

From: [Pw Carey](#)
To: [Comments](#)
Cc: [Pw Carey](#); tc-pcarey@raland.com; [Robert C. Misyka](#)
Subject: Staff Consultation Paper, Auditing Accounting Estimates and Fair Value Measurements
Date: Monday, November 03, 2014 1:28:40 PM
Attachments: [Pws COMMENTS Submitted Nov. 3rd, 2014 PCAOB August 19th, 2014 SCP Auditing Accounting Estimates Fair Value Measurements.pdf](#)
[Pws COPY Risk Assessments via NIST Six Steps.doc](#)

Dear PCAOB Folks:

Good morning and hope you all are enjoying some nice EST weather....

- Please Note; We've attached our formal comments in support of the PCAOB's 'Fair Value Measurement' initiative regarding Securities, Derivatives et cetera.....
- We have attached both our comments and an example of a supporting Risk Assessment Strategy to your attention.....
- We hope there is a least one useful comment among the pearls.....

In closing, our best wishes in this regard and good luck, too as the goblins manning the gates and barriers to FAIR VALUE reform are spooky looking, at least from a distance....

Respectfully yours,

Pw Carey

Respectfully yours,
Regards / Met vriendelijke groet
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STAFF CONSULTATION PAPER

AUDITING ACCOUNTING ESTIMATES AND FAIR VALUE MEASUREMENTS

AUGUST 19, 2014

This paper was developed by staff of the Office of the Chief Auditor (the "staff") of the Public Company Accounting Oversight Board (the "Board" or "PCAOB"). It is not a statement of the Board, nor does it necessarily reflect the views of the Board or its members.

This paper discusses and solicits comment on certain issues related to auditing accounting estimates and fair value measurements. It describes the staff's preliminary views concerning the potential need for change and presents potential revisions to PCAOB standards in response to that potential need for change. This paper requests comment on these issues and on a possible approach to changing existing standards, as well as possible alternatives.

The staff welcomes comment on the matters discussed in this paper. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the PCAOB's website at: www.pcaobus.org. All comments should refer to the Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*, on the subject or reference line and should be submitted no later than November 3, 2014.

Questions about this paper should be directed to Martin F. Baumann, Chief Auditor (202/207-9192, baumannm@pcaobus.org); Greg Scates, Deputy Chief Auditor (202/207-9114, scatesg@pcaobus.org); Barbara Vanich, Associate Chief Auditor (202/207-9363, vanichb@pcaobus.org); Nike Adesoye, Assistant Chief Auditor (202/591-4177, adesoyen@pcaobus.org); or Dominika Taraszkievicz, Assistant Chief Auditor (202/591-4143, taraszkieviczd@pcaobus.org).

Summary of Comments on Pws_COMMENTS_Submitted_Nov 3rd 2014_PCAOB_August 19th 2014_SCP_Auditing_Accounting_Estimates_Fair_Value_Meas urements (2).pdf

Page: 1

 Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:59:36 AM

Dear PCAOB FOLKS:

Good morning and hope you all will receive our comments in the same spirit they were given.....an honest effort to help out, offered up by a citizen of the United States of America.....

Please Note: The over whelming majority of fraud is conducted around Financial Accounting by folks who look like you and me....this does not address Sovereign

Fraud, Capital Markets Fraud such a LIBOR et cetera...but it's a good start....looking forward to the 2nd Edition....

Please Note: All of our comments are from the point of view of an IT GRC Auditor specializing in Fraud.....Respectfully yours, Pw

 Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Highlight Date: 9/14/2014 12:07:14 PM -04'00'

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Introduction

The staff of the PCAOB's Office of the Chief Auditor is evaluating whether existing PCAOB standards relating to auditing accounting estimates and fair value measurements can and should be improved. This paper seeks additional information to help the staff assess the potential need for changes to the PCAOB standards in this important area and develop a possible approach for the Board's consideration.

As discussed in this paper, auditing accounting estimates and fair value measurements¹ has proven challenging to auditors. Over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.² Through its oversight activities, the PCAOB has observed significant audit deficiencies in this area.³ Deficiencies have been noted in audits performed not only under the standards of the PCAOB, but also under the standards of other standard setters around the world. For example, the past two surveys by the International Forum of Independent Audit Regulators ("IFIAR") found the highest number of deficiencies in audits of public companies to be in the area of fair value measurements.⁴

¹ This paper uses the terms "accounting estimate" and "fair value measurement" to have the same meaning as those terms have in AU sec. 342, *Auditing Accounting Estimates* ("AU sec. 342") and AU sec. 328, *Auditing Fair Value Measurements and Disclosures* ("AU sec. 328") and does not intend to convey that fair value measurements generally are not accounting estimates. The discussion of a potential new standard, including examples of possible requirements, generally uses the term "accounting estimate" to mean both accounting estimates and fair value measurements.

² The Financial Accounting Standards Board ("FASB") has issued standards relating to accounting estimates and fair value measurements. See footnote 16 for additional detail.

³ See, e.g., *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*, PCAOB Release No. 2010-006 (September 29, 2010). See also *Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013).

⁴ See generally *Report on 2013 Survey of Inspection Findings*, IFIAR (April 10, 2014), https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf; and *2012 Summary Report of Audit Inspection Findings*, IFIAR (December 18, 2012),

The staff has had a project on its agenda for a number of years to consider replacement or amendment of the Board's existing standards on auditing accounting estimates and fair value measurements.⁵ During that time, the staff has issued guidance, performed research, and conducted outreach to inform the project, particularly with respect to the use of third parties in determining fair value measurements. This work has included, among other things:

- Six Staff Audit Practice Alerts issued by the PCAOB between 2007 and 2012 that addressed, to varying degrees, auditing accounting estimates and fair value measurements;⁶
- Meetings with the Board's Standing Advisory Group (the "SAG") on auditing fair value measurements, including in 2007 and 2009;⁷
- Meetings with the Pricing Sources Task Force (the "Task Force")⁸ in May, June, and September of 2011 that included discussions on fair value related topics, such as the use of third-party pricing sources and how financial instruments are valued in an illiquid market;
- The ongoing review of inspection findings related to audit deficiencies of both large and small firms concerning accounting estimates and fair value measurements, together with actions the firms have taken to address audit deficiencies; and

[https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-\(2\).pdf](https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-(2).pdf).

⁵ See Office of the Chief Auditor, *Standard-Setting Agenda*, PCAOB (June 30, 2014), http://pcaobus.org/Standards/Documents/201406_standard_setting_agenda.pdf.

⁶ See footnote 18 for a description of these Staff Audit Practice Alerts.

⁷ See *Standing Advisory Group Meeting*, PCAOB (June 21, 2007), http://pcaobus.org/News/Events/Pages/06212007_SAGMeeting.aspx; and *Standing Advisory Group Meeting*, PCAOB (October 14–15, 2009), http://pcaobus.org/News/Events/Pages/10142009_SAGMeeting.aspx, respectively.

⁸ The Task Force of the SAG was formed to assist the staff in gaining insight into issues related to auditing the fair value of financial instruments.

- Continuing coordination and discussion with PCAOB inspection personnel on related matters involving audit firm practices, such as: audit practices related to the use of third-party sources, including pricing services; the use of centralized pricing desks or groups by firms; and how audit firms currently apply specific substantive audit procedures to accounting estimates and fair value measurements.

As part of its work on this project, the staff has been exploring a possible recommendation to the Board for revisions to the Board's existing standards concerning the auditing of accounting estimates and fair value measurements. While the staff continues to analyze a number of alternatives, it is considering developing a single standard (the "potential new standard") for the Board to consider proposing. As envisioned by the staff, the potential new standard could replace AU sec. 342 and AU sec. 328, and replace certain or all of the requirements in AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* ("AU sec. 332") (AU sec. 342, AU sec. 328, and AU sec. 332 are collectively referred to as the "existing standards"). As discussed further in this paper, the potential new standard could be designed to: (i) align with the Board's risk assessment standards;⁹ (ii) generally retain the approaches to substantive testing from AU sec. 328 and AU sec. 342, but include requirements that apply to both accounting estimates and fair value measurements; (iii) establish more specific audit requirements relating to the use of third parties in developing accounting estimates and fair value measurements; and (iv) create a more comprehensive standard related to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application.

Before recommending to the Board a specific standard-setting proposal, the staff is conducting additional outreach by issuing this consultation paper to obtain information and views, beyond what it has learned from the Board's oversight activities. Specifically, the staff is seeking information on: (i) the potential need for changes to the Board's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements and (ii) current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements. For example, the staff is interested in obtaining information about current audit practices related to, among other things, the

⁹ The Board's "risk assessment standards," Auditing Standards No. 8 through No. 15, set forth requirements relating to the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (August 5, 2010).

use of centralized pricing desks or groups by accounting firms, and the use of third parties. The staff also is seeking commenters' views on a possible approach to changing existing standards, and the requirements of a potential new standard. Additionally, the staff is seeking relevant economic data about potential economic impacts of standard setting in this area, including data to inform the PCAOB's economic analysis associated with standard setting in this area.

The staff welcomes input on these matters and any other matters that commenters believe are relevant. While this paper focuses on a preliminary approach to a potential new standard and the audit requirements that might be included in this approach, the staff is also interested in commenters' views on alternative approaches that warrant consideration. This paper also includes general and specific questions and requests for pertinent information and data that will help the staff in developing improvements to the PCAOB's auditing standards in this area.

The Potential Need for Standard Setting

A. Background

In general, accounting estimates are typically derived from an initial measurement, re-measurement, or recognition of a transaction or event in the financial statements. Accounting estimates may be based on subjective or objective information (or both) and involve some level of measurement uncertainty. While some accounting estimates may be easily determinable, others are inherently subjective or complex. Fair value, as a measurement, is defined by the financial reporting frameworks. Under U.S. generally accepted accounting principles ("GAAP"), a fair value measurement represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.¹⁰ Like other accounting estimates, fair value measurements may be based on subjective or objective information and generally involve measurement uncertainty. Accounting estimates and fair value measurements involving a high degree of subjectivity and judgment may be more susceptible to misstatement and generally require more auditor focus.

Financial statements and disclosures of most companies include accounting estimates. Examples of accounting estimates include allowances for doubtful accounts, impairments of long-lived assets, valuations of financial and non-financial assets, and estimates of revenues from contracts with customers.

¹⁰ FASB Accounting Standards Codification ("ASC"), Topic 820, Fair Value Measurement, paragraph 10-35-2.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 7:46:42 AM

Are we referring to potential acts of bad behavior forced upon the parties by the economic realities of raising funds from a Funds Management perspective rather than from a Risk Management perspective.....yep, that's what were referring to.....Respectfully yours, Pw

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 7:50:11 AM

Does this refer to Hedge Accounting, too....such as 'hedge accounting' is designating one or more [hedged instruments] so that a there change in "FAIR VALUE" is an (Off Set) to the CHANCE in "FAIR VALUE" or CASH FLOWS of a 'HEDGED ITEM'; no opportunity here for fudging is there, ere hedging....Respectfully yours, Pw

1 → Currently, a number of auditing standards, issued at different points in time, address how the auditor considers accounting estimates, fair value measurements, derivatives, and investments in securities ("securities"). For example, the risk assessment standards, adopted by the Board in 2010, set forth general requirements for the auditor's assessment of and response to risk in an audit.¹¹ The risk assessment standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results.

Also, the existing standards establish requirements that relate specifically to auditing accounting estimates, fair value measurements, derivatives, and securities. The Board adopted the existing standards in 2003 on an interim basis along with other standards of the American Institute of Certified Public Accountants ("AICPA") in existence at the time.¹²

Briefly, the existing standards cover the following areas:

- 2 →
- AU sec. 328 (originally issued in January 2003) – contains guidance and requirements related to auditing the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.¹³
 - AU sec. 332 (originally issued in September 2000) – contains guidance and requirements related to planning and performing audit procedures for assertions about derivative instruments, hedging activities, and investments in securities. Its scope includes, among other things, requirements for auditing the valuation of derivative instruments and securities, including those measured at fair value.¹⁴

¹¹ See PCAOB Release No. 2010-004.

¹² On April 16, 2003, the PCAOB adopted on an interim, transitional basis, the generally accepted auditing standards, described in the AICPA's Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, then in existence. Since that time, the Board has superseded or amended many of those auditing standards and has been engaged in updating and reconsidering the remaining standards and, more recently, aligning them with the risk assessment standards.

¹³ See generally AU sec. 328.01.

¹⁴ See generally AU secs. 332.01–.04.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 7:53:35 AM

Can they also do open heart surgery while standing on one foot....?...give us a break, it's at this point in time they should be required to call in outside expertise knowledge to assist in conducting an audit that can protect the interests of the Investment Community...Pw

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:05:48 AM

Does this take into account cross-border jurisdictional disputes, Safe Harbor, multi-layers of imbedded derivaties, and multiple proxys and multi-layers of Counter-Party Credit Exchanges (Regulated) and OTC's (Un-Regulated)....which reminds us, that Dodd-F bill (HR contains 253 Exemptions and only 800 plus use of the term...."may"...as in we may follow the rules or we may not.....is this our standard for protecting the interests of the investment community, (aka: that little guy standing in the corner...shivering) not that fat turkey who based on recent history, is above the law.....oops, please disregard that inadvertent editorial....Respectfully yours, Pw



- AU sec. 342 (originally issued in April 1988) – contains guidance and requirements related to auditing accounting estimates.¹⁵

Since the issuance of the existing standards, the financial reporting frameworks have continued to evolve. Over the last decade, there have been changes in the financial reporting frameworks related to accounting estimates and an increasing use of fair value as a measurement attribute, along with new disclosure requirements.¹⁶ FASB's adoption of a definition of fair value for financial reporting purposes provided clarification on how fair value should be measured; for example, market participant assumptions must now be considered.¹⁷

Financial instruments also continue to evolve. The complex nature of some financial instruments creates challenges in determining their value, which can be based primarily on unobservable inputs (that is, inputs not corroborated by market data). As a result, many companies and auditors use third parties, including pricing services, to obtain information relevant to determining and auditing fair value or estimates of fair value for financial instruments, which may or may not be developed using unobservable inputs.²

In addition, a number of other accounting estimates in a company's financial statements may be developed by management using information provided by third parties. For example, companies often use a valuation specialist to inform

¹⁵ See generally AU sec. 342.01.

¹⁶ See, e.g., *Statement of Financial Accounting Standards ("SFAS") No. 159: The Fair Value Option for Financial Assets and Financial Liabilities*, FASB (February 2007), <http://www.fasb.org/pdf/fas159.pdf>. See also paragraph B41 of *SFAS No. 141 (Revised 2007): Business Combinations*, FASB (December 2007), <http://www.fasb.org/pdf/fas141r.pdf>, at 62 (listing in the basis for conclusions as a reason to eliminate the pooling method: "Both Boards observed that the pooling method is an exception to the general concept that exchange transactions are accounted for in terms of the fair values of the items exchanged."). See also *Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606)*, FASB (May 2014), <https://asc.fasb.org/imageRoot/00/51801400.pdf>.

¹⁷ See FASB ASC subparagraph 820-10-05-1C ("Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, a reporting entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value").

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 10:03:12 AM

But wait...there's beams of hope of light flowing from the SEC's wand-of-clarification...addressing 'hedge accounting' such as the following:

ISDA had requested that the SEC staff determine whether hedge accounting under U.S. GAAP should be terminated if a derivative that is designated as a hedging instrument is novated to a different counter-party with the same financial terms. The SEC staff's guidance indicates that it would not object to a conclusion for accounting purposes that the original derivative contract has not been terminated and replaced with a new derivative, nor would it object to the continuation of the existing hedging relationship. This guidance is specific to situations in which the terms of the contract remain the same, excluding changes that were caused by the novation, and any of the following circumstances exist:

For an OTC derivative entered into applying the mandatory clearing requirement, an entity voluntarily clears the OTC contract through a central counter-party, even if the counter-parties did not agree to clearing and novation when they entered into the transaction;

• For an OTC derivative entered into applying the mandatory clearing requirement, the counter-parties agree in advance to clear through a central counter-party according to standard market terms and conventions, and the entity's hedging documentation describes the counterparties' expectations that the OTC derivative will be novated to the central counter-party; or

• A counter-party to an OTC derivative who is prohibited by the Act (or is expected to be prohibited) from engaging in certain types of derivative transactions novates the underlying OTC derivative contract to a consolidated affiliate that is not insured by the FDIC and does not have access to Federal Reserve credit facilities.

.....(just more mud)...Doesn't make sense to me, but then I'm just a Citizen.....

Lastly, we've never met a Novation we didn't want to kick to the curb.....
Respectfully yours, Pw Carey

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:15:36 AM

Who pays for these Pricing Services....?....as in, we'll give you fifty bucks if you give us a really, really, really 'fair value'.....quick note: The more there is greater layers of complexity associated with a financial instrument/product the greater is the opportunity for FRAUD.....that is difficult to detect and then prove in a court of law.....Respectfully yours, Pw

management's estimation of the value of assets acquired and liabilities assumed in a business combination or to assess whether intangible assets are impaired.

The complexity and risks of material misstatement associated with certain accounting estimates and fair value measurements, as well as the changes in the overall economic environment affecting estimates since the adoption of the existing standards, have led the staff to prepare several Staff Audit Practice Alerts to highlight considerations relevant to auditing accounting estimates and fair value measurements.¹⁸

B. ~~The~~ ² **Potential Need for Improvement**

The potential need for improvement to the Board's standards in the area of accounting estimates and fair value measurements is illustrated by a number of factors that are summarized briefly below. These include: (i) audit deficiencies noted by the PCAOB and by other audit regulators; (ii) the changes in the financial reporting frameworks relating to accounting estimates, including fair value measurements; (iii) changes in the methods used to develop accounting estimates and fair value measurements, including the growing reliance on the work of third parties; and (iv) concern expressed by some auditors over perceived inconsistencies in the existing standards.

As previously noted, revisions to the financial reporting frameworks affect the use of management judgments and estimates in significant accounts. Recently, for example, in May 2014, the FASB and the International Accounting Standards Board issued new requirements for recognizing revenue from contracts with customers. The recognition of revenue under the new accounting standard requires, among other things the determination of a transaction price, which may include variable consideration; the allocation of the transaction price to the performance obligations in the contract; and

¹⁸ Staff Audit Practice Alerts relevant to auditing accounting estimates and fair value measurements include: (1) *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, Staff Audit Practice Alert No. 2, (December 10, 2007); (2) *Audit Considerations in the Current Economic Environment*, Staff Audit Practice Alert No. 3 (December 5, 2008); (3) *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*, Staff Audit Practice Alert No. 4 (April 21, 2009); (4) *Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities*, Staff Audit Practice Alert No. 7 (December 20, 2010); (5) *Assessing and Responding to Risk in the Current Economic Environment*, Staff Audit Practice Alert No. 9 (December 6, 2011); and (6) *Maintaining and Applying Professional Skepticism in Audits*, Staff Audit Practice Alert No. 10 (December 4, 2012).

 Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:20:21 AM

Are these 'valuation specialists' the same folks who worked for Moody's & S&P, et al...during the TARP fiasco and are they the same folks who rated TOXIC/CRAP Securities AAA....hope not.....Respectfully yours, Pw

 Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Cross-Out Date: 11/3/2014 8:21:10 AM

 Number: 3 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:22:42 AM

Please limit your use of caveats, which is much better than the Dodd-F baseline....keep up the good effort....Pw

determination of when performance obligations are satisfied. These procedures may involve adjusting the transaction price for the time value of money, estimating the amount of variable consideration to which the company will be entitled, and estimating the relative standalone selling price.¹⁹ Given that revenue is one of the most important measures used by investors, and that improper revenue recognition represents a presumed fraud risk,²⁰ the staff expects that revenue recognition and the related accounting estimates will continue to warrant significant audit attention.

The complexity inherent in auditing certain accounting estimates and fair value measurements also has been raised at various meetings of the SAG.²¹ In these meetings, many SAG members recognized the complexities related to accounting estimates and fair value measurements, and were generally supportive of the Board's standard-setting efforts in these areas. Discussions with the SAG led to the formation of the Task Force, which included auditors, issuers, investors, regulators, and representatives from several pricing sources. The Task Force held several meetings in 2011 and focused primarily on the use of third-party pricing sources to determine fair value of financial instruments, including issues observed when auditing fair value measurements of financial instruments that are not actively traded and issues regarding how third-party sources develop their estimates. During the meetings, information was obtained about the different valuation methodologies used by pricing sources, including the extent of transactions of comparable instruments and broker quotes used in the development of prices. Other topics discussed included types of substantive audit procedures that are used when a range of acceptable prices exists and auditors' use of centralized approaches to performing certain substantive procedures.

The staff's assessment of the potential need for changes to the existing standards also has been informed, in part, by the work and experience of other auditing standard setters that have updated and amended their standards. For example, the International Auditing and Assurance Standards Board ("IAASB") in 2009 issued a single standard that establishes requirements related to auditing accounting estimates and fair value estimates, International Standard on Auditing 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* ("ISA 540"). The ASB issued an analogous standard, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* ("AU-C

¹⁹ See generally *Accounting Standards Update 2014-09, Revenue from Contracts with Customers*, FASB in Focus (FASB, Norwalk, Connecticut), May 28, 2014 at 1.

²⁰ See generally paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

²¹ See footnote 7.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:31:54 AM

**We believe this is a good time to introduce the concept of Auditor's vs Treasurers be modified to Auditor's Collaborating with Treasurers to understand their daily/quarterly juggling of the books; (P&L, Cash Flows, Debt Equity, Assets and Liabilities, et cetera) both near-term and long term for a clear and true representation of the forces driving many of their management decisions and the significant GAPS in their knowledge and expertise surrounding derivatives....to name just one....
....Respectfully yours, Pw**

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 10:17:05 AM

Provide entities with 30 days from time of identification of improper revenue recognition an opportunity to correct and re-published, before instantaneous\$10,000.00 dollar per day penalties are invoked up to a maximum fine, based upon the size of the restatement....Respectfully yours, Pw

Number: 3 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 10:21:37 AM

Here's a thought.....Perform a small number of Stress Tests vs Investment Grade Indices....and compare the results (near-term, mid-term & long-term).....

Impact of the Counter-Party Credit Risk Spread Exposure....

Calculate your credit curve by buying 5 years of Credit by converting the Credit curve with the Credit Recovery....(a sliding scale, not static...)....Pw

540").²² However, notwithstanding these revisions to auditing standards, the issue of fair value measurement continues to be an issue of ongoing concern for audit regulators globally.²³

Observations from the Board's oversight activities may illustrate some of the challenges of auditing accounting estimates and fair value measurements. The Board's inspection staff has identified audit deficiencies, at both large and small audit firms, that relate to various types of fair value measurements and accounting estimates.²⁴ Deficiencies were observed relating to auditing data and testing assumptions used in determining fair values, as well as issues relating to understanding information provided by third-party pricing sources sufficient to assess reliability and relevance of the information. Deficiencies were noted related to various aspects of substantive testing, including numerous situations in which auditors did not adequately test fair value measurements. Deficiencies were also noted related to auditing accounting estimates for a variety of audit areas, including the allowance for doubtful accounts or loan losses, goodwill and intangible asset impairment, inventory valuation allowances, and income tax valuation allowances.

The staff is in the process of reexamining the existing standards in view of the nature and extent of the Board's inspection findings. The staff understands that some auditors have expressed concern over perceived inconsistencies in the existing standards, including the existing standards' scope and required procedures. The staff

²² The IAASB and ASB did not issue a separate standard for auditing derivatives and securities.

²³ See generally *Report on 2013 Survey of Inspection Findings*, IFIAR (April 10, 2014) at 1 https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf, ("The survey, conducted in 2013, indicates the persistence of deficiencies in important aspects of audits and that there is a basis for ongoing concerns with audit quality."); *id.* at 2 ("For audits of listed [public interest entities (e.g., publicly traded companies)], the three inspection themes with the highest number of findings were: [f]air value measurement, [i]nternal control testing, and [a]dequacy of financial statements and disclosures.") (emphasis added). See also *2012 Summary Report of Audit Inspection Findings*, IFIAR (December 18, 2012), [https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-\(2\).pdf](https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-(2).pdf), at 2 ("The survey results indicate that the largest number of inspection findings in audits of public companies occurred in the following areas: [f]air value measurements; [i]nternal control testing; and [e]ngagement quality control reviews.") (emphasis added).

²⁴ See PCAOB Release No. 2010-006. See also PCAOB Release No. 2013-001.

has observed that while the existing standards became effective at different times and differ in scope, they share a number of common concepts and, in certain cases, common audit procedures.

The factors discussed previously, including the effect of changes to the financial reporting frameworks relating to accounting estimates and fair value measurements since the issuance of the existing standards, the complexity of certain accounting estimates and fair value measurements, and the evolution of auditing practices for testing the valuation of financial instruments, suggest the need to consider updating the existing standards. Further, the number of audit deficiencies identified in the Board's oversight activities also have led the staff to consider whether changes to the existing standards could improve audit quality, including by addressing perceived inconsistencies, further integrating the requirements of the existing standards with those of the risk assessment standards, and adding requirements in certain areas, such as with respect to the auditor's use of third parties.

C. Current Requirements and Certain Audit Practices

1. Current Requirements

As discussed above, current requirements of the PCAOB relating to auditing accounting estimates and fair value measurements are in the risk assessment standards and also in the existing standards.

The risk assessment standards set forth the foundational requirements for identifying, assessing, and responding to risk in an audit, and for evaluating the results of the audit. The risk assessment standards include requirements that apply broadly in an audit and contain several requirements that are specific to accounting estimates. Those requirements include specific procedures regarding identifying and assessing risks of material misstatement in accounting estimates,²⁵ evaluating identified misstatements in accounting estimates,²⁶ and evaluating potential management bias associated with accounting estimates.²⁷

The existing standards contain specific procedures relevant to auditing accounting estimates and fair value measurements. AU sec. 328 and AU sec. 342 provide the primary procedural requirements related to auditing fair value

²⁵ See *generally* paragraph 13 of Auditing Standard No. 12.

²⁶ See paragraph 13 of Auditing Standard No. 14, *Evaluating Audit Results*.

²⁷ See paragraph 27 of Auditing Standard No. 14.

measurements and accounting estimates. These standards share common approaches for substantively testing accounting estimates and fair value measurements and certain common concepts under each approach. In general, there are three approaches common to both standards, as discussed below. When performing an audit, the auditor selects one or a combination of these approaches.

- Testing management's process.



- The auditor generally evaluates significant assumptions used by management for reasonableness and tests the data used, including evaluating whether the data is complete, accurate and relevant.²⁸
- The auditor also evaluates the consistency of assumptions used by management.²⁹

- Developing an independent estimate.



- The auditor can use management's or alternative assumptions to develop an independent estimate or an expectation as to the estimate.³⁰

- Reviewing subsequent events or transactions.



- The auditor can use events or transactions occurring subsequent to the balance sheet date but prior to the date of the auditor's report to provide evidence about the reasonableness of the estimate.³¹

In addition to the common concepts described above, AU sec. 328 specifies additional procedures for testing management's process and developing an independent estimate.³² For example, when the company estimates fair value using a valuation method, AU sec. 328.18 requires the auditor to evaluate whether the company's method of measurement is appropriate in the circumstances. AU sec. 332 primarily addresses auditing derivative instruments and the related assertions. This

²⁸ See generally AU sec. 342.11 and AU secs. 328.26–.39.

²⁹ *Id.*

³⁰ See generally AU sec. 342.12 and AU sec. 328.40.

³¹ See generally AU sec. 342.13 and AU secs. 328.41–.42.

³² See generally AU secs. 328.26 –.40.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:48:02 AM

Does this include addressing some of the following positive and negative aspects impacting both Exchange Traded Derivatives vs OTC Derivatives:

How the market changes over time

How Exchange Rates Change Over Time

Changes in Market Rates

Potential Exposure of a Derivative Over-Time

Spot Exchange Market Rates Over-Time

Periodic Cash Flows That Settle Over-Time

Counter-Party Transactions...

Potential Liability to a Counter-Party

EPE Expected Positive Expense

ENE Expected Number Expense (Over Multiple Jurisdictions)....

Margin or Netted....? it's a choice.....

Credit Exposure

Credit Risk Premium (that the Counter-Party might not Perform)

What Assets Do we need to Find?

What is our Margin Risk based upon our Liquidity Risks....? and what about CVA....? CREDIT VALUE ADJUSTMENTS.....how many folks out there in the Great White Way understand, really understand what this all means...

Ok, just pick one....Respectfully yours, Pw

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:51:55 AM

Using the term 'management' and 'independent estimate' in the same sentence.....is just plain silly...or if you prefer...it's an oxymoron....dummy....(aka: Our President is a Genius, per say)....Respectfully yours, Pw

Number: 3 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 8:54:48 AM

Or, evidence of other frauds being perpetrated at another previous point in time....neat eh?.....Respectfully yours, Pw

standard also includes requirements regarding auditing valuation, including valuation based on an investee's financial results and testing assertions about securities based on management's intent and ability.³³

2. Certain Aspects of Current Practice

As described above, the Board, through its oversight activities, has observed practice issues and reviewed inspection findings relating to the auditor's evaluation of accounting estimates and fair value measurements. The staff understands that, in response to such inspection findings, some audit firms have taken steps to modify their internally developed audit guidance to improve compliance with the existing standards.



The PCAOB staff also has obtained information and conducted outreach to further understand current firm practices. The staff understands that many firms with international audit practices are familiar with and use ISA 540. Additionally, the staff has conducted outreach relating to how audit firms use third-party sources in the determination of accounting estimates and fair value measurements, including through the Task Force. The staff's understanding is that, depending on the nature of the estimate, such third-party sources may include, among others:

- Pricing services, which may provide pricing information generally available to customers; and
- Specialists,³⁴ who may develop independent estimates or assist in evaluating a company's estimate or the work of the company's specialist.

Some larger audit firms have implemented centralized approaches to developing independent estimates of fair value measurements of financial instruments. These firms may use centralized, national-level pricing desks or groups to perform certain procedures relating to the pricing of financial instruments. The level of information provided by these centralized groups to engagement teams varies. In some cases, the national-level pricing desk obtains price quotes from third-party pricing services and provides these quotes to the audit engagement team. In other cases, the national-level pricing desk itself may develop estimates of fair value for certain types of securities.

³³ See generally AU secs. 332.28 – .34 and AU secs. 332.56 – .57.

³⁴ The staff's agenda has a separate project relating to the use of specialists, *Auditors' Responsibilities with Respect to Other Accounting Firms, Individual Accountants, and Specialists*. See Office of the Chief Auditor, *Standard-Setting Agenda*, PCAOB (June 30, 2014), http://pcaobus.org/Standards/Documents/201406_standard_setting_agenda.pdf.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 9:02:44 AM

We must have missed it along the way....but we didn't see any statistics, standards, regulations, testing procedures addressing:

Corporate Culture,

as in a fish stinks from the head.....(aka: Corp. Culture drives the majority (90%) of all fiduciary, ethical, business, regulatory decisions made on a daily, on-going basis....(more or less)....via the invisible Corp. thumb is on the scales measuring 'Fair Value'just a thought....looking forward to seeing Corp. Culture addressed in the future....Respectfully yours, Pw

National-level pricing desks or valuation specialists employed by audit firms sometimes perform an analysis of prices obtained from pricing services, interact with the pricing services to obtain an understanding of controls and methodologies, and may provide information to inform an audit engagement team's risk assessment or evaluation of audit differences. In other cases, engagement teams do more of this work themselves.

As will be further discussed, the staff is exploring whether audit procedures tailored to the source of information used by the auditor are appropriate for developing an independent estimate. The staff is also seeking comment on emerging developments in current audit practices, particularly those related to the use of third parties including pricing services. The staff is specifically requesting views and relevant data on the following:

Questions:

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

Staff Consideration of Alternative Approaches

A. Alternative Approaches

The staff has identified a number of alternative approaches that the Board may wish to consider to address the issues raised regarding auditing accounting estimates and fair value measurements. The staff is interested in views relating to these alternative approaches, which are summarized below, together with certain considerations that may be relevant to the appropriateness of those alternatives.

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 9:11:06 AM

As in one Latin American country, (Brazil) all Security Transactions are Registered....regardless.....and to go one further, each Registered Transaction must be published to the outside world for Public viewing and review, and published to the Regulatory Industries.....what a concept.....this could also be implemented whenever the PCAOB conducts an assessment/investigation of the Audit Services Industry.....Push the results to the outside world for the Public's viewing and review.....or, Provide a Notice that if the Investment Community would like to view the PCAOB's report they can contact the following individual at the entity contained in the Report.....Respectfully yours, Pw

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 10:26:13 AM

Does your efforts in knowledge gathering come with a 'Get Outta Jail Free' card.....for those you all interview, and document and identify.....?

Respectfully yours, Pw

Issue Staff Guidance

One alternative approach to standard setting would be for the staff to issue additional staff guidance. Since 2007, the PCAOB has issued six Staff Audit Practice Alerts that discuss various issues relating to auditing accounting estimates and fair value measurements.³⁵ The staff has considered issuing additional practice alerts or other staff guidance specific to the use of third parties, such as pricing services.³⁶ This approach could provide targeted guidance to auditors in a relatively short period of time. However, guidance issued by the staff would be limited to discussing the auditor's application of the existing standards and therefore may not be a long-term solution to the issues raised in this paper regarding auditing accounting estimates and fair value measurements.

Develop a Separate Standard on Auditing Fair Value of Financial Instruments in Addition to the Existing Standards

The staff has considered developing a separate standard that would specifically address auditing the fair value of financial instruments. This approach could provide a framework for auditors specific to an area that may pose significant auditing challenges. Existing PCAOB standards, however, already include requirements for auditing fair value measurements and for auditing derivatives and securities, and the addition of a separate standard could result in confusion and potential inconsistencies in the application of these standards. Additionally, the auditing issues pertinent to accounting estimates and fair value measurements, including financial instruments, inherently overlap.

Enhance Existing Standards on Auditing Accounting Estimates and Fair Value Measurements Through Targeted Amendments

The staff has considered amending, rather than replacing, the three existing standards relating to auditing accounting estimates, fair value measurements, derivatives, and securities. This approach could involve fewer changes to firms' existing audit methodologies. However, retaining multiple standards with similar requirements would not eliminate redundancy and could result in confusion and potential inconsistencies in the application of the standards. In addition, the nature and extent of

³⁵ See footnote 18.

³⁶ Other standard setters have issued guidance relating to their existing standards. For example, the IAASB issued International Auditing Practice Note 1000, *Special Considerations in Auditing Financial Instruments* (December 16, 2011), to provide guidance to auditors when auditing fair value measurements of financial instruments.



Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 9:22:45 AM

Provide the Auditor, with the Blue Attestation Screen of Death Certificate (the one with the Gold Trim Filigree)....which states the following:

**At this point in time, based upon the information and data provided by [insert entities name here] management team [insert full names of the management team here] we cannot attest to the correctness and/or accuracy of their Fair Value estimates, as they have been applied by this Management Team to this entities assets and liabilities
.....Respectfully yours, Pw Carey**

amendments that could be made to the existing standards could essentially result in new standards.

Issue a New Single Standard That Addresses Auditing of Accounting Estimates and Fair Value Measurements and Supersedes the Existing Standards

As discussed in this paper, the staff is currently considering developing a single standard on auditing accounting estimates and fair value measurements for the Board to consider proposing. The potential new standard the staff is considering would replace the existing standards. While this approach to standard setting may involve more significant change to existing PCAOB standards, a single standard on auditing accounting estimates and fair value measurements could provide a more comprehensive approach to auditing accounting estimates and fair value measurements that could promote more consistent auditor performance. In addition, a potential new standard that is further integrated with the risk assessment standards could help auditors improve their overall assessments of and responses to risks of material misstatement, including risks associated with accounting estimates and fair value measurements.

While this paper focuses on the development of a potential new standard, the staff is continuing to consider the various approaches described above and is seeking commenters' views on these matters.

B. Overview of the Approach Being Considered by the Staff

As noted above, based on research and outreach to date, the staff is considering developing a single standard for the Board to consider proposing that would supersede AU sec. 328 and AU sec. 342, and much of AU sec. 332. The potential new standard could be designed to: (i) align with the risk assessment standards; (ii) generally retain the approaches to substantive testing from AU sec. 328 and AU sec. 342, but include requirements that apply to both accounting estimates and fair value measurements; (iii) establish more specific audit requirements related to the use of third parties in developing accounting estimates and fair value measurements; and (iv) create a more comprehensive standard related to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application.

Notably, the research and outreach conducted by the staff to date have not led the staff to initially conclude that the common approaches for testing accounting estimates and fair value measurements in the existing standards should be replaced. The potential new standard also could take into account the various ways that auditors develop independent estimates.



 Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Highlight Date: 11/3/2014 10:32:29 AM

 Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 10:34:26 AM

Then why are you all taking up our time and courteous attention, if you don't see the need....(aka: nothing to see here, keep moving.....nothing to see here....keep moving...) Respectfully yours, Pw

A potential new standard also could supersede the requirements in AU sec. 332 related to auditing the valuation of derivatives and securities. AU sec. 332 includes guidance and requirements related to auditing assertions, other than valuation with respect to derivatives and securities, that in many cases are duplicative of the requirements in the risk assessment standards. The staff is interested in commenters' views on (i) whether to supersede AU sec. 332 in its entirety, (ii) whether elements of AU sec. 332 should be retained, and (iii) whether enhancements could be made to this standard that could result in improved audit quality.

The staff is requesting views and relevant data on the following:

Questions:

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?
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?
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?
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?
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?

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 9:53:49 AM

Yes, yes, yes.....&....yes, such as the following considerations must be addressed and resolved to protect the interests of the Investment Community....and it's chubby cousin Sarah Guv.

Always think; '...what's best for that little guy shivering in the corner?.....':

**Adjust Market to Market Derivatives Processes from 15 years ago....
updated to LIBOR (London Inter-Bank Obligation Rates) currently undergoing billions of dollars in fines and penalties for fraud by all major banks...about 15 more or less....**

How do you take the Credit Risk for a Bond into account...

All Bond Cash Flows are Positive...

The Risk Free Rate....Discounting The Risk Premium

How to Measure a Credit Risk Swap?:

The Entire Port Folio Analysis

Credit-Risk Premium

Uncertainty Estimates...

Bi-Lateral Notes of a Cash Flow Swap....spread out to 15 years....or longer....or shorter...

Market Risk vs Credit Risk....

Also consider The Survival Rate...business decisions made when a Counter-Party may not be around any longer in time to pay off their loan obligation and/or debt obligation...and how should this be handled....with another derivative loan....?

**Place boundaries on some hedging activities when faced with Extreme Adverse Events....(aka: no tingo dinero)....Respectfully yours,
Pw Carey**

Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:10:07 AM

Don't forget to reach out to the EU in Europa....as they have a different way of looking at things, such as the following:

The International Accounting Standards Board (IASB) today announced the completion of a package of amendments to the accounting requirements for financial instruments. The amendments:

- 1. bring into effect a substantial overhaul of hedge accounting that will allow entities to better reflect their risk management activities in the financial statements;**
2. allow the changes to address the so-called 'own credit' issue that were already included in IFRS 9 *Financial Instruments* **to be applied in isolation without the need to change any other accounting for financial instruments;** and
- 3. remove the 1 January 2015 mandatory effective date of IFRS 9,** to provide sufficient time for preparers of financial statements to make the transition to the new requirements.

Hedge accounting

The IASB has today introduced a new hedge accounting model, together with corresponding disclosures about risk management activity for those applying hedge accounting.

The changes to hedge accounting and the associated disclosures were developed in response to concerns raised by preparers of financial statements **about the difficulty of appropriately reflecting their risk management activities in the financial statements.**

The changes also address concerns raised by users of the financial statements about the difficulty of understanding hedge accounting.

The new model represents a substantial overhaul of hedge accounting that will enable entities to better reflect their risk management activities in their financial statements.

The most significant improvements apply to those that hedge non-financial risk, and so these improvements are expected to be of particular interest to non-financial institutions.

As a result of these changes, **users of the financial statements will be provided with better information about risk management** and about the **effect of hedge accounting on the financial statements.**

Own credit

As part of the amendments, **the changes introduced also enable entities to change the accounting for liabilities that they**

A potential new standard also could supersede the requirements in AU sec. 332 related to auditing the valuation of derivatives and securities. AU sec. 332 includes guidance and requirements related to auditing assertions, other than valuation with respect to derivatives and securities, that in many cases are duplicative of the requirements in the risk assessment standards. The staff is interested in commenters' views on (i) whether to supersede AU sec. 332 in its entirety, (ii) whether elements of AU sec. 332 should be retained, and (iii) whether enhancements could be made to this standard that could result in improved audit quality.

The staff is requesting views and relevant data on the following:

Questions:

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?
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?
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?
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?
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?

have elected to measure at fair value, before **applying any of the other requirements in IFRS 9**.

This change in accounting would mean that:

1. gains caused by a **worsening in an entity's own credit risk on such liabilities**
2. are no longer recognised in profit or loss.

Please ignore our Editorial outburst Respectfully yours, Pw Carey.....**SO WHERE ARE THEY RECOGNIZED...DUMMY?**

Today's amendments will facilitate earlier yours, application of this long-awaited improvement to financial reporting.

9. Are there considerations relevant to auditing accounting estimates and fair value measurements including other regulatory requirements³⁷ specific to certain industries that the staff should take into account?

Key Aspects of a Potential New Standard and Related Potential Requirements

This section discusses possible options for a potential new standard on auditing accounting estimates and fair value measurements (generally referred to as "accounting estimates" in this section) as well as related potential requirements under consideration. Similar to the existing standards, the objective of the auditor under a potential new standard would be to obtain sufficient appropriate audit evidence to determine whether accounting estimates are reasonable and in conformity with the applicable financial reporting framework. Although the staff continues to explore potential alternatives, this discussion focuses and seeks input on the approach of auditing accounting estimates through a single standard.

In summary, under the approach being considered by the staff:

- The auditor would continue to perform procedures in accordance with Auditing Standard No. 12 to identify and assess risks of material misstatement related to accounting estimates, and continue to perform procedures in accordance with Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, to design and implement an audit response to the identified and assessed risks. These include substantive procedures and, as appropriate, tests of controls.
 - Targeted amendments could be proposed to Auditing Standards Nos. 12 and 13 to specifically address accounting estimates and the related disclosures in certain areas.
- A potential new standard on accounting estimates would generally not duplicate or restate risk assessment requirements relating to the auditor's identification and assessment of risks of material misstatement in these areas. The potential new standard could establish specific requirements for performing substantive audit procedures for the auditor's response to identified and assessed risks of material misstatement related to accounting estimates.

³⁷ See, e.g., U.S. Securities and Exchange Commission ("SEC"), *Codification of Financial Reporting Policies Section 404.03, Accounting, Valuation and Disclosure of Investment Securities*, Accounting Series Release No. 118 (December 23, 1970).

Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:22:41 AM

Mandatory Auditor Obligation: Unless the Auditor can fully understand the near-term, mid-term and long-term risks linked directly to the financial products being used by the Management Team (at the C-Suite Level) to ameliorate the negative impacts on the operation and survivability of the business of too much debt and/or too little debt (aka: a take over target).....they can not attest to the material effective outcome of their chosen strategy at that point in time.....; Pw

- The specific requirements included in the potential new standard could generally retain the approaches for substantive audit procedures included in AU sec. 328 and AU sec. 342, but refine the requirements under each approach so that they are applicable to both accounting estimates and fair value measurements. For example:

- Testing the company's process could include:



- Evaluating specific considerations regarding whether the company's method used to develop accounting estimates is appropriate;
- Audit procedures for testing data, including accuracy and completeness of the data, internal consistency of the data, and relevance to the measurement objective for the accounting estimate;
- Factors to assist the auditor in identifying significant assumptions;
- Factors that the auditor evaluates in determining the reasonableness of significant assumptions and
- Auditor considerations when management uses a specialist.

- Developing an independent accounting estimate ~~could~~ include:



- Audit procedures tailored to whether the data and assumptions used in the independent accounting estimate were produced by the company, determined by the auditor, or obtained from a third party; and
- Audit procedures specific to evaluating evidence obtained from third-party sources related to fair values of financial instruments.

 Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:28:51 AM

Industry Peer Evaluation across the mean, median and mode of the Industry...will identify an Out Lier compared against their Industry.....Plus: Corporate Culture Assessment, using th e also familiar, often used yet never cited; '...Is there a strong oder coming from the Head of The Fish Algorithm....'

Respectfully yours, Pw

 Number: 2 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Cross-Out Date: 11/3/2014 11:29:24 AM

 Number: 3 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:33:34 AM

Will automatically generate triggers, red flags, fireworks and balloons tied into various exotic animal shapes, by a scary giant Clown.....Pw

- Evaluating audit evidence from subsequent events could include:
 - Factors for the auditor to take into account in evaluating the relevance of audit evidence from subsequent events or transactions.

A. Alignment with the Risk Assessment Standards

The staff is considering an approach to integrate a potential new standard with the risk assessment standards. The risk assessment standards set forth the foundational requirements for identifying, assessing, and responding to risk in an audit, and for evaluating the results of the audit. As a result, the staff believes it is important to consider the interaction of the risk assessment standards with any new auditing standards, especially standards that establish audit performance requirements. While the risk assessment standards apply broadly to identifying, assessing, and responding to risk in an audit, they also include requirements that are specific to accounting estimates.³⁸ In addition to the risk assessment standards, the existing standards also contain certain requirements that include elements of assessing the risks of material misstatement and that are specifically relevant to accounting estimates.³⁹



As discussed earlier, under existing requirements, the auditor performs risk assessment procedures in accordance with Auditing Standard No. 12 to identify and assess risks of material misstatement related to accounting estimates and in accordance with Auditing Standard No. 13 to design and implement an audit response to the identified and assessed risks, including substantive procedures and, as appropriate, tests of controls. Under the approach being considered by the staff, a potential new standard could establish specific requirements for performing substantive audit procedures in response to identified and assessed risks of material misstatement related to accounting estimates, and generally would not duplicate or restate requirements relating to identifying and assessing those risks presented in Auditing Standard No. 12.

Additionally, the staff is exploring certain targeted amendments to the risk assessment standards that specifically address matters relating to accounting estimates. The potential amendments and the staff's possible approach for integrating a potential new standard with the risk assessment standards are discussed below.

³⁸ See, e.g., paragraph 27 of Auditing Standard No. 14.

³⁹ See, e.g., AU sec. 328.09.

 Number: 1 Author: Pw Carey, Senior IT Auditor (GRC), CISSP, CISA Subject: Compliance Partners, LLC, Barrington, IL 60010 USA
Date: 11/3/2014 11:46:43 AM

Please Refer to Attached Risk Assessment as one example of a Risk Assessment Strategy.....Pw

1. Identifying and Assessing Risks of Material Misstatement

Auditing Standard No. 12 establishes requirements regarding the process of identifying and assessing risks of material misstatement.⁴⁰ This process involves obtaining an understanding of the company and its environment,⁴¹ including among other things, the company's selection and application of accounting principles, and related disclosures.⁴² Auditing Standard No. 12 further states that the accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions, are relevant to the understanding of the company's selection and application of accounting principles.⁴³

The risk assessment process under Auditing Standard No. 12 also involves obtaining an understanding of internal control over financial reporting.⁴⁴ This includes obtaining an understanding of the company's risk assessment process, information system relevant to financial reporting, and control activities. These requirements inform the auditor's understanding of how the company develops accounting estimates including related internal controls.

Further, Auditing Standard No. 12 requires the auditor to identify the significant accounts and disclosures and their relevant assertions based on their qualitative and quantitative risk factors such as the nature of the account or disclosure and the accounting and reporting complexities associated with the account or disclosure.⁴⁵ Accordingly, with respect to accounting estimates, it is important for the auditor to evaluate the nature of the asset or liability being valued and the measurement objective of the accounting estimate in determining whether the related account or disclosure is significant. The auditor also should determine the likely sources of potential misstatements related to accounting estimates. This includes determining whether the

⁴⁰ See paragraph 1 of Auditing Standard No. 12.

⁴¹ See *generally* paragraphs 7 through 17 of Auditing Standard No. 12.

⁴² See paragraph 7.c. of Auditing Standard No. 12.

⁴³ See paragraph 13 of Auditing Standard No. 12.

⁴⁴ See *generally* paragraphs 18 through 40 of Auditing Standard No. 12.

⁴⁵ See paragraph 60 of Auditing Standard No. 12.

components of accounting estimates and the related disclosures are subject to significantly differing risks.⁴⁶

Lastly, under Auditing Standard No. 12, the auditor should determine whether any of the identified and assessed risks are significant risks; this includes identified and assessed risks related to accounting estimates.⁴⁷

As the requirements in Auditing Standard No. 12 already apply to accounts and disclosures involving accounting estimates, additional audit requirements to identify and assess risks of material misstatement may not be necessary in a potential new standard. However, the staff is exploring whether certain targeted amendments to Auditing Standard No. 12, as further discussed, could enhance the existing requirements for identifying and assessing risk as they relate to accounting estimates.

Questions:

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?
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?

a. Understanding Processes Used to Develop Accounting Estimates



The staff is considering recommending to the Board a potential amendment to Auditing Standard No. 12 to emphasize that the auditor, as part of understanding internal control over financial reporting, should understand the company's methods, data, assumptions, and use of third parties in developing accounting estimates. Auditing Standard No. 12 already requires that the auditor obtain an understanding of the company's information system relevant to financial reporting, including the classes of transactions in the company's operations that are significant to the financial statements, and the procedures by which those transactions are initiated, authorized, processed, recorded, and reported.⁴⁸ AU sec. 328 also requires that the auditor obtain an

⁴⁶ See *generally* paragraph 63 of Auditing Standard No. 12.

⁴⁷ See *generally* paragraphs 70 and 71 of Auditing Standard No. 12.

⁴⁸ See *generally* paragraph 28 of Auditing Standard No. 12.

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Date: 11/3/2014 11:49:39 AM

Please Review the Attached Risk Assessment (14 pg.) Strategy as one example....Respectfully yours, Pw

understanding of the company's process for determining fair value measurements and disclosures, and of the relevant controls.⁴⁹

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.

Questions:

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?
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?

b. Identifying Significant Accounts and Disclosures and Significant Risks

As discussed earlier, Auditing Standard No. 12 already requires that the auditor identify significant accounts and disclosures.⁵⁰ In the staff's preliminary view, additional requirements involving the identification of significant accounts and disclosures specific

⁴⁹ See AU sec. 328.09.

⁵⁰ See paragraph 59.e. of Auditing Standard No. 12.

to accounting estimates may not be necessary. However, the staff is considering recommending to the Board a potential amendment to Auditing Standard No. 12 to require that the auditor evaluate certain additional factors relevant to accounting estimates in determining which risks are significant risks.

Currently, Auditing Standard No. 12 sets forth certain factors used to evaluate which risks are significant risks. These factors include the degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially if the measurements involve a wide range of measurement uncertainty.⁵¹ Subjective assumptions and complex calculations or models used to determine accounting estimates often can result in a wide range of measurement uncertainty. In the staff's view, certain environmental factors, such as changes in market liquidity, may affect the extent of unobservable inputs that are used to determine fair value measurements. The greater use of these unobservable inputs in turn may result in a wider range of measurement uncertainty.

As such, the staff is considering whether Auditing Standard No. 12 should be amended to add factors that an auditor should evaluate in determining which risks are significant risks. Specifically, 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.

⁵¹ See paragraph 71.f. of Auditing Standard No. 12.

Questions:

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

2. *Responding to the Risks of Material Misstatement*

Once the auditor has identified and assessed the risks of material misstatement pursuant to Auditing Standard No. 12, the auditor must design and implement an audit response to those risks pursuant to Auditing Standard No. 13.⁵² The auditor's response includes tests of controls and substantive procedures, and requires the auditor to determine the nature, timing, and extent of the audit procedures to be performed. A potential new standard could focus on the nature of substantive procedures to be performed. Such an approach could require the auditor to continue to look to Auditing Standard No. 13 for requirements related to the timing and extent of those procedures.

The following discussion addresses other specific issues relevant to accounting estimates the staff is considering related to the auditor's response to risks.

Question:

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?

⁵² See paragraph 3 of Auditing Standard No. 13.

a. Testing Conformity with the Applicable Financial Reporting Framework

In general, financial reporting frameworks govern the preparation of accounting estimates, and related disclosures. Under Auditing Standard No. 14, the auditor has a responsibility to evaluate whether the financial statements are presented fairly in conformity with the applicable financial reporting framework.⁵³ Further, AU sec. 328 requires the auditor to evaluate whether the disclosures about fair values made by the company are in conformity with GAAP. The auditor also evaluates whether the company has made adequate disclosures about fair value information.⁵⁴

Given the existing requirement in Auditing Standard No. 14, the staff is not considering including in a potential new standard additional requirements for evaluating whether the company's disclosures are in conformity with the applicable financial reporting framework. However, the staff is exploring a potential amendment to the risk assessment standards to emphasize the auditor's responsibilities related to testing conformity with the applicable financial reporting framework. Specifically, 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.

Questions:

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?

⁵³ See paragraph 30 of Auditing Standard No. 14.

⁵⁴ See *generally* AU secs. 328.43–.45.

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 hierarchy⁵⁵)?

b. Tests of Controls

As discussed previously, a possible approach for a potential new standard would be to focus on substantive procedures. Auditing Standard No. 12 requires the auditor to obtain an understanding of each of the five components of internal control sufficient to plan the audit.⁵⁶ The existing requirements in Auditing Standard No. 13 (and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*, as applicable) require the auditor to obtain evidence that the controls selected for testing were designed and operated effectively during the entire period of reliance.⁵⁷ While the requirements in existing PCAOB standards address tests of controls and can be readily applied to tests of controls over accounting estimates, the staff is considering whether additional requirements related to accounting estimates are necessary.

Question:

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)?

c. Procedures Relating to Significant Risks

For significant risks, Auditing Standard No. 13 already requires the auditor to perform substantive procedures, including tests of details that are specifically responsive to the assessed risks.⁵⁸ The staff is considering whether a potential new standard should include additional audit procedures if the auditor concludes that an identified and assessed risk related to accounting estimates or fair value measurements is a significant risk.

⁵⁵ See FASB ASC, subparagraph 820-10-50-2b.

⁵⁶ See *generally* paragraph 18 of Auditing Standard No. 12.

⁵⁷ See paragraph 16 of Auditing Standard No. 13.

⁵⁸ See paragraph 11 of Auditing Standard No. 13.

The staff has considered the approach in ISA 540, which generally requires, for accounting estimates that give rise to significant risks, the auditor to evaluate: (i) reasonableness of management's significant assumptions; (ii) consideration by management of alternative assumptions or outcomes; and (iii) other steps taken by management to address estimation uncertainty in making the accounting estimate.⁵⁹ ISA 540 also requires the auditor to obtain sufficient appropriate audit evidence about whether management's decision to recognize the accounting estimates in the financial statements, and the selected measurement basis for the accounting estimates, are in accordance with the requirements of the applicable financial reporting framework.⁶⁰

The staff believes that the procedures in the preceding paragraph are inherent in the requirements of Auditing Standard No. 13 and the other requirements discussed in this paper. Nonetheless, the staff is sensitive to concerns that auditors might need additional direction in the standard to adequately address measurement uncertainty associated with significant risks in accounting estimates. Thus, the staff seeks input on whether additional specificity is needed regarding the nature of potential audit procedures to respond to significant risks in accounting estimates.



Question:

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?

B. Substantive Procedures for Testing Accounting Estimates

The staff is exploring the nature of substantive procedures for testing accounting estimates that might be included in a potential new standard. Under existing audit requirements, the auditor performs substantive audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.⁶¹ This would include performing substantive audit procedures relating to accounting estimates in significant accounts and disclosures.

⁵⁹ See *generally* paragraph 15 of ISA 540.

⁶⁰ See paragraph 17 of ISA 540.

⁶¹ See *generally* paragraph 8 of Auditing Standard No. 13.

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Yes, and include a few Use Cases to help them along with understanding what they should be looking for.....Pw

As previously discussed, the existing standards require that the auditor use one or a combination of the following approaches to test accounting estimates: (i) test the company's process; (ii) develop an independent estimate; and (iii) review subsequent events and transactions. The staff is considering retaining these approaches, with possible refinements to the existing requirements. The staff is also exploring whether to provide direction on the selection of the appropriate testing approach. While the nature of the accounting estimate informs the auditor's selection of a testing approach, certain other factors may also affect this determination. For example, it is possible that the availability of audit evidence, the results of the auditor's tests of controls and the auditor's retrospective review required by paragraph 64 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, also could inform the auditor's selection of testing approaches.

The staff is considering including in the potential new standard factors the auditor should take into account when selecting testing approaches.

Questions:

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

1. Testing the Company's Process

As noted above, the staff is considering whether a potential new standard should retain the ability for the auditor to test the company's process used to develop an accounting estimate. A company's process for developing accounting estimates generally consists of a particular method used to develop the estimate and the relevant data and assumptions applied to the method. The method used to develop an accounting estimate depends on the measurement objective of the estimate and, in some instances, the requirements of the applicable financial reporting framework. In

some cases, observable market data may exist and be used by management in developing accounting estimates. In other cases, the accounting estimate is determined primarily using unobservable data.

A potential new standard could build on the requirements in the existing standards for testing the company's process including: (i) evaluating the appropriateness of the company's methods; (ii) testing the data used; and (iii) evaluating the reasonableness of significant assumptions. The staff is exploring possible enhancements to the requirements for testing the company's process, as discussed below. Further, the staff is exploring whether the existing requirements for testing the data used in paragraph 39 of AU sec. 328, could be included in a potential new standard or if those requirements should be enhanced.

Question:

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

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

The staff is considering what requirements a potential new standard could include relating to evaluating the company's method used to develop accounting estimates. The existing standards generally require that the auditor evaluate the appropriateness of the method used by the company to develop an accounting estimate. For example, AU sec. 328 requires that the auditor evaluate whether the company's method of measurement is appropriate in the circumstances when management uses a valuation method.⁶² This evaluation includes, among other things, obtaining an understanding of management's rationale for selecting the valuation method, and considering certain factors related to the valuation method, such as the appropriateness in relation to the item being valued and the company's business, industry, and environment.⁶³

A potential new standard could carry forward the concepts in the existing standards by requiring the auditor to evaluate whether the company's methods used to develop accounting estimates are appropriate. Further, as discussed below, the potential new standard could specify certain factors the auditor should evaluate as part of determining the appropriateness of the company's methods.

⁶² See AU sec. 328.18.

⁶³ *Id.*

For example, similar to the existing standards, a potential new standard could require that the auditor, in evaluating whether the company's methods used to develop the accounting estimates are appropriate, evaluate whether the company's methods are in conformity with the applicable financial reporting framework. For certain accounting estimates, the financial reporting framework may suggest a specific method to be used in determining the accounting estimate. For example, in determining the value of certain share-based payment arrangements, the valuation technique utilized should meet the criteria outlined in the financial reporting framework -- such as use of a lattice or closed-form model.⁶⁴ In other instances, the financial reporting framework does not prescribe a specific method and may allow for a more principles-based approach to developing the accounting estimate or fair value measurement.

Consistent with the existing standards, a potential new standard also could require that the auditor evaluate whether the company's methods are accepted within the company's industry.⁶⁵ In cases where the financial reporting framework allows for judgment in the selection of the method for determining an accounting estimate, the auditor's evaluation could include whether the company's industry follows a particular method of measurement to develop the estimate. In those circumstances, the use of an alternate method by the company might pose additional risks that require audit attention similar to the requirements for evaluating the company's selection and application of accounting principles in Auditing Standard No. 12.

Similar to existing requirements, a potential new standard also could state that evaluating the appropriateness of the company's methods includes evaluating whether the methods used to develop accounting estimates are applied consistently.⁶⁶ The evaluation could take into account whether the consistency is appropriate, considering changes in the environment or circumstances affecting the company.⁶⁷

The staff is aware that situations may arise where circumstances affecting the company would necessitate a change in the method used to develop an accounting

⁶⁴ See FASB ASC, Topic 718, Compensation—Stock Compensation, paragraph 10-55-16.

⁶⁵ See AU sec. 328.18.

⁶⁶ See AU sec. 328.19.

⁶⁷ *Id.*

estimate.⁶⁸ The staff also recognizes that, for some accounting estimates, more than one method to develop the estimate is permitted under the applicable financial reporting framework. To address those circumstances, a potential new standard could require the auditor to determine the reasons for the method selected by the company and to evaluate the appropriateness of the selection and the reasons for the change.

Further, in situations where a company uses more than one method in developing an accounting estimate, and the company has determined that different methods result in significantly different estimates, a potential new standard also could require the auditor to determine the reason for the method selected by the company and evaluate the appropriateness of the selection.

For example, 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.

⁶⁸ Under these circumstances, the auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle in accordance with Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

Questions:

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?
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?

b. Evaluating the Reasonableness of Significant Assumptions

The staff is exploring potential enhancements to the requirements for identifying and evaluating the reasonableness of the significant assumptions underlying the company's accounting estimates. The audit procedures in the existing standards set forth requirements for identifying significant assumptions and testing those assumptions for reasonableness.⁶⁹ The staff envisions that similar requirements could be included in a potential new standard but with certain refinements. For example, for the purpose of evaluating reasonableness of the assumptions used by the company in developing an accounting estimate, the potential new standard could require the auditor to identify the assumptions used by management that are significant to the accounting estimate, that is, the assumptions that are important to the recognition or measurement of the accounting estimate in the financial statements. Similar to the existing standards, the auditor's evaluation of reasonableness could include, among other things, evaluating the significant assumptions for consistency with certain factors. A potential new standard could also take into account information the auditor obtained in performing procedures required by the risk assessment standards, such as information on the company's objectives and strategies and relevant industry factors.⁷⁰

i. *Identifying Significant Assumptions*

The existing standards require the auditor to devote attention to the significant assumptions that management has identified.⁷¹ A potential new standard could build on the existing requirement by also requiring the auditor to evaluate whether management

⁶⁹ See generally AU secs. 328.26–.36 and AU sec. 342.11.

⁷⁰ See generally paragraph 7 of Auditing Standard No. 12.

⁷¹ See generally paragraph AU sec. 328.33.

has identified the significant assumptions in the accounting estimate. In the staff's view, in circumstances where the company has a robust process in place for developing accounting estimates, it is likely that management would have, as part of this process, identified the significant assumptions that were used. As such, the auditor would include those assumptions identified by management in the auditor's identification of significant assumptions. The auditor also may identify additional significant assumptions. To address circumstances when management has not identified as significant an assumption that is important to the overall measurement of the accounting estimate, a potential new standard could require the auditor to nevertheless test that significant assumption. The new requirement could help to assure that the significant assumptions are evaluated even if management has not identified or disclosed them to the auditor.

Further, to help the auditor determine whether the significant assumptions have been identified, the potential new standard could provide a description of significant assumptions, along with certain identifying characteristics. In a potential new standard, significant assumptions could include those that are important to the recognition or measurement of the accounting estimate in the financial statements, such as assumptions that:

- a. Cause a significant change in the accounting estimate, based on a minor variation in the assumption;
- b. Are susceptible to manipulation or bias;
- c. Are based on unobservable data;
- d. Are based on observable data adjusted by the company;
- e. Are based on the company's intent and ability to carry out specific courses of action; or
- f. Are otherwise important to the recognition or measurement of the accounting estimate.

Questions:

- 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?

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?

ii. Evaluating the Reasonableness of Significant Assumptions Identified

As discussed earlier, the existing standards require the auditor to evaluate significant assumptions for reasonableness. A potential new standard could include a similar requirement. A potential new standard could also emphasize that the auditor, in evaluating the reasonableness of the assumptions, should take into account all relevant and reliable evidence, regardless of whether it appears to corroborate or contradict management's assertions regarding the assumptions. This is consistent with the requirements of Auditing Standard No. 14.

In addition, a potential new standard could include additional factors to take into account in evaluating the reasonableness of assumptions, drawing largely from the corresponding factors in AU sec. 328.⁷² The factors could relate to information about the company and its environment obtained while performing procedures required by Auditing Standard No. 12.

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:

⁷² See generally AU sec. 328.36.

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.

Question:

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?

c. Management's Use of a Specialist

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. Under existing requirements in AU sec. 328, 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.⁷³ The staff understands that a company's process to develop an accounting estimate or fair value measurement often includes using a specialist. A similar requirement to test assumptions could apply to both accounting estimates and fair value measurements.

Therefore, a potential new standard could include the existing requirement related to testing assumptions developed by a company's specialist in AU sec. 328, but apply it more broadly to information provided for accounting estimates. As such, if a company uses a specialist to develop an accounting estimate, a potential new standard

⁷³ See footnote 2 to AU sec. 328.05.

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.



Question:

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?

2. *Developing an Independent Accounting Estimate*

As noted earlier, the staff is considering that a potential new standard would continue to allow auditors to test accounting estimates by developing an independent estimate.

Under existing standards, when developing an independent estimate using management's assumptions, the auditor is required to evaluate those assumptions for reasonableness consistent with the procedures for testing management's process.⁷⁴ Instead of using management's assumptions, the auditor may use his or her own assumptions to develop an independent estimate. In that situation, the auditor nevertheless is required to understand management's assumptions. Under AU sec. 328, the auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate.⁷⁵ The auditor also is required to test the data used to develop the independent estimate. AU sec. 342 takes a similar approach by allowing an auditor to independently develop an expectation as to the estimate by using

⁷⁴ See generally AU sec. 328.40.

⁷⁵ *Id.*

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Date: 11/3/2014 11:56:42 AM

The over whelming majority of fraud is conducted around Financial Accounting by folks who look like you and me....this does not address Sovereign

Fraud, Capital Markets Fraud such a LIBOR et cetera...but it's a good start....looking forward to the 2nd Edition....

Please Note: All of our comments are from the point of view of an IT GRC Auditor specializing in Fraud.....Respectfully yours, Pw

A potential new standard also could emphasize the auditor's responsibility to take into account all information relevant to the accounting estimate. This information could include, for example, consideration of significant variables from management's assumptions in circumstances where the independent accounting estimate is determined by the auditor.

As discussed earlier, AU sec. 328 requires the auditor to test data used to develop the fair value measurement. The staff is exploring how this requirement should apply when the auditors independently derive or obtain data from other sources. The staff recognizes that, in practice, the auditor may obtain data and assumptions from other sources other than the company. For example, the auditor could obtain mortality rates from a third party for the purposes of testing the company's pension liability. Based on its outreach, the staff understands that there may be limitations in testing data obtained from certain third-party sources for completeness and accuracy.

One approach may be that a potential new standard could nonetheless require that the auditor determine whether data is appropriate, which includes testing reliability and relevance to comply with paragraph 6 of Auditing Standard No. 15. In summary, the procedures to be applied when the auditor develops an independent accounting estimate could be tailored to the source of the data and assumptions used in the independent accounting estimate. For example, requirements in a potential new standard could include the following:

Data and Assumptions Produced by the Company and Used by the Auditor in Developing an Independent Estimate

- When developing an independent estimate using data and assumptions produced by the company, the auditor should test the accuracy and completeness of the data, evaluate the internal consistency of the data, and evaluate whether the data is relevant to the measurement objective for the accounting estimate.
- The auditor should also evaluate the reasonableness of the significant assumptions, which includes identifying the assumptions that are important to the recognition or measurement of the accounting estimate in the financial statements.

Data and Assumptions Obtained by the Auditor from Third Parties and Used in Developing an Independent Estimate

- When the auditor obtains data and significant assumptions from a third party, the

auditor should evaluate the relevance and reliability of the data and assumptions in accordance with the requirements of Auditing Standard No. 15, *Audit Evidence*.

Questions:

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

a. **Developing an Independent Accounting Estimate as a Range**

Auditing Standard No. 14 provides for developing a range of possible estimates for purposes of evaluating misstatements relating to accounting estimates. In addition, AU sec. 342.12 states that the auditor may independently develop an expectation of an estimate by using other key factors or alternative assumptions about those factors.

The staff is considering what a potential new standard could include related to developing an independent estimate as a range of estimates. One approach may be 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.

Question:

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

3. *Evaluating Audit Evidence from Subsequent Events*

As previously discussed, the staff is contemplating that a potential new standard would continue to allow auditors to test accounting estimates by reviewing subsequent events and transactions. The existing requirements recognize that events and

transactions that occur after the balance-sheet date but before the date of the auditor's report may provide audit evidence regarding management's accounting estimates and fair value measurements as of the balance-sheet date.⁷⁸ Additionally, the existing standards recognize that such information may be important in identifying and evaluating the reasonableness of accounting estimates or assumptions used in the preparation of an accounting estimate.⁷⁹

Existing PCAOB standards also provide that some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet date and thus do not constitute appropriate evidence of the fair value measurement at the balance-sheet date (for example, the prices of actively traded marketable securities that change after the balance-sheet date).⁸⁰ A potential new standard also could include a similar procedure that makes allowance for these considerations. A potential new standard might also include factors for the auditor to take into account when evaluating the relevance of the audit evidence from the subsequent events or transactions.

For example, requirements in a potential new standard addressing the use of subsequent events could include the following:

When the auditor obtains audit evidence from events or transactions that occur subsequent to the measurement date, the auditor should determine that the audit evidence is reliable and relevant to the recorded accounting estimate.

- In evaluating the relevance of the audit evidence from the event or transaction to the accounting estimate, the auditor should take into account:
 - The period between the event or transaction date and the measurement date;
 - The comparability of the event or transaction involved to the company's accounting estimate, as appropriate; and
 - Changes in the company's circumstances or the general economic conditions between the event or transaction date and the measurement date.

⁷⁸ See generally AU sec. 328.41 and AU sec. 342.13.

⁷⁹ See generally AU sec. 342.13.

⁸⁰ See AU sec. 328.42.

Questions:

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?
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?

C. Use of Third Parties

As previously discussed, the staff is exploring ways a potential new standard could address the varying circumstances when auditors obtain information from third parties, including specialists engaged by the auditor. Based on its outreach, the staff understands that auditors often engage a specialist or use specialists on staff for the purpose of developing an independent estimate. One approach would be for the auditor to continue to look to the requirements of existing PCAOB standards (e.g., AU sec. 336, *Using the Work of a Specialist*), as applicable. However, an auditor may obtain information from third-party sources that provide the same information to the public. For example, pricing services often provide uniform price information and other data about financial instruments to the public for a fee. In that case, the auditor does not engage the third party specifically to develop an estimate; rather, the auditor obtains information that is developed for, and widely available to, the public. In other cases, the auditor obtains a specific estimate directly from a third-party source that is generated specifically for the auditor. The staff is considering developing an approach in the potential new standard that could potentially recognize some of these differences.

In other instances, third parties, for example pricing services, may be used by both the company and the auditor to provide values of financial instruments. In other instances, a company might use values of financial instruments provided by a third party, for example a custodian, who obtains the values from the same pricing service used by the auditor. These instances may raise questions about whether the auditor could arrive at an independent estimate.

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.

Questions:

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?
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?

1. *Evaluating Audit Evidence from Third-Party Sources*

As part of its overall outreach to date, the staff sought input on auditors' use of third-party sources in obtaining fair value measurements of financial instruments. The discussions with the Task Force members brought to light the various methodologies used by third-party pricing sources to value these instruments and the measurement uncertainty inherent in those valuations. The existing standards address the auditor's consideration of data and assumptions in the determination of fair value measurements.

The staff understands that, in many cases, financial instruments are valued using methodologies that incorporate a mix of inputs. Further, available observable inputs may be adjusted for other market factors in the ultimate determination of the price. The existing standards do not specifically address the use of alternate valuation methodologies employed by many pricing sources. The staff also understands that pricing sources are increasingly providing products that could provide auditors with insight as to how their prices or estimates are developed.

The staff is considering how a potential new standard could address audit evidence obtained from third-party sources, such as pricing services and broker-dealers. In considering potential requirements related to fair value of financial instruments, the staff recognizes the nature of evidence obtained from third-party sources varies based on the type of instrument being valued and the source of information used by pricing services. Some pricing services provide consensus prices; that is, a value derived from prices provided by each subscriber to the services. Other pricing services use their own methodology based on various market data obtained or

derived from other sources, including trades of comparable instruments, broker quotes, and historical trade activity to determine a value. Pricing services also may combine multiple approaches to arrive at a value for a particular instrument.⁸¹

Furthermore, auditors also may obtain a price for a financial instrument directly from a broker-dealer that is based (or not based) on a binding quote. Given the differences in how values of financial instruments are derived and obtained, 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

⁸¹ See generally SEC, Money Market Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) at 281-82, 79 Federal Register 47736 (August 14, 2014) at 47813 ("In matrix pricing, portfolio asset values are derived from a range of different inputs, with varying weights attached to each input, such as pricing of new issues, yield curve information, spread information, and yields or prices of securities of comparable quality, coupon, maturity, and type. ... [P]rices from third-party pricing services ... may take into account these inputs as well as prices quoted from dealers that make markets in these instruments and financial models.") (footnotes omitted).

market quotations;

- b. When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- c. 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
- d. 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.

Questions:

- 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?
- 41. Are there other approaches to testing evidence obtained from third-party pricing sources that the staff should consider?
- 42. How could a potential new standard differentiate between a third-party pricing source and a specialist?
- 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)?

Questions Related to Economic Impacts and Implications

As the staff continues to explore an appropriate standard-setting approach, it is interested in information and views regarding economic implications of the alternatives described above. The staff is seeking data and other information on current practices and potential regulatory alternatives that would help to inform its analysis. This includes information on the likely costs and benefits of a potential new standard and of alternative approaches, such as those discussed in the section titled "Staff Consideration of Alternative Approaches."

The staff welcomes the views of commenters on the general economic implications of alternatives, including a potential new standard discussed in this paper, and on these specific matters:

Questions:

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?
45. As part of considering the need for change, the staff is reviewing academic literature, including identified papers that synthesize the academic literature.⁸² 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?

* * *

⁸² See, e.g., Roger D. Martin, Jay S. Rich, and T. Jeffrey Wilks, *Auditing Fair Value Measurements: A Synthesis of Relevant Research*, 20 *Accounting Horizons*, 287 *passim* (2006); Brant E. Christensen, Steven M. Glover, and David A. Wood, *Extreme Estimation Uncertainty in Fair Value Estimates: Implications for Audit Assurance*, 31 *Auditing: A Journal of Practice & Theory*, 127 *passim* (2012); Timothy B. Bell and Jeremy B. Griffin, *Commentary on Auditing High-Uncertainty Fair Value Estimates*, 31 *Auditing: A Journal of Practice & Theory*, 147 *passim* (2012); and Brian Bratten, Lisa Milici Gaynor, Linda McDaniel, Norma R. Montague, and Gregory E. Sierra, *The Audit of Fair Values and Other Estimates: The Effects of Underlying Environmental, Task, and Auditor-Specific Factors*, 32 *Auditing: A Journal of Practice & Theory*, 7 *passim* (2013).

other key factors or alternative assumptions about those factors based on the auditor's understanding of the facts and circumstances.⁷⁶

Auditors also may use third-party sources in developing independent accounting estimates, for example, information from third-party pricing sources when developing an independent estimate of the fair value of a financial instrument.

A potential new standard could retain the requirements from the existing standards for developing an independent estimate but recognize that auditors develop independent estimates in different ways. For example, a potential new standard could include audit procedures specific to the source (such as the company or a third party) of the data and assumptions. Including audit procedures that are tailored to the source of the data and assumptions may be more reflective of the various ways in which auditors determine independent estimates.

Under this approach, a potential new standard could present separate requirements that depend on the source of the data and assumptions, which may provide greater clarity regarding the procedures to be performed for developing an independent estimate.

A potential new standard could retain the ability for the auditor to develop an independent accounting estimate using his or her own assumptions or those produced by the company. Under this scenario, the potential new standard could generally include the requirements in the existing standards to test the accuracy and completeness of the data, evaluate the internal consistency of the data, and evaluate whether the data is relevant to the measurement objective for the accounting estimate.⁷⁷ This approach would retain the existing requirement in AU sec. 328 with regard to testing company-provided data.

If the auditor obtains data and significant assumptions from a third party in developing an independent estimate, the potential new standard could emphasize that, under those circumstances, the auditor evaluates the relevance and reliability of the data and assumptions obtained in accordance with Auditing Standard No. 15, *Audit Evidence*. Additional discussion of this potential requirement is included in the section titled "Evaluating Audit Evidence from Third-Party Sources" of this paper, including discussion of additional factors for evaluating the relevance and reliability that could be included in a potential new standard.

⁷⁶ See AU sec. 342.12.

⁷⁷ See generally AU sec. 328.39.

Risk Assessments:

- **Tier 1: Organization Level---Tier 2: Business Process Level---Tier 3: Information Systems Level**

Used for systemic information/data security-related risks associated with:

- **Organizational Governance (GRC) Governance, Risk & Compliance**
- **Management Activities**
- **Business Processes**
- **Enterprise Architecture**
- **Funding Information Security Programs**

Tier 3 Risk Assessments:

- **Security Categorization**
- **Security Control Selection**
- **Security Control Implementation**
- **Security Control Risk assessment**
- **Information System Authorizations, and**
- **Monitoring**

Information Systems include:

- **People—Processes—Technologies--Facilities, and--Cyberspace**

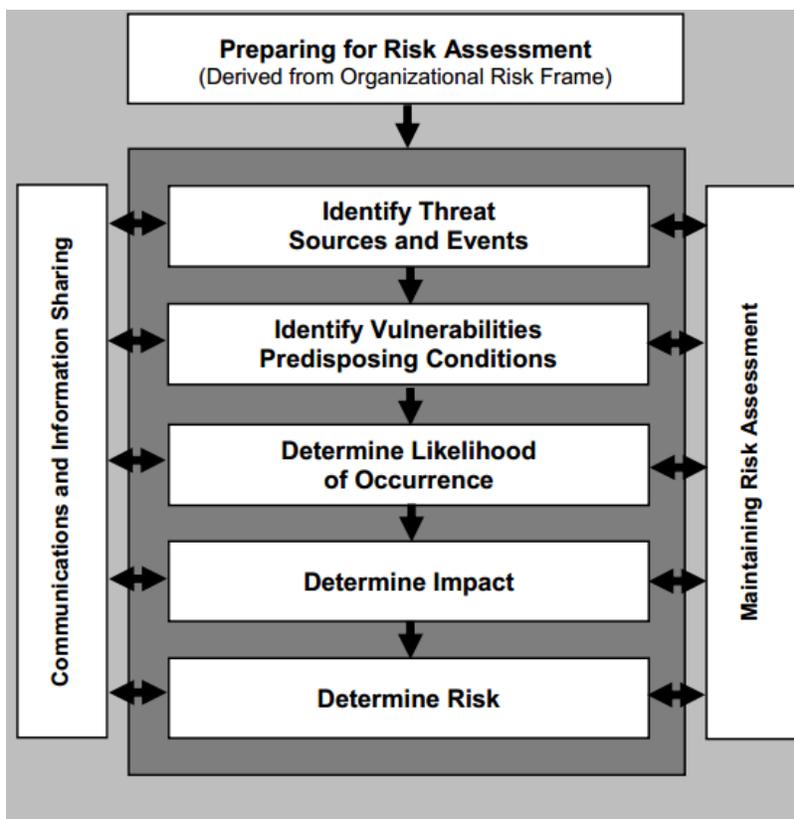


FIGURE 5: RISK ASSESSMENT PROCESS

Six Step RMF Risk Management Frame Work:

Step 1: CATEGORIZE

- Information System(s)
- Organizational Inputs
- Laws,
- Directives,
- Policy Guidance
- Strategic Goals and Objectives
- Priorities and Resource Availability
- Supply Chain Considerations

TASK 1-1: CATEGORIZE the information system and document the results of the security categorization in the security plan. (Who owns what and what it does)

TASK 1-2: DESCRIBE the information system (including system boundary) and document the description in the security plan.

TASK 1-3: REGISTER the information system with appropriate organizational program/management offices.

The registration process begins by identifying the information system (and subsystems, if appropriate) in the system inventory and establishes a relationship between the information system and the parent or governing organization that owns, manages, and/or controls the system. Information system registration, in accordance with organizational policy, uses information in the system identification section of the security plan to inform the parent or governing organization of:

- the existence of the information system;
- the key characteristics of the system; and
- any security implications for the organization due to the ongoing operation of the system.

Information system registration provides organizations with an effective management/tracking tool that is necessary for security status reporting in accordance with applicable laws, Executive Orders, directives, policies, standards, guidance, or regulations.

Milestone Checkpoint #1

- Has the organization completed a security categorization of the information system including the information to be processed, stored, and transmitted by the system?
- Are the results of the security categorization process for the information system consistent with the organization's enterprise architecture and commitment to protecting organizational mission/business processes?
- Do the results of the security categorization process reflect the organization's risk management strategy?
- Has the organization adequately described the characteristics of the information system?
- Has the organization registered the information system for purposes of management, accountability, coordination, and oversight?

Step 2 SELECT Security Controls

TASK 2-1: Identify the security controls that are provided by the organization as common controls for organizational information systems and document the controls in a security plan (or equivalent document).

TASK 2-2: Select the security controls for the information system and document the controls in the security plan.

TASK 2-3: Develop a strategy for the continuous monitoring of security control effectiveness and any proposed or actual changes to the information system and its environment of operation.

TASK 2-4: Review and approve the security plan.

Milestone Checkpoint #2

- Has the organization allocated all security controls to the information system as system-specific, hybrid, or common controls?
- Has the organization used its risk assessment (either formal or informal) to inform and guide the security control selection process?
- Has the organization identified authorizing officials for the information system and all common controls inherited by the system?
- Has the organization tailored and supplemented the baseline security controls to ensure that the controls, if implemented, adequately mitigate risks to organizational operations and assets, individuals, other organizations, and the Nation?
- Has the organization addressed minimum assurance requirements for the security controls employed within and inherited by the information system?
- Has the organization consulted information system owners when identifying common controls to ensure that the security capability provided by the inherited controls is sufficient to deliver adequate protection?
- Has the organization supplemented the common controls with system-specific or hybrid controls when the security control baselines of the common controls are less than those of the information system inheriting the controls?
- Has the organization documented the common controls inherited from external providers?
- Has the organization developed a continuous monitoring strategy for the information system (including monitoring of security control effectiveness for system-specific, hybrid, and common controls) that reflects the organizational risk management strategy and organizational commitment to protecting critical missions and business functions?
- Have appropriate organizational officials approved security plans containing system-specific, hybrid, and common controls?

Step 3 IMPLEMENT Security Controls

TASK 3-1: Implement the security controls specified in the security plan.

TASK 3-2: Document the security control implementation, as appropriate, in the security plan, providing a functional description of the control implementation (including planned inputs, expected behavior, and expected outputs).

Milestone Checkpoint #3

- Has the organization allocated security controls as system-specific, hybrid, or common controls consistent with the enterprise architecture and information security architecture?
- Has the organization demonstrated the use of sound information system and security engineering methodologies in integrating information technology products into the information system and in implementing the security controls contained in the security plan?
- Has the organization documented how common controls inherited by organizational information systems have been implemented?
- Has the organization documented how system-specific and hybrid security controls have been implemented within the information system taking into account specific technologies and platform dependencies?
- Has the organization taken into account the minimum assurance requirements when implementing security controls?

Step 4 ASSESS Security Controls

Develop, review, and approve a plan to assess the security controls.

Organizations consider both the technical expertise and level of independence required in selecting security control assessors. Organizations also ensure that security control assessors possess the required skills and technical expertise to successfully carry out risk assessments of system-specific, hybrid, and common controls. This includes knowledge of and experience with the specific hardware, software, and firmware components employed by the organization.

- **Impartiality implies that assessors are free from any perceived or actual conflicts of interest with respect to the development, operation, and/or management of the information system or the determination of security control effectiveness.**
- **The authorizing official determines if the level of assessor independence is sufficient to provide confidence that the risk assessment results produced are sound and can be used to make a risk-based decision on whether to place the information system into operation or continue its operation.**
- **Security control risk assessments occur as early as practicable in the system development life cycle, preferably during the development phase of the information system. These types of risk assessments are referred to as developmental testing and evaluation and are intended to validate that the required security controls are implemented correctly and consistent with the established information security architecture.**

Developmental testing and evaluation activities include, for example, design and code reviews, application scanning, and regression testing. Security weaknesses and deficiencies identified early in the system development life cycle can be resolved more quickly and in a much more cost-effective manner before proceeding to subsequent phases in the life cycle.

The objective is to identify the information security architecture and security controls up front and to ensure that the system design and testing validate the implementation of these controls.

- **Supporting materials such as procedures, reports, logs, and records showing evidence of security control implementation are identified as well. In order to make the risk management process as timely and cost-effective as possible, the reuse of previous risk assessment results, when reasonable and appropriate, is strongly recommended.**
- **For example, a recent audit of an information system may have produced information about the effectiveness of selected security controls. Another opportunity to reuse previous risk assessment results comes from programs that test and evaluate the security features of commercial information technology products.**

- **Additionally, if prior risk assessment results from the system developer are available, the security control assessor, under appropriate circumstances, may incorporate those results into the risk assessment . And finally, assessment results are reused to support reciprocity where possible.**
- **Organizations may choose to develop an executive summary from the detailed findings that are generated during a security control assessment.**
- **An executive summary provides an authorizing official with an abbreviated version of the assessment report focusing on the highlights of the risk assessment , synopsis of key findings, and/or recommendations for addressing weaknesses and deficiencies in the security controls.**

TASK 4-1: Develop, review, and approve a plan to assess the security controls.

TASK 4-2: Assess the security controls in accordance with the risk assessment procedures defined in the security risk assessment plan.

TASK 4-3: Prepare the security risk assessment report documenting the issues, findings, and recommendations from the security control risk assessment .

TASK 4-4: Conduct initial remediation actions on security controls based on the findings and recommendations of the security assessment report and reassess remediated control(s), as appropriate.

Milestone Checkpoint #4

- Has the organization developed a comprehensive plan to assess the security controls employed within or inherited by the information system?
- Was the risk assessment plan reviewed and approved by appropriate organizational officials?
- Has the organization considered the appropriate level of assessor independence for the security control risk assessment ?
- Has the organization provided all of the essential supporting risk assessment -related materials needed by the assessor(s) to conduct an effective security control risk assessment ?
- Has the organization examined opportunities for reusing risk assessment results from previous risk assessment s or from other sources?
- Did the assessor(s) complete the security control risk assessment in accordance with the stated risk assessment plan?
- Did the organization receive the completed security risk assessment report with appropriate findings and recommendations from the assessor(s)?
- Did the organization take the necessary remediation actions to address the most important weaknesses and deficiencies in the information system and its environment of operation based on the findings and recommendations in the security risk assessment report?
- Did the organization update appropriate security plans based on the findings and recommendations in the security risk assessment report and any subsequent changes to the information system and its environment of operation?

Step 5 AUTHORIZE Information System

TASK 5-1: Prepare the plan of action and milestones based on the findings and recommendations of the security risk assessment report excluding any remediation actions taken.

The plan of action and milestones, prepared for the authorizing official by the information system owner or the common control provider, is one of three key documents in the security authorization package and describes the specific tasks that are planned:

- to correct any weaknesses or deficiencies in the security controls noted during the risk assessment ;
and
- to address the residual vulnerabilities in the information system.

The plan of action and milestones identifies:

- the tasks to be accomplished with a recommendation for completion either before or after information system implementation;
- the resources required to accomplish the tasks;
- any milestones in meeting the tasks; and
- the scheduled completion dates for the milestones.

The strategy helps to ensure that organizational plans of action and milestones are based on:

- the security categorization of the information system;
- the specific weaknesses or deficiencies in the security controls;
- the importance of the identified security control weaknesses or deficiencies (i.e., the direct or indirect effect the weaknesses or deficiencies may have on the overall security state of the information system, and hence on the risk exposure of the organization, or ability of the organization to perform its mission or business functions); and
- the organization's proposed risk mitigation approach to address the identified weaknesses or deficiencies in the security controls (e.g., prioritization of risk mitigation actions, allocation of risk mitigation resources).

A risk risk assessment guides the prioritization process for items included in the plan of action and milestones.

TASK 5-2: Assemble the security authorization package and submit the package to the authorizing official for adjudication.

The security authorization package contains:

- the security plan;
- the security risk assessment report; and
- the plan of action and milestones.

The information in these key documents is used by authorizing officials to make risk-based authorization decisions.

Providing orderly, disciplined, and timely updates to the security plan, security risk assessment report, and plan of action and milestones on an ongoing basis, supports the concept of near real-time risk management and ongoing authorization. It also facilitates more cost-effective and meaningful reauthorization actions, if required.

TASK 5-3: Determine the risk to organizational operations (including mission, functions, image, or reputation), organizational assets, individuals, other organizations, or the Nation.

Primary Responsibility:

The risk management strategy typically describes:

- how risk is assessed within the organization (i.e., tools, techniques, procedures, and methodologies);
- how assessed risks are evaluated with regard to severity or criticality;
- known existing aggregated risks from organizational information systems and other sources;
- risk mitigation approaches;
- organizational risk tolerance; and
- how risk is monitored over time.

TASK 5-4: Determine if the risk to organizational operations, organizational assets, individuals, other organizations, or the Nation is acceptable.

The authorization decision document conveys the final security authorization decision from the authorizing official to the information system owner or common control provider, and other organizational officials, as appropriate. The authorization decision document contains the following information:

- authorization decision;
- terms and conditions for the authorization; and
- authorization termination date.

The security authorization decision indicates to the information system owner whether the system is:

- authorized to operate; or
- (not authorized to operate).

The terms and conditions for the authorization provide a description of any specific limitations or restrictions placed on the operation of the information system or inherited controls that must be followed by the system owner or common control provider. The authorization termination date, established by the authorizing official, indicates when the security authorization expires.

The authorization package provides relevant information on the security state of the information system including the ongoing effectiveness of the security controls employed within or inherited by the system. Inputs from the risk executive (function), including previously established overarching risk guidance to authorizing officials, provide additional organization-wide information to the authorizing official that may be relevant and affect the authorization decision (e.g., organizational risk tolerance, specific mission and business requirements, dependencies among information systems, and other types of risks not directly associated with the information system).

Risk executive (function) inputs are documented and become part of the security authorization decision. Security authorization decisions, including inputs from the risk executive (function), are conveyed to information system owners and common control providers and made available to interested parties within the organization (e.g., information system owners and authorizing officials for interconnected systems, chief information officers, information owners/stewards, senior managers).

The authorization decision document conveys the final security authorization decision from the authorizing official to the information system owner or common control provider, and other organizational officials, as appropriate. The authorization decision document contains the following information:

- authorization decision;
- terms and conditions for the authorization; and
- authorization termination date.

The security authorization decision indicates to the information system owner whether the system is:

- authorized to operate; or
- not authorized to operate.

The terms and conditions for the authorization provide a description of any specific limitations or restrictions placed on the operation of the information system or inherited controls that must be followed by the system owner or common control provider. The authorization termination date, established by the authorizing official, indicates when the security authorization expires.

Milestone Checkpoint #5

- 1) Did the organization develop a plan of action and milestones reflecting organizational priorities for addressing the remaining weaknesses and deficiencies in the information system and its environment of operation?
- 2) Did the organization develop an appropriate authorization package with all key documents including the security plan, security risk assessment report, and plan of action and milestones (if applicable)?
- 3) Did the final risk determination and risk acceptance by the authorizing official reflect the risk management strategy developed by the organization and conveyed by the risk executive (function)?
- 4) Was the authorization decision conveyed to appropriate organizational personnel including information system owners and common control providers?

Step 6 MONITOR Security Controls

TASK 6-1: Determine the security impact of proposed or actual changes to the information system and its environment of operation.

TASK 6-2: Assess a selected subset of the technical, management, and operational security controls employed within and inherited by the information system in accordance with the organization-defined monitoring strategy.

TASK 6-3: Conduct remediation actions based on the results of ongoing monitoring activities, risk assessment of risk, and outstanding items in the plan of action and milestones.

TASK 6-4: Update the security plan, security risk assessment report, and plan of action and milestones based on the results of the continuous monitoring process.

SECURITY STATUS REPORTING

TASK 6-5: Report the security status of the information system (including the effectiveness of security controls employed within and inherited by the system) to the authorizing official and other appropriate organizational officials on an ongoing basis in accordance with the monitoring strategy.

ONGOING RISK DETERMINATION AND ACCEPTANCE

TASK 6-6: Review the reported security status of the information system (including the effectiveness of security controls employed within and inherited by the system) on an ongoing basis in accordance with the monitoring strategy to determine whether the risk to organizational operations, organizational assets, individuals, other organizations, or the Nation remains acceptable.

INFORMATION SYSTEM REMOVAL AND DECOMMISSIONING

TASK 6-7: Implement an information system decommissioning strategy, when needed, which executes required actions when a system is removed from service.

Milestone Checkpoint #6

- 1) Is the organization effectively monitoring changes to the information system and its environment of operation including the effectiveness of deployed security controls in accordance with the continuous monitoring strategy?
- 2) Is the organization effectively analyzing the security impacts of identified changes to the information system and its environment of operation?
- 3) Is the organization conducting ongoing risk assessments of security controls in accordance with the monitoring strategy?
- 4) Is the organization taking the necessary remediation actions on an ongoing basis to address identified weaknesses and deficiencies in the information system and its environment of operation?
- 5) Does the organization have an effective process in place to report the security status of the information system and its environment of operation to the authorizing officials and other designated senior leaders within the organization on an ongoing basis?
- 6) Is the organization updating critical risk management documents based on ongoing monitoring activities?
- 7) Are authorizing officials conducting ongoing security authorizations by employing effective continuous monitoring activities and communicating updated risk determination and acceptance decisions to information system owners and common control providers?