CalCPA

1800 Gateway Drive, Ste 200
San Mateo CA 94404-4072
(800) 922-5272
www.calcpa.org

October 29, 2014

Via e-mail: comments@pcaobus.org

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

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

The Accounting Principles and Assurance Services Committee (the "Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the referenced proposal. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 40,000 members. The Committee consists of 53 members, of whom 47 percent are from local or regional CPA firms, 27 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 10 percent are in academia and 4 percent are in international CPA firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee's Overall Comments

The Committee supports the reorganization of the current PCAOB standards, but we do not see the need for any significant expansion of audit procedures. We suggest that the reorganization correspond with changes in content made in the AICPA clarity project (which did not expand audit procedures).

While the PCAOB has encountered deficiencies in the auditing under all three of the current standards, this may be inevitable because the complexity of the accounting requirements may make it difficult for the auditor to fully grasp the requirements and properly use the various audit tools that are available. If the auditor does not fully grasp the accounting and disclosure requirements, audit deficiencies are inevitable, and more auditing standards will do very little to improve this. What really may be needed is better accounting practice aids.

Questions

Current Requirements and Certain Audit Practices

1. Does the information presented above reflect aspects of current audit practice? Are there additional aspects of current practice, of both larger and smaller audit firms – including centralized testing, the use of third parties, or specific challenges to auditing accounting estimates and fair value measurements – that are relevant to the staff's consideration of the need for standard setting in this area?

The information presented does reflect aspects of current practice. The Committee believes the current audit standards are generally adequate. As accounting standards and the relevant underlying transactions evolve, there may be a need to interpret how the audit standards may be applied, but it is futile to try to continuously update basic audit standards themselves for new accounting standards and underlying transactions.

2. The staff understands differences may exist in the use of centralized or national-level pricing desks at audit firms. The staff is interested in current practice for interaction between national-level pricing desks and engagement teams. For example, how (and by whom) are national-level pricing desks supervised given the engagement partner's responsibility under the risk assessment standards? How should these considerations affect auditing standards?

The use of national-level pricing desks or in-firm valuation specialists varies from firm to firm in our experience, and smaller firms that perform PCAOB audits may not possess such resources. For example, depending on the complexity and number of investments for a specific client, in one firm the engagement partner will decide whether or not to use the firm's internal valuation group to verify client inputs that the client used in their valuation model (typically Level 3 investments). If a model is used by a client to value an investment, the firm's internal valuation group would verify the inputs by using Cap IQ services. Additionally, for all investments that are not fair valued using a model, the firm has local staff that is trained on the use of the Bloomberg Terminal and IDC in order to verify the prices for securities in the specific client's portfolio. All of this firm's engagements are subject to price checking verification through the use of Bloomberg or IDC quotation services for those investments that are traded on exchanges. That firm also uses these quotation services to check the volume of trading to determine that the investment has been correctly classified within the fair value level hierarchy, and to validate other inputs that the firm's clients use in applying various option pricing models.

Another firm has a standing national-level Valuation Committee to assist local engagement team members in determining the reasonableness of values assigned to "hard to value" investments. In this case the firm's National Accounting and Auditing Partner is a member of the Valuation Committee.

Based on the Committee's experience, firm policies regarding the use of national-level resources, whether they be internal specialists or the endorsed use of third-party valuation services are sufficiently comprehensive, and do not require any specific action on the part of the PCAOB at this time. However, one aspect regarding the use of third-party valuation services the PCAOB might evaluate is the general lack of available service organization examination reports. The Committee believes that if a third-party valuation service provided a service organization examination report, it may enhance the reliability of the information they provide, and may be cost-beneficial if such report enables CPA firms and their user clients to reduce the cost of the effort expended in order to place reliance on the valuation information provided by such service organizations by more than any additional cost related to such report.

3. **What other issues relevant to the need for standard setting should be considered by the staff?**

Please refer to the Committee's comments regarding the lack of service organization examination reports in our response to Question 2 above.

Staff Consideration of Alternative Approaches

A. Alternative Approaches

B. Overview of the Approach Being Considered by the Staff

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 Committee believes that accounting estimates and fair value measurements should be included within a single standard. This is also the approach adopted by the AICPA in its clarity project and by the IAASB.

5. **Are there considerations affecting accounting estimates relative to the financial reporting frameworks, such as recent changes to revenue recognition, that the staff should specifically take into account in developing a potential new standard?**

Such matters should be considered only if they necessitate a broad new standard, and none of the recent changes seem to rise to that level. The changes to revenue recognition create challenges in determining the appropriate accounting, but the estimation and valuation processes are similar to those encountered in other areas of accounting.

Accounting is not, never has been, and never will be an exact science; judgment will always be required in recording an entity's activities. More standards are not needed in some attempt to narrow the amount of judgment needed to do a proper audit.

6. Are there other considerations relating to the alternatives explored, including other alternatives not discussed in this paper, that the staff should consider in connection with this project?

The staff should carefully consider whether the standards are the problem, or performance is the problem, and whether different standards will solve the performance problems; the Committee doubts that different standards will solve performance problems.

7. Based on commenters' experience in applying ISA 540 (or AU-C 540), are there any aspects, positive or negative, of a single-standard approach that the staff should consider in connection within a potential new standard? Are there any other lessons learned from the implementation of ISA 540 (or AU-C 540) that the staff should consider in its approach to standard setting in this area?

The Committee supports the single-standard approach as discussed in our response to Question 4.

8. If AU sec. 332 were to be superseded, are there elements that should be retained? With respect to derivatives and securities, are there enhancements related to auditing assertions other than valuation that the staff should consider?

The Committee does not see a need to retain AU 332. Parts of it are not specific to derivatives, hedging and investments in securities and these can be incorporated into AS 12 and 13. Parts that are unique should be incorporated into a combined standard on auditing accounting estimates and fair value measurements. Provisions that duplicate requirements in the risk assessment standards can be deleted.

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?

No. Any specific industry considerations should be handled separately as Practice Alerts or similar publications, but would be too specific to be elevated to the status of a standard.

Key Aspects of a Potential New Standard and Related Potential Requirements

A. Alignment with the Risk Assessment Standards

1. Identifying and Assessing Risks of Material Misstatement

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?

The Committee believes that such requirements that are unique to identifying and assessing risks of material misstatement with respect to accounting estimates and fair value measurements should be separately set forth in a potential new standard on auditing accounting estimates and fair value measurements. Such requirements that are not unique should be included in AS 12, or eliminated if duplicative of what is already in AS 12.

11. Are there additions or revisions to the existing requirements in PCAOB standards for identifying and assessing risks of material misstatement regarding accounting estimates that should be considered?

The Committee has none to recommend.

a. Understanding Processes Used to Develop Accounting Estimates

12. 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?

The description of the potential amendments is clear, but the Committee does not believe they are appropriate. As stated in our response to Question 10, the Committee believes that such requirements that are unique to identifying and assessing risks of material misstatement with respect to accounting estimates and fair value measurements should be separately set forth in a potential new standard on auditing accounting estimates and fair value measurements. Only such requirements that are not unique to accounting estimates and fair value measurements should be included in AS 12.

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?

As we discussed in our response to Question 2 above, the general lack of service organization examination reports from third-party valuation services requires the user organization and their auditors to consider the matters the PCAOB refers to in its question above. The Committee also believes that guidance contained in the PCAOB's AU 336 Using the Work of a Specialist is relevant.

b. Identifying Significant Accounts and Disclosures and Significant Risks

14. **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)?**

The Committee believes that the potential amendment is clear but that it should not be part of AS 12 but rather included in a potential new standard on auditing accounting estimates and fair value measurements.

The Committee does not have any other factors to suggest for consideration.

15. **Are there additional factors specific to accounting estimates or fair value measurements that would be useful in identifying significant accounts and disclosures, or in determining significant risks that should be considered?**

The Committee does not have any other factors to suggest for consideration.

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

Certain estimates and fair value measurements that are not based on actual transactions and cannot be assessed by reference to actual substantially similar transactions should be presumed to be significant risks absent evidence to the contrary. This would include level 3 fair value measurements. It might also include items such as estimated losses on certain material receivables, costs to complete large non-repetitive contracts, environmental remediation costs and provisions for litigation losses (this list of items is not all-inclusive). However, the Committee has significant reservations about trying to identify which accounting estimates or fair value measurements should always be presumed to be significant risks, because such risks may not always be significant, and conversely, there may be significant risks that are not included in those specifically identified.

2. Responding to the Risks of Material Misstatement

17. **Are there considerations particular to the timing and extent of these procedures (e.g., interim audit procedures), beyond the requirements of paragraphs 42–46 of Auditing Standard No. 13, that the staff should consider including in a potential new standard?**

The Committee does not have any other considerations to suggest.

a. Testing Conformity with the Applicable Financial Reporting Framework

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?**

This seems unnecessary in the view of the Committee. There is already a requirement to disclose the framework in the financial statements, and no further emphasis seems necessary.

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)?**

Disclosure requirements are set forth in the applicable accounting standards. The only specific audit procedure might be to test whether the disclosures comply with applicable standards.

b. Tests of Controls

20. **Given the existing requirements related to testing controls in Auditing Standard No. 13 (and Auditing Standard No. 5, as applicable), would specific requirements on testing internal controls over accounting estimates be useful (e.g., evaluation of design and operating effectiveness of key review controls over accounting estimates)?**

The controls relating to all areas of significant risk are especially important. Material estimates and fair value determinations are often significant risks. While these areas are often subject to significant substantive audit procedures, internal controls over these areas are no less important. Thus emphasizing that the controls over these determinations are especially important would be helpful.

c. Procedures Relating to Significant Risks

21. **Should a potential new standard include specific audit procedures that would be applicable when the auditor identifies and assesses a risk related to accounting estimates as a significant risk? If so, are there factors regarding measurement uncertainty or any other characteristics relevant to staff considerations of potential audit requirements?**

The Committee believes that the standards are sufficiently instructive on how an auditor should respond to a significant risk. However, the Committee also supports conformity among PCAOB, AICPA and IAASB standards, and would support inclusion of requirements consistent with the approach in ISA 540.

B. Substantive Procedures for Testing Accounting Estimates

22. **Are there specific factors that affect the auditor's selection of approaches related to testing accounting estimates? What considerations would be appropriate for the auditor to take into account when determining which approach (or combination of approaches) for testing accounting estimates should be selected?**

Selection of specific audit procedures is usually driven by the specific entity circumstances and the experience of the auditor. The first consideration is adopting an audit approach that is effective in providing sufficient appropriate audit evidence; the second consideration is often audit efficiency. The Committee does not believe these considerations need to be mentioned in a standard, and that existing standards already have adequate guidance for testing accounting estimates.

23. **Aside from testing management's process, developing an independent estimate, or reviewing subsequent events and transactions as further discussed, should a potential new standard allow for or require other approaches to testing accounting estimates? If so, what other approaches would be appropriate?**

The Committee has no additional approaches to suggest.

24. **Are there certain types of accounting estimates for which substantive procedures other than those described in this paper would provide better audit evidence?**

No. See the Committee's response to Question 23.

1. Testing the Company's Process

25. **Are there enhancements to the existing requirements for testing data used by management to develop the accounting estimate the staff should consider?**

No. The Committee believes that the existing requirements are adequate.

a. Evaluating the Company's Method Used to Develop an Accounting Estimate

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 Committee does not believe the potential requirements are appropriate.

In the first paragraph, the evaluation of whether the methods are in conformity with the applicable financial reporting framework is not necessary. See the Committee's response to Question 18.

Subparagraph a. referencing evaluating of whether the methods are accepted within the company's industry may be unworkable. The information may not be available to the company or the auditor, and if available to the auditor, may be confidential. Disclosures in public documents often do not have sufficient detail to be useful. And there is no assurance that what others in the industry do is actually correct.

Consistency, described in subparagraph b. and following paragraphs, should already be within the scope of other audit requirements, but may be helpful to cover in any proposed new requirements.

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?**

See the Committee's response to Question 26 concerning industry practice; it might be worthy of consideration, but such a requirement may not be workable. The Committee has no other criteria to recommend; there is an underlying requirement that criteria are reasonable, and we believe auditors are generally able to meet the challenge of evaluating the appropriateness of a company's method used to develop accounting estimates.

b. Evaluating the Reasonableness of Significant Assumptions

i. Identifying Significant Assumptions

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?**

Identification of which assumptions used by management are significant assumptions should be done by management, and tested by the auditor. The Committee does not see any practical difficulty in auditors determining which assumptions identified by management as significant are, in the auditor's judgment, significant.

However, the potential need to identify assumptions not used by management which might be important can be problematic. Does important equate to significant? If not, what does it mean? Would the auditor be obligated to seek out other assumptions even though the auditor is satisfied that assumptions identified by management are appropriate? Does failure by management to identify all important assumptions raise concerns over the adequacy of controls over the estimation process? And what if management does not agree that additional assumptions identified by the auditor as important are not, in management's view, significant or important? The Committee believes a requirement for the auditor to evaluate whether management has identified all significant assumptions is adequate, without any additional provisions.

29. Is the potential requirement suggested above clear and appropriate for both accounting estimates and fair value measurements? Are there other specific characteristics of significant assumptions that should be included?

The list of suggested factors is appropriate for evaluating the reasonableness of significant assumptions, as long as it is made clear that each factor may not be relevant to every situation, and that the list may not be all inclusive.

ii. Evaluating the Reasonableness of Significant Assumptions Identified

30. 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?

The Committee believes the suggested factors are vague and unnecessary. The Committee does not have any other factors to suggest.

c. Management's Use of a Specialist

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 Committee believes that it is not appropriate, and is beyond the declared scope of the Staff Consultation Paper. Standards for Using the Work of a Specialist are in AU 336, and this provides audit guidance for use of specialists employed or engaged by the company as well as specialists engaged by the auditor, and would include specialists used in developing accounting estimates. The proposed requirement is not necessary in view of AU 336.

2. Developing an Independent Accounting Estimate

32. Are the potential requirements described above for developing an independent estimate, including the potential requirements regarding testing data and assumptions, clear and appropriate for both accounting estimates and fair value measurements? Would these requirements present challenges for certain types of accounting estimates and fair value measurements?

The Committee believes that the potential requirements described above for developing an independent estimate, including the potential requirements regarding testing data and assumptions, are clear and appropriate for both accounting estimates and fair value measurements. The Committee does not believe that these requirements would present challenges for certain types of accounting estimates and fair value measurements.

33. **Are there additional considerations that should be addressed with respect to information obtained by the auditor from a third-party source?**

No, the Committee does not believe there are additional considerations.

34. **Are there factors that the staff should consider when developing potential audit requirements for testing the reliability and relevance of data independently derived by the auditor or obtained from other sources?**

No, the Committee believes current standards are adequate.

a. Developing an Independent Accounting Estimate as a Range

35. **Are there other matters relevant to developing a range that a potential new standard could address (e.g., requiring a sensitivity analysis)?**

The Committee does not believe that there other matters relevant to developing a range that a potential new standard should address.

3. Evaluating Audit Evidence from Subsequent Events

36. **Are the potential requirements described above for evaluating audit evidence from events or transactions that occur subsequent to the measurement date through the date of the auditor's report, appropriate for both accounting estimates and fair value measurements?**

The Committee does not take exception to the potential requirements, but it is not necessary to include them in any proposed requirements since they are already included in the subsequent events standards which distinguish between a type 1 and a type 2 subsequent event.

37. **Are there additional factors that should be taken into consideration when evaluating the relevance of the audit evidence obtained from events or transactions that occur subsequent to the measurement date through the date of the auditor's report?**

No, the Committee does not have any additional factors to suggest.

C. Use of Third Parties

38. **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?**

The Committee believes there are unique issues, as identified by the PCAOB, regarding both user firms and their CPA's use of third-party sources of valuation data that are not specifically covered by the existing standards and that bears further evaluation. Unfortunately, the issue is applicable to both large and smaller CPA firms. Larger CPA firms will have greater resources to deal with developing policies on a national level, while smaller CPA firms might have to deal with the issue on a client-by-client basis. Therefore, the PCAOB may have to deal with cost considerations at smaller CPA firms in developing any new guidance in this area.

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?**

No. The auditor should assess the objectivity and reliability of the specialist, and conclude whether it is necessary to engage a different third party. Mandating universal use of a different third party may not be practical where the number of third parties is limited, or if the cost of engaging a different third party is higher than any benefits that may be achieved.

1. Evaluating Audit Evidence from Third-Party Sources

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 Committee does not believe that the factors should be included is any proposed standard. The factors are useful, and there may be others, but they are appropriate for a Practice Alert or similar publication.

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

Please refer to the Committee's response to Question 2 suggesting that the PCAOB consider service organization examination reports from third party valuation services.

42. **How could a potential new standard differentiate between a third-party pricing source and a specialist?**

The Committee does not believe it is necessary or useful to differentiate between a third-party pricing source and a specialist because a single entity may be both. A differentiation could be made between pricing services and specialists (e.g., appraisers), but it is not clear whether the distinction is useful because audit standards seem to deal with both adequately.

43. **Would the potential requirement address the various methods used by third-party pricing sources for determining fair value measurements of financial instruments (e.g., use of consensus pricing and proprietary models)?**

See the Committee's response to Question 42.

Questions Related to Economic Impacts and Implications

44. **What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this consultation paper? Are there any unintended consequences that might result from the alternatives?**

If the new standard is limited to reorganizing existing standards into a new standard on auditing accounting estimates and fair value measurements and amendments and the risk standard (AS 12 and 13), then the costs would consist principally of training for the auditing firms, and these would be non-recurring. The initial and ongoing costs would increase to the extent that any new PCAOB standards differ from the comparable AICPA standards. If significant new auditing steps are added by a new PCAOB standard, then there could be significant ongoing audit costs; it is very difficult to assess the benefits of those costs because they are not directly measurable.

45. **As part of considering the need for change, the staff is reviewing academic literature, including identified papers that synthesize the academic literature. Is there ongoing research or other information that the staff should consider in evaluating the economic aspects of changes in standards for auditing accounting estimates and fair value measurements?**

The Committee has none to suggest.

We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

Michael D Feinstein

Michael D. Feinstein
Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants