to the extent that appropriate accreditation and certification standards are established for management specialists and related requirement for issuers to only use suitably accredited specialists are established, the auditing standards should provide for the ability of auditors to place appropriate reliance on work that they have performed.

ECONOMIC IMPACT AND IMPLICATIONS

We support the PCAOB Staff’s efforts to obtain information and views regarding economic implications of the alternatives addressed in the paper. We encourage the PCAOB Staff to continue to conduct additional research and analysis as alternatives are considered, and as they develop the proposed standards addressing not only accounting estimates, but also use of specialists.

Expanded requirements for auditors will of course result in increased audit effort and related costs. For example, requirements for auditors to test information produced by third parties “as if it was produced by management” will drive incremental audit effort. We believe the suggestions in our letter will help ensure that any new requirements are implemented in a cost-effective manner, such that the benefits of applying the standard outweigh the associated costs. The importance of clear expectations or requirements for issuers that are aligned with the responsibilities for auditors also cannot be over-emphasized, especially as they relate to the related financial reporting controls and the extent to which management can use or rely on work performed by specialists or information provided by third parties. Disproportionate increases in audit costs will likely result if the requirements for auditors are not aligned with those of management. Therefore, in order for costs of expanded requirements for auditors to be managed most effectively, and consistent with some of our recommendations in this letter, new approaches must be considered and developed that take account of, and carefully coordinate requirements for auditors and for preparers.

As noted above, outreach to and collaboration with others, including preparers, investors, the FASB, SEC, and specialist professions is an essential element of this project and key to developing approaches for the initiative to not only address the issues relating to accounting estimates as discussed above, but also in connection with assessing the economic impact and implications of proposed alternatives to amending the PCAOB’s auditing standards.

* * *

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments in this letter and the accompanying Appendix A are intended to assist the PCAOB in analyzing the relevant issues and potential effects of PCAOB standard-setting activities related to accounting estimates and fair value measurements. We have attempted to provide comprehensive input which we hope will be helpful to the PCAOB Staff as they move forward to the next stage of this very important project. We

encourage the PCAOB to continue to engage in active and transparent dialogue with commenters and other stakeholders as any proposed standards are developed and alternatives are considered.

Notwithstanding our recommendation for addressing issues and challenges related to auditing accounting estimates holistically, given their significance we believe it is important for the PCAOB to take action in moving this initiative forward. We would very much welcome the opportunity to assist in whatever way we can, including as an initial step meeting with the PCAOB Chief Auditor and his staff to further discuss our viewpoints on the consultation paper, and provide additional insights on the matters and issues discussed in this letter including, but not limited to:

- Discussing specific examples of different types of accounting estimates and the related challenges that we face today, and how those challenges might be affected through application of some of the requirements proposed in the consultation paper
- Providing further insight into our centralized due diligence approach for pricing vendors.

If you have any questions or would like to discuss these issues further, please contact John Fogarty at 203-761-3227, Thomas Omberg at 212-436-4126 or William Platt at 203-761-3755.

Very truly yours,

Deloitte & Touche LLP

Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
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Daniel M. Gallagher, SEC Commissioner
Kara M. Stein, SEC Commissioner
Michael S. Piwowar, SEC Commissioner
James V. Schnurr, SEC Chief Accountant
Brian T. Croteau, SEC Deputy Chief Accountant

APPENDIX A

In this Appendix, we have addressed certain issues raised in the consultation paper in more detail, including where applicable, the proposed drafting suggestions for new requirements that might be included in a potential new standard. Our comments and observations are organized as follows:

- I. Alignment with the Risk Assessment Standards
- II. Substantive Procedures for Testing Management's Estimates

I. ALIGNMENT WITH THE RISK ASSESSMENT STANDARDS

The PCAOB is considering integrating a potential new standard with the PCAOB's risk assessment standards. We are supportive of this approach and agree that it is important that any new standard is closely integrated with the PCAOB's risk assessment standards, and also that any new standard and related conforming amendments build upon the requirements of the risk assessment standards for identifying, assessing, and responding to the risks of material misstatement. We also believe that it is important that the PCAOB specifically consider and address the linkage between a new proposed standard and the requirements of PCAOB AU 316, *Consideration of Fraud in a Financial Statement Audit*, which addresses the consideration of risks of material misstatement due to fraud.

The PCAOB is considering an approach whereby targeted amendments would be made to the risk assessment standards to address incremental considerations specific to accounting estimates. We believe it would be more appropriate for the PCAOB to build on the requirements in the risk assessment standards, but instead include additional requirements and guidance in a new accounting estimates standard, as having the content in one place might facilitate more consistent application of the requirements. As noted above, practical implementation guidance that is acknowledged and accepted by the PCAOB as satisfying the requirements of the PCAOB's auditing standards would provide additional context and detail for auditors and would facilitate more consistent application of the PCAOB's standard and improved audit quality.

Identifying and Assessing Risks of Material Misstatement. We believe it is appropriate for the risk assessment process for accounting estimates to include understanding management's process for developing such estimates.

Understanding How a Company Develops its Accounting Estimates When Using Specialists or Third-Party Information Providers. The potential amendment to PCAOB AS 12, *Identifying and Assessing Risks of Material Misstatement* (PCAOB AS 12), proposed in the consultation paper for understanding the extent to which the company uses a third party or information provided by a third party in developing accounting estimates,¹⁶ does not make a distinction between the two. As discussed in our overall comments, we believe however that a distinction exists, and that a potential new standard should acknowledge these differences and thereby support differentiation in the auditor's responsibilities. Practical implementation guidance developed in accordance with the approach that we describe above

¹⁶ See page 24 of the consultation paper.

and which addresses use of specialists and third-party information providers for different types of accounting estimates would be very helpful in driving consistent application of a potential new standard.

Determining which Risks are Significant Risks. Paragraph 71 of PCAOB AS 12 specifies factors that should be evaluated in determining which risks are significant risks, and includes sub-paragraph f. as follows:

“The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.”

The factors identified in the proposed amendment on page 25 may provide additional guidance to the auditor in applying the existing requirement in PCAOB AS 12.71f as it relates to accounting estimates and fair value measurements (i.e., as considerations that may be useful “in evaluating the degree of complexity or judgment in the recognition or measurement of an accounting estimate”). We believe that the factors should be provided as guidance and not as matters the “auditor should take into account.” As drafted in the consultation paper, the proposed amendment appears to imply that all of the matters would need to be explicitly addressed for each accounting estimate and therefore the documentation of such assessment for each accounting estimate would need to include consideration of all of the factors in all cases. In many cases not all of the factors would be relevant (or relevant to the same degree) and therefore this proposed requirement would likely be unduly onerous in such cases, particularly for less complex or subjective estimates. We also believe it would be helpful to indicate in a proposed standard what the auditor should consider relative to the types of models or calculations used and how that would be expected to inform the assessment of the significance of the related risks of material misstatement (e.g., is it expected that the more complex or more unique the models are, or the more complex the calculations, the more likely the auditor would assess the related risks of material misstatement as significant?).

We are not supportive of designating certain types of accounting estimates or fair value measurements as presumed significant risks. Not all assertions or risks of material misstatement related to a particular assertion are necessarily of the same significance. For example, certain aspects of a particular estimate are likely to always be more inherently risky than others (e.g., certain assumptions for the valuation assertion for a particular estimate might have higher estimation uncertainty than others), and accordingly auditors should be encouraged to focus on designating only those aspects that have the highest inherent uncertainty as significant risks, rather than identifying entire accounting estimates as significant risks. Even complex or subjective estimates likely include aspects that are not as inherently risky.

Consistent with our overall remarks regarding an appropriate emphasis on internal control, we believe that it is important that the potential standard also remind auditors of the responsibility pursuant to PCAOB AS 12 to identify the relevant controls that address significant risks relating to estimates (including fraud risks), evaluate their design, and determine that they have been implemented (and for integrated audits, the responsibility pursuant to PCAOB AS 5 to also test the operating effectiveness of such controls).

Extent and Timing of Substantive Procedures. As noted in the consultation paper, paragraphs 42-46 of PCAOB AS 13, *The Auditor's Responses to the Risks of Material Misstatement* (PCAOB AS 13), address the extent and timing of substantive procedures. While we agree that these requirements are also applicable to substantive procedures performed to address accounting estimates, we also believe that

auditors would benefit from additional guidance on how to apply these requirements in the context of accounting estimates.

Analysis that we have performed into our inspection findings (both generally as well as specifically related to auditing accounting estimates) supports that time pressure during the year-end procedures is a relevant causal factor for audit deficiencies. We therefore believe that a potential new standard should explicitly address whether and how substantive procedures to address accounting estimates can be performed as of an interim date. The appropriate approach for interim procedures might vary for different types of accounting estimates and would also be a function of the significance of the assessed risks of material misstatement; so flexibility in the wording used in a proposed standard would be necessary. This is also an area where implementation guidance could be developed to illustrate application of the requirements of the requirements on a proposed standard (see discussion in our overall comments for a possible approach to the development of such guidance). Generally, we believe that an appropriate approach would be for auditors to obtain a detailed understanding of accounting estimates as part of the risk assessment process and to perform procedures to corroborate that understanding as of an interim date, including testing information used in developing accounting estimates and if applicable, performing tests of the design and operating effectiveness of the related controls. In a well-controlled company and particularly as it relates to less complex, less subjective accounting estimates, audit procedures performed at an interim date (including tests of relevant controls) should provide the basis for the auditor to perform less extensive procedures at year end (e.g., perform appropriate procedures to rollforward interim conclusions to the period end instead of performing all the work at the period end).

Testing Conformity with the Applicable Financial Reporting Framework. We believe that consideration of the requirements of the applicable financial reporting framework is foundational to the assessment of the risks of material misstatement for any significant account balance or disclosure,¹⁷ and therefore a key element of the risk assessment process. PCAOB AS 13 requires that the auditor address the risks of material misstatement through appropriate overall audit responses and audit procedures. We also agree with the PCAOB's assessment that the existing requirement in PCAOB AS 14, *Evaluating Audit Results*, is an appropriate overall assessment as to whether the company's disclosures are in conformity with the applicable financial reporting framework. Accordingly, we believe that the additional statement proposed to amend paragraph 36 of PCAOB AS 13¹⁸ would be disconnected from the risk assessment process, in addition to being redundant with existing requirements.

Similarly, we also do not believe that it is necessary for a new potential standard to include specific or incremental audit procedures related to auditing disclosures of accounting estimates, as the requirements to perform procedures to address risks of material misstatement relating to disclosures already exist within the PCAOB's risk assessment standards. There are a large number of different accounting estimates with a variety of different disclosure requirements, including situations in which the applicable requirements might differ between applicable financial reporting frameworks (e.g., differences between

¹⁷ PCAOB AS 12, paragraph 60 states "As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated."

¹⁸ The proposed amendment is "Performing substantive procedures for the relevant assertions of significant accounts and disclosures involves testing whether the significant accounts and disclosures are in conformity with the applicable financial reporting framework."

U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards). By including detailed requirements relating to aspects of specific accounting estimates, we believe that there is a risk that the PCAOB's auditing standards might be perceived as setting accounting guidance for issuers, and we believe strongly that the PCAOB's auditing standards should remain framework-neutral. We recognize however that some disclosures for certain accounting estimates might be more significant or sensitive, thereby warranting additional focus by the auditor. The auditing of particular disclosures (e.g., disclosures on levels within the fair value hierarchy) would be an appropriate topic to be addressed by implementation guidance that might be developed in accordance with the process described in our overall comments.

Testing Controls. We believe the existing requirements in PCAOB AS 13 and PCAOB AS 5 provide an appropriate framework for testing relevant controls, and that such framework can be applied to testing controls over accounting estimates. The auditing of relevant controls over accounting estimates, and in particular management review controls would also be an appropriate topic to be addressed by implementation guidance that might be developed in accordance with the process described in our overall comments.

Procedures Relating to Significant Risks. As a general matter, it is very important that specific audit procedures are tailored to address the risks specific to the particular estimate. On page 29, the consultation paper discusses the approach taken in ISA 540 to include more specific requirements addressing estimation uncertainty and recognition and measurement criteria for accounting estimates that give rise to significant risk. The requirements in the ISA are accompanied by application guidance that results in an approach that is scalable, but without being overly prescriptive. We therefore believe that it will be difficult to draft detailed audit procedures that would be applicable to all significant risks related to all accounting estimates, given the range of different types of estimates and therefore the variety of the related significant risks that may be identified. The approach taken in the ISAs is capable of being applied to the different significant risks that might arise for different types of accounting estimates, and therefore represents an appropriate starting point for the PCAOB's potential standard. We also encourage the PCAOB to consider whether this approach may also be appropriate for the aspects of accounting estimates that give rise to higher, but not necessarily significant risks.

II. SUBSTANTIVE PROCEDURES FOR TESTING MANAGEMENT'S ESTIMATES

The approaches in the existing standards for performing substantive procedures to address risks of material misstatement relating to accounting estimates (i.e., testing the company's process, developing an independent estimate, or reviewing subsequent events and transactions) should be retained in a potential new standard, but should not indicate that one approach would always be seen as preferable to another. Given the specific facts and circumstances relevant to a particular accounting estimate, the processes management might use in developing the estimate and the related risks of material misstatement, one or more of these approaches may be more appropriate or might not be possible, and therefore auditors should be able to apply professional judgment in making a determination as to the approach to follow. A potential new standard requiring use of one of the approaches, or implying that there was a barrier to be overcome in making a selection to use one method versus another, would likely be difficult, if not impossible to apply in practice.

Testing the Company's Process. We support the retention of the ability to address the substantive testing of an accounting estimate through testing the company's process. In some situations, including

where management has used a specialist in developing a particular accounting estimate, alternative methods to develop the estimate might not exist such that the auditor would not be able to develop an independent estimate. We acknowledge however the implicit challenges in testing the company's process from the perspective of addressing the risk of management bias, and in particular, that the exercise of professional skepticism by the auditor may be hampered by confirmation bias (i.e., the human tendency to accept evidence that confirms our beliefs and to reject evidence that contradicts them). Addressing confirmation bias is challenging, but awareness of its existence and the likelihood that judgments can be affected, as well as active efforts to identify and understand contradictory information are key aspects. Accordingly, we are supportive of emphasis being placed in a potential standard on the importance of considering contradictory or disconfirming information, together with the recognition of the reality that the auditor can never eliminate the risk of bias completely.

Evaluating the Company's Method Used to Develop an Accounting Estimate. We support the first part of the proposed requirement on page 33 of the consultation paper that the auditor should evaluate whether the company's methods used to develop the accounting estimates are appropriate, including evaluating whether the methods are in conformity with the applicable financial reporting framework (noting that this is consistent with existing standards.) However, we don't believe that the auditor should be required to evaluate whether the methods are "accepted within the company's industry," as we don't believe that what is accepted within the industry is objectively established for all accounting estimates, and in some cases, practices used by companies within the same industry may be justifiably different based on different underlying facts and circumstances. Management would not have a similar requirement to consider the acceptability of a company's method against other methods used within the same industry. We therefore believe it is sufficient and appropriate that the methods used to develop accounting estimates be evaluated by the auditor against the requirements of the applicable financial reporting framework, as this is the same requirement that management would have to comply with in preparing the financial statements. Even if it were possible to determine "accepted industry practices," it's not clear what the auditor would do when such practices might conflict with the requirements of the applicable financial reporting framework. Similarly, we don't believe that it is necessary to include a specific requirement to address the consistency of the application of the methods to develop accounting estimates. The consistency of the application of a company's accounting policies is addressed in the requirements of the applicable financial reporting frameworks, and the auditor's considerations are addressed in PCAOB AS 6, *Evaluating Consistency of Financial Statements*.

Evaluating the Reasonableness of Significant Assumptions. We support including requirements for understanding the significant assumptions underlying accounting estimates and testing those assumptions for reasonableness, consistent with existing standards. We also believe the characteristics of significant assumptions as described in the consultation paper on page 35 may be helpful to auditors, particularly for auditing fair value measurements; however they should not be set forth as a complete list of factors that would need to be explicitly evaluated for each and every assumption relevant to a particular accounting estimate. Given the wide range of different types of estimates, not all the factors would always be relevant and there may also be other relevant factors specific to particular assumptions that would make them more significant for the applicable accounting estimate.

The proposed standard should also not include a requirement to “identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate.”¹⁹ The company’s controls should address the determination of which are the significant assumptions. It is not clear how the auditor would establish the population of assumptions not used by management, and therefore the requirement would likely be difficult, if not impossible, to apply in practice, particularly for estimates that have numerous significant assumptions and arguably many potential alternatives. We believe that emphasis in a proposed standard would be better placed on the importance of exercising appropriate professional skepticism including in understanding and evaluating the effectiveness of management’s controls, whether and how management has considered alternative assumptions or outcomes, why they may have been rejected or how management has otherwise addressed estimation uncertainty in developing the accounting estimates.

While the factors included in the proposed requirement on page 37 of the consultation paper for evaluating the consistency of significant assumptions may be generally helpful, we are concerned that a requirement for the auditor to evaluate the consistency of *each* significant assumption with all of the factors listed will be difficult to apply in practice. It’s not clear what process the auditor would be expected to follow to define the factors and what level of detail would be expected (e.g., how much work would the auditor be expected to undertake to identify and assess “relevant industry, regulatory and other external factors” or “existing market information” beyond the overall understanding obtained as part of the auditor’s risk assessment activities performed to address the requirements of PCAOB AS 12). Any requirement for the auditor to evaluate significant assumptions should rather be grounded in the requirements of the applicable financial reporting framework as it is those requirements that management has to comply with (and which the company’s controls need to be designed to address).

Developing an Independent Accounting Estimate. We agree that a potential new standard should retain the option of developing an independent accounting estimate as one of the overall approaches to testing an accounting estimate. Consistent with the commentary in the consultation paper,²⁰ auditors develop independent estimates in different ways, and it would therefore be appropriate for the new standard to provide the necessary flexibility to accommodate the different approaches.

There are different risks associated with information developed internally vs. information developed externally, and therefore we are supportive of a potential new standard distinguishing between data and assumptions produced by the company versus being obtained from third parties (as suggested in the proposed requirement in the consultation paper).²¹ There is more risk that internally-developed information is subject to management bias (either intentionally or inadvertently) and therefore the auditor’s assessment of the accuracy and completeness of such information is more important. However, we believe that generally there may be less risk that information provided by third parties is subject to bias, particularly if the same information is provided to a broad range of users (see discussion in our overall comments). Of course, it is still important for the auditor to carefully consider the nature of the information being used, and whether it is appropriate for the circumstances. However, as it relates to information provided by reputable third parties (e.g., the U.S. treasury or other government departments) that is provided broadly to a wide range of users (e.g., published interest rates or rates of inflation), we

¹⁹ As suggested in the consultation paper in question 28 on pages 35 and 36.

²⁰ See discussion on page 39 of the consultation paper.

²¹ See proposed requirement on page 40 of the consultation paper.

believe that the auditor should be focused on assessing the relevance and reliability of such information in accordance with PCAOB AS 15 rather than being required to test its accuracy and completeness, which depending on the nature of the information may be impossible. Consistent with our comments above however, we encourage the PCAOB to include applicable requirements in PCAOB AS 15 to address information prepared by a management specialist, similar to the requirements in the IAASB's and ASB's audit evidence standards.²²

Developing an Independent Accounting Estimate as Range. We note that the consultation paper²³ is considering an approach “*for a potential new standard to emphasize that the estimate is limited to outcomes within the range that are supported by sufficient appropriate audit evidence.*” Depending on the level of estimation uncertainty, the range of possible values for an accounting estimate could be wide (and in some cases above materiality), and the process involved in developing the estimate can be complex and involve significant levels of judgment. It would be helpful for the potential new standard to explicitly acknowledge this situation. We are concerned that the proposed statement implies a level of precision for all amounts within the range that may not be capable of being determined for all estimates (and which would go beyond the requirements of the applicable financial reporting frameworks), especially for those that have high estimation uncertainty.

Evaluating Evidence from Subsequent Events. We are supportive of a potential new standard continuing to provide for the option of testing accounting estimates by considering audit evidence that may be provided by or in relation to events or transactions that occur after the balance sheet date. Such option may also be used in isolation, or in combination with testing the company's process or developing an independent accounting estimate. We believe the proposed requirement to address audit evidence that might be provided from subsequent events or transactions that is included on page 42 of the consultation paper captures what is implicit in the existing standards for auditing accounting estimates (including fair value measurements); however, the additional clarity it would provide would be helpful.

²² See ISA 500, paragraph 8 and AU-C 500, paragraph 8, and related application material.

²³ See page 41 of the consultation paper.