Verband der Industrie- und Dienstleistungskonzerne in der Schweiz
Fédération des groupes industriels et de services en Suisse
Federation of Industrial and Service Groups in Switzerland

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Office of the Secretary
U.S. PCAOB
1666 K Street, N.W.
Washington, D.C.
US-20006-2803

Comment Letter – PCAOB Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements

Dear Sir/Madam,

SwissHoldings, the Swiss Federation of Industrial and Service Groups in Switzerland, represents 60 Swiss groups, including most of the country's major industrial and commercial enterprises. As certain of our members are registered with the SEC as Foreign Private Issuers and are audited in accordance with PCAOB standards, we are pleased to take the opportunity to comment on the above mentioned staff consultation paper (the paper). Our response below has been prepared in conjunction with our affected member companies.

GENERAL COMMENTS

We agree with the paper's observation that accounting estimates and fair value measurements involve uncertainty and management judgment. We also agree that the use of fair value in measuring financial statement items has increased recently, and continues to increase as economic activity and the underlying transactions, assets and liabilities represented in financial statements become more complex. While we agree that accepted practice should include a degree of consistency in how estimates and measurements are prepared and audited, detailed rules cannot replace the essential role of judgment. We also believe that enhancing audit standards may be a less effective remedy for the audit deficiencies referred to in the paper than enhancing the client acceptance, technical competence, audit team supervision and engagement quality review processes of audit firms.

In the discussion in the paper about the use of independent third party experts, it is suggested that the auditors treat the output of the experts as if it were prepared by the company. We agree that the work of an independent expert needs to be audited, but to ignore the independence of the experts would negate the whole purpose of using them, which is to get additional audit benefit from their expertise and independence beyond what the preparer/client would be able to provide themselves.

We thank you for the opportunity to submit our comments on your proposal.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Michel Demaré	Christian Stiefel
Chair	Director

cc SH Board

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS IN THE RELEASE

We respond below to a representative sample of those questions for which we believe the experience of our members is most relevant.

Overview of the Approach Being Considered by the Staff

Question 4

Do accounting estimates and fair value measurements have sufficiently common attributes that the audit procedures should be included within a single standard? Are there limitations to the approach of having a single standard address both auditing accounting estimates and fair value measurements?

In our view, there are limitations to addressing both fair value measurements and other estimates in a single standard. IFRS and U.S. GAAP both contain specific, detailed (and converged) guidance on fair value measurement. Preparers and auditors can refer to this guidance. Any additional guidance on auditing fair value measurements needs to follow the applicable accounting standard closely. Many of the requirements for measuring fair value, such as the need to adopt the viewpoint of a typical market participant, do not apply to other accounting estimates.

Identifying and Assessing Risks of Material Misstatement

Question 10

Should the requirements for identifying and assessing risks of material misstatement with respect to accounting estimates and fair value measurements – including risk assessment procedures – be included in Auditing Standard No. 12 or be separately set forth in a potential new standard on auditing accounting estimates?

Question 12

A potential amendment to Auditing Standard No. 12 could state that, as part of obtaining an understanding of the company's information system relevant to financial reporting, the auditor should obtain an understanding of how a company develops its accounting estimates, specifically: The processes used to develop accounting estimates, including:

a) *The methods, which may include models;*
b) *The data and assumptions; and*
c) *The extent to which the company uses a third party or information provided by a third party in developing the accounting estimates.*

Is the potential amendment to Auditing Standard No. 12 described above clear and appropriate for both accounting estimates and fair value measurements? Are there other matters relevant to understanding the process used to develop accounting estimates or fair value measurements that could be included in Auditing Standard No. 12?

We agree that the amendment described above would be appropriate.

Question 13

In circumstances where the company uses information obtained from a third party, are there matters – such as information systems at third parties, controls that management has over the work of third parties, and controls at third parties – not currently addressed in AU sec. 324, Service Organizations, or other standards that the staff should consider?

In our opinion, the processes set out in AU sec. 324 are sufficient for an auditor to form an opinion whether there is reasonable assurance that the outputs of a company's third party service provider are free from material error.

Identifying Significant Accounts and Disclosures and Significant Risks

Question 14

The staff is considering recommending to the Board a potential amendment to paragraph 71 of Auditing Standard No. 12 that would require the auditor to take into account particular factors that could be relevant to assessing the degree of complexity or judgment in the recognition or measurement of an accounting estimate. For example:

"In evaluating the degree of complexity or judgment in the recognition or measurement of an accounting estimate, especially those measurements involving a wide range of measurement uncertainty, the auditor should take into account:

- *a) The extent of unobservable inputs used;*
- *b) The type of models or calculations used, if applicable;*
- *c) The degree of subjectivity associated with a future occurrence or outcome of events underlying the assumptions used such as estimates of future cash flows or prepayment assumptions; and*
- *d) The extent of market liquidity or activity for the asset or liability, if relevant to the measurement objective."*

Is the potential amendment to Auditing Standard No. 12 described above clear and appropriate for both accounting estimates and fair value measurements? Are there other factors that would be relevant in the auditor's evaluation of the degree of complexity of judgment in the recognition or measurement of an accounting estimate or fair value measurement (e.g., the use of a third party for the determination of a price)?

We agree that the potential amendment is clear and appropriate.

Question 16

Are there certain types of accounting estimates or fair value measurements that should be presumed to be significant risks?

In our view, inherent risks arise mainly from how uncertain the business environment relevant to the item being estimated or measured is, control risks arise mainly from the quality of the company's internal controls over financial reporting, and measurement risks arise from the quality and quantity of inputs available to perform the estimate or measurement. The type of accounting estimate or fair value measurement is not the most important factor in determining risk and may not always be significant.

<u>Testing Conformity of Financial Statement Disclosures with the Applicable Financial Reporting Framework</u>

Question 18

The staff is contemplating whether an amendment to Auditing Standard No. 13 would be useful to underscore the importance of considering the related accounting requirements when auditing significant accounts and disclosures. For example, paragraph 36 of Auditing Standard No. 13 could be amended by adding the following statement:

"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".
Is the potential amendment to Auditing Standard No. 13 described above helpful in emphasizing the auditor's consideration of the applicable accounting framework when auditing significant accounts and disclosures?

Question 19

Should a potential new standard include specific audit procedures related to auditing disclosures of accounting estimates (e.g., disclosures on levels within the fair value hierarchy?

We believe that how auditors should discharge their responsibility with regard to auditing financial statement disclosures is already clear, and further amendment to Auditing Standards would not be the best way to remedy any shortcomings the staff are aware of in this area.

<u>Evaluating the Company's Method Used to Develop an Accounting Estimate</u>

Question 26

A potential new standard could include the following requirements relating to the auditor's evaluation of the appropriateness of the company's methods used to develop an accounting estimate:

"The auditor should evaluate whether the company's methods used to develop the accounting estimates are appropriate. In evaluating the appropriateness of the methods, the auditor should evaluate whether the methods are in conformity with the applicable financial reporting framework. The auditor also should evaluate whether the methods are:

a) Accepted within the company's industry; and

b) Applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company.

If the company has changed the method for determining the accounting estimate, the auditor should determine the reasons for and evaluate the appropriateness of such changes. In circumstances where the company has determined that different methods result in significantly different estimates, the auditor should determine the reasons for the method selected by the company and evaluate the appropriateness of the selection."

Are the potential requirements described above for evaluating whether the company's method used to develop accounting estimates appropriate for both accounting estimates and fair value measurements?

Question 27

In circumstances where the financial reporting framework does not specify the use of a particular valuation method, is the consideration of methods accepted by the company's industry relevant? Are there other criteria that auditors could use to evaluate the appropriateness of the company's method used to develop accounting estimates?

It is important that the auditing framework allow and support advances in measurement techniques. There is a danger that such advances would be blocked from being introduced by a formal requirement that only techniques which are already generally accepted in the company's industry are allowed to be applied. Otherwise, we agree that the above requirements are appropriate for both accounting estimates and fair value measurements.

<u>Evaluating the Reasonableness of Significant Assumptions Identified</u>

Question 30

The following requirement could be included in a potential new standard relating to the auditor's evaluation of the reasonableness of the identified significant assumptions:

"When evaluating significant assumptions, the auditor should evaluate the consistency of each significant assumption with the following, if applicable:

a) Relevant industry, regulatory, and other external factors, including economic conditions;

b) The company's objectives, strategies, and related business risks;

c) Existing market information;

d) Historical or recent experience, taking into account changes in conditions and events affecting the company; and

e) Other interdependent assumptions used by the company."

Are the suggested factors described above appropriate for evaluating the reasonableness of significant assumptions? Are there other factors the auditor should assess when evaluating the reasonableness of significant assumptions relevant to accounting estimates?

We agree that the factors described above are appropriate for evaluating the reasonableness of significant assumptions. We are not aware of other factors the auditor should consider.

<u>Management's Use of a Specialist</u>

Question 31

The staff is also exploring whether to include in a potential new standard audit procedures to address information developed by a company's specialist related to accounting estimates. If a company uses a specialist to develop an accounting estimate, a potential new standard could direct the auditor to test that information as if it were produced by the company. In this case, the auditor would be required, as applicable, to evaluate the appropriateness of the methods, test the data used, and evaluate the reasonableness of significant assumptions, with respect to the information provided by the specialist. For example, the potential new standard could include the following requirement:

"When the company uses a specialist employed or engaged by the company to develop an accounting estimate, the auditor should test the information provided by the specialist as if it were produced by the company."

In our view, the reasons why companies engage specialists to report on matters relevant to accounting estimates, and why auditors are generally happy to work with specialists in that context, are the following:

- the specialists' experience and expertise in their particular field reduces the risk of the company making an error on account of its own employees lacking the requisite skills in that specialist field; and
- information an auditor obtains from an independent third party has greater value as audit evidence than similar information provided by the company directly. Therefore, the involvement of a specialist allows the auditor to obtain sufficient audit evidence to support the company's estimates more easily than if no specialist is involved.

We acknowledge that the auditor cannot simply accept the work of a specialist without making further enquiries, and must obtain evidence that the specialist is sufficiently qualified and that adequate controls exist over information sent to the specialist such that it can be reasonably assured the specialist will apply his/her expertise to the correct data set and interpret that data set in a way consistent with the company's intentions and practices.

Nevertheless, for the reasons we have set out above, we are of the view that the requirement described above would lead to the auditor performing unnecessary audit procedures. A formal requirement, as worded above, would almost certainly involve both the auditor and the company's specialist in additional time and effort compared to current practice, with all the additional costs that would entail. In fact, the requirement would raise the possibility that the auditor might engage similar specialists to re-perform at least some aspects of the work performed by the company's specialists, duplicating the costs involved. These incremental costs would have to be borne by the company, which means ultimately by the company's investors.

Also, we would point out that not allowing the external auditors to rely on reputable experts used by their clients and requiring the auditors to request the views of another independent expert will lengthen the process of preparing and auditing the financial statements and will likely delay the publication of the financial statements. As any specialist can only give an opinion, we suggest therefore that only if the auditor has concerns about the quality or independence of the expert should another expert be brought in.

Use of Third Parties

Question 38

The staff is considering including a requirement that would apply when the auditor and the company use the same third-party source to arrive at an accounting estimate. For example: "If the third-party source used by the auditor is the same as the third-party source used by the company, the auditor should evaluate the audit evidence obtained as if it were produced by the company, which includes testing data and evaluating reasonableness of significant assumptions".

Would the potential requirements described above address procedures performed by audit firms that use a centralized testing approach? Would these requirements create issues in practice for smaller firms?

Question 39

Should the potential new standard require the auditor to use a third party that is different from the third party used by management? Would such a requirement present challenges for certain types of accounting estimates and fair value measurements?

We agree that the auditor should always consider whether information obtained is appropriate audit evidence before using it as such, regardless of the source of that information. However, as in our response to Question 31 above, we are of the view that to treat third party information as if it were produced by the company would ignore the benefits of the third party's independence and expertise and lead to unnecessary audit procedures being performed.

We do not see why it is necessary to require the auditor to use a third party that is different from the one used by company management. Indeed this may not be possible because there may be only one independent third party source of certain information the auditor needs to obtain in order to audit a company's estimate and that source would necessarily also be the company's source of information to develop the estimate. We understand that accepted audit practice in these and similar situations often already includes the auditor meeting with the third party separately from meeting with the company in order to discuss the third party's estimate and how it is prepared, so that the auditor can conclude whether it can rely on the third party's information. In our view, this procedure should be sufficient.

Evaluating Audit Evidence from Third-Party Sources

Question 40

The staff is exploring whether a new standard should set forth specific requirements for evaluating information from third-party pricing sources as part of evaluating the relevance and reliability of the evidence pursuant to Auditing Standard No. 15. Under that approach, the auditor would first evaluate the reliability of the evidence provided by the third-party pricing source, taking into account certain factors. For example:

a) *" The experience and expertise of the third party relative to the type of asset or liability being valued; and*

b) *The methods used by the third party in determining fair value for the specific company's assets or liabilities being tested and whether the methodology used is in conformity with the applicable financial reporting framework".*

Under this approach, the auditor would then evaluate the relevance of the evidence obtained from the third-party source. For example:

"The auditor should evaluate whether the evidence provided by the third-party source is relevant to the fair value measurement, which includes determining the following:

a) *Whether fair values are based on trades of the same instrument or active*

b) *market quotations;*

c) *When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;*

d) *When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed represent the assumptions that market participants would use when pricing the asset or liability, if applicable; or*

e) *When the fair value measurement is based on a broker quote, whether the broker quote:*
    i. *"Is from a market maker who transacts in the same type of financial instrument; and*
    ii. *Is binding or nonbinding, with more weight placed on quotes based on binding offers"*

Would the factors noted above help the auditor in evaluating the reliability and relevance of evidence obtained from third-party pricing sources? Are there other factors that are applicable in determining the reliability or relevance of evidence obtained from third-party pricing sources?

Question 41

Are there other approaches to testing evidence obtained from third-party pricing sources that the staff should consider?

When a company uses a third party pricing service as a source of fair value information in financial statements, we agree that an auditor needs to obtain sufficient evidence about how the pricing service develops its estimates in order to conclude whether the company has presented the information correctly (e.g. what fair value hierarchy level the pricing estimate should be assigned to in the associated disclosure table). We agree that the factors described above are relevant.