October 24, 2014

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

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

Members of the Board:

I appreciate the opportunity to comment on the Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements.* I applaud the PCAOB's ongoing effort to enhance the quality of audits and as a result, to help ensure the integrity and quality of financial reporting. I support the staff's proposal to issue a new single standard that addresses auditing of accounting estimates and fair value measurements, which would replace AU sec. 328, *Auditing Fair Value Measurements and Disclosures* and AU sec. 342, *Auditing Accounting Estimates,* and part of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities.* A more comprehensive standard that is integrated with the risk assessment standards would enhance usefulness to users and provide a more effective approach to auditing a broad range of assets and liabilities that by their nature frequently are estimates, and not precise values subject to recurring, routine valuation processes.

The PCAOB has been responsive to developments in the financial markets, including through the issuance of Staff Audit Practice Alerts ("the Alerts") that directly, or indirectly address fair value measurements and other accounting estimates. I hope that the Staff will incorporate the guidance contained in the Alerts into the new single standard. I further suggest that the Staff consider developing additional guidance for recurring audit deficiencies, including use of fair value measurements determined at other than the financial statement reporting date, and reliance on internal controls and roll-forward procedures that may be inappropriate given the nonrecurring or market-based nature of the estimates, as well as additional guidance on auditing significant assumptions. Note that AU 328.25 through 328.39 conceptually address these issues, although given the recurring audit deficiencies related to these matters, more specific guidance and examples would be appropriate either in the new standard or in a Staff Audit Practice Alert that consolidates and expands the concepts now contained in Alerts No. 2, 3, 4 9 and 10.

Many of the questions for which the Staff seeks comment are directed to audit firms, or relate to matters for which others may have more expertise. Accordingly, I have answered only selected questions. I have highlighted the original question in bold, followed by my response.

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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?

The International Auditing and Assurance Standards Board issued ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which combines both accounting estimates and fair value measurements in a single framework. That standard incorporates the common attributes and provides an audit framework. It would be beneficial to carry forward the principles contained in AU sec. 328, AU sec. 342 and AU sec. 332 to a new single standard on auditing accounting estimates and fair value measurements, while considering the guidance contained in the risk assessment standards and in ISA 540, and further establishing more specific audit guidance on use of third parties.

The principle limitation to using a single standard is the risk that guidance on fair valuation becomes less transparent. For example, audit deficiencies noted instances where auditors failed to adequately verify inputs or the investment valuation model being used. The new standard should focus investment valuation-related issues in a contiguous discussion, to the extent possible, to ensure that auditors properly test the fair valuation process and understand the risks, possible assumptions and inputs to prevent valuation bias and errors.

9. Are there considerations relevant to auditing accounting estimates and fair value measurements including other regulatory requirements specific to certain industries that the staff should take into account.

The Investment Company Act of 1940 requires auditors of SEC registered investment companies to obtain an independent valuation, which the SEC Staff has interpreted to be an independent valuation different than that used by the investment company. Generally, most registered investment companies hold securities that are traded on public markets, although many investment companies may hold derivatives, swaps, and other unlisted investments. Accordingly, the single standard should inform auditors that valuation procedures for registered investment companies should comply with these and other statutory requirements.

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.

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements for identifying and assessing risks of material misstatement. It sets forth procedures for understanding a company's control environment and internal controls over financial reporting, and requires the auditor to identify significant accounts and disclosures and their relevant assertions based on risk factors. These procedures generally would encompass those procedures required to identify and assess risks of material misstatement with respect to accounting estimates and fair value. To avoid duplication, it would seem appropriate to include these requirements and supplemental guidance in Auditing Standard No. 12, with appropriate cross-reference in the new standard.

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.

Many companies have service models that rely increasingly on third parties, including through software as a service ("SAAS"). SAAS may utilize a software licensing and delivery model in which software is licensed on a subscription basis and centrally hosted. AU sec. 324 does not specifically contemplate these contractual relationships and the pace at which specific software may be implemented and relied upon for specific applications, including fair valuation and investment trading functions.

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

Certain financial instruments that are subject to cash waterfall structures to distribute cash to various classes of ownership, investments with unobservable inputs, investments dependent on a complex capital or tax structure to derive all or part of their economic value, and investments whose value is dependent on a particular legal interpretation, as examples, should be presumed to present significant risks. However, there are many investments that are dependent on publicly disclosed factors, such as LIBOR, which historically have been published and generally accepted as independent, third party indices. It would be helpful if the proposed guidance would clarify the extent to which auditors may rely on these indices in good faith even though they frequently cannot be independently derived.

18. 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?

The potential amendment that clarifies that performance of substantive procedures for the relevant assertions of significant accounts and disclosures would involve testing of whether the significant accounts and disclosures are in conformity with the applicable financial reporting framework is helpful in clarifying the auditor's consideration of the accounting framework.

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)?

Many companies, especially within financial services, include substantial disclosures of financial instruments within the fair value hierarchy. The audit effort put into verifying these disclosures quite often is significant, costly, and has no impact on the balance sheet or statement of operations results. Specific audit procedures related to auditing the fair value hierarchy for financial instruments would be useful, including guidance on when it may be permissible to rely in part on a reporting entity's internal controls for developing and disclosing such information.

26. 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?

The potential requirements are broad and inclusive enough that they would appear appropriate for developing both accounting estimates and fair value measurements.

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?

Valuation methods used by the company's industry are relevant; however, the requirements should be clear that other methods may be appropriate where a method is not specified by the financial reporting framework or where the company has unique business attributes for which a different model may be more suitable.

28. Would a requirement for the auditor to determine which assumptions used by management are significant assumptions present difficulties in practice? Should the staff consider a requirement for the auditor to identify assumptions not used by management, which might be important to the recognition or measurement of the accounting estimate.

The fair valuation process at some investment entities is complex, and may involve multiple fair valuation committees. For example, separate committees may address CDOs, swaps, private equity, real estate, privately structured notes, and other investments, each with multiple significant assumptions. Accordingly, it is important to recognize that a single preparer may have a large number of assumptions. It is appropriate to include a requirement for the auditor to identify those assumptions that might be important to the recognition or measurement of the accounting estimate. However, it also is important to clarify that this process does not need to be performed for items that are immaterial or for which the probability of a material variation from the estimate determined by management is not significant.

I suggest adding other characteristics that mirror those listed on page 25 of the Staff Consultation Paper, including those assumptions that are associated with a future occurrence or outcome, such as "paydown" factors used in the valuation of certain asset-backed securities.

31. Is the potential requirement described above appropriate for all types of accounting estimates? Are there other considerations that should be taken into account in applying this requirement to accounting estimates?

The requirement that the auditor should test the information provided by the specialist, as if it were produced by the company, is conceptually sound. However, it may be difficult to obtain the inputs for models that were used by the specialist and to test that information and those models. As a result, the guidance should specify that it may be necessary to perform other procedures to enable the auditor to conclude on a particular accounting estimate. Those procedures may include back-testing the results of the specialist's model or consideration of other independent and objective information.

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?

It normally would be possible to obtain a third party source that is different from the source used by management. Auditors of registered investment companies are, in fact, required to follow such procedures. However, outside of this requirement, this procedure is unnecessary for liquid financial instruments, for which a recent trade (or a similar trade) may be indicative of fair value. Use of a different pricing service should produce a similar value as the inputs likely are drawn from the same market activity. This requirement could be problematic in those instances where the estimates are obtained from a market maker with unique proprietary information about the specific financial instrument being valued.

40. 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?

The factors identified would be helpful to the auditor in evaluating the reliability and relevance of evidence obtained form third-party pricing sources. They provide a conceptual framework that could be adapted to most valuation situations. I suggest adding consideration of the internal controls at the third party, including those covered by SSAE 16 *Reporting on Controls at a Service Organization*.

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I appreciate the opportunity to share my viewpoints. If the Board has any questions regarding my comments, please feel free to contact me.

Sincerely,

Steven E. Buller
Independent Trustee/Director